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Working with the Revenue code - 1977

Irvin F. Diamond

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AICPA

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Foreword

We are privileged to have Mr. Irvin F. Diamond, CPA, of Rogoff and Youngberg, Albuquerque, New Mexico, as editor of *Working With the Revenue Code—1977.*

Mr. Diamond has compiled the most pertinent material appearing in the Tax Clinic, a monthly column in the Institute's tax magazine, *The Tax Adviser.* He has revised the book by eliminating articles that are no longer important, adding new items of current interest, and updating all of the articles to reflect current developments. Also included are a table of court cases cited and a listing of Revenue Rulings and Procedures mentioned in the text.

We hope the book will provide a base from which common problems can be identified and the necessary research conducted. The specific items in the book are categorized by Code Section; providing an orderly approach for the text material. The table of contents, subject index, case table, and ruling list are additional tools designed to permit easy reference.

This book has been a cooperative effort of the contributing editors and of numerous practitioners who have submitted articles over the years. The contributing editors to the Tax Clinic Department of *The Tax Adviser* for 1976 are:

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I also wish to acknowledge the fine efforts of Roger Miller, CPA, Manager, Federal Tax Division, for his oversight of the project within the Institute, Michael Walker, CPA, of Rogoff and Youngberg, who assisted Mr. Diamond in the technical editing, Gene Linett, editor of *The Tax Adviser*, and Diane Ganci Bree and Laurie Leighton, the production editors for the book.

Thomas R. Hanley, CPA
Director
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Contents

Section		Page
	Corporate distributions and adjustments	

Section		**Page**
334	Transfer of life insurance contracts in Sec. 334(b)(2) liquidations	93
	Subsidiary's debt to parent: pitfall to avoid	94
	Subsidiary liquidations: avoiding Sec. 334(b)(2)	95
337	Sec. 337: liquidation-reincorporation tax trap may be avoided	96
	Timing important in applying Sec. 337 to condemnations or involuntary conversions	97
346	Partial liquidation of a subsidiary	98
	Partial liquidation: "termination" vs. "contraction" of business	99
351	Sec. 351 risk in insolvency recapitalizations	100
	IRS rulings policy on debentures issued in a Sec. 351 exchange	101
	Sec. 351 transaction and immediate public offering	103
	Planning for Lifo inventory in Sec. 351 transactions	104
	Double Sec. 351 exchange: IRS ruling policy	105
355	IRS ruling policy on premerger spin-offs	106
	Sec. 355: Purchases within five-year period retained after split-off	107
356	Contingent shares in reorganization require careful handling	108
	Combining contingent and escrowed shares in tax-free acquisitions	110
367	Sec. 367 clearance ruling need not be followed by taxpayer	112
	Failure to obtain a ruling under Sec. 367	113
368	F reorganizations: basis of stock received	114
	Reorganizations: indirect continuity of interest	115
	Use of voting trust in a "B" reorganization	117
	"B" reorganization: release of shareholders' guaranty of corporate debt	117
	Reorganization or Sec. 351: which takes precedence?	119

Deferred compensation

Accounting periods and methods of accounting

Section		Page
446	Planning may save ten-year spread for accounting method change required on merger	138
	Are financial statements the taxpayer's "books"?	139
	Losses: book and tax conformity not expected	140
	Ruling policy on change to the completed contract method	141
451	Constructive receipt: deferred compensation funded with life insurance	142
	All purchase discount income can be deferred until merchandise is sold	143
453	Installment method: use of *Rushing* approach	143
	Installment reporting on sale of corporation	145
	Sec. 453: sale and redemption of family corporation stock integrated	146
	Indeterminable selling price: protect your capital gain	146
	Installment sale and escrow deposits: Rev. Rul. 73-451 vs. 68-246	148
	Disposition of installment obligations	149
	Installment obligations passing at death	150
461	Pay contested liability prior to corporate liquidation	152
	Contested liabilities: no necessity for claimants to sign trust agreement	153
463	Vacation pay: Sec. 463 election vs. change in business practice or accounting method	154
471	Cost variances under full absorption regulations	158
	Full absorption: Sec. 481 adjustment period can be less than 10 years	159
	IRS terms for approving inventory changes: clarification of prior item	161
	Inventories: the average cost method	162
472	IRS suggests two separate adoptions of Lifo acceptable	163

Exempt organizations

Corporations used to avoid income tax on shareholders

Banking institutions

Estates, trusts, beneficiaries and decedents

Partners and partnerships

Regulated investment companies and real estate investment trusts

Tax based on income from sources within or without the United States

Section		Page

Gain or loss on disposition of property

Capital gains and losses

Readjustment of tax between years and special limitations

Election of certain small business corporations as to taxable status

Consolidated returns and controlled corporations

Determination of tax liability

Who is taxpayer: corporate title holder vs. beneficial owner

The current status of the tax law makes it more likely than not that a corporate title holder will be considered to be the real owner of property. Therefore, the expenses attributable to the corporate title holder may be disallowed to the individuals who claim beneficial ownership. The cases and commentaries, however, do not foreclose the possibility that a true corporate agent or trustee can be created. And there are some cases, though few, which do hold that the corporation is either a sham corporation or agent for the beneficial owners. *Steinmetz*, TC Memo 1973-208; *K-C Land Co., Inc.*, TC Memo 1960-35; *Worth Steamship Corp.*, 7 TC 654 (1946); *Emery Management Corp.*, Sup. Ct. of Mich., 33 NW2d 126.

The more carefully the beneficial owners treat the corporation as a sham or agent and do not treat it as the actual owner, the more likely it is that the beneficial owners will be entitled to the tax deductions. However, the more activities that the corporation must perform in its own name, the more likely it is that the straw or agent status will be challenged.

In many instances, a corporation is used to borrow money in order to construct improvements on real estate. Because the usury laws limit the interest rates which can be charged individuals, the lender insists on making its loans to a corporation. (In some instances, see, e.g., Rev. Rul. 75-31, law or administrative practice may require use of a corporate borrower.) Some lenders are anxious not to violate the usury laws and will not want the corporation to be disregarded as a sham or agent for fear of violating these laws. These lenders might require more activities in the corporation's name—signing of leases, election of officers, minutes, bank accounts, etc.—to assure themselves that the corporation is real. This weakens the beneficial owners' tax case.

The following factors will help support the case that the individuals, and not the corporation, should be taxed as the owner of the property. Note, however, that without an advance ruling these factors will not necessarily guarantee the outcome of an IRS challenge.

- An agency relationship should be established with the corporation rather than trying to treat the corporation as a sham or nonentity.
- The shareholders, officers, directors and signatories of the straw corporation should not be owners of the beneficial interest in the real estate.
- The corporation should be in the business of being an agent for the beneficial owners and should charge a fee for its services. The fee could be based on the number of documents signed or the period of time the corporation holds title.
- The corporation's articles of incorporation should limit its activities to holding real estate for the benefit of others as agent and deny the corporation the power to hold real estate on its own account.
- The agency agreement with the beneficial owners of the real estate should clarify what the corporation will do, to whom it will be responsible, and the fees to be charged. In addition, the agreement should specifically provide that

—the corporation acknowledges its agency status with respect to the property;

—the corporation agrees to deal with the property as directed by the beneficial owners; and

—the corporation agrees to execute any documents requested by the beneficial owners to establish the true ownership of the property.

- Disbursements and receipts, contracts, negotiations and other dealings with third parties relating to the property should be in the names of the beneficial owners to the extent possible. (The corporation, however, should receive the fee for its services and file corporate tax returns reflecting this income.)

- The corporate records should include authorizations for each agency transaction entered into on behalf of the beneficial owners.
- The relationship with the corporation should be ended as soon as it is no longer needed.
- Consideration should be given to filing Form 56, Nature of Fiduciary Relationship, annually with the IRS, stating that the corporation acts for or on behalf of the owners under authority of the agency agreement. Consideration might also be given to filing annual fiduciary income tax returns indicating that the fiduciary relationship is revocable and that the income and expense is being reported by the owners. Such actions might help to provide evidence of the sort that was missing in *John R. Collins II*, DC–Ga., aff'd CA-5, 1975. ("The record in the present case raises no factual question in respect to the agency theory.")

Because of the conflicting cases which seem to interpret general fact patterns differently, it would appear difficult to be assured that a corporation could be structured as a straw corporation and successfully defend a challenge by the IRS. It is our understanding that the IRS is currently not issuing rulings on this question while it attempts to develop a definitive policy.

Editor's note: See also William B. Strong, *66 TC No. 3 (1976), wherein the corporate form was not disregarded, even though the taxpayer had only a minimal business purpose and negligible activity. The decision is on appeal to CA-2.*

Investment credit: recapture on disposition by former subchapter S corporation

Sec. 47

Sec. 48(e) provides that qualifying Sec. 38 property is to be allocated among the shareholders of a subchap. S corporation as of its year-end. The shareholders to whom the qualified property is allocated get the benefit of the credit allowed (subject to limitations at the individual level) by including the

Sec. 47 basis of the property allocated to them, together with any other eligible property which they may acquire individually, on their tax return for the year in which or with which the taxable year of the corporation ends (Regs. Sec. 1.48-5(a)(1)). In the case of an early disposition of such Sec. 38 property, however, situations can arise which lead to questions as to the correct handling of the recapture required by Sec. 47.

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

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

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

Capitalized leases: investment credit and depreciable basis

The IRS generally requires lessees to capitalize property subject to a long-term lease and claim depreciation over the property's expected useful life to the lessee. For example, Rev. Rul. 55-540 sets forth certain conditions that, in the absence of compelling factors to the contrary, warrant treating a transaction for federal income tax purposes as a conditional sales contract rather than a lease of equipment. Rev. Ruls. 55-541, 55-542, and 57-371 illustrate transactions determined to be sales rather than leases. Rev. Rul. 72-408 discusses the federal income tax consequences of a transaction cast in the form of a lease subsequently determined to be a sale. Rev. Rul. 75-21 contains guidelines, for advanced ruling purposes, for determining the existence of leases in leveraged lease transactions.

For investment credit purposes, long-term lessors of qualifying property can elect to pass the credit through to the lessee. However, the pass-through on short-term leased property is limited. See Sec. 48(d)(2).

Under relatively recent generally accepted accounting principles, capitalization of long-term leases is also required for financial statement purposes.

The interplay of these various requirements poses some difficult questions, as the following situation demonstrates:

> *Example.* A taxpayer leased a computer and consented to a lessor's election statement to accept the investment credit. The lessor assigned a $52,000 fair market value and a 5-6 year life to the computer. The taxpayer's accountants determined that, under the lease terms, the agreement constituted an installment purchase.
>
> For financial statement purposes, the lease was capitalized at $52,000 with a 5-year depreciable life. A prepaid interest account was established equal to the sum of the lease payments less $52,000. The effective computed interest rate was approximately 14%.
>
> For tax purposes, the taxpayer followed the financial statement treatment to avoid timing differences.

Investment credit. What should be done with the lessor's election statement in determining the investment credit? The capitalized lease appears as a fixed asset addition, both in the depreciation schedule and in the investment credit schedule, so that there is no apparent need to describe a lease in Schedule A of the investment credit form in order to justify

Sec. 48 the credit. Yet, since the lease is a legal one, would failure to file a copy of the consent in the taxpayer's return void the credit?

On the other hand, in another situation, what if a taxpayer's useful life differed from the lessor's? Would not the language in Sec. 46(c)(2) require the investment credit to be based on the depreciable life, thus rendering null and void the lessor's election statement? See also Rev. Rul. 72-408 where the lessee was required to capitalize a lease and take depreciation deductions, and was entitled to claim an investment credit on the capitalized cost (subject to the used property limitation).

Suppose that the taxpayer, anticipating capitalization of the lease, declined to consent to the election. Would this not invite the lessor to claim the credit as well?

Depreciable basis. Sec. 483(b) and Regs. Sec. 1.483-1(c) and (d) require that unstated interest be computed at 7% compounded semiannually when the contract does not call for an interest rate of at least 6% per annum simple interest. Does this mean that the depreciable basis for tax purposes should be greater than that selected (the lessor's determination of fair market value) for generally accepted accounting purposes since the regulatory interest rate is 7% (14% − 7%) less than that based upon the lessor's determination of fair market value? Or may the taxpayer argue that the lessor's election statement containing an expression of fair market value may be coupled with the lease agreement so as to state, by formula, an interest rate (14%) which is more than 6%?

Conclusion. Thus, it seems desirable for the lessee to

—consent to the lessor's election statement to preclude the unintended situation where both parties would claim the credit, and to support the position that both parties have agreed to a de facto interest rate, and

—treat the capitalized lease as a purchase of Sec. 38 property in its depreciation schedule, make no mention of the lease in Schedule A of the investment credit form, and exclude the lessor's election statement from its tax return.

While it is recognized that a greater investment credit might be obtained by discounting the lease payments at 7%, it would also force the taxpayer to substantiate a qualified investment in excess of fair market value, which may not be justifiable.

Eligibility of computer software for the investment tax credit

Sec. 48

The IRS apparently takes the position that the separately determined cost of computer software is not eligible for the investment tax credit. However, (1) the conflict between two Service pronouncements and (2) the decisions of at least two courts provide taxpayers with strong arguments to the contrary.

In Rev. Proc. 69-21, the IRS stated that the costs of developing software are analogous to research and development costs and held that when software is purchased as part of a package and the software costs are separately stated, the software must be treated as an intangible asset. Although the investment credit implications of software were not discussed in Rev. Proc. 69-21, since it was published when the investment credit had been suspended, the Procedure would appear to imply that software is not eligible for credit since under Sec. 48(a)(1) only tangible property qualifies.

The Revenue Procedure would appear to conflict with Rev. Rul. 71-177 which holds that purchased software qualifies for the investment credit if it is purchased in connection with computer hardware and the price of the software is not separately stated. The IRS thus apparently holds that software qualifies for the investment credit only when its cost cannot be separately determined. There is no basis in the Code or regulations for such a conclusion.

At least two courts have dealt with a similar issue. In *Walt Disney Productions*, CA-9, 480 F2d 66 (1973), the Court held that motion picture and television films are tangible personal property eligible for the investment credit. The Court determined that the definition of tangible personal property must have its ordinary meaning, since it has not been defined by Congress in the enactment of the investment credit. The Court pointed out that films were certainly "tangible" within that word's ordinary meaning since they have weight, can be seen and touched, and negatives are used to manufacture prints. A similar result was reached in *Walt Disney Productions*, DC–Cal., 1974 (Aff'd in part CA-9(8/5/76)), in which the Court rejected the government's argument that films constituted investments in intangible copyrights instead of in tangible personal property and held that film negatives constitute depreciable property.

Sec. 48 It would appear that a strong argument can be made that computer software is tangible personal property for purposes of the investment tax credit. Computer software is closely analogous to films in that the ultimate products have weight, can be seen and touched, and are used in the taxpayer's business. Software includes magnetic tapes, discs, and punch cards and appears to fit the ordinary definition of tangible property rather than intangible as determined in Rev. Proc. 69-21.

Investment credit developments

• Recent litigation suggests that the question of investment credit entitlement should be reviewed for each special-purpose building erected by the taxpayer during the year. Relevant cases include: *Adolph Coors Co.*, TC Memo 1968-256 (beer curing facility); *Arne Thirup*, CA-9 508 F2d 915 (1975) (greenhouse); *Brown-Forman Distillers Corp.*, Ct. Cls., 499 F2d 1263 (1974) (whiskey maturing and storage structure); *Yellow Freight System, Inc.*, DC-Mo, (1975) (truck terminal structure); and Rev. Rul. 71-359, (peanut storage building). In short, a functional test has replaced the appearance test of Regs. Sec. 1.48-1(e)(2).

Furthermore, a claim for the investment credit should be considered for the portion of a general purpose building which is specifically designed to store fungible commodities, see *R. E. Catron*, 50 TC 306 (1968) and Sec. 48(a)(1)(B)(iii).

• A question has been raised on applicability of the 10% investment credit rate for property acquired prior to January 22, 1975, by the lessor, then delivered to and placed in service by a lessee after January 21, 1975. Sec. 46(a)(1), as amended by the 1975 Tax Reduction Act, refers to property acquired after January 21, 1975, and placed in service before January 1, 1977. The Conference Committee explanation refers to property acquired and placed in service after January 21.

The 1971 investment credit restoration is described in Sec. 50(a)(2) as property acquired by the taxpayer after August 15, 1971, and the 1966-67 suspension is described in Sec. 48(h)(2)(B) as property acquired during the suspension period. Based upon Regs. Sec. 1.46-3(d)(3) which treats property as placed in service when possession is transferred to the lessee, ınd the concept in Regs. Sec. 1.48-4 that the lessor elects to treat the lessee as having purchased the property, it appears that a lessee should claim the 10% credit where he receives possession after January 21, 1975. *Sec. 48*

Editor's note: The Eighth Circuit reversed the Yellow Freight *holding 6/15/76.*

WIN for clients and CPA firms

Sec. 50A

The federal government, through tax credits and other incentives, seeks to provide additional employment opportunities for the economically disadvantaged, unemployed, and under-employed. Manufacturers especially could find these incentives advantageous to them. For CPA firms, clerical employees are the most likely type of eligible personnel employable for this purpose.

A brief and general description of these incentives follows.

WIN I. Employers are entitled to an income tax credit of up to 20% of wages paid or incurred to qualified WIN participants for services rendered during the first 12 months of employment (not necessarily consecutive, but not beyond a 24-month period) by employees certified by the Secretary of Labor as being employed under a WIN program established under the Social Security Act (see Sec. 50B).

The WIN program is administered by the Department of Labor and is implemented at the local level by state employment and security and welfare agencies. To be eligible for the WIN tax credit on wages paid to a WIN participant, the employer must obtain a Certification of Placement of WIN Participant from the local office of the state employment or manpower agency. A WIN participant cannot be hired for a vacancy created by the displacement of another employee. The vacancy may not be the result of a strike or a lockout. The hiring of a WIN participant may not cause a reduction in wages, hours, or job benefits for other employees. There cannot be any laid-off employees waiting to be recalled for the position.

The credit can be used to offset the first $25,000 of tax liability. Fifty percent of any excess credit is used to offset any remaining tax liability. In no case can the credit exceed the tax

Sec. 50A liability. An unused WIN credit is available for a carryback and carryover. There is also a recapture of WIN credit in case of early termination of employment by the employer.

WIN II—federal welfare recipient employment incentive tax credit. The 1975 Tax Reduction Act extended the WIN credit to employers who hire people eligible to receive Aid for Dependent Children. For the employer to be eligible for the WIN II credit, the employee must have been hired after March 29, 1975, and must have received AFDC financial assistance for 90 days before being hired. The employer can get a tax credit of up to 20% of wages paid to an eligible employee after 30 consecutive days of employment on a substantially full-time basis for services rendered before July 1, 1976.

The employer cannot get a double WIN credit if the employee meets the eligibility requirements of both WIN I and WIN II. The WIN II credit is subject to the same limitation, carryback and carryover rules, as the WIN I credit. However, the WIN II credit is not subject to recapture for early termination of employment. A taxpayer is eligible for a WIN II credit for hiring an eligible employee for nonbusiness services such as household help, gardening, etc. The credit available to nonbusiness employers, however, cannot exceed $1,000.

Fast write-off provision. Depreciable property used for on-the-job training of workers or for day-care centers for workers' children can be amortized over a 60-month period for tax purposes pursuant to Sec. 188. This special amortization privilege applies to expenditures made after Dec. 31, 1971, and before Jan. 1, 1977, for buildings, improvements, and equipment used specifically for on-the-job training of workers and day-care centers for children of workers. The training of workers is not limited to WIN employees. Property that is being amortized under this provision is not eligible for the investment credit or depreciation.

On-the-job training. The National Alliance of Businessmen is responsible for this program. Briefly, under the Comprehensive Employment and Training Act (CETA) of 1973, employers can be reimbursed within certain limitations for (a) one-half of the employee's hourly wages for on-the-job training, (b) the cost of instruction including supervisors, (c) medical, dental, transportation, and meal allowances, and child care, and (d) 10% of the costs of services rendered as reimbursable administrative costs. *Sec. 50A*

Those eligible for training and employment are people considered economically disadvantaged, unemployed, or underemployed. All applicants must be processed through a CETA center. However, that does not preclude an employer from hiring an eligible employee directly, but he must first be referred to a CETA center to enable the employer to qualify for an on-the-job training contract.

Editor's note: The Tax Reform Act of 1976 liberalized the rules as follows:

WIN—The credit is available from the date of hiring if employment is not terminated without cause before the end of six months. There is no recapture for lay-offs due to lack of business. The limit on the credit is increased to $50,000 plus one-half the excess over $50,000.

Welfare Recipient Tax Credit—The change provides a limit of twelve months for any one employee. The limit on the credit is increased to that under WIN. The expiration date was extended from July 1, 1976 to January 1, 1980.

Minitax: carryovers on consolidated return

Sec. 56

Sec. 56(c) provides that the excess of federal income taxes paid in taxable years ending after Dec. 31, 1969, over the sum of items of tax preference in excess of $30,000 shall be carried forward for seven years to reduce tax preference items.

Where an affiliated group is formed and an election made to file a consolidated federal return, a question arises as to the amount of the deduction permitted by Sec. 56(c) where the subsidiary's prior taxable years were "separate return limitation years" under Regs. Sec. 1.1502-1(f).

To date, regulations have not been issued setting forth the manner of computing this deduction. It would appear any such excess taxes paid by the common parent in separate return years (giving effect to any reverse acquisitions under Regs. Sec. 1.1502-1(f)(3)) should be allowed as a deduction in

Sec. 56 consolidated return years. Further, until the issue is clarified in regulations, taxpayers should consider an aggressive approach and deduct such excess tax payments made by the subsidiaries in separate return limitation years.

Editor's note: The Tax Reform Act of 1976 eliminates the carryover of taxes not used to offset tax preferences of the current year.

Sec. 57 Tax preference: exercise of qualified stock option by deceased employee's widow

An interesting problem was presented to the National Office relating to the applicability of the 10% preference tax under the following circumstances:

- Employee (*D*) receives a qualified stock option, with an option price of $25.
- *D* dies prior to exercising the option; under its terms, however, his widow (*W*) can exercise it.
- The fair market value of the stock at date of death is $50; consequently, the option is valued for estate tax purposes at $25.
- *W* exercises the option and acquires the stock at the $25 option price.

The National Office advised us that this situation has been considered and that the minimum tax would apply upon *W*'s exercise of the option even though she herself had no preference—in effect having paid the full fair market value price of the stock ($25 option price plus $25 option value).

The tax can be avoided, however, by selling the stock within the taxable year in which the option was exercised. (Proposed Regs. Sec. 1.57-1(f)(5).) It would then appear that the stock could be immediately repurchased (assuming bona fide transactions) without any adverse consequence.

Sec. 72 Investment annuity contracts

Many tax consultants have been requested to advise their clients as to whether an investment annuity "policy" or an investment annuity "contract" is a reliable tax shelter device. For this discussion— *Sec. 72*

- A "policy" refers to the agreement between the investor-annuitant and the insurance company, with investment decisions made by the insurance company; and
- A "contract" relates to a three-cornered arrangement among the investor-annuitant (contract holder), the custodian and the insurance company in which the contract holder or the custodian makes the investment decisions. Typically, a sales commission (loading charge) and annual investment management fees are charged on premium payments and the invested account, similar to those charged by mutual funds.

Proponents of the policy or contract point to numerous tax advantages:

- Ordinary investment income is allocated by the insurance company to a reserve account, which, under Sec. 801(g), exempts such income from current taxation to the insurance company. Capital gains, however, are currently taxable, and the policy holder is required to reimburse the insurance company for such taxes.
- The policy holder is otherwise exempt from income tax until the annuity starting date, unless he withdraws funds in excess of his cumulative premium payments.
- An irrevocable secondary annuitant or beneficiary designation can be made by the contract holder, insuring usage by him of his federal gift tax lifetime exemption. The nontax advantage of "avoiding probate" is also secured.
- Income received after the annuity starting date is only partly taxable because of the Sec. 72 return of investment computation. If a remote annuity starting date is selected, the income ultimately will be reportable by beneficiaries who are expected to be in lower income tax brackets.

The arrangement is described as the perfect combination—

- Permitting the taxpayer to invest in a vehicle which closely resembles a mutual fund (and, in some cases, to make current investment decisions);
- Accommodating emergency needs of the taxpayer through nontaxable withdrawals (assuming the cumulative withdrawals do not exceed the cumulative premium payments);
- Accelerating the accumulation of an investment portfolio without the burden of current income taxes on ordinary dividend and interest income; and
- Providing the opportunity for taxation of such income in

Sec. 72 future years, when the contract holder is taxed at lower brackets, or taxation of beneficiaries subjected to tax at lower rates.

The contract or policy may be used as an investment medium for a qualified Sec. 401 corporate or H.R. 10 retirement plan, or Sec. 403(b) individual annuity plan (for an employee of a Sec. 501(c)(3) organization). The IRS confirmed suitability for tax-sheltered annuity use, in Rev. Rul. 68-488, for a custodial contract arrangement under which money and securities held in the account were considered to be the property of the insurance company. The ruling is silent as to which party in the arrangement exercised investment decision authority.

The tax benefits described are available for a "nonqualified" investment only if the policy or contract is determined to be an annuity as defined in Sec. 72. It should also be noted that the policy or contract may not be a suitable lifetime gift subject, since the income payable after the contract holder's death is income in respect of a decedent, and therefore does not take a stepped-up basis at death because of Sec. 1014(c).

The tax adviser may recommend caution—i.e., may fear that the contract is not assured Sec. 72 status—where the contract holder has investment direction authority, makes frequent withdrawals from the contract, is allowed to defer the annuity starting date, or selects an unrealistically remote annuity starting date. Sec. 72 status may be further attenuated if the contract holder is a corporation, and a stockholder or "key man" life is used for the policy or contract measurement.

Recognition of the policy or contract as a Sec. 72 annuity may also be affected by the SEC ruling which determined that variable life insurance contracts are subject to the federal securities law. The courts have previously held that a variable annuity insurance contract is not a contract of insurance, exempt from the securities laws. (*SEC* v. *Variable Annuity Life Insurance Company of America*, 359 US 65 (1959).) The tax adviser may surmise, since the contracts are considered subject to securities regulations, that the IRS may contend, at least prospectively, that they should be treated similar to mutual fund investments, rather than annuity contracts, for income tax purposes.

In view of the three-party arrangement, and the controls, present in a particular case, of the contract holder over the fund, the argument might also be made that the arrangement in substance is a "grantor trust," with all income and deductions currently reportable by the contract holder. Sec. 72

Dividends on restricted stock as deductible compensation

Sec. 83

Prop. Regs. Sec. 1.83-1(a) suggests that a corporate employer which has issued restricted dividend-paying shares to key employees may be able to deduct as compensation the current dividends on such shares in the year the dividends are declared by an accrual-method employer. The regulation states "until such transfer [of the restricted stock] becomes complete . . . any income from such property received by the employee . . . constitutes additional compensation and shall be included in the gross income of such employee . . . for the taxable year in which such income is received [year of lapse]. . . ."

As compensation, the dividends should be deductible by the corporation even though no offsetting income is reportable by the corporation. Under Sec. 1348(b)(1) the compensation income should also be eligible for maximum tax treatment on the employee's return. Furthermore, Prop. Regs. Sec. 1.83-4(b) can be read literally to allow the employee to increase the basis for his stock by such dividend income, even though the dividends have been received in cash.

Avoiding ordinary income on executive stock purchase

A small corporation (earning two cents per share) is willing to sell a key executive 25% of its stock (1,000 shares) for $1,000. Book value of the 25% is $50,000. Problem: Will the executive have substantial ordinary income on a bargain purchase? Solution: Sell the stock to the executive at fifty times earnings per share (which is $1,000) with the corporation having the right to acquire the stock, in the event of any proposed disposition, at the same fifty times earnings per share. Tax result? The repurchase option is a restriction which

Sec. 83 "by its terms will never lapse," and the price so determined is presumptively the fair market value (with the IRS having the burden of proving otherwise). Caution: If the stock is subsequently freed from the repurchase option, the executive will then have income if the release is compensatory—but the income element will be only the excess of the then fair market value over the price under the repurchase option. (Proposed Regs. Sec. 1.83-5.)

Sec. 103 Exempt interest: "purchase and resale" agreements

Perhaps unaware of the possible tax consequences, a number of financial institutions have been entering into "sale-repurchase" agreements with other financial institutions or with some of their customers.

In the typical transaction, a financial institution (*A*) having excess funds locates another financial institution or even a bank customer (*B*) having a tax loss. *A* purchases from *B* state or municipal bonds or mortgages under an agreement that *B* will buy back the bonds or mortgages on or before a specified date. Or, *B* may borrow from *A*, putting up tax-exempt securities as collateral.

The interest rate on the bonds and mortgages may be a relatively favorable one so that *B* does not want to part with them for the long term. By virtue of the agreement, *B* has funds to invest in other ways for a period of time and is able to eventually reacquire the obligations under the sale-repurchase agreement.

A, it appears, secures tax-exempt income for a period of time. An innocent enough transaction, or so it seems. In Rev. Rul. 74-27, however, the IRS takes the position, and perhaps rightly so, that *A does not* have tax-exempt income. Such transactions, says the IRS, simply affect loans of money by *A* to *B* upon collateral security and such arrangements are not real purchases by *A* of the securities for investment. The tax-exempt interest is the income of *B* or the customer who "sold" the securities to *A* or presented them for collateral. Furthermore, if one applies the results of *Union Planters National Bank of Memphis*, CA-6, 462 F2d 115 (1970), the same results can occur even if the sale-repurchase agreement is not in writing, but can be found to be the intent of the parties and a practice of reacquiring the securities. *Sec. 103*

And, if this is not enough, there is the possibility that *B* also would not be able to deduct the interest on its indebtedness due to the operation of Sec. 265(2), and Rev. Proc. 70-20 which discusses the circumstances under which a sale-repurchase agreement of this type might represent a direct connection between the borrowing by *B* and the tax-exempt investment.

In short, the situation is that tax-exempt income will be exempt only to the "real owner" and if a direct link exists between the borrowing and the tax-exempt investment, the "real owner" is denied an interest deduction.

Avoiding income from cancellation of debt

Sec. 108

A corporation in financial difficulties will frequently transfer some of its shares to creditors as part, or perhaps even as the entire amount, of an overall debt settlement. Such a transfer of stock seems to avoid problems of income from discharge of indebtedness or of reduction of basis of assets.

In a bankruptcy context, holding (C) of Rev. Rul. 59-222 makes clear that the transaction is, with respect to the corporation, looked upon as a mere restructuring of debt and capital. Whether the debt was represented by "securities" is irrelevant. Accordingly, there is no reduction of basis under Regs. Sec. 1.1016-7 since there has been no income from discharge of indebtedness excluded from gross income under Regs. Sec. 1.61-12(b)(1).

Apparently, the same rules apply in a nonbankruptcy context. See, e.g., Rev. Rul. 58-546, which relates to an exchange of "securities" for stock. It therefore appears that generally there is no income from discharge of indebtedness for which an election to reduce basis of assets need be made under Sec. 108. Accordingly, there would be neither gross income under Sec. 61 nor reduction of basis in property in accordance with Sec. 1017.

As an interesting sidelight, Rev. Rul. 58-546 does, however, require the inclusion in gross income of forgiven interest for which tax benefits had previously been realized, unless excluded by a Sec. 108 election.

Sec. 108 Can cancellation of indebtedness income yield permanent tax deferral?

Frequently, events fall together so that when viewed in retrospect, they look like pieces in a master tax plan. Here is the timetable of an actual case in point.

1967–Q corporation floated a large bond issue.

1969–Q decided to restructure and streamline its operation. As a result, *Q* became a holding company whose principal asset was stock of a subsidiary. Its liabilities consisted primarily of bonds issued in 1967.

1970—In view of the money market, *Q*'s bonds are now selling for 50% of the issue price. *Q* is considering buying up these bonds in the market.

Can *Q* elect not to recognize cancellation-of-indebtedness income under Sec. 108? The IRS National Office agreed in principle that Sec. 108 relief is available to *Q*.

However, the IRS was concerned by the fact that since the basis of the assets to be reduced under Sec. 1017 would be the stock in the subsidiary, it was possible that a permanent tax deferral would result. The reason is that *Q* could liquidate its subsidiary under Sec. 332 and carry over the tax basis of the subsidiary's assets; *Q*'s basis for the stock of the subsidiary would completely disappear.

The feeling in the National Office was that Sec. 108 was not an exclusion provision but merely a deferment section; therefore, its application in this area would be a distortion of congressional intent. However, the only case involving this type of situation supports the applicability of Sec. 108. In *Retail Properties, Inc.*, TC Memo 1964-245, the following language is found:

> If a corporation were to incur an indebtedness to purchase a single piece of property, which was then transferred to a newly formed subsidiary, leaving the transferor with the subsidiary's stock as its only asset, it would seem that, upon a subsequent discharge of that indebtedness at a discount, the corporation would be compelled to reduce the basis of such stock upon electing not to include in its income the gain realized from such discharge. A contrary result would defeat the purpose of the statutory scheme in this area.

Despite this language, the IRS refused to rule favorably on *Q*'s request. Instead, a closing agreement was entered into providing for nonrecognition of gain on purchase of the bonds and reduction in basis of the subsidiary's stock. This is in accordance with the rules of Secs. 108 and 1017. However, *Q* also had to agree that if it should liquidate or merge the subsidiary into itself or vice versa, the unrecognized gain on purchase of the bonds would be applied to reduce the basis of the subsidiary's assets—which was primarily depreciable property. Thus, in that event, the unrecognized gain would be recovered by reduced depreciation deductions and/or a recognition of greater gain on the disposition of the subsidiary's assets. *Sec. 108*

It should be noted that in the event the stock of the subsidiary was sold, the entire gain—including that attributable to basis reduction—would be capital gain. This point also troubled the National Office, but this conversion of ordinary income into capital gain was not considered as offensive as complete avoidance of income.

Avoiding tax on repurchase of own bonds at discount

A drop in value of a bond below its issue price offers an opportunity for the issuing corporation, if it has the available funds, to purchase the bonds in the open market at a discount. But ordinary income will generally be recognized at such time unless an election has been made under Sec. 108. The effect of such election will generally be to increase taxable income over a period of years beginning with the year of retirement.

It should be possible to defer recognition of the income indefinitely, however, if an affiliated company, rather than the issuing company, purchases the bonds out of its own funds. As long as the bonds remain outstanding, no tax should be due. (*Peter Pan Seafoods, Inc.*, CA-9, 417 F2d 670 (1969).)

There may be additional current benefits if:

- The affiliated purchasing company is on the cash basis and is not a personal holding company;
- The issuing company uses the accrual basis; and
- The companies are not included in a consolidated tax return.

Assuming the bonds continue to be bona fide obligations, the issuing company should be entitled to deduct the annual interest accrued even though the related purchaser is not taxed until payment is received.

Sec. 108

Sec. 267 disallows deductions for interest and other expenses owed to certain related taxpayers which are not constructively received by, or paid out within, 75 days after the end of the taxable year to such taxpayers. However, this section has no application here since it does not apply to transactions between related corporations where neither one is a personal holding company.

It may even be possible to entirely avoid tax on the accrued interest even though full tax benefits have been received by the issuer from the interest deductions. This would occur if a 100% parent of the issuer purchases the bonds and makes a gratuitous contribution to the subsidiary's capital of the accrued interest before the bonds mature. See *Fender Sales, Inc.*, CA-9, 338 F2d 924 (1965), which appears to have revitalized the rule enunciated back in 1935 by the Second Circuit in *Auto Strop Safety Razor Co., Inc.*, CA-2, 74 F2d 226 (1935), and by the Supreme Court in 1943 in *American Dental Co.*, 318 US 322 (1943). These cases hold that no taxable income is recognized by a controlled corporation from cancellation of accrued interest, rent, salaries, etc., owing to its sole shareholder, even though the debtor corporation received a tax benefit from items in prior years.

Editor's note: The avoidance of tax on the forgiveness of the accrued interest is likely to be strongly resisted by IRS. Rev. Rul. 76-316 would tax the forgiveness to the subsidiary under similar circumstances. The Service recently announced nonacquiescence to the Hartland Associates *(54 TC 1580) decision. In this case a shareholder-creditor cancelled previously deducted accrued interest and the amount was considered a capital contribution rather than income. In view of continued taxpayer successes (see* Putoma Corp., *66 TC No. 60), one hopes the Service will become less obdurate on the issue. In any event, even if the transaction was successfully attacked, the taxpayer could elect to adjust basis pursuant to Sec. 108 and Sec. 1017.*

Sec. 151

Separate returns by newly married graduates can save taxes for parents

If any of your clients are parents of recently married college graduates, you should not overlook the tax savings of having the parents claim their children as dependents on their income tax return in the year the children graduate and marry.

Taxpayers can claim their married children as dependents, no matter what their income, provided they meet the support test under Sec. 152, the child was a full-time student during five months of the taxable year, and the child does not file a joint return. (Sec. 151(e).) *Sec. 151*

Example. John and Mary Student graduated from State University in June and were married in September. John's and Mary's income for the year was $6,500 and $4,500 respectively, consisting solely of wages. The tax on a joint return using the standard deduction is $1,352; the combined tax on a separate return basis is $1,383, or an increase of $31. The parents' tax savings are governed by their present tax bracket, which could range from $105 (14%) to $525 (70%) per family. The additional tax the children would pay is nominal when compared to the savings the parents would realize.

John and Mary Student's parents should also not overlook deducting sales tax on the wedding reception and medical bills paid on behalf of their children or taxes on gasoline paid for by the parents but used by the child. These deductions are available to the parents regardless of whether dependency exemptions are claimed for their children.

Deductibility of start-up costs **Sec. 162**

The deductibility vis-a-vis capitalization of start-up costs usually depends upon when business operations commence. For instance, the granting of a license or permit may be sufficient to establish the beginning of business operations, even though a taxpayer has not yet opened his doors. See *Richmond Television Corp.*, CA-4, 345 F2d 901 (1965); *Petersburg Television Corp.*, TC Memo 1961-49.

In addition, deductibility is sometimes questioned when an existing business operation enters a new geographic or business area. The Tenth Circuit allowed a national bank to deduct start-up costs incurred in participating in the Master Charge credit card system in *Colorado Springs National Bank*, CA-10, 505 F2d 1185 (1974). The Court held that the credit card system merely enables a bank to carry on an old business in a new way, and thus represented an expansion of an existing business rather than the start-up of a new one.

Editor's note: For other taxpayer victories see First Security Bank of Idaho, *63 TC 644 (1975), wherein the bank had de-*

Sec. 162 *ductible costs related to adopting the BankAmericard system; and* Briarcliff Candy Corp., *CA-2, 475 F2d 775 (1973), wherein a company incurred costs in developing suburban markets.*

The Regs. at Sec. 1.248-3 provide that when activities have advanced to the point where the nature of business operations is established, a corporation will have begun business.

Reasonable compensation: assignment of payment concept

Examining agents of the Service, armed with Internal Revenue Manual audit guidelines, invariably propose a seemingly "automatic" unreasonable compensation adjustment when examining closely held corporations. Frequently, the focus of their attack is compensation paid to the spouse of an officer-shareholder, particularly when such spouse is not active in corporate affairs.

In refuting an agent's arguments, practitioners should be alert to the possibility of advancing an "assignment of payment" argument. Ignoring constructive dividend and gift tax considerations, it may be possible to argue that the compensation paid to the inactive spouse represents additional compensation to the officer-shareholder who assigned payment of such amount to the inactive spouse.

In *Tri-Borough Transportation*, TC Memo 1946-105, the Tax Court allowed a corporate deduction for amounts paid to the wife of a beneficial shareholder even though she rendered no services to the corporation. The Court held that such amounts represented reasonable compensation to the husband for his services.

Utilizing the assignment of payment concept in the situation above can, of course, shift the reasonable compensation issue to the active spouse. It does, however, present an opportunity for possible preservation of the corporate deduction.

Tax treatment of payment for reacquisition of franchise rights

Rodeway Inns of America, 63 TC 414, discusses the tax recovery of a payment by a franchisor to his franchisee for cancellation of a franchise.

In that case, a taxpayer, in the business of operating a chain of motels, entered into an agreement with an unrelated corporation under which the taxpayer granted the exclusive right to construct motels under the franchise name within a specified geographical area. After four years, the taxpayer paid the franchisee a sum of money ($100,000) in consideration of the cancellation of the franchise agreement. The taxpayer deducted the payment as an ordinary and necessary business expense. The IRS disallowed the deduction, contending that the payment was a nonamortizable capital expenditure. *Sec. 162*

In the Tax Court, the taxpayer first argued that it did not acquire a capital asset. The Court, however, found that the taxpayer had acquired a capital asset by reason of obtaining a valuable right to do business in a particular area. The fact that it was merely reacquiring a right previously possessed by it was no reason to treat the transaction any differently than the initial purchase of the business. The taxpayer's second argument was that the payment was a business expense because it was made in return for release from a burdensome contract. This argument was also rejected by the Court which stated that the taxpayer was not making a payment to reduce or eliminate losses or expenses, but rather was attempting to augment its income. Thus, the taxpayer had acquired an intangible capital asset.

The Court also held that the intangible asset could be amortized since it had a useful life which could be estimated with reasonable accuracy. Both the taxpayer's argument that the useful life of the franchise agreement was 22 months and the IRS's argument that its life was indeterminable were rejected. The Court found that the desirable locations in the area covered by the franchise agreement would be taken within four or five years. It therefore concluded that the useful life of the agreement was five years and that the taxpayer could amortize the cost of cancelling the agreement over that period.

Importers' fees for letters of credit: capitalize or deduct?

It is a common practice for importers to finance their purchases through letters of credit issued by U.S. banks. The letter of credit is delivered to the exporter in the foreign country in exchange for documents evidencing title and ship-

Sec. 162 ment. Thereafter, the bank processes the documents, honors the letter of credit, and sometime later either charges the importer's account or receives a short-term note from the importer.

The IRS has in several instances required an importer to capitalize the letter of credit fee paid to the bank. Apparently, the IRS position is that the fee is a "cost necessary to acquire possession of the goods" and therefore becomes part of the inventory cost under Regs. Sec. 1.471-3(b).

It appears, however, that importers could make a reasonable argument that the fee is deductible either as interest or as a business expense.

As to interest, the bank actually advances its funds for a short period on behalf of the importer. (*Wynnefield Heights, Inc.*, TC Memo 1966-185.) Rev. Rul. 69-189 provides that if a loan charge is for services rather than for the use or forebearance of money, the charge is not interest under Sec. 163. However, the revolving-credit finance charge ruling (Rev. Rul. 72-315) may be helpful to the taxpayer. There, the IRS stated that a nondeductible service charge bears no relationship to the amount borrowed or the time given to pay, while interest is based on the amount deferred and the period of deferral. The letter of credit fee is a fixed percentage of the amount of the credit, and the credit is outstanding for a determinable period (i.e., one dictated by customary banking practices).

Perhaps the best argument is that the fee is tantamount to a standby or commitment fee and is deductible under Sec. 162. (Rev. Ruls. 54-43 and 56-136.)

Sec. 163 Investment interest/capital gain tax trap

The limitation on deduction of investment interest has been in effect since the Tax Reform Act of 1969 was enacted. Working with the rules of Sec. 163, tax planners have occasionally been surprised to discover that a yearend maneuver to reduce taxable income will result in capital gain being converted to ordinary income. Thus, the benefits of prepayment of interest can be partially or totally eliminated. This unhappy result is brought about by the special rule of Sec. 163(d)(5).

The following example will help illustrate the application of the limits imposed by Sec. 163(d). The taxpayers (husband and wife) had the following items of income and expense for 1973: Sec. 163

Income	
Salary	$ 65,000
Interest and dividends	25,000
Gross rents—warehouse (net lease)	10,000
Net long-term capital gain—at 100%	150,000
Deductions	
Warehouse, real estate taxes and straight-line depreciation	1,500
Interest on warehouse mortgage (including $7,000 prepaid)	15,000
Interest on home mortgage	10,000
Interest on demand notes—land investment	50,000

Sec. 163(d) limits the deduction by individuals of "investment interest" on a joint return to $25,000, plus:

(1) Net investment income,

(2) Excess long-term capital gain over short-term capital loss,

(3) One-half of the excess of investment interest over $25,000 plus (1) and (2).

Sec. 163(d)(5), in effect, provides that to the extent that investment interest is deductible by reason of the taxpayer having capital gains, the gains are treated as ordinary income.

Under the above facts, the following items enter into the computation of the allowable investment interest deduction:

Investment interest paid:

Demand note	$50,000	
Warehouse mortgage (net lease)	15,000	$ 65,000
Net investment income:		
Interest and dividends	25,000	
Rents (less taxes and depreciation at straight line)	8,500	33,500
Excess of investment interest over net investment income		31,500
Exemption		25,000
Excess investment interest before capital gains		6,500
Capital gains		$150,000

Sec. 163

Since investment interest expense exceeds the total of net investment income and the exemption by $6,500, capital gains income will be converted to ordinary income in the amount of $6,500. The effect of this is an increase in taxable income of $3,250. This results from the fact that capital gains come into income at only 50% whereas ordinary income is taxed in full. Thus the prepayment of $7,000 of interest in 1973 did not significantly reduce the 1973 taxable income. Obviously, it would have been advisable for taxpayers to "defer the prepayment of interest" until a later year in which investment income could absorb it.

Editor's note: The Tax Reform Act of 1976 revises these rules so that generally the deduction for future interest is limited to $10,000 plus investment income, not including capital gains.

Mortgage points and prepaid interest

As a result of the termination of the prepaid interest "honeymoon" by Rev. Rul. 68-643, it becomes necessary to determine whether a prepaid interest deduction "materially distorts income" of a taxpayer. Based on Rev. Ruls. 69-183 and 69-582 and on informal discussions with the IRS, it appears that prepaid interest and mortgage points ("loan processing fees") must be combined in determining whether there has been a sufficient prepayment of interest in excess of 12 months so as to create a presumption of material distortion.

As a consequence, a taxpayer risks disallowance where he deducts points in the same year he deducts one year's *prepaid* interest. The amount disallowed as a deduction in the year paid would be subsequently deductible on the accrual basis.

Editor's note: See Editor's note at end of Code Sec. 163 items for Tax Reform Act comments.

Prepaid interest: new relief or an added restriction?

Another test seems to be gaining momentum in the prepaid interest controversy with the recent Tax Court decisions, *S. Rex Lewis*, TC No. 56 (1975), and *J. B. Howard*, TC Memo 1976-5. In these two cases the Court found a provision for a penalty on prepayment of principal under the terms of the loan agreement to be a significant factor in allowing a deduction for prepaid interest.

The facts in *Lewis* and *Howard* were similar. The taxpayers were partners in a transaction that involved a year-end payment of $44,000 which was to be applied against interest accruing in the following year. The loan agreement provided that if more than 20% of the principal was prepaid, an additional amount equal to 180 days interest on the original principal would also be due. The Court found that since the borrowers were obligated for this amount (the prepayment penalty) even if the loan was paid off immediately, it represented a non-refundable interest payment for which a deduction was allowable in the earlier year.

The Tax Court previously looked at refundability in *A. A. Sandor*, 62 TC 469 (1974), which involved a five-year prepayment of interest on a loan that could be paid off at any time, and found that since the interest could be refunded it was more in the nature of a deposit. In the current cases the Court also decided that there was no material distortion of income present as had been involved in *G. Douglas Burck*, recently affirmed by the Court of Appeals for the Second Circuit, 63 TC 556 (1975), aff'd, CA-2, 3/4/76. In *Burck*, a prepayment of 12 months' interest on the last day of the year, which was several times greater than the taxpayer's gross income of the previous years and which indicated a substantial tax savings motive, was disallowed in the year of payment.

What will be the effect of these decisions? Perhaps taxpayers now have something to rely on in planning prepaid interest transactions when the loan agreements provide for prepayment penalties. On the other hand, when refund of the amount prepaid is not precluded for practical purposes by a penalty provision, there may be some concern that the deduction will be lost even though there is no material distortion of income or tax avoidance purpose.

Editor's note: See Editor's note at end of Code Sec. 163 items for Tax Reform Act comments.

Prepaid interest: continued confusion on more than 12 months' payment

In Rev. Rul. 68-643, the IRS announced that "in view of certain abuses" with respect to prepaid interest, it had re-

Sec. 163 examined its long-standing position in IT 3740 that up to five years prepaid interest would generally be considered allowable as a deduction by taxpayers computing their taxable income under the cash method of accounting. The authority behind this new ruling was based on the Commissioner's authority under Sec. 446(b) to change the method of accounting for a particular item when that item distorts income under the method of accounting being used by the taxpayer.

Under the rules contained in Rev. Rul. 68-643, if interest is prepaid for a period extending more than 12 months beyond the taxable year of payment, the deduction of such prepaid interest will be considered as materially distorting income. The Service will, therefore, require the taxpayer to change his method of accounting with respect to such prepaid interest and allocate it over the taxable years involved. Where interest is prepaid for a period of not more than 12 months beyond the year of payment, the Service will examine each deduction on a case-by-case basis to determine whether a material distortion of income has resulted.

Tax Court and Court of Appeals decisions after the issuance of Rev. Rul. 68-643 have generally sided with the IRS in its treatment of prepaid interest. See, e.g., *G. Douglas Burck*, CA-2, 3/4/76. However, the courts have not taken a uniform approach in deciding these cases and few have relied on the 1968 ruling as strong authority. In fact, there is dicta in a number of cases to the effect that there may well be circumstances under which the deduction of more than 12 months' prepaid interest will not be considered as materially distorting income. For example, in *Sandor*, 62 TC 469, aff'd CA-9, 5/28/76, Judge Drennen stated, in a well-written opinion, that, "We are not prepared to say that a deduction of any prepaid interest extending beyond a period of 12 months following the year of payment would distort income under all circumstances and justify changing a taxpayer's method of accounting with respect to the prepaid interest item. This would be ruling in advance of any knowledge of the facts and circumstances. We believe the Revenue Service may be called upon to support its determination in some cases."

Unfortunately, Judge Drennen's opinion did not suggest any standard or guideline to determine under what circumstances the deduction of more than 12 months' prepaid interest will be viewed by the courts as not materially distorting income. Nor have other cases, which contain similar provisos with respect to the Service's position in Rev. Rul. 68-643, suggested any specific or hypothetical circumstances under which the burden of proof could be overcome by the taxpayer. To add to the confusion, the majority of recent cases on point, in deciding against the taxpayer, have contained language suggesting that prepaid interest might be deductible, if at all, under conditions less favorable than those outlined in Rev. Rul. 68-643. For example, in S. *Rex Lewis*, 65 TC No. 56 (1975), the taxpayer's deduction of one year's prepaid interest was allowed only to the extent of the non-refundable prepayment penalty (180 days interest) provided for in the loan agreement. *Sec. 163*

Therefore, even though the door appears to have been left open for the deduction of prepaid interest in excess of IRS standards, this possibility must be weighed against the trend of current judicial thinking which has been unfavorable to taxpayers.

On the basis of these developments, it must be concluded that the deductibility of prepaid interest continues to be an unsettled and unpredictable area with the current weight of authority on the side of the Government.

Editor's note: The Tax Reform Act of 1976 settles many of the above questions. Prepaid interest is now deductible only on an accrual basis. In addition, mortgage "points" (except in a purchase of an individual's personal residence) are deductible ratably over the term of the loan. Also construction period interest and taxes must be capitalized and amortized over a term that will eventually be ten years.

Securities loss may be ordinary if "theft" is involved

Sec. 165

Normally, when a taxpayer's investment in a corporation becomes worthless, he is entitled only to a capital loss deduction, see Sec. 165(g). Suppose, however, a taxpayer was induced to acquire stock and his decision was based on false and fraudulent financial statements prepared by the officers of the corporation. If the newly-acquired stock becomes worthless, is it possible the taxpayer may be able to treat the loss as ordinary?

Sec. 165(a) and (c) allow an ordinary deduction for any loss sustained during the tax year (including a theft loss) that is not compensated for by insurance or otherwise. Regs. Sec. 1.165-8(d) defines the term "theft" as including but not li-

Sec. 165 mited to larceny, embezzlement, and robbery. Furthermore, in Rev. Rul. 72-112, the IRS developed a broad definition of theft by requiring the taxpayer to prove only that an illegal taking of property was done with criminal intent. It was considered irrelevant that the alleged act did not amount to a statutory "theft" under local law. This ruling seems to imply that losses incurred by reason of crimes such as fraud, false pretenses, and swindling will qualify as theft losses under Sec. 165(c)(3).

In Rev. Rul. 71-381 it was held that a theft loss deduction may be taken for amounts loaned to a corporation based on financial reports issued by the corporation that were later found to be fraudulent. The facts in the ruling indicated that the issuance of the false and misleading financial documents had been a violation of the state securities law, and their use to induce the loan was a "theft."

In contrast is the holding of *L. I. Paine*, 63 TC No. 70 (1975). In *Paine*, the taxpayer, a stock broker, claimed that he purchased stock through the American Stock Exchange based on misrepresentations in the financial statements of the corporation. The Tax Court denied his attempt to take the decline in value of the near worthless stock as a theft loss because the taxpayer failed to show there was a misrepresentation to him by the person who created the false financial statements, and thus, there was no criminal taking under state law.

In a situation where a taxpayer is induced to acquire stock through false or fraudulent financial statements prepared by officers of a corporation, he may be able to deduct the loss under Sec. 165(a) and (c). In order to do so, he must be able to show that the inducing acts are tantamount to a "theft" under Rev. Rul. 71-381. On the other hand, the limitation of *Paine* would, if applicable, deny ordinary loss treatment.

Editor's note: Paine *has been affirmed by CA-5, 11/3/75. See also* George S. Ladas, *TC Memo 1976-64 for reaffirmation that a crime must exist under applicable state law, although an actual conviction is not necessary.*

Sec. 166 Written evidence of intercorporate business loan may convert bad debt into capital loss

For business-related reasons, corporation *A* made an arm's length loan, evidenced by a note, to unrelated corporation *B*.

More than six months later, because of financial difficulties, *B* repaid only a part of the loan pursuant to a compromise agreement and the note was cancelled.

Is *A*'s loss a bad debt (ordinary deduction) under Sec. 166(a) or a long-term capital loss (deductible only against capital gains)?

Ordinary bad debt. Sec. 166 specifically allows an ordinary deduction for all bad debts except non-business ones. Subsection (d) provides for short-term capital loss treatment of a nonbusiness bad debt—i.e., a bad debt which is not business connected *and* which is sustained by a noncorporate taxpayer. *A*'s bad debt fulfills neither of the two parts of the definition since the loan is business connected and *A* is a corporation. Sec. 166(h) cross-refers to other sections which modify the rules of Sec. 166 (e.g., to Sec. 271 relating to political bad debts), but all the specified sections are irrelevant to *A*'s problem.

Therefore, since Sec. 166 specifically covers bad debts and since the exception for nonbusiness debts is inapplicable, it appears to be clear that *A* is entitled to an ordinary deduction. However, Sec. 1232 beclouds the issue.

Capital loss treatment. Despite the fact that ordinary bad debt treatment is clearly called for by the Code section which on its face is specifically and exclusively applicable to business bad debts sustained by a corporate taxpayer, it has been generally accepted that Sec. 1232 requires capital loss treatment of *A*'s bad debt.

Sec. 1232(a)(1) provides, in effect, that capital gain or loss is realized where amounts are received upon the *retirement* of bonds, notes, or other evidences of indebtedness which are *capital assets* in the hands of the lender and which are issued by a corporation (or a governmental body). Thus, if the compromise settlement constitutes a *retirement* of the note and if the note is a capital asset in the hands of *A*, the loss sustained by *A* will constitute a capital loss rather than an ordinary loss.

In *Schlumberger Technology Corporation*, DC-Tex. (1970), 305 F Supp 1020, rev'd on another ground, 443 F2d 1115 (CA-5, 1971), the District Court concluded, without discussion, that a compromise of a debt constitutes a retirement of an evidence of indebtedness within the meaning of Sec. 1232(a)(1). This conclusion is supported by the Supreme

 Court's decision in *McClain,* 311 US 527 (1941). Therefore, indisputably, there was a "retirement" of *B*'s note.

Under the facts given, *B*'s note constituted a capital asset in *A*'s hands. In effect, Sec. 1221 negatively defines a capital asset as "any property" except those properties which are specifically excluded by paragraphs (1) to (5) of the section. None of the exceptions apply to a note receivable for a loan made by one corporation to another.

The list of noncapital assets specified in Sec. 1221(1) to (5) was enlarged, however, in *Corn Products Refining Company,* 350 US 46 (1955). There, the taxpayer purchased corn future contracts in order to hedge against increases in raw material costs; as delivery dates approached, the excess futures were sold. The Supreme Court concluded that although the future contracts literally constituted capital assets under the statute, they should be treated as a noncapital asset since the future transactions were an integral part of the taxpayer's business. The Court reasoned that Congress intended that profits and losses arising from the everyday operation of a business should be treated as ordinary income or loss, not capital gain or loss.

In *Schlumberger Technology Corp.,* above, the Fifth Circuit held that Sec. 1232(a)(1) was inapplicable to a loss sustained on the retirement of a subsidiary's promissory notes because the loans were integral and necessary acts in the lender's business and were not investment-motivated. Thus, the notes were not capital assets. (It is implicit in the Fifth Circuit's decision that if it had not found that the "integrated business activity" test had been satisfied (contrary to the District Court's finding), the loss would have been treated as a capital loss under Sec. 1232.)

Situations which present no Sec. 1232 problem. It should be noted that the capital loss problem generally will be academic if the loan is made to a loss subsidiary which joins the lender in consolidated returns which show consolidated taxable income. In this situation, in effect, the bad debt receives ordinary loss treatment as the subsidiary's net operating losses are offset against the other members' income.

Also, Sec. 1232(a)(1) will not apply where the loan becomes wholly worthless since the lender would receive nothing on account of the retirement of the evidence of indebtedness. By its terms, the section applies only where "amounts [are] received by the holder on retirement."

Tax planning. Where the "integrated business activity" exception to the definition of capital assets is inapplicable to an intercorporate loan, the lending corporation should consider the following suggestions for avoiding capital loss treatment under Sec. 1232(a)(1) in the event the loan becomes partially worthless: *Sec. 166*

- Instead of taking a note or other evidence of indebtedness from the borrowing corporation, the lender could merely set up an account receivable on its books. Thus, there would be no "evidence of indebtedness." By legal definition an "evidence of debt" is a "term applied to written instruments or securities for the payment of money, importing on their face the existence of a debt." Thus it would be generally inadvisable to take back a note from a corporation which the lender controls, such as a subsidiary. However, it may not be a good business practice to make loans on open account to unrelated corporations.
- Sec. 166(a)(2) provides, "when satisfied that a debt is recoverable only in part, the IRS may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction." Interim write-offs of a partially worthless note receivable from a corporation should be considered as a means of avoiding capital loss treatment under Sec. 1232. Since there would be no "retirement" of the evidence of indebtedness accompanying an interim write-off, Sec. 1232 would not preclude an ordinary bad debt deduction for the amount of the partial write-off.

Apparently, there is no authoritative prohibition against the partial write-off of a note receivable even though the instrument is a capital asset. In fact, the partial write-off of a capital asset is supported by dictum. (*Corbin*, 39 BTA 1163.) In this case an ordinary deduction was denied for the charge-off of a partially worthless government bond, but the Board rested its decision on the ground that at the time of the write-off the taxpayer knew that the bond would be retired in the following year at less than face value.

However, in dictum, the Board indicated that an ordinary deduction might have been allowed if the retirement of the bonds had not been foreseeable.

Maximizing ADR depreciation by switching from DDB to SYD

Sec. 167

Taxpayers depreciating assets under ADR and using the double declining balance method (DDB) should consider

Sec. 167 switching from that method to the sum-of-the-years digits method (SYD) after a full year's DDB depreciation has been claimed (this will generally be the start of the second year after the asset is placed in service).

The acceleration of depreciation resulting from such a switch is rather dramatic. To illustrate, assume that an asset costing $100,000 with a ten-year useful life is placed in service in year one and that a half year's DDB depreciation is claimed. A taxpayer switching from the DDB to SYD at the beginning of the third year of the asset's useful life would enjoy additional depreciation as follows:

Year	*Cumulative Additional Depreciation*
3	713
4	2,527
5	4,866
6	7,272
7	8,717
8	8,384
9	6,274
10	2,386
End of life	0

This comparison is made assuming DDB depreciation with a switch to straight line depreciation at the optimum time.

It should be pointed out that the ability to make this switch automatically is only available to taxpayers utilizing ADR depreciation. Consideration might be given to requesting permission to make such a switch for other assets. However, except in the case of assets being depreciated under the new regulations for guidelines, salvage value must be taken into account in determining the amount of annual depreciation.

A request for change in method of depreciation must be filed within the first 180 days of the taxable year to which the change is to apply.

ADR depreciation: extraordinary retirements

Regs. Sec. 1.167(a)-11(d)(3) provides rules for the determination of whether or not gain or loss should be recognized upon the retirement of assets from vintage accounts elected pursuant to the ADR regulations. These rules become important since the rules under the general depreciation regulations dealing with normal and abnormal retirements (Regs. Sec. 1.167(a)-8) are made inapplicable to such ADR retirements.

No problems appear to exist with respect to any retirement of Sec. 1250 property or to the retirement of Sec. 1245 property if such retirement is a direct result of fire, storm, shipwreck, or other casualty. These are clearly extraordinary retirements on which gain or loss is recognized. A problem of recognizing gain or loss does appear to exist where other types of retirements of Sec. 1245 property occur because such retirements must meet two tests in order to be considered extraordinary. The two tests, set forth in Regs. Sec. 1.167(a)-11(d)(3)(ii)(c), are:

- The asset is Sec. 1245 property which is retired as the "direct result of a cessation, termination, curtailment, or disposition of a business, manufacturing, or other income producing process, operation, facility, or unit," and
- The unadjusted basis of the retired assets exceeds 20% of the unadjusted basis of the vintage account prior to such retirement. A grouping of accounts of the same vintage and of the same guideline class is required for the purpose of this 20% test.

While the second test is objective and capable of mathematical measurement, the first test can often cause a problem. For example, if a taxpayer sells assets representing over 20% of the unadjusted basis of assets in a 1973 vintage account but replaces the bulk of these assets in 1976 with new assets of the same general type, there would not appear to be a curtailment of an income-producing process, operation, facility, or unit. This is not dealt with in the regulations. Assuming no curtailment because the assets sold have been replaced, if a loss is involved in the transaction, the loss would be deferred; similarly, if a gain results, the gain may be partially or completely deferred depending upon the size of the depreciation reserve of the vintage account, see Regs. Sec. 1.167 (a)-11(d)(3)(iii) (treatment of ordinary retirements).

Both tests should be borne in mind whenever sales of Sec. 1245 ADR assets take place. While the regulations make it difficult to qualify a loss as resulting from an extraordinary retirement, a gain, as indicated above, can sometimes be deferred even where the cost of the assets sold exceeds 20% of the cost of the entire vintage account.

Sec. 167

How to handle short-lived assets included under an ADR election

A provision under the Class Life System (ADR) regulations provides an opportunity for taxpayers with short-lived assets which are otherwise includible in a relatively long-lived class to obtain a tax benefit at the end of the physical life of the asset.

The asset or a group of assets (with similar short lives) would be placed in a separate vintage account and depreciated over a different life (within the ADR) or depreciated under a different allowable method than other assets in the same asset guideline class. It is necessary that a different life or depreciation method be used for these special vintage accounts since all vintage accounts with the same depreciation period and/or depreciation method within an asset guideline class are considered one vintage account for purposes of the above regulation.

Upon retirement of the last asset in this vintage account, any excess of basis over the reserve for depreciation is deductible in that year as a loss under Sec. 165 or as depreciation under Sec. 167 (Regs. Sec. 1.167(a)11(d)(3)(ix)(b)). The effect is the same as an extraordinary retirement, although the stricter requirements for an extraordinary retirement need not be met.

This provision is particularly useful in industries with relatively long class lives but which contain a significant amount of short-lived assets that cannot be considered subsidiary assets. Although the recovery of cost on these assets may not be spread over the actual useful life of the asset, recovery of the asset's cost is obtained during the physical life of the asset instead of over a longer class life.

Component depreciation for used building: pros and cons

As early as 1959, the Tax Court held in *Shainberg*, 33 TC 241, that the components of an entire building may be segregated for purposes of computing separate depreciation lives with respect to new property. In Rev. Rul. 66-111, however, the Service ruled that component depreciation may not be used by the purchasers of a used building because of the difficulty of allocating purchase price to the components. In the ruling, the taxpayer's basis in the building was apparently allocated in proportion to the relative construction cost of the components as determined by the original owner. *Sec. 167*

Harsh Investment Corp., DC–Ore., (1971), upheld as a matter of law the use of component depreciation for a used building where the total cost of the building was broken down into its components by independent appraisers. In Rev. Rul. 73-410, finally conceding, the Service held that component depreciation may be utilized with respect to used real property provided:

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

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

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

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

Sec. 167 *Conclusion.* The change in position by the Service relative to component depreciation of used property will certainly result in revitalized interest in this method of depreciation. Tax professionals should be alert to the cons as well as the pros of this vehicle—its tax detriments as well as its tax benefits.

Paint is a separate item under the component method of depreciation

A private ruling discusses whether a partnership may elect the component method of depreciation for a new 248-unit residential housing project, and also if painting may be shown as a separate component of the housing project. It holds as follows:

> Computation of depreciation of real properties by use of components is not a specific method of depreciation, but is a practice that may be used only in the year of acquisition providing the proper allocation of basis can be made for each component. (See Rev. Rul. 73-410, IRB 1973-41, 8.) The composite rate used for real property is a weighted average of the various component rates and, therefore, the depreciation allowance in the year of acquisition would be the same regardless of the way depreciation is computed. The allocation of basis and the component rate are factual matters under the jurisdiction of the local district director's office which should be substantiated by the taxpayer upon examination of the tax return involved.
>
> Ordinarily, painting is not one of the component accounts set out by taxpayers to determine depreciation allowances as the original painting is capitalized as part of the original cost of the shell, and subsequent repainting costs are normally expensed in the year incurred.
>
> As an alternative to the above, the partnership's proposed method of separate component depreciation is permissible if the partnership can establish with reasonable accuracy that the cost shown in the separate component account is the actual cost of the original painting, and that it is the partnership's normal practice to retire this component at the end of the life established. Subsequent repaintings would be capitalized and depreciated over the appropriate useful life.

Depreciation: "original use" of building temporarily leased by builder-seller

The IRS National Office Engineering and Valuation Branch has clarified the application of Rev. Rul. 66-372 for a building erected by a dealer. The investor had entered into an executory contract to purchase the building, while it was under construction, for lease to a third party, but did not close the purchase until after the tenant had occupied the building. No rental income was received, nor were any depreciation deductions claimed, by the builder-dealer. *Sec. 167*

The IRS concluded that generally in these circumstances original use of the property within the meaning of Regs. Sec. 1.167(c)-1(a)(2) does not begin with the builder-seller. This conclusion is consistent with Rev. Ruls. 75-538 and 69-272, dealing with temporary dealer use of an automobile or airplane as a demonstrator.

Interplay of contributions and NOL carryovers

Sec. 170

Where a corporation has a net operating loss (NOL) carryover and a charitable contribution carryover to the same taxable year, the question arises as to which carryover is absorbed first.

Consider the following situation:

	Carryover	
From	Charitable contributions	NOL
1970	$12,000	—
1971	13,000	—
1972	10,000	$100,000
1973	9,000	50,000
1974	15,000	250,000
	$59,000	$400,000

For 1975 the taxpayer made no charitable contributions and had taxable income of $300,000.

Sec. 170(d)(2)(A) allows contribution carryovers to be deducted in each of the five succeeding taxable years to the extent the maximum deductible amount (5% of the succeeding year's taxable income) exceeds the succeeding year's current contributions plus the aggregate of the excess contributions made in years prior to the year in which the carryover arose.

Sec. 172(b)(2) provides that the entire amount of the NOL for any loss year is to be carried to the earliest of the taxable years to which such loss may be carried. Further, the portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which the loss may be carried.

Although Sec. 170(d)(2)(B) provides for adjustments to a contribution carryover where it would increase a NOL carryover, no guidance is given as to priority of utilization. Compare Regs. Sec. 1.170A-11(c)(2), which does not deal precisely with the facts given above.

In the case of one taxpayer, the Service has issued technical advice to the effect that in the example above, 1975 taxable income would be decreased by a $15,000 contribution carryover ($300,000 × .05) for purposes of computing the amount of NOL carryover to 1976 ($400,000 − $285,000 = $115,000 NOL carryover to 1976). Further the charitable contribution carryover to 1976 would be correspondingly decreased by $15,000 ($59,000 − $15,000 = $44,000 contribution carryover to 1976). The effect of the above is to permit the taxpayer to utilize the expiring charitable contribution carryover from 1970 in 1975.

Charitable contribution of mortgaged, appreciated realty

Facts. *T* owns a personal residence with a fair market value of $1,900,000, which he has owned for over six months and on which there is a mortgage indebtedness of $230,000. *T*'s tax basis in the property is $1,000,000. He has never used the property for the production of income and has never taken any depreciation for federal income tax purposes. His annual adjusted gross income for 1975 and later years will be $800,000. He will have no other charitable contributions.

X is a nonprofit educational organization which qualifies for exemption under Sec. 501(c)(3).

T proposes to donate the real estate to *X*, either donating his entire interest in the property subject to the existing mortgage, or donating an undivided 50% interest in the property at this time, with the expectation, but no commitment, that he will donate the balance of his interest in 1981.

Analysis. The impact (net of capital gain) of the contribution of a 100% interest on taxable income for 1975 is computed as follows: Sec. 170

Without special election—$201,885	
Fair market value of property	$1,900,000
Ratio of mortgage to selling price	12.11%
12.11% of $1,000,000 tax basis	$ 121,100
Capital gain in "bargain sale" element of gift ($230,000 mortgage — $121,100 allocated basis)	108,900
Net capital gain after 50% deduction	54,450
Net value of gift	1,670,000
30% of adjusted gross income	256,335
Net taxable income reduction ($256,335 — $54,450)	$ 201,885
With special election—$372,775	
Net value of gift	$1,670,000
Tax basis, net of portion allocated to "bargain sale"	878,900
Unrecognized capital gain element in gift	791,100
50% of unrecognized gain	395,550
Adjusted contribution	1,274,450
50% of adjusted gross income	427,225
Net taxable income reduction ($427,225 — $54,450)	372,775

The unused charitable contribution in both instances will be a carryover to the succeeding five years, or until absorbed sooner, subject to the respective 30% and 50% limitations. Thus, without the special election in 1975, the 1976 charitable contribution carryover would be $240,000, while with the special election it would be $400,000. The total charitable contribution carryover absorption would then be:

	Without election	With election
1976	$ 240,000	$400,000
1977	240,000	400,000
1978	240,000	47,225
1979	240,000	—
1980	240,000	—
Expiring unused	213,665	—
Total	$1,413,665	$847,225

Sec. 170 The impact of the contribution of an undivided 50% interest in the property on taxable income for 1975 is computed as follows assuming, which may not be the case, that an undivided 50% interest has a fair market value of 50% of a 100% interest:

Without special election—$220,942	
Net capital gain after 50% deduction	$ 27,225
Net value of gift	835,000
30% of adjusted gross income	248,167
Net taxable income reduction ($248,167 — $27,225)	$220,942

With special election—$386,387	
Adjusted contribution	$637,225
50% of adjusted gross income	413,612
Net taxable income reduction ($413,612 — $27,225)	386,387

Without the 1975 election, $240,000 would be deducted in 1976, $240,000 in 1977, and $106,833 in 1978. With the election, $223,613 would be deducted in 1976.

Discussion. Sec. 170 allows a charitable contribution deduction for the fair market value of real property which is a capital asset. However, to the extent of any debt against the property, the donation is treated as a bargain sale for the amount of the debt and a capital gain must be reported. The capital gain has the effect of reducing the benefit of the charitable contribution deduction. In addition, the Code puts a 30% ceiling on the contribution deduction of property with a value exceeding its tax basis, as compared to the normal ceiling of 50% of adjusted gross income. However, by electing to reduce the charitable contribution deduction by half of the spread between fair market value and tax basis, the 30% ceiling limitation can be avoided. Finally, the Code allows a carryover of either the 30% or 50% excess to the succeeding five years.

The tax results in a situation such as this are related to the income level of the donor and to such other specific facts of the transaction as the tax basis and the amount of the mortgage. A donor with too low a level of income, all other factors remaining the same, would find that the capital gain created by the mortgage might wipe out his tax benefit entirely for

1975. Thus, if the taxpayer donating 100% of his interest in the property had 1975 adjusted gross income of about $127,000, he would find that the increase in his net taxable income resulting from the mortgage would offset the charitable contribution to which he would otherwise be entitled. Of course, a taxpayer with such a level of income would also find himself unable, in any event, to utilize the contribution as a tax deduction during the five-year carryover period. The appropriate approach might be for a taxpayer at such an income level to donate, say, an undivided 2½% interest in the property in 1975. Such a donation would produce a reduction in taxable income of $37,148 for 1975 computed as follows, assuming, which is likely not to be the case, that an undivided 2½% interest has a fair market value of 2½% of a 100% interest: Sec. 170

Net capital gain after 50% reduction	$ 1,360
Net value of gift	41,750
30% of adjusted gross income	38,508
Net taxable income reduction ($38,508 — $1,360)	37,148

Similarly, any variance in the amount of debt, the tax basis of the property, or the fair market value of the property would affect all the computations indicated above.

Charitable contributions: maximizing deductions by gifts to public charity for unrelated use

The 1969 Tax Reform Act limited the maximum allowable deduction for contributions of cash and certain other property to public charities to 50% of adjusted gross income for individual taxpayers. Within this limitation, contributions of appreciated capital gain property to which Sec. 170(e)(1)(B) does not apply are further limited to 30% of adjusted gross income under Sec. 170(b)(1)(D)(i). However, at the taxpayer's election under Sec. 170(b)(1)(D)(iii), he can have the 50% limitation apply to contributions of appreciated capital gain property provided he agrees to reduce his current and carryover con-

Sec. 170 tributions of appreciated property by half of the appreciation. To illustrate, assume the following facts:

	1973	1974	
Adjusted gross income (AGI)	$100,000	$100,000	
Contributions			
Cash	$ 20,000		
Tangible personal property	Property 1	Property 2	Property 3
Fair market value (FMV)	$40,000	$40,000	$22,000
Basis	$20,000	$20,000	$18,000

Also assume for the moment that all three property contributions were contributed to public charities and are used by them in accomplishing their exempt function. The sale of all three properties would have resulted in long-term capital gain if sold by the taxpayer. Sec. 170(e)(1)(B) thus does not apply.

In 1973 and 1974, the taxpayer's charitable contribution deductions are $50,000 and $30,000, respectively. The deductions and carryovers to subsequent years are computed as follows:

	1973	1974
Limitation (50% of AGI)	$50,000	$50,000
Cash	$20,000	—
Appreciated capital gain property (limited to 30% of AGI)	30,000	30,000
Amount deductible	$50,000	$30,000

Carryovers	Property 1	Total of Property 2 & 3
FMV of appreciated property	$40,000	$62,000
Less amount deducted	30,000	30,000
Carryovers available	$10,000	$32,000
Carryover to 1974 from 1973		10,000
Total carryover to 1975		$42,000

The taxpayer can increase the amount currently deductible in 1974 to $50,000 by making a 50% election; however, his carryover to 1975 would be reduced to zero (*figures in thousands*):

	1973	1974		
	Prty. 1	Prty. 2	Prty. 3	Total
FMV	$40	$40	$22	$62
Basis	20	20	18	38
Appreciation	$20	$20	$ 4	$24
½ of appreciation	$10	$10	$ 2	$12
Basis	20	20	18	38
Total	$30	$30	$20	$50
Less amount deducted on 1973 return	30	—	—	—
Amount deductible on 1974 return subject to 50% limitation	—	$30	$20	$50

Although the taxpayer has increased his deduction from $30,000 to $50,000 in his 1974 return, he has "lost" $22,000 ($10,000 in 1973 and $12,000 in 1974) in appreciation as a carryover by making the 50% election. Note that the 50% election must be made as to *all* 30% property contributed in a year. See Sec. 170(b)(1)(D)(iii).

To ameliorate the rather harsh effect of the 50% election, during 1974 the taxpayer could have arranged to donate the appreciated tangible personal property with a fair market value of $22,000 (Property 3) to an exempt organization which puts the property to an unrelated use, and not make the 50% election as to Property 2 or Property 1, see Regs. Sec. 1.170A-4(b)(3) for an example. Under Sec. 170(e)(1)(B), the taxpayer is required to reduce contributions of tangible personal property by one-half of the appreciation if the organization puts this property to an unrelated use. The 50% limitation applies to the reduced contribution. The taxpayer's deduction for 1974 would again be $50,000 *but he would retain carryover of $20,000!*

FMV of contribution put to unrelated use (Property 3)	$22,000
Basis of Property 3	18,000

Sec. 170

Appreciation	$ 4,000
½ of appreciation	2,000
Basis	18,000
Amount deductible subject to the 50% limitation	$20,000
Overall limitation	$50,000
Contribution for unrelated use (50%)	$20,000
Contribution of capital gain property (30%) (Property 2)	30,000
Amount deductible	$50,000

Carryover	
FMV of property contributed in 1974 (Property 2)	$40,000
Less amount deducted in 1974	30,000
	$10,000
Carryover from 1973	10,000
Carryover to 1975	$20,000

The taxpayer has "lost" only $2,000 in appreciation and has preserved a large carryover to 1975 by donating appreciated tangible personal property to a public charity which does not use the property in accomplishing its exempt function.

This is an ideal planning point for individuals who desire to preserve their cash flow, but still desire to support various public charities with contributions of appreciated tangible personal property.

Ready reference chart for charitable contributions

Because of the 1969 Tax Reform Act, the tax treatment of charitable contributions of appreciated property is a complicated matter. In fact, with respect to gifts of appreciated property, merely remembering how much will be deemed contributed and what is the maximum percentage contribution base that is deductible is apt to tax a practitioner's powers of recall. The ready reference chart presented opposite is intended to help practitioners avoid researching the problem every time it arises.

Character of property and type of charitable organization	Amount deemed contributed	Percentage limitation[1]
1. Ordinary income and short-term capital gain properties		
1.1 Operating and "pass-through" private foundations	Tax basis only	50%
1.2 Private foundations other than 1.1 type	Tax basis only	20%[2]
1.3 Public charities (including churches and schools)	Tax basis only	50%
2. Long-term capital gain properties except those described in (3)	At individual taxpayer's election:[4]	
	Tax basis + 50% of appreciation *or*	50%
2.1 Operating and "pass-through" private foundations	Full fair market value	30%
2.2 Private foundations other than 2.1 type	Tax basis + 50%[3] of appreciation	20%[2]
2.3 Public charities (including churches and schools)	Same as 2.1	Same as 2.1
3. Long-term capital gain paintings, works of art and similar tangible personal property the use of which is unrelated to donee's exemption function		
3.1 Operating and "pass-through" private foundations	Tax basis + 50%[3] of appreciation	50%
3.2 Private foundations other than 3.1 type	Tax basis + 50%[3] of appreciation	20%[2]
3.3 Public charities (including churches and schools)	Tax basis + 50%[3] of appreciation	50%

NOTES:

1. The maximum amount deductible by a corporation continues to be 5% of taxable income, with certain adjustments. Excess contributions of individuals (except where made to private foundations other than operating or pass-through) and of corporations (without exception) may be carried over for five years.

2. The maximum is 20%; it could be less—see Sec. 170(b)(1)(B)(ii).

3. If the donor is a corporation, 37½% of appreciation is used instead of 50% in computing the amount deemed contributed (second column).

4. If donor is a corporation, amount deemed contributed is full market value.

Sec. 171 Amortizable bond premium in recapitalizations

During 1974, there was a rash of corporate recapitalizations because of the opportunity for corporations to retire outstanding bonds at substantial discounts as a result of the current high interest rates. For example, in a typical exchange a new long-term $6,000, 9% bond yielding $540 interest per annum would be exchanged for an old long-term $10,000, 5% outstanding bond yielding $500 per annum. The yield on the new bonds was generally designed to exceed the interest on the old bonds to more than make up for the reduction in face amount of new bonds received in the exchange.

No gain or loss will be recognized to the bondholders on such an exchange in a tax-free recapitalization under Sec. 368(a)(1)(E), since the face amount of bonds received doesn't exceed the face amount of bonds exchanged. (Secs. 354(a)(2) and 356(d)(2).) However, it appears that the exchange will result in amortizable bond premium to the bondholders under Sec. 171. Compare Rev. Rul. 75-39, which held that original issue discount realized in a tax-free "E" reorganization was not recognizable.

Thus, in the above example, if the bondholder paid $10,000 for the old bond, he should now have amortizable bond premium of $4,000 since the amount payable on maturity will be only $6,000. If the taxpayer had paid a premium for the old bonds which he had been amortizing, he should be able to tack on the unamortized premium in computing the new amount to be amortized. If he had not been amortizing the premium, it appears that he cannot tack on the amount of premium which could have been amortized prior to the exchange. (Regs. Sec. 1.171-2(a).)

An election can be made to amortize the bond premium, generally over the life of the bonds. Since the premium arises as a result of the exchange, the period over which it is amortizable would appear to be from the effective date of the exchange to the maturity date (ignoring earlier call dates).

By electing to amortize, the taxpayer will not only start to get immediate deductions but will convert into an ordinary income deduction what would otherwise be a capital loss (if the bonds are held to redemption) or a reduction in capital gain or increase in capital loss (if sold prior to maturity).

Is the low income allowance a nonbusiness deduction in computing NOLs?

An individual has a net operating loss (NOL), including nonbusiness income of $2,000, and itemized deductions which are less than the low income allowance. Can the $1,300 ($1,900 for years ending after 1974) low income allowance of Sec. 141(c) be utilized as a nonbusiness deduction to partially offset the $2,000 of nonbusiness income under Sec. 172(d)(4)?

The National Office of the IRS had considered the question at a time when there was a "minimum standard deduction" of $200 plus $100 per exemption. At that time the IRS concluded, for internal purposes only, that the minimum standard deduction could not be used as a nonbusiness deduction for NOL purposes. The IRS felt that the NOL was intended to give relief from an "economic loss," and that an arbitrary amount, such as the minimum standard deduction, does not contribute to an economic loss.

Taxpayers should be advised, however, that the statutory wording seems to allow the use of the low income allowance in computing a NOL. Sec. 172(c) states that a NOL is "the excess of the deductions allowed by this chapter . . . computed with the modifications specified in subsection (d)." Sec. 141 allows, as a standard deduction, the larger of the percentage standard deduction (Sec. 141(b)) or the low income allowance (Sec. 141(c)). None of the modifications listed in Sec. 172(d) relates to the standard deduction.

REITs: NOL carryback and carryover to non-REIT years . . .

Due to the recent economic problems of REITs, many trusts are planning to disqualify. One of the tax considerations in such a decision is whether losses incurred in REIT years can be carried back and forward to non-REIT years. It must be remembered that a "net operating loss" (NOL) is defined in Sec. 172(c) as the excess of deductions over gross income. In recent years, the increase in non-earning assets and the occurrence of real estate foreclosures have created an excess

Sec. 172 of deductions over gross income for more than a few REITs. Thus, a REIT can incur a NOL in a qualifying year within the meaning of the statute.

In determining the amount of the loss that can be carried to a given year, the NOL is reduced only by the taxable income in an earlier year *to which the loss could have been carried.* A similar provision applies to net capital losses. Accordingly, even though trusts are precluded from taking a NOL deduction in REIT years under Sec. 857(b)(2)(E) and carrying back a net capital loss to a REIT year pursuant to Sec. 1212(a)(4)(C), these limitations should not apply in non-REIT years.

The National Office of the IRS has issued several private rulings in this area. In accordance with the above reasoning, the rulings have held that the NOLs and net capital losses incurred in REIT years can be carried back and forward to non-REIT years. Further, the NOLs and capital losses are not reduced by the taxable income and capital gains of a carryback year in which the trust had REIT status.

Editor's note: The Tax Reform Act of 1976 amended Sec. 172 and Sec. 857 to allow carryovers (but not carrybacks) of REIT losses to subsequent REIT years. Thus, voluntary disqualification solely to utilize the losses is unnecessary. Losses in years ending after 1/1/76 may be carried over for eight years. For earlier years the carryover period is five years, unless taxpayer was a REIT for the loss year and all intervening years in the period up through which the loss can be carried, i.e., the sixth, seventh, or eighth succeeding year.

Does an NOL survive a Chapter XI proceeding?

The current economic decline has left behind displaced executives and corporate bankruptcies. In the wake of these corporate downfalls, an interesting tax question becomes of greater concern. What happens to the net operating loss of a corporation in a Chapter XI proceeding?

X corporation, with an NOL of $3 million, had its debts reduced by $900,000 in the course of a Chapter XI proceeding. What effect does this $900,000 "gain" have on the $3 million loss of the corporation?

None at all. Ordinarily, under Sec. 61(a)(12), cancellation of debt results in taxable income. An exception to this general rule is found in Section 795 of the Bankruptcy Act, which provides that no income or profit shall be recognized on account of the cancellation or modification of indebtedness in a Chapter XI proceeding. (Regs. Sec. 1.61-12 and Rev. Rul. 58-600.) Since no income is recognized on account of the reduction in debt, the NOL is not reduced—it survives the Chapter XI proceeding intact.

It is important to keep in mind, however, that the basis of *X*'s assets must be reduced, but not below market value, by an amount equal to the cancellation-of-indebtedness income not recognized. The manner in which property should be reduced is provided in Regs. Sec. 1.1016-7.

Although the NOL survives the Chapter XI proceeding, if *X* is acquired in a taxable or tax-free reorganization, extreme care must be taken to guard against a denial or decrease of the NOL carryover. If the NOL is to benefit the acquiring company, the hurdles raised by the subjective and objective tests found in Secs. 269, 381 and 382 must be overcome.

Editor's note: The effect of the forgiveness on the Company's E & P should not be overlooked. Although Lucile H. Meyer, *CA-8, 383 F2d 883 (1967), held that such forgiveness under a Chapter XI arrangement would not result in an increase in E & P, IRS announced in Rev. Rul. 75-515 that* Meyer *would not be followed, and that cancellation of debt in excess of basis reductions would increase E & P.*

Subchapter S: offsetting nonbusiness expenses with dividends

A's subchap. S corporation (taxed at the shareholder level) has provided him with $50,000 to $75,000 a year for a number of years. He knew that times were tough this year, but he was shocked when the fiscal year ended June 30 showed a loss of $60,000. On top of this business disaster, one of his dependent parents (not covered by insurance) suffered a stroke and is now confined to a nursing home. This will cost *A* at least $20,000 during 1975. His only consolation, he thinks, is that he will be able to carry this total loss of $80,000 back three years and get a tax refund. Then *A* gets the final bad news—the medical expense is *not* part of the loss carryback. "Nonbusiness" expenses are deductible only against "nonbusiness" income—and *A* didn't have any!

So, naturally *A* calls his CPA. "No problem," says the CPA. "You say that you expect business to improve. Along about November we will simply pay you a dividend of $20,000. Even though it is from your subchap. S corporation, the IRS holds that subchap. S dividends are *not* business income. [See Rev. Rul. 66-327.] This will give you $20,000 more income this year, but because of the operating loss you won't have any tax. The nonbusiness dividend will absorb all your medical expenses; you will be able to carry back the full $60,000 business loss and get its full tax benefit. [See Sec. 1374(d)(1).] And next year you will pay tax on $20,000 *less income* because you drew the dividend in 1975 instead of 1976."

NOLs: losses from oil and gas partnerships

Can the losses flowing through to a partner from an oil and gas partnership be considered as items qualifying for the NOL deduction? The current IRS position in answer to this question appears to be still the same as that outlined in Rev. Ruls. 61-55 and 69-355. The essence of these rulings is that the ownership, exploration, development, and operation of oil and gas properties is a trade or business within the meaning of the applicable Code sections. However, the mere ownership of a royalty interest in oil properties is not a trade or business. Of course, if the activity qualifies as a trade or business, it is allowable for NOL purposes, and this also holds true for a partner in a partnership regardless of whether the partner is a general or a limited partner.

Rev. Rul. 61-55 states that the ownership and operation of oil and gas properties is a trade or business. Rev. Rul. 69-355 makes the distinction that the ownership of a mere royalty right in an oil and gas lease is not considered a trade or business. In addition, the case of *C. A. Prater*, 30 TC 1262, rev'd on other issues, (CA-5, 1960), 273 F2d 124 concludes that a working interest in oil and gas properties does qualify as a trade or business and the loss therefrom becomes a deductible item in computing a NOL carryover.

Reporting income of investment partnerships

Sec. 212

The Service, in Rev. Rul. 75-523, maintains that investment expenses of a partnership, the only activity of which is investments, should flow through to the partners as deductions under Sec. 212. As such, they are not deductible in arriving at adjusted gross income; rather, they are deductions which must be claimed on Schedule A of Form 1040 in the case of an individual partner. Accordingly, such expenses should be shown on line 14 of Schedule K (and of Schedule K-1 with respect to the individual partners); they should not be deducted on lines 13 through 24 of page 1 of Form 1065.

If it happens that a corporation is a member of the partnership, its share of the deductions are business expenses under Sec. 162, since Sec. 212 is not applicable to corporations. Accordingly, the deductions may be of one type to one partner and of another type to another.

Perhaps this item should end at this point. But consider further the investment partnership which acquires investments in state or municipal obligations, the interest on which is wholly exempt from tax. Sec. 265(1) disallows expenses, otherwise allowable under Sec. 212, which are allocable to tax-exempt interest. There is no such disallowance with respect to Sec. 162 expenses of a corporation. Accordingly, this creates an enigmatic situation in which expenses allocable to tax-exempt interest are nondeductible by individual partners but are deductible by corporate partners! (Of course, by reason of Sec. 265(2), interest on indebtedness incurred to purchase or carry such obligations is not allowable to either individual or corporate partners.)

Election to match moving expense with reimbursement

Sec. 217

It is common for an employee to incur moving expenses prior to the date he submits an accounting to his employer for reimbursement. Regs. Sec. 1.82-1(a)(2) provides that an employee who receives an advance to pay his moving expenses will be deemed to have received a reimbursement at the time he accounts to his employer. An employee who completes a move late in the year and accounts to his employer the follow-

Sec. 217 ing year may wind up with all of his expenses deductible in the year prior to the "reimbursement."

To avoid the problem of distortions of income which could result from timing of reimbursements, Regs. Sec. 1.217-2(a)(2) provides that an employee may elect to deduct the expense in the same year as the reimbursement. The election may be made by claiming the deduction on the return, on an amended return, or on a claim for refund.

A special problem arises with a self-employed individual who is a member of a partnership. Any reimbursement he receives would be an allocation of the partnership's income taxable to him in his taxable year which includes the end of the partnership's year. In the absence of other guidance in the regulations, it must be assumed that the increased allocation of partnership income is a "reimbursement" and that the partner could elect to deduct his expenses in the year he reports his partnership income.

Sec. 219 IRAs: is retired employee "active participant" in former employer's plan?

When an employee retires from a corporation which provides both a pension plan and a profit-sharing plan for its employees, the retiring employee will receive monthly retirement benefits from the pension plan but may elect to take a lump sum distribution from the profit-sharing plan. Assume an employee retires in 1976 and elects to receive a lump sum distribution from his profit-sharing plan and is scheduled to receive his pension payments beginning in 1980. The pension plan is actuarially not fully funded and therefore the employer continues to make additional contributions on behalf of the retired employee. Under these circumstances will the retired employee be permitted to establish an individual retirement account (IRA)?

ERISA permits an individual to obtain a tax deduction for amounts paid for his own retirement benefit. The Sec. 219 deduction for retirement savings is not allowed if for any part of the year the individual was "an active participant in" a qualified retirement plan. See Sec. 219(b)(2). Proposed Regs. Sec. 1.219-1(c)(ii) provide that an "active participant" is one for whom, at any time during the taxable year, benefits are accrued under the plan on his behalf, or for whom the employer is obligated (or would have been obligated if any contributions were made) to contribute to or under the plan on his behalf. This is true regardless of whether or not his benefits are nonforfeitable. *Sec. 219*

The National Office of IRS has held that there is a distinction between active participants and retired participants. It has stated informally that while both are participants in the plan, the fact that one has retired from service will remove him from the active participant class. Thus, the above individual can apparently qualify for an IRA.

Consolidated returns: dividends-received deduction pitfall for S&L-PHC groups

Sec. 243

In the case of a thrift institution to which Sec. 593 applies, Sec. 596 provides a limitation on the total amount of the dividends-received deductions under Secs. 243, 244 and 245. The total deduction otherwise allowable must be reduced by the applicable percentage used in computing its addition to the reserve for losses on loans under Sec. 593(b)(2), the percentage of taxable income method. In implementing this rule for consolidated return purposes, Regs. Sec. 1.1502-26 does so in a manner which is highly detrimental to an affiliated group that includes one or more subsidiaries which receive qualifying dividends but which are not themselves subject to Sec. 593.

In a consolidated return, the dividends-received deduction under Secs. 243(a)(1), 244(a) and 245 is computed on a consolidated basis subject to the general rules of Sec. 246(b). However, if Sec. 593 applies to one or more members and any member computes its reserve addition under Sec. 593(b)(2), the *consolidated* deduction must be reduced for qualifying dividends received by *all* members of the group, other than the common parent corporation (provided it does not use Sec. 593(b)(2)), by the highest applicable percentage under Sec. 593(b)(2)(A) and (B) of any member of the group. This rule applies even if, for example, the only "Sec. 593 subsidiary" receives no qualifying dividends in the year.

Sec. 243

The detriment of this rule is illustrated below for a calendar year group, which includes an S&L subsidiary which receives no qualifying dividends and which has 47% as its applicable percentage under Sec. 593(b)(2).

	Qualifying dividends	*Other income (net)*	*Total*
Parent: holding company	$100,000	$ 500,000	$ 600,000
Subsidiary: subject to Sec. 593	0	400,000	400,000
Other subsidiary	400,000	600,000	1,000,000
Total	$500,000	$1,500,000	$2,000,000
85% limitation under Sec. 243(a)(1)			425,000
Reduction under Regs. Sec. 1.1502-26 (47% of $400,000)			188,000
Consolidated Sec. 243(a)(1) deduction			$237,000

Thus, the group has suffered a $188,000 loss of its consolidated deduction under Sec. 243(a)(1), as compared with the aggregate of the comparable separate return deductions. In light of the clear case of overkill by Regs. Sec. 1.1502-26, it is hoped that the Treasury department will modify this provision to produce a result which will be more in keeping with the intended purpose of Sec. 596—i.e., to allocate the dividends-received deduction allowable to an S&L between the portion of income which is subject to tax and the portion which is allowed as a "bad debt reserve" deduction. In the above case, there is obviously no dividends-received deduction allowable to the S&L subsidiary, and therefore there is nothing to be allocated to the bad debt deduction.

Dividends within a controlled vs. affiliated group of corporations

An "affiliated group" as defined in Sec. 1504(a) also constitutes a "controlled" group as defined in Sec. 1563(a). However, it is possible that a controlled group, e.g., a brother-sister controlled group, may not qualify as an affiliated group. The Tax Reform Act of 1969 phased out the multiple surtax election for both types of groups. Many affiliated groups will now be filing consolidated returns or at least electing the 100% dividends received deduction provided in Sec. 243 if separate returns continue to be filed. *Sec. 243*

A controlled group which does not qualify as an affiliated group cannot file a consolidated return (Sec. 1501) or elect the 100% dividends received deduction (Sec. 243(b)(5)). Such controlled groups must continue to file separate returns and pay a tax on intercompany dividends. Even though actual dividend distributions are not made, there is the possibility of having constructive dividends imposed as a result of an IRS examination. Since these controlled groups now seem to have a distinct disadvantage when compared with affiliated groups, consideration should be given to a corporate reorganization that will result in an affiliated group.

Editor's note: The 100% deduction is never available for dividends from earnings and profits of "preaffiliation" years (Sec. 243(b)(1)(B)(i)), or dividends from earnings and profits of affiliation years for which multiple surtax elections were effective (Sec. 243(b)(1)(B)(ii)).

Limitation trap on dividends-received deduction

Sec. 246

In 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)).

This situation can be illustrated as follows:

Dividends received	$100,000
Other income	300,000
	$400,000
Deductions (other than dividends-received deductions)	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, there would have been 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, two dollars less income could convert the taxable income of $12,751 into a net operating loss of $1!

Sec. 248 Deductions for reorganization expenses

Reorganization expenses are not always nondeductible. Regs. Sec. 1.248-1(b)(4) states:

> [e]xpenditures connected with the reorganization of a corporation, *unless directly incident to the creation of a corporation*, are not organizational expenditures within the meaning of section 248 and this section. (Emphasis supplied.)

In other words, if the reorganization results in the creation of a new corporation, the expenditures should be amortizable under Sec. 248. The expenses are deductible ratably over a period selected by the corporation, which period must be at least 60 months.

There is case law support for the proposition that the expenses directly incident to a consolidation are amortizable under Sec. 248. In *Deering Milliken, Inc.*, 59 TC 469 (1972), five corporations were consolidated into one new corporation. It was accepted, and not even contested, that the expenses incident to the consolidation were amortizable. The issue in the case was whether or not certain costs pertaining to appraisal proceedings were directly incident to the consolidation. The Court held that the contested items did not meet the "but for" test. That is, the dissenting stockholders did not have the votes to prevent the consolidation and the appraisal proceedings did not directly result in the consolidation which would have taken place in any event. Sec. 248

In most consolidations, the legal fees, investment banking costs, some of the accounting, and some of the other costs would appear to meet the "but for" test—that is, the consolidation could not take place *but for* the fact that these services were rendered.

In setting up a transaction so that a new legal entity is involved rather than a merger of one or more existing corporations into an existing corporation, there is not a mere placing of form over substance, but, rather, making the form comply with the substance of the transaction. In actual fact, two or more old corporations are combining into one new corporation. The stockholders of the old corporation will receive stock of a new corporation.

It should be noted that normally a consolidation is not an available alternative. This is so because generally a larger corporation is acquiring a smaller corporation. The larger one will, therefore, survive and, in fact, the stockholders of the smaller corporation will receive stock of the larger one. But where a true consolidation is feasible with none of the old corporations surviving and completely new stock being issued, this alternative can make a substantial difference in after-tax cost of reorganization.

As set forth above, *Deering Milliken* involved the amortization of expenses incurred in the course of an "A" reorganization. Note that Rev. Rul. 70-241 allowed amortization of such expenses in an "F" reorganization and *Reef Corp.*, TC Memo 1965-72, allowed it in the case of a "D" reorganization.

Organizational expenses vs. taxes

When a new corporation is formed certain organizational expenses can be deducted over sixty months under the provisions of Sec. 248. Expenses eligible for the sixty month write-off include fees paid to the state of incorporation. See Regs. Sec. 1.248-1(b)(2). However, payments made to the state of incorporation should be carefully examined to determine whether they are actually "fees" or "taxes." If the pay-

Sec. 248 ments are taxes they are currently deductible under Sec. 164(a) rather than amortizable under Sec. 248.

Upon incorporation many states impose a "tax" measured by the number of shares or par value of shares of stock to be issued. The Service has held in Rev. Ruls. 63-259 and 72-47 that such taxes imposed by the States of Iowa and Michigan are currently deductible under Sec. 164. Further, the Service has held in a technical advice memorandum that a similar tax imposed by the State of New York (NY Tax Law Sec. 180) qualifies as currently deductible under Sec. 164.

Sec. 263 De minimus rule for minor equipment purchases

Some taxpayers have arbitrarily set their own rules for expensing purchases of minor equipment. Write-off 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 through any regulation, ruling or internal memorandum.

In the 1970 Court of Claims decision *The Cincinnati, New Orleans and Texas Pacific Railway Company*, Ct. Cls., 424 F2d 563 (1970), 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 as 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 Secs. 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.

This is 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 minimus rule for minor equipment has a lot to recommend it.

Bank trust department fees: alternative allocation techniques

Trust department custodial and management fees are generally not directly allocable to particular classes of exempt or nonexempt income because banks generally compute their fees by applying a graduated rate table to the carrying value of the customer's total portfolio. Banks also generally do not attempt to allocate their fees to each security transaction or custodial function. Thus, the fees, although computed on the basis of the value of the securities held in custody, are for a wide range of services—from collecting and disbursing funds to rendering investment advice for customers. Because of the inherent nature of tax-exempt securities as a long-range investment, banks often do very little other than collect income from such securities. Thus, if most of the bank's time is spent on looking after the taxable securities, the fee is nonetheless based on the value of all securities in the portfolio.

In a recent IRS examination, an agent attempted to allocate trust department custodial fees to tax-exempt income based on the ratio of the fair market value of the tax-exempt bonds in the taxpayer's portfolio to the fair market value of the entire portfolio. The agent contended that such allocation was reasonable since the bank's fees were computed in the same manner. This contention is not reasonable, however, and results in disproportionately high fees being allocated to securities which produce less income and require less time to manage.

Regs. Sec. 1.265-1(c) states that if an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in light *of all the facts and circumstances in each case* shall be allocated to each. Based on the wide variety of circumstances which arise, there appear to be four alternatives for allocating trust department custodial fees to exempt and nonexempt income:

- Ratio of the dollar value of transactions involving taxable securities to total transactions;
- The extent of time devoted by the bank to taxable and tax-exempt securities;
- Percentage of the market carrying value of taxable securities to the value of all securities;

Sec. 265 • Ratio of income from taxable securities over total income from all securities included in the portfolio.

Allocation based on the valuation of the portfolio as suggested by the examining agent is supported by *Alt*, TC Memo 1969-292. In that case, however, this method of allocation was determined to be the most appropriate under the circumstances since the taxpayer had not offered an allocation method which was more persuasive and in fact had deducted the entire custodian fee on the return as filed. The Tax Court discounted representations by an officer of the bank's trust department to the effect that a majority of the time had been devoted to taxable securities as opposed to tax-exempt securities.

Another possibility for allocation is discussed in detail in Rev. Rul. 73-565. There, certain office expenses are allocated to taxable (and tax-exempt) income based on a ratio, the numerator of which included income from taxable securities and capital gains and the denominator of which was total income. In this ruling, the taxpayer had capital losses as well as capital gains but properly took into account only capital gains in the numerator and denominator of the ratio.

Still another alternative allocation is based on the number of transactions for the year. However, since more effort may be spent on the sale or exchange of securities as opposed to the simple collection of interest or dividends, it may be more representative to base the allocation on the total dollar value of all transactions occurring during the year. This approach, however, could result in an inordinately high percentage of the fee being deductible in those cases where there is high turnover of short-term taxable money market instruments.

In any event, no one allocation factor can be used for every situation. It is also clear, however, that allocation based on relative fair market values of taxables and tax-exempts is not reasonable where only a small portion of the bank's time is devoted to tax-exempt transactions. It is advised to take nothing for granted and use some imagination to determine the most reasonable allocation method for each set of circumstances.

Sec. 267 Yearend accruals may be constructive income to controlling shareholder

Yearend accruals for salaries and certain other expenses owed by closely held corporations to controlling shareholders must be made with care to achieve the desired results —current deduction for the corporation and deferral of income for the shareholders. It is necessary to comply carefully with the requirement to pay the accrued amount within two and one-half months of the corporation's yearend. (Sec. 267). In addition, the IRS has recently used the "constructive receipt doctrine," which corporate taxpayers successfully invoked in three Sec. 267 cases to obtain a deduction for yearend accruals, as the basis for a broader and potentially more serious attack on the shareholders' deferral of income. *Sec. 267*

One purpose of Sec. 267 is to limit the period for the tax deferral that occurs when a closely held corporation accrues salaries or other expenses owed to its controlling cash basis shareholders in one year but defers actual payment until a later year. Assuming both corporation and shareholder are calendar year taxpayers, the corporation deducts the expense in the year of accrual, while the shareholder does not report the income until the later year in which he actually receives payment. Sec. 267 attempts to limit abuses in this area by permanently denying a deduction for accrued expenses owed to controlling shareholders unless the corporation makes payment within the two and one-half month period following its yearend.

The three cases were *Fetzer Refrigerator Co.*, CA-6, 437 F2d 577 (1971), *W.C. Leonard & Co.*, 324 F Supp 422 (1971) and *White*, 61 TC 763 (1974). The Service sought to disallow corporate deductions for accrued salary and rents owed controlling shareholders because payment was not made during the required period. However, the courts held that the corporations were entitled to the deductions because the payment had been "constructively" received by the shareholder-creditors. The corporations successfully argued that actual payment within the stated time period was not required because the income was constructively received by virtue of the control held by the payees (shareholders) and the lack of any restrictions on the timing of the payment. The shareholders could have collected their money at any time by merely writing themselves a check.

In Rev. Rul. 72-317, the Service stated that it would follow the *Fetzer* and *Leonard* decisions and treat similar accrued expenses as being constructively received by the shareholders at the time of the accrual. The specific fact situation outlined in the ruling differed from that in the two 1971 cases.

In the ruling, the authorized but undrawn 1970 salary of the shareholder-officer was determined to be constructively received in 1970 although not actually credited to his account on the books until January 31, 1971, the corporation's yearend. In the two cases, the shareholders and the corporation had a common yearend. Neither court commented on the importance of the common yearend. They appeared to emphasize the following facts in finding that constructive receipt had been established:

- Shareholders directly or indirectly controlled the corporation.
- At the time of the accrual, the corporation had the ability to pay.
- There were no substantial limitations or restrictions on the timing of the payment.

The *White* case involved a subchapter S corporation with the Service arguing that constructive receipt is not sufficient in the case of a subchapter S corporation. The Tax Court held otherwise and the service will appeal the decision.

Some commentators have suggested that a broad application of the ruling may not be attempted by the Service since it appears to ignore a basic tax concept—that a corporation and its controlling shareholders are separate taxable entities and items booked by one should not be treated as immediately constructively received by the other. However, until the full impact of the ruling is known, taxpayers should take protective action where possible.

In similar fact situations, taxpayers may find it advisable to specify, by corporate minutes or other action, that the accrued expense shall be payable on (not before) a specific date which occurs within two and one-half months after the corporation's yearend and which falls in the later taxable year of the shareholder. The restrictions on payment, however, should be more than mere "window-dressing" in order to be effective.

Editor's note: In Rev. Rul. 75-180, *the Service permitted a bonus based on net sales, computed after yearend by a calendar year corporation and paid to an officer-shareholder within the two and one-half month period, to be accrued by the corporation but taxed to the individual when received.*

Postacquisition losses and Sec. 269

Overreaction to *Hall Paving Co.*, CA-5, 471 F2d 261 (1973) seems to be inhibiting acquisition of operations where postacquisition operating losses are anticipated (e.g., in bringing a new product to market). Two types of postacquisition losses can be incurred:

(1) Losses that are "built in" within the meaning of Regs. Sec. 1.1502-15(a)(2) and

(2) Losses that are neither incurred economically nor recognized for tax purposes until after the acquisition.

The first category of losses clearly falls within the scope of Sec. 269 if the other requirements are met. The trial judge so held. But the trial judge concluded, perhaps more logically than legally, that the second category of losses is not covered by Sec. 269 as a matter of law.

As to the second type, the Fifth Circuit reversed and remanded the case for the District Court to determine if, on the facts, Sec. 269 was applicable to the postacquisition losses. In terms of the cases, the reversal is on solid ground. If the "principal purpose for which such acquisition was made is evasion or avoidance of federal income tax by securing the benefit of a deduction . . . which such . . . corporation would not otherwise enjoy, then such deduction . . . shall not be allowed."

However, with proper documentation of the analysis made at the time of acquisition, the taxpayer should be able to negate any imputation that losses that might be economically sustained after the acquisition were the "principal purpose" for the acquisition. The Fifth Circuit, recognizing this economic truism, commented, "The Government may have difficulty proving such motivation for postacquisition losses, but such difficulty does not lead this Court to establish a per se rule preventing the Government from attempting to do so."

Unfortunately, the real world seldom presents clear-cut problems. If only "real" postacquisition losses would be involved, then a Sec. 334(b)(2) liquidation might sometimes solve the problem—at least in the Fifth Circuit, which has held that Sec. 269 does not prevail over Sec. 334(b)(2). (*Supreme Investment Corp.*, CA-5, 468 F2d 370 (1972).) In any event, *Hall* should not be read as holding much more than this: adequate documentation is needed to justify a deduction for a "real" postacquisition loss.

Sec. 274 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 shareholder 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). But also, consider how such agreements might be viewed by an examining agent asserting unreasonable compensation. (*Saia Electric, Inc.*, TC Memo 1974-290, on appeal by taxpayer to CA-5.)

Editor's note: In Charles Schneider & Co., Inc., *CA-8, 500 F2d 148 (1974), the court held that such agreements might indicate pre-existing knowledge as to the unreasonableness of compensation.*

Corporate distributions and adjustments

Bootstrap acquisitions require careful planning

Sec. 301

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

The *Zenz* case, CA-6, 213 F2d 914 (1954), is an authority for this type of transaction. In *Zenz* this method was used primarily because the purchaser wanted to eliminate the accumulated earnings of the corporation rather than because (the classic reason) the purchaser lacks the funds to make the acquisition. Interestingly, in *Zenz* the IRS contended that the redemption was "essentially equivalent to the distribution of a taxable dividend" to the *seller*. The Sixth Circuit did not agree.

A different approach was taken by the IRS in *Wall*, CA-4, 164 F2d 462 (1947) and *Holsey*, CA-3, 258 F2d 865 (1958). In these cases, the redemption was considered by the IRS to be a constructive dividend to the remaining shareholders since their interest in the corporation was increased by the use of corporate funds. The IRS was upheld in *Wall* because the remaining shareholders were personally liable to make the acquisition but subsequently transferred this liability to the corporation. In *Holsey*, however, the court did not consider the remaining shareholder to have received a constructive dividend since he had only an option to acquire the remaining shares and the option was transferred to the corporation, which then exercised it.

The *Enoch* (57 TC 781) case, which had points in common with all of the above cases, illustrates the careful planning required. *Enoch* involved an initial acquisition as in *Zenz*, rather than the buy-out of other interests as in *Wall* and *Holsey*. The major asset of the corporation acquired in *Enoch* was an apartment complex. The purchase price was $1,500,000, which the seller said could be paid in part with corporate assets, including the proceeds of a refinancing arrangement on the apartments. The taxpayer-purchaser borrowed $255,000 of the purchase price personally, and this debt was assumed by the acquired corporation. This amount, along with corporate funds, was put into an escrow account from which the purchase and redemption were accomplished. The purchaser bought one share of stock for approximately $72,000; the remaining 19 shares were redeemed.

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

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

Editor's note: A constructive dividend resulted where a corporation redeemed stock of taxpayer's former wife where the taxpayer had an unconditional obligation to purchase it under the divorce settlement. (John K. Gordon, *TC Memo 1975-86.)*

More on bootstrapping an acquisition

The Fifth Circuit decision in *Casner*, CA-5, 450 F2d 379 (1971), is another example of the need for increased care in planning a "bootstrap" acquisition of stock of a corporation by individual purchasers.

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

On appeal, the Fifth Circuit held the pro rata distributions to be taxable:

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

The latter holding was based on the view that the purchasing shareholders received the economic benefit from the distributions of the sellers. The Court based its decision upon *Steel Improvement and Forge Co.*, CA-6, 314 F2d 96 (1963) and *Waterman Steamship Corp.*, CA-5, 430 F2d 1185 (1970). *Note*: The Tax Court continues to rule in favor of the taxpayer. (*Walker*, TC Memo 1972-223.)

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

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

In *Casner*, the entire distribution to the selling shareholders was taxed to the purchasing shareholders as a constructive

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

It would seem that purchasing shareholders can avoid having the entire distribution, as in *Casner*, taxed to them as a dividend by purchasing part of the stock of the selling shareholders followed by the corporation's redeeming the balance of their shares, resulting in a complete termination of their interests. This view is supported by the decisions in *Zenz*, CA-6, 213 F2d 914 (1954) and *Enoch*, 57 TC 781.

Editor's note: IRS will not follow Casner *and has ruled in Rev. Rul. 75-493 that the distribution to the selling shareholder will be a dividend.*

Sec. 302 . . . corp.'s ability to fund installment sale redemption must be demonstrated

It is quite common in the case of a redemption of a shareholder's interest for the redemption price to consist in part of notes of the redeeming corporation. This is often dictated by the corporation's need to preserve cash or, in many cases, by the shareholder's desire to report gain on the installment method under Sec. 453. Normally, because of the amounts involved, practitioners are careful to comply with IRS informal guidelines, e.g., notes must be payable within 15 years after the date of redemption, etc. However, practitioners should not overlook the additional IRS requirement that the corporation must be able to demonstrate its ability to pay off the notes.

A recent ruling request illustrates the IRS's concern with the "ability to pay" question. The ruling involved the redemption of stock of the major shareholder of a corporation engaged in the construction business. It was intended that the transaction qualify as a complete termination of interest under Sec. 302(b)(3) through application of the waiver of family attribution rules. Because of the corporation's cash position, and to allow the shareholder to use the installment basis, it was proposed that the shareholder receive cash and a 14-year promissory note of the corporation in payment for the stock. The financial statements submitted to the IRS reflected the fact that recent activity in the construction business had been slow.

The IRS showed a substantial interest in the corporation's prior earnings history, present financial situation, and estimates of expected earnings. In addition to furnishing information concerning projected earnings, the corporation was required to represent to IRS that its activities had changed, that it was heavily involved in work on contracts, and that this work was being done on a profitable basis. Also, the company had to show that it had a substantial backlog of firm contracts and provide estimates of the expected earnings from these contracts. It was only after the close review of, and the company's representations concerning, its earnings capability that the IRS issued a favorable ruling that the 14-year note was indeed debt and not equity and, therefore, the redemption qualified as a complete termination of interest under Sec. 302(b)(3).

The same approach and analysis will be utilized by the IRS when a "balloon payment" at the end of the note period exists.

Editor's note: See Claude Lisle, *TC Memo 1976-140 wherein the Tax Court held a 20-year note to represent valid debt.*

"Bail out" of corporate funds through charitable donations

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

In *Carrington*, CA-5, 476 F2d 704 (1973), the Commissioner, relying on the "step transaction" approach, contended that the gift must be disregarded "because it was merely an intermediate step in the taxpayer's overall plan . . . (to avoid) the imposition of a dividend tax on the distribution." The taxpayer had transferred 51% of the stock of his wholly owned corporation as a gift to a church. Within eight days the corporation redeemed the stock from the church. However, the Court stated that the main criterion was whether the taxpayer "parted with all dominion and control over the donated property." The Court concluded the criterion was satisfied, noting that there was "neither evidence of, nor suggestion that there was a prior obligation on the part of the church to redeem this stock."

In *Grove*, CA-2, 490 F2d 241 (1973), "despite the absence of any prearranged agreement between" a taxpayer and a donee institution, the institution followed a pattern of redeeming shares donated by a taxpayer with his closely held corporation between one and two years after they were donated. The donee was required to first offer the shares to the corporation for purchase before disposing of them. It was found that there "was no informal agreement between [the taxpayer and the institution that the latter] would offer the stock in question to the corporation for redemption or that, if offered, the corporation would redeem it." The Court rules that in the absence of such an obligation, the "step transaction" doctrine could not serve to recast the transactions as a redemption by the corporation of the taxpayer's stock and as a gift of the proceeds by the taxpayer to the institution. This was because "the gift was complete and irrevocable when made."

Other taxpayers have had tentative plans for the future repurchase of donated stock revealed to the donee. Yet, this fact did not by itself constitute "any agreement or commitment and was not so construed" by the parties. It was found that the taxpayers "relinquished complete dominion and control over" the donated shares. (*Dewitt*, Ct. Cls. Commissioner's Report (1973) and *Palmer*, 62 TC 684 (1974).

Thus there is an excellent tax planning opportunity that is available to the stockholder of a closely held corporation who has charitable impulses. These cases emphasize the reluctance of the courts to ignore substantive transactions despite an overall intent to reduce tax liability. However, a careful reading of the cases involving this issue is recommended.

Before advising clients of this tax planning opportunity, the tax adviser should be familiar with the IRS's position and the guidelines that the courts have established as a prerequisite for favorable treatment. Sec. 302

Editor's note: The redemption of stock from a charitable organization to satisfy a pledge will not constitute a dividend to the shareholder where the charity had the power to reverse the redemption. See Robert A. Wekesser, *TC Memo 1976-214.*

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

When a corporation buys its own stock from a shareholder, the transaction is called a "redemption." The shareholder, whom the Code calls a "distributee," may be taxed as he would have been had he sold the stock, or he may be treated as having received a dividend, depending on the applicability of Secs. 302 and 303. While Sec. 303 applies only to a deceased stockholder who owned substantial amounts of the corporation's stock, Sec. 302 can apply to any distributee. Sec. 302(b) describes those redemptions that are treated as a sale of stock. Included therein, as subsection (b) (3), is a redemption which terminates the interest of the shareholder —that is, a redemption of all of the shareholder's stock after which he ceases to have any interest in the corporation.

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

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

In the case of *Crawford,* 59 TC 830, a wife and her husband owned one-third of a corporation's stock, and their sons owned the remaining two-thirds. When the husband died, his will left everything to his wife. The corporation redeemed all of the wife's stock and all of the husband's estate's stock at the same time. Both filed Sec. 302(c)(2) statements. The IRS took the position that the estate is not a "distributee" who can file this statement, and the attribution rules made the transaction a dividend to the estate. The Tax Court held that, at least under these facts, an estate can file the statement. The IRS dismissed its appeal to the Ninth Circuit and announced its nonacquiescence.

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

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

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

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

Editor's note: The Tax Court refused to rule whether a trust could file the Sec. 302(c)(2) statement. (Robert Haft Trust, 62 *TC 145 (1974).*)

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 these 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 designed to ensure that the relationship between the corporation and retiring shareholders is completely severed as a result of the redemption.

Editor's note: IRS will not grant a ruling where the redemption price is contingent upon future corporate earnings. (Rev. Rul. 76-53.)

Practical problems in applying Sec. 303

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

Sec. 303 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 $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. Assuming 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 con-

sider 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 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 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

Sec. 303 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.

Sec. 303 redemption may cover interest on installment payment of estate tax

A reduction of stock under Sec. 303 to pay death taxes offers a rare opportunity for an estate-controlling stockholder to withdraw money from a corporation without the realization of ordinary dividend income (or capital gain). For this reason, the maximum benefit available under this provision should be obtained whenever the requirements of Sec. 303 can be satisfied.

Distributions in redemption of stock pursuant to Sec. 303 will be accorded treatment as payment in exchange for stock not to exceed the sum of (1) death taxes, "including any interest collected as part of such taxes" and (2) funeral and administration expenses allowable as deductions under Sec. 2053.

Where a stock redemption meets the requirements of Sec. 303, it is not uncommon for the estate to also meet the requirements of Sec. 6166, which permits payment of the estate tax over a ten-year period. The question arises whether the interest imposed on the deferred tax payments qualifies as "interest collected as part of [death] taxes" for Sec. 303 purposes. The regulations under Sec. 303 do not answer the question. However, a supervisor in the rulings division of the National Office of the IRS has given an informal opinion that a Sec. 303 redemption covers interest paid pursuant to Sec. 6166.

Sec. 306 "Widely held" defined for Sec. 306 purposes

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

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.

More unexpected results from 1969 "E&P reform"

Sec. 312

Sec. 312(m), added by the 1969 Tax Reform Act, "reformed" the rules for computing earnings and profits (E&P) where accelerated depreciation is used for determining taxable income. For taxable years beginning after June 30, 1972, E&P must, generally, be computed using only a straight-line method of depreciation.

While enacted for the announced purpose of curtailing the ability of certain public utility companies to make distributions to shareholders which would be treated as a return of capital rather than as a dividend, Sec. 312(m)'s impact in other areas, particularly with respect to closely held corporations, has not gone entirely unnoticed. Thus, it has been noticed, this new provision will affect subchapter S corporations attempting to distribute previously taxed income, corporations computing the credit for accumulated earnings tax under Sec. 535(c), and corporations liquidating in one month under Sec. 333.

Sec. 312

Another area which is less obviously affected by Sec. 312(m) is the computation of the investment adjustment under the consolidated return regulations. Regs. Sec. 1.1502-32 provides that a parent company's basis in the stock of a subsidiary is increased annually to reflect undistributed E&P of the subsidiary (or decreased to reflect a deficit in E&P). A comparable adjustment is made to the E&P of the parent company, although this is not mandatory but may be elected for years prior to 1976. (Regs. Sec. 1.1502-33(c)(4).) The purpose of the investment adjustment provision was to eliminate in the consolidated return area the dual tax consequences normally attributable to corporate profits and losses—i.e., the investment adjustment assures that the subsidiary's income or losses already accounted for on the tax return are not later reflected in an investment gain or loss when the subsidiary's stock is disposed of.

For years to which Sec. 312(m) applies, a disparity occurs because the use of accelerated depreciation by the subsidiary will ordinarily cause its E&P to be higher than current taxable income. Under these circumstances, where the subsidiary has experienced a profit, the investment adjustment would permit (require) the parent company to increase the basis of the stock of its subsidiary by an amount greater than the taxable income reported in the consolidated return. Where the subsidiary has had a loss, the parent's reduction in the basis of the stock of its subsidiary (or increase in the excess loss account with respect to the subsidiary) will ordinarily be less than the amount of the taxable loss contributed to the consolidated return.

Unlike the effect of Sec. 312(m) in most areas, this one seemed to give the affected taxpayer a benefit, rather than impose a detriment, which was neither anticipated nor intended by the statute.

Sec. 316 Deficit in current E&P prorated to dates of distributions

X corporation has $200,000 of accumulated E&P (for both book and tax purposes) at January 1, 1975, the start of its taxable year. Operations for the first quarter break even, but it is obvious by March 31 that the balance of 1975 will produce a loss that will probably exceed $200,000. The two stockholders have been advised that they could pay themselves a

Sec. 316

dividend now, and that this would be legal under state law up to the $200,000 of accumulated E&P. They would like to do this—but not at the cost of paying 70% of the $200,000 to the tax collector. They have also been advised that the calculation of E&P available for dividends is unaffected by interim operations but is made at the end of the year. As of the end of the year, the advice went, there will be neither current nor accumulated E&P. Thus, the "dividend" will be a tax-free recovery of part of their stock basis.

But that is not the way it works! As spelled out in Rev. Rul. 74-164, a deficit in E&P of the taxable year is treated differently from E&P for the taxable year. A dividend paid on March 31, at a time when the corporation had neither accumulated nor current E&P, would still be taxable as out of current E&P up to the full amount thereof if operations for the year produced a profit. However, the calculations are different in a year with a deficit in E&P. Regs. Sec. 1.316-2(b) provides that status as of the date of distribution controls tax effect. If the actual current E&P to the date of a distribution can't be determined, then the deficit of the current year will be prorated to the date of the distribution, and the prorated portion will reduce accumulated E&P available for dividends.

Thus, in the situation discussed in the first paragraph, the entire $200,000 would be a taxable dividend. Given the same facts, but absent the ability to calculate the E&P through March 31, one-fourth of the year's deficit in E&P (assume $200,000 for this purpose) would be attributable to the first quarter, thus making the $200,000 distribution to the stockholders a taxable dividend to the extent of $150,000.

Anders rule will not be applied in ordinary liquidation

Sec. 331

A corporation which was in the process of an ordinary (Sec. 331) liquidation owned a valuable supply of samples, the cost of which had been fully deducted in prior years. Since the samples could be used by a charitable organization to further its tax exempt purpose, the corporation desired to make a gift of them. However, the 5% limitation on corporate contributions would have eliminated most of the deduction because the corporation's taxable income for its final year was low due to winding up of corporation affairs.

Sec. 331 An opportunity to obtain greater tax benefit would be available if the samples were distributed in liquidation to the corporation's shareholders, enabling them to make charitable contributions if they desired. The capital gain on liquidation otherwise realized by the shareholders would be increased by the value of the samples. However, those making the contribution to the organization for use in furtherance of its tax exempt purpose would be entitled to a deduction for the full fair market value of the samples (subject to the new 50% limitation). (Secs. 170(b)(1)(D) and (e)(1)(B).)

The decision in *Anders*, CA-10, 414 F2d 1283 (1969), posed a problem for the corporation. *Anders*, upholding Rev. Rul. 61-214, held that if a taxpayer deducts the cost of items such as supplies and tools and subsequently sells them in a transaction otherwise qualifying under Sec. 337, the proceeds are taxable as ordinary income under the tax benefit rule. (Rev. Rul. 74-396 amplifies the IRS position with respect to liquidations and recovery of previously deducted amounts.)

The possible application of the *Anders* rule was discussed with the National Office of the IRS. The informal advice was that the IRS would not apply the *Anders* rule to these circumstances since the corporation would receive no cash or property in exchange for the samples. Accordingly, there would be no recovery of an amount previously deducted with a tax benefit and no ordinary income realized on the distribution.

The surrounding facts must, of course, support a finding that the gift was, in fact, made by the individual shareholders and not by the corporation. (*Cumberland Public Service Co.*, 338 US 451 (1950).)

Editor's note: But see Tennessee-Carolina Transportation, Inc., *65 TC 440, wherein the Court held the tax benefit rule for previously expensed items applicable in a Sec. 334(b)(2) liquidation. This is significant because the liquidating corporation likewise receives no cash or property in the liquidation.*

Sec. 332 Dual character of merger of controlled subsidiary with minority interests

Where a corporation (*P*) desires to liquidate its 80%-or-more subsidiary (*S*), the transaction may take the form of a statutory merger under state law. However, for tax purposes, the nonrecognition provisions of Sec. 332(a) remain controlling, notwithstanding the receipt by *P* of property attributable to minority interests in *S*. (Regs. Sec. 1.332-2(d).)

However, compare Rev. Rul. 69-617, which held that where an 80%-owned *S* is merged into *P* and then all the former assets of *S* are transferred by *P* to its new wholly owned subsidiary, the transaction constituted a statutory merger (within the meaning of (1)(A) and (2) of Sec. 368) for all parties, including the minority shareholders, notwithstanding its literal compliance with Sec. 332. The planned transfer of *S*'s assets to the new subsidiary was considered to be inconsistent with a complete liquidation of *S*.

Sec. 332(a) merely authorizes nonrecognition treatment for the gain or loss realized by *P*, and leaves unresolved the treatment of the former minority shareholders of *S* who exchange their cancelled stock for *P* stock. With respect to the minority stockholders, the last clause of Sec. 332(b) implies (but fails to specify) that their exchange may qualify as nontaxable under Sec. 354. Regs. Sec. 1.332-2(e) describes a situation involving this problem, but also fails to provide a clear solution.

A private ruling was obtained concerning the proposed liquidation of *S*, 90% of whose stock had been owned by *P* for more than two years, pursuant to a statutory merger, with the minority shareholders exchanging their *S* stock for *P* stock. For ruling purposes, the IRS viewed the transaction as having a dual character, with the merger constituting a transfer by *S* of all its property to *P* in complete liquidation under Sec. 332, but an "A" reorganization as to the minority shareholders. Thus, consistent with Sec. 361(a), the ruling held no gain or loss will be recognized by *S* upon the transfer of property attributable to the minority shareholders' interest in exchange for *P* stock. Similarly, under Sec. 354(a)(1), no gain or loss will be recognized by the minority shareholders upon their exchange of *S* stock for *P* stock.

Continuity of interest. Our situation presented no problem of "continuity of interest," but it should be noted that this requirement may preclude reorganization treatment for the minority shareholders unless (as explained below) *P*'s interest in *S* is "old and cold."

Sec. 332 The *Kass* case, 60 TC 218, aff'd CA-3 (1974), highlights the continuity of interest problem with respect to a Sec. 334(b)(2) purchase situation. There, a two-step transaction enabled shareholders owning 10% of *X* to gain control of *X* within a short period. They transferred their *X* shares to newly formed *Y*, the latter purchased another 84% of the *X* shares pursuant to a tender offer, and then *X* was merged into *Y*. The nontendering shareholders exchanged the remaining 6% interest in *X* for *Y* shares.

The Tax Court held that reorganization treatment was not available to a nontendering shareholder where an integrated plan provides for a purchase by *Y* of the *X* shares, followed by a merger of *X* into *Y*. The Court reasoned that in determining whether there was sufficient continuity of interest, *Y*'s premerger interest is included only if *Y*'s interest is "old and cold." Otherwise, the interests of the prepurchase stockholders are the only ones counted in testing for continuity of interest. Under this approach, the continuity of interest was merely 16% (10% interest transferred to *Y* at the time of its formation and 6% interest exchanged for *Y* stock following the merger), the remaining 84% having been held by the *X* shareholders who did not receive a postmerger interest in *Y*.

Problems of obtaining tax benefits from unprofitable subsidiaries

When a profitable parent corporation holds stock of an unprofitable subsidiary, attention will eventually be concentrated on methods of obtaining tax benefit from the latter's losses. Problems confront the tax adviser in planning to make the most of such unhappy situations.

The first inclination is to liquidate the subsidiary. If the liquidation qualifies under Sec. 332, the subsidiary's tax attributes (including net operating loss and investment credit carryovers) will be available to the parent under Sec. 381, unless the basis of the subsidiary's assets are determined under Sec. 334(b)(2). However, there may be technical obstacles to the Sec. 332 approach and it may not yield the greatest tax benefit.

It is well known that a liquidation will not qualify under Sec. 332 unless some payment (measured by fair market value of net assets) is received for the stock. If the parent corporation has made large advances to the subsidiary, it is not uncommon to find the subsidiary insolvent. In Rev. Rul. 68-602, the taxpayer attempted to remedy the insolvency problem by cancelling the debt as a capital contribution immediately prior to liquidation. It was ruled that the cancellation constituted a transitory step to achieve the benefits of the carryovers and therefore would not be recognized. *Sec. 332*

The ruling then invites the taxpayer to consider the alternatives of a bad debt deduction and a worthless security loss (which would be an ordinary deduction under Sec. 165(g)(3) if its stock ownership and income tests are met). This approach may yield a lesser tax benefit than the liquidation approach where the subsidiary has unused investment credit carryovers or where net operating losses have been financed by outside borrowings. On the other hand, the bad debt/worthless stock approach may provide greater tax benefits where the subsidiary's loss carryovers have expired or are in danger of expiration prior to utilization by the parent.

Unfortunately, a creditor-parent may not be able to select the more advantageous approach. In the ruling cited above, the taxpayer apparently preferred the Secs. 332—381 approach but the IRS refused to recognize solvency. On the other hand, if the taxpayer seeks to obtain bad debt and worthless stock loss deductions, the IRS may also refuse to consider the subsidiary as insolvent.

Example. *P* owns all the stock of *S* which has derived its gross receipts solely from the active conduct of a trade or business. *S*'s balance sheet shows the following:

Assets	$50,000
Due *P*	60,000
Capital stock	10,000
Retained earnings	(20,000)
	$50,000

S has an unexpired net operating loss carryover of only $5,000.

It would appear that *P* is entitled to ordinary deductions for a $10,000 bad debt loss ($60,000 less $50,000 in assets received) and a $10,000 worthless stock loss under Sec. 165(g)(3). The combined deductions exceed the available net operating loss carryover of $5,000.

However, consider the problem created if $15,000 of the advances by *P* is held to be a capital contribution. There would be no bad debt deduction, since there are $50,000 in assets to apply against the $45,000 debt. After satisfaction of the debt, $5,000 remains for payment to the parent corporation on account of its stock investment. Since the *S* stock is not worthless, Sec. 332 applies and no loss is recognized. The overall result is that *P*'s loss is not recognized under Sec. 332. *P* would have the benefit of only the $5,000 net operating loss carryover.

Sec. 333

Sec. 333 liquidations: installment notes as "securities"

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

—his pro rata share of earnings and profits (E&P) accumulated after February 28, 1913 or

—money and post-1953 acquired stock or securities (valued at fair market value) received by such shareholder.

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

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

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

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

Sec. 312(m): a potential trap in a Sec. 333 liquidation

Sec. 333

In an attempt to rectify certain tax inequities which, in the eyes of Congress, had created unwarranted tax benefits, the Tax Reform Act of 1969 ushered in a plethora of tax traps for the unwary tax practitioner.

One such trap lies hidden within the confines of Sec. 312(m), which deals with the effect of depreciation on earnings and profits (E&P). Sec. 312(m) provides that for purposes of computing E&P (but not taxable income) of a corporation—any corporation—the allowance for depreciation (and amortization, if any) shall be limited to the amount that would have been allowable if the corporation had used the straight-line method of depreciation for each taxable year beginning after June 30, 1972.

Although primarily intended to curtail the practice by public utilities and real estate corporations of utilizing accelerated depreciation and amortization to reduce or eliminate E&P, thus permitting capital gain or nontaxable dividend distributions to shareholders, Sec. 312(m) carries over into other sections whose tax implications depend upon earnings and profits (e.g., Secs. 333 and 531).

Corporations considering the use of a Sec. 333 liquidation (one-month liquidation which defers shareholders' recognition of gain on appreciated corporate property) should first determine the consequences of Sec. 312(m) if substantial depreciation deductions have been claimed under an accelerated depreciation method. With respect to post-1972 years in which depreciation deductions exceed the amount allowable under the straight-line method, Sec. 312(m) can have the effect of pyramiding E&P.

Sec. 312(m) causes an increase in E&P to the extent the amount of accelerated depreciation (or amortization, if any) exceeds straight-line depreciation for post-1972 years. Moreover, to the extent that the same excess depreciation is recaptured upon liquidation, E&P is further increased by such amount (net of taxes). Thus, the interplay of Sec. 312(m) and the recapture rules could prove to be very costly to the shareholder who must report the corporation's accumulated E&P as ordinary income under Sec. 333(e) and (f).

This result makes it necessary to consider not using corporations as investment vehicles for improved realty and quickly

Sec. 333 liquidating realty investment corporations new in existence. Where corporations are used and a Sec. 333 liquidation is contemplated in a few years, an immediate switch to straight-line depreciation should be considered.

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

A corporation planning to sell its assets and liquidate may do so under Sec. 337 without recognition of gain. It is sometimes suggested that in an appropriate case a corporation may find a Sec. 333 ("one-month") liquidation followed by the shareholders' sale of the assets more advantageous than the Sec. 337 route. The advantage suggested is that under a Sec. 333 liquidation, the shareholders may report the gain on the sale of the assets under the installment method; whereas under a Sec. 337 liquidation, in effect, the entire gain on sale of the assets by the corporation is taxed to the shareholders upon liquidation.

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

Cumberland Public Service Co., 338 US 451 (1950) and *Court Holding Company*, 324 US 331 (1945), indicate the split of decisional law that can be expected on the factual question of who made the sale. The problem is compounded in the closely held corporation situation, since the corporate officers and the shareholders are generally identical, and because there is a natural reluctance to liquidate prior to a firm offer.

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

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

Editor's note: In a recent case, Aaron Cohen, *63 TC 527 (1975), shareholders of a closely held corporation incurred substantial tax liabilities by running afoul of this doctrine. In* Cohen *the corporation negotiated the sale of unimproved realty (the sole asset), liquidated before transfer of title, and conveyed the realty four days later. The IRS, invoking the* Court Holding Co. *doctrine, asserted that the corporation made the sale, thereby creating earnings and profits which would result in the liquidation gain being taxed as ordinary income to the distributee shareholders. The Tax Court upheld IRS by stating that, because of the facts of the case, application of the "imputed" seller rule was even more strongly mandated in* Cohen *than it had been in* Court Holding Co. *In addition, the Court rejected the taxpayers' attempt to revoke the Sec. 333 election.*

The decision resulted in capital gain tax to the corporation on the sale and tax at ordinary rates to the shareholders.

Depressed securities market and personal holding company liquidations

If the market value of the securities held by the personal holding company has declined below the tax basis of the stock of the company, a liquidation under Sec. 331 can be accomplished without a current tax cost to the shareholders while providing them with a capital loss, all without change in the security portfolio. In addition, the liquidation provides a means of eliminating in the future the double tax on income—one at the corporate level and one at the shareholder level because of the required dividend payment to avoid the personal holding company tax.

If a one-month liquidation under Sec. 333 is desirable, a sale of the securities by the company at a loss prior to liquidation will reduce the accumulated earnings and profits (even though such loss cannot be utilized as an offset to capital gains) so that the impact of tax on the shareholders will be less. This also would apply in the case of a corporation that was not a personal holding company.

Cutting Sec. 333 shareholder taxes by collecting receivables

If the assets of an accrual-basis corporation have appreciated in value and the shareholders are planning to liquidate under Sec. 333, the corporation would be well advised to sell the receivables or otherwise accelerate their collection prior to distribution. By so doing, the shareholders may save considerable taxes because the basis of the receivables distributed in liquidation will decrease in relation to assets which have appreciated in value. Thus, any amounts collected after liquidation in excess of the recomputed basis will be considered ordinary income to the distributee-shareholder. (*Garrow*, 43 TC 890.)

Recognized gain in a one-month liquidation under Sec. 333 is the greater of earnings and profits (E&P) after 1913, or the sum of the money received and the fair market value of stock and securities (acquired after 12/31/53) received. Any gain to noncorporate taxpayers is taxable as dividends to the extent of E&P and any remainder is taxable as capital gain. The basis of the assets distributed in liquidation is the same as the basis of the stock, decreased by the amount of money received and increased by the amount of gain recognized and liabilities assumed. The total basis is then allocated to the distributed assets according to their net fair market value. (Regs. Sec. 1.334-2.)

A problem arises when the FMVs of the assets have appreciated and the value of the receivables remain at or below book value, as is normally the case. *Sec. 333*

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

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

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

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

The basis of the distributed assets is allocated as follows:

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

When the $200,000 of receivables is collected by the shareholders, ordinary income of $120,000 will be taxable to them. (*Osenbach*, 17 TC 797.)

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

Maximizing benefits of Sec. 334(b)(2) liquidation

Sec. 334

To obtain a step-up in basis for assets of an acquired subsidiary under Sec. 334(b)(2), among other things the subsidiary must be liquidated within a two-year period after a plan of liquidation is adopted. Where it is desired to have the business of the acquired subsidiary continued in a subsidiary and not merged with the parent's business, the general practice is to form a new subsidiary to acquire the stock of the old subsidiary.

If there was a direct acquisition by the parent company followed by a transfer of the business and assets of the acquired subsidiary to a new subsidiary, there would be a substantial risk that the transactions may be treated as a Sec. 368(a)(1)(D) reorganization or that the liquidation may be disregarded. In either event, the parent would be denied the desired step-up in basis.

A transfer of the subsidiary's stock to a new subsidiary into which the acquired subsidiary is liquidated won't work either. The transfer will then run afoul of Sec. 334(b)(3), which denies step-up in basis of assets where the basis of the stock of the acquired subsidiary is determined by reference to the basis in the hands of the transferor.

The direct acquisition obstacle to a Sec. 334(b)(2) step-up, where it is desired to have the operations of the liquidated subsidiary continued in a separate corporation, may be overcome, however, by transferring the business and assets of the parent company, rather than those of the acquired subsidiary, to a new subsidiary. A favorable ruling on this procedure was received from the IRS. The liquidation of the acquired subsidiary was held to fall under Sec. 334(b)(2), and the transfer of the business and assets of the parent company to a new subsidiary was treated as a separate tax-free transfer under Sec. 351.

The Sec. 334(b) ruling also involved an interesting twist in facts. The acquired subsidiary—prior to its liquidation under a one-year (Sec. 337) plan of liquidation—sold part of its assets. Since the liquidation met the requirements of Sec. 334(b)(2), the Service ruled that gain realized by the subsidiary on the sale of assets during the 12-month period would not be recognized under Sec. 337(a), except to the limited extent prescribed in Sec. 337(c)(2)(B). Gain was therefore taxable only to the extent that sale proceeds exceeded that part of the parent's basis for the stock—determined under Sec. 334(b)(2)—which was allocable to the assets sold. If the basis of assets to the parent company had been determined under Sec. 334(b)(1), instead of Sec. 334(b)(2), not only would the step-up in basis be lost, but also the entire gain realized by the subsidiary would have been taxable since Sec. 337 would not have been applicable.

Transfer of life insurance contracts in Sec. 334(b)(2) liquidations

Sec. 334

As a general rule, Sec. 101(a)(1) provides that life insurance proceeds are excluded from gross income. However, as an exception to the general rule, Sec. 101(a)(2) provides that if a life insurance contract has been transferred for a valuable consideration, the proceeds are taxable to the extent they exceed the consideration paid for the contract plus premiums and other amounts subsequently paid by the transferee.

There are two limitations to the transfer-for-value exception. First, the exception does not apply if the transferee's basis in the insurance contract for determining gain or loss is determined by reference to the transferor's basis. (Sec. 101(a)(2)(A).) Thus, it would appear that the general (nontaxable) rule would apply where an insurance contract on an employee's life was acquired by a parent corporation in a nontaxable liquidation of a subsidiary under Sec. 332. Under Sec. 334(b)(1), the subsidiary's basis for the insurance contract would carry over to the parent.

However, the transfer-for-value exception rather than the general rule would apply if the liquidation meets the criteria of Sec. 334(b)(2). In the case of a Sec. 334(b)(2) liquidation, the subsidiary's basis for its assets will not carry over to the parent. Instead the basis for such assets will be determined by reference to the parent's purchase price for the subsidiary's stock. Consequently, since the parent company's basis in the insurance contract is not determined by reference to the subsidiary's basis, the proceeds received on the death of the employee would be taxable under the transfer-for-value rule.

However, the fact that the basis for the subsidiary's life insurance contract is determined under paragraph (2) rather than (1) of Sec. 334(b) does not necessarily sound the death knell for nontaxable treatment of the insurance proceeds. The second limitation to the transfer-for-value rule arises where the policy is transferred to a corporation in which the insured is a shareholder or officer. (Sec. 101(a)(2)(B).) The insured need not be an officer of the transferor corporation.

Often, the acquisition of one corporation by another corporation in a Sec. 334(b)(2) transaction is effected through the use of a subsidiary created for that purpose. Usually, under such circumstances, officers and key employees of the acquired company will be employed by the new subsidiary. If a life insurance contract on such an officer or employee of the acquired corporation will be transferred to the new subsidiary, consideration should be given to designating the insured as an officer of the new subsidiary.

Subsidiary's debt to parent: pitfall to avoid

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

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

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

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

The above comments only explore some possibilities. The actual composition of the assets of a subsidiary would have to be evaluated in each case, since it appears that the taxpayer's objectives might be achieved in some cases by paying such debt in cash, and in others by paying such debt with property. If the subsidiary is liquidated without specifying the assets allocable to the debt, it appears that a portion of each asset would be considered as having been distributed for that purpose. *Sec. 334*

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

Often, in business acquisitions, one corporation will acquire all the stock of another corporation in a taxable transaction and then immediately liquidate the new subsidiary; the primary purpose of the stock acquisition is to obtain the acquired corporation's assets. Under these circumstances, Sec. 334(b)(2) provides that the purchase price of the stock, with certain adjustments, will become the basis of the assets acquired. Since the purchase price of the stock usually exceeds the acquired corporation's basis for its assets, the result is a stepped-up basis for depreciation.

In a case, however, Sec. 334(b)(2) created the opposite result. In *Kansas Sand and Concrete, Inc.*, CA-10, 462 F2d 805 (1972), corporation *A* acquired all the stock of *B* in a taxable transaction on September 28, 1964. On December 31, 1964, *B* was "merged" into *A* in accordance with the provisions of Kansas law. Since *B*'s tax basis for its assets exceeded the purchase price of its stock, it would be advantageous to have *B*'s basis carry over to *A*. This would be the natural result in a statutory merger under Sec. 368(a)(1)(A).

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

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

Another possibility is to arrange for a tax-free acquisition of the stock or assets of the acquired corporation, with the stock

Sec. 334 of the acquiring corporation, in a "B" or "C" reorganization. In a "C" reorganization, the basis of assets would carry over; a "B" reorganization followed by an immediate liquidation is usually treated as a "C" reorganization with the same result. Of course, this approach may be impractical if the stockholders of the acquired corporation will take only cash.

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

Sec. 337

Sec. 337: liquidation-reincorporation tax trap may be avoided

The tax adviser must carefully assess the liquidation-reincorporation status of purported Sec. 337 liquidation transactions which involve transfers of assets between corporations which may be controlled by the same stockholders. Consider the following:

> An individual plans to liquidate his wholly owned corporation. The plan calls for the corporation to sell all its assets except cash to another corporation in which the individual holds 60% direct control; the remaining 40% has been held for many years by a trust for the benefit of the adult children of the individual. The individual does not have a beneficial interest in the trust. It is planned that under Sec. 337, no gain from the sale will be recognized by the corporation. The cash will then be distributed by the corporation to the individual in complete liquidation.

If the transaction is in substance a Sec. 368 reorganization, no complete liquidation will have occurred and Sec. 337 will thus be inapplicable. (*Telephone Answering Service Co., Inc.*, 63 TC 423.)

The control definition of Sec. 368(c) requires at least 80% direct control. The constructive ownership rules of Sec. 318 are not applicable. Accordingly, the Service, because of the absence of the requisite control as defined in Sec. 368(c) (direct ownership of the transferee corporation is merely 60%), will be unable to find a "D" reorganization.

There remains consideration of whether there is an "F" reorganization. So far, the courts have not found an "F" reorganization where new stockholders gain an ownership interest in the assets transferred. In *Reef Corp.*, TC Memo 1965-72, however, an "F" reorganization was held to result where owners of 48% of the stock of the old corporation did not acquire a stock interest in the new corporation but there were no new shareholders. This decision raises the possibility that the courts may, in the future, develop law in the "F" reorganization area to include this proposed transaction.

Although it would appear that Sec. 337 will apply to the proposed plan under the present state of the law, the taxpayer will have to do without the comfort of a private ruling since the Service has promulgated in Rev. Proc. 72-9 a "no-ruling" policy under Sec. 337 where there is continuity of ownership of more than 20%.

Note, however, that in *Telephone Answering Service Co., Inc.*, above, the Tax Court held that Sec. 337 was inapplicable to the "reincorporation-liquidation" transaction before it without deciding whether that transaction was a reorganization.

Editor's note: The finding of an "F" reorganization in a liquidation-reincorporation remains a possibility, however. In Rev. Rul. 75-561 IRS has ruled there must be complete identity of shareholders and their proprietary interests when combining two or more corporations to qualify as an "F" reorganization. The ruling examined the types of transactions permitting the carryback of net operating losses. Thus it is doubtful that IRS will want to expand the "F" reorganization further.

Timing important in applying Sec. 337 to condemnations or involuntary conversions

One of the requirements for nonrecognition of gain from the sale of property during the liquidation of a corporation

Sec. 337 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).

The following case points out how this works. In *Covered Wagon, Inc.*, CA-8, 369 F2d 629 (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. The Supreme Court has affirmed this principle, at least insofar as involuntary conversions are concerned, in *Central Tablet Mfg. Co.*, 94 SCt 2516 (1974), which involved a fire.

Sec. 346 Partial liquidation of a subsidiary

Consider the problem of having a transaction qualify as a partial liquidation under Sec. 346 where the business being disposed of is conducted by a subsidiary. There are five possible methods of effecting the liquidation:

(1) The subsidiary sells the business assets and liquidates; then the parent distributes the net proceeds to its shareholders in redemption of a portion of their stock.

(2) The subsidiary liquidates; then the parent sells the acquired assets and distributes the net proceeds to its shareholders in redemption of a portion of their stock.

(3) The subsidiary liquidates; then the parent distributes the acquired assets in kind to its shareholders in redemption of a portion of their stock.

(4) The parent sells the subsidiary's stock and distributes the net proceeds to its shareholders in redemption of a portion of their stock.

(5) The parent distributes the subsidiary's stock to its shareholders in redemption of a portion of their stock.

With respect to distributions under methods 1, 2 and 3, it is understood the Service will rule that such distributions to the shareholders qualify as a distribution in partial liquidation (assuming that a contraction or termination of business within the meaning of Sec. 346(a)(2) or Sec. 346(b) has occurred).

The Service will not rule that the distribution under method 4 qualifies under Sec. 346, regarding this as an unsettled area. In fact, if the Service were to take a position on the question, it would probably hold, following the rationale of *Morgenstern*, 56 TC 44, that the sale of stock of a subsidiary does not constitute a contraction or termination of a business of the parent.

As for method 5, if the distribution cannot qualify as a spin-off under Sec. 355, it will most likely be treated as equivalent to a dividend under Sec. 302(d)—unless the transaction can qualify as a redemption which either is substantially disproportionate or terminates a shareholder's interest. (Sec. 302(b)(2) or (3).) Note that should the provisions of Sec. 302 apply and appreciated property be distributed, the parent may have recognized gain under Sec. 311(d).

Editor's note: In Rev. Rul. 75-223, IRS ruled that distributions under methods 1 and 2 qualify as a contraction of business under Sec. 346(a)(2). Method 5, however, was held to be a corporate separation and, accordingly, governed by Sec. 355.

Partial liquidation: "termination" vs. "contraction" of business

In *Bann*, CA-9, 451 F2d 198 (1972), the Tax Court held that in order to have a partial liquidation under Sec. 346(b), all the proceeds attributable to the termination of a business must be distributed. We inquired as to what position the IRS is taking on this issue and were told that if a taxpayer is relying on Sec. 346(b), the IRS will require that all assets (or proceeds of sale) of the terminated business be distributed. The language of Sec. 346(b) seems to require this result.

However, if a taxpayer brings his case under Sec. 346(a)(2) and Regs. Sec. 1.346-1(a) as a contraction of business, the IRS

Sec. 346

will rule that less than all of the proceeds of the contraction can be distributed. We understand rulings have been issued holding Sec. 346(a)(2) applicable to the distribution of part of the proceeds of a business contraction where the remainder of the proceeds were retained by the corporation as working capital in its remaining business.

Sec. 351

Sec. 351 risk in insolvency recapitalizations

A corporation in financial difficulty will frequently attempt to reduce its outstanding indebtedness by techniques which may include the issuance of its stock to its creditors as a part of an overall package. This may occur in both bankruptcy and nonbankruptcy situations. On occasion, the creditors may wind up with a significant stock ownership—perhaps even 80%. If attained, this 80% mark (actually 80% of the total combined voting power of all classes of stock entitled to vote, plus 80% of the total number of shares of all other classes of stock) can spell trouble for the creditors by reason of Sec. 351.

Assume that a corporation has creditors of three types:

- Open account trade creditors;
- Holders of short-term notes (with an original life not sufficiently long to qualify the notes as "securities"); and
- Long-term notes which qualify as "securities."

If all these creditors receive stock (whether or not in addition to money or some amount of extended indebtedness) the 80% control (toward which stock previously owned by any creditors will count) means that the creditors have participated in a Sec. 351 transaction. (*A. E. Duncan*, 9 TC 468, although decided under the 1939 Code, makes clear that a prior existing debt of the transferee corporation qualifies as property under Sec. 351.) Accordingly, any loss realized will not be recognized with respect to any of the three categories of creditors by reason of Sec. 351(c). It thus may be desirable for creditors to use the partial bad debt write-off approach in order to avoid this or other problems.

The Sec. 351 problem can be avoided by making sure that the creditors, together with any other contemporaneous transferors of property, do not own as much as 80%. However, the holders of the long-term notes which qualify as securities will not be entitled to any recognized loss because they will have participated in a recapitalization as described in Sec. 368(a)(1)(E) by having turned in securities for stock. Note that the holders of the open accounts and short-term notes will enjoy a recognized loss because Sec. 354(a)(1), the nonrecognition section, applies only to stock or *securities* which are exchanged.

IRS rulings policy on debentures issued in a Sec. 351 exchange

Ordinarily the IRS will not issue a ruling as to the tax effect of an exchange under Sec. 351 where the transferors receive debentures or other evidences of indebtedness of the transferee corporation. (Sec. 4.01-7 of Rev. Proc. 72-9.) This ruling policy is applied without exception where the transferee is a domestic corporation. However, where the transferee is a foreign corporation, a ruling will be issued if certain requirements are satisfied. First, for Sec. 367 purposes, it must be demonstrated that the issuance of debentures, rather than stock, will not result in tax avoidance. This is done by submitting a computation comparing

(*A*) the U.S. tax liability that would result to the taxpayer (giving effect to foreign tax credit) if all the payments of interest on the debenture and the payment of the principal amount of the debenture at the end of its term were treated as dividends, with

(*B*) the U.S. tax liability that would result by taxing the interest as interest and taxing the gain on the retirement of the debenture as a capital gain.

If the tax under (*B*) is equal to or greater than the tax under (*A*), the absence of tax avoidance will be established and a favorable ruling will be granted under Sec. 367 (assuming compliance with the other requirements of Rev. Proc. 68-23). (However, if the tax under (*A*) is greater than the tax under (*B*), no ruling will be granted under either Sec. 367 or 351.)

The computations described above must be made by applying the actual applicable tax rates (foreign and U.S.) to the actual payments. Since one cannot predict changes in rates in the future, the present rates must be used. Hypothetical computations will not be accepted. The computations will be included in the ruling and the ruling will be made contingent on the computations being verified upon examination by the district director.

Sec. 351 If the above computation test is satisfied and a favorable ruling is granted under Sec. 367, the second step is the Sec. 351 ruling. The ruling that the IRS will grant under Sec. 351 will be determined as follows:

- The Corporation Tax Branch will consider the debenture to determine whether it is debt or equity.
- If it is determined that the debenture is debt, the Reorganization Branch must then determine whether it is a security. If so, the receipt of the debenture will be held tax free under Sec. 351(a). If the debenture is held to be debt but not to be a security, its receipt will be held taxable as other property under Sec. 351(b).
- If the Corporation Tax Branch determines that the debenture is equity, then it will be treated as stock for purposes of the ruling and its receipt will be held tax free under Sec. 351(a).
- If the facts are such that it is not clear to the Corporation Tax Branch whether the debenture should be classified as debt or equity, no ruling will be granted by the Reorganization Branch as to the application of Sec. 351 to the proposed transaction. But, as noted above, a ruling under Sec. 367 would be issued if the computation test described above is satisfied.

Incidentally, a copy of the debenture must be submitted with the ruling request, and the complete terms of the debenture must be given in the request.

The Service *will* also rule on "securities" in a reorganization situation. In discussing the standards which the National Office uses for ruling on securities, several IRS employees quoted the language in Rev. Rul. 59-98, and the language in *Camp Wolters Enterprises, Inc.*, CA-5, 230 F2d 555 (1956), cited in that Revenue Ruling, that

> . . . though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietory interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc.

However, there is a 10-year rule of thumb which the IRS is reluctant to discuss or even admit exists but which it apparently does follow. The rule is that where the indebtedness runs for less than 10 years, the taxpayer will have a very difficult job establishing that it constitutes a security. On the other hand, if it runs for 10 years or more, the Service is quite likely to approve it as a security. But note that in Rev. Rul. 59-98, bonds with a 6½ year "average life" were approved as securities. In a planning situation, it is probably best to follow the 10-year rule of thumb.

It appears that a "call" or redemption feature could affect the results. For example, the Service might consider a 6-year call feature as an indication that the parties do not intend the bonds to remain outstanding for 10 years; presumably a taxpayer would have to overcome this inference. It would be safer to have a call feature effective only after 10 years.

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. 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, 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.

Sec. 351

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, 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, 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.

Editor's note: These conclusions are buttressed by the recent case of Intermountain Lumber Company, *65 TC No. 89, wherein it was held that an incorporator who had an irrevocable contract to sell 50% of the newly issued stock as part of the incorporation did not have control.*

Planning for Lifo inventory in Sec. 351 transactions

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

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

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

On the other hand, if the inventory is transferred in a Sec. 351 transaction to a subsidiary already using Lifo, the subsidiary would have to integrate the acquired Lifo inventory into its own Lifo layers, thus retaining the original acquisition dates and costs. (Rev. Rul. 70-565; *Joseph E. Seagram & Sons, Inc.*, CA-2, 394 F2d 738 (1968).)

Double Sec. 351 exchange: IRS ruling policy

Under Sec. 351 no gain or loss is recognized if property is transferred to a corporation solely in exchange for stock in such corporation and immediately after the exchange the transferors are in control of the corporation. The IRS has ruled in Rev. Rul. 56-613 that the 80% control test of Secs. 351 and 368(c) contemplates direct ownership of the stock of the transferee corporation and that indirect ownership through an affiliated corporation will not satisfy the test.

If, pursuant to a plan, the transferee corporation transfers property received from transferors to a subsidiary in exchange

Sec. 351 for its stock, does the second transfer affect the application of Sec. 351?

In the past, the IRS has taken the position that the two steps should be viewed as one integrated transaction: that the real effect is a transfer of the property to the subsidiary, that the transferors own the subsidiary stock only indirectly, and that, therefore, the control requirement of Sec. 351 is not satisfied.

However, rulings have been issued to the effect that Sec. 351 applies separately to each exchange and that no gain or loss is recognized on either. But the IRS, recognizing a possible step-transaction argument, will not issue such a ruling unless the transferors of the property have at least an 80% indirect ownership in the subsidiary.

Example. *X* and *Y* transfer property to corporation *P* and own 90% of its stock immediately thereafter, then *P* transfers the property to its subsidiary, *S*, in exchange for stock which gives *P* an 80% interest in the *S* stock. The IRS will not rule that Sec. 351 applies, since the indirect ownership of *X* and *Y* in the *S* stock would be only 72%.

Any taxpayer contemplating a double Sec. 351 exchange should consider the advisability of securing an advance ruling.

Sec. 355 IRS ruling policy on premerger spin-offs

In *Morris Trust*, CA-4, 367 F2d 794 (1966), it was held that the spin-off of an acquired corporation's business in which an acquiring corporation by law could not engage to permit the merger of the two corporations, qualifies for tax-free treatment under Sec. 355. The IRS has indicated it will follow *Morris Trust* in similar situations. (Rev. Rul. 68-603.)

We understand that the IRS will not grant a favorable ruling for premerger spin-offs, however, where the value of the properties being spun off is greater than the value of those being transferred to the acquiring corporation in the merger. The IRS apparently feels that where the dominant business is the one spun off and kept by the stockholders of the acquired corporation, rather than merged, the contention that the business purpose of the spin-off is to make possible the merger loses force as an acceptable business purpose.

Furthermore, if the value of assets that will be spun off is less than the value of those to be transferred in the merger but exceeds 25% of the value of total assets of the distributing corporation, a favorable ruling will be granted only upon a showing of significant business purpose for the merger and a convincing showing that the acquiring corporation in the merger either is prohibited from acquiring the assets that are proposed to be spun off or insists that it will not agree to the merger unless the assets are spun off. In other words, it must be shown that the acquiring corporation, rather than the transferor distributing corporation or its shareholders, is the one that wants the spin-off to be carried out.

Editor's note: Approval of pre-merger spin-off really depends upon business purpose examined on a case by case basis. See Rev. Rul. 74-406, IRB 1975-38, 7, where IRS allowed spin-off to be followed by a merger of spun-off corporation with unrelated corporation.

Sec. 355: Purchases within five-year period retained after split-off

X corporation owned four stores. Two of the stores had been owned for more than five years; one had been purchased, and one opened new, within the past five-year period. One of the old stores is to be transferred to a new corporation whose stock will be exchanged for all of the *X* stock of one of the shareholders (*A*). The remaining shareholders will retain ownership of the remaining three stores in *X*. This proposed split-off was occasioned by differences of opinion regarding the operation of the business which resulted in serious disputes between *A* and other shareholders and had an acute effect on normal operations.

There was concern that the acquisition of two stores in the five-year period might make Sec. 355 inapplicable since these stores would constitute more than 50% of the total assets remaining in *X* after the split-off. Nevertheless, in a private ruling, the IRS held that both corporations had been engaged in an active trade or business for the five-year period and ruled that the transaction was tax free under Sec. 355.

One of the representations that IRS requested related to the proportion of fair market value (FMV) of the split-off store

Sec. 355

to the total FMV of the three remaining stores. The representation was made that the FMV of the split-off store exceeded 45% of the total FMV of all three remaining stores in *X*. This was sufficient to obtain the favorable ruling. Moreover, it was *informally and unofficially* indicated that a favorable ruling would be granted if the FMV of the split-off store exceeded 20% of the total FMV of the remaining stores in the corporation.

Editor's note: The IRS has issued Rev. Proc. 75-35, a checklist of information required in a Sec. 355 ruling request.

Sec. 356 Contingent shares in reorganization require careful handling

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

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

The Service's theory is, apparently, that on placing the shares in escrow the shareholders of the acquired corporation become the beneficial owners of such shares and that their subsequent return to the acquiring corporation is a separate, taxable transaction not embraced by the original tax-free reorganization exchange. This position seems inconsistent with at least one court decision—*McGlothlin Estate,* CA-5, 370 F2d 729 (1967). In that case a payment by the taxpayer in satisfaction of a guarantee issued in connection with a reorganization exchange of the stock of his company was held to be a part of the "purchase price" of the stock of the acquiring corporation and not a deductible loss.

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

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

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

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

Sec. 356 *The return of escrowed stock of the acquiring corporation due to the failure of the acquired corporation in a "B" reorganization to attain a specified earnings level does not result in gain or loss to a former shareholder of the acquired corporation, where, under the escrow agreement, the number of shares to be returned was based upon their initial negotiated value, and the shareholder had no right to substitute other property for the escrowed shares. (Rev. Rul. 76-42.)*

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

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

Combining contingent and escrowed shares in tax-free acquisitions

Where it is difficult to determine the value of a corporation to be acquired for stock in a tax-free reorganization because its earnings record is short or erratic, it is common practice for the acquiring corporation to issue a fixed amount of its shares and to agree to issue additional shares if earnings meet specified levels within prescribed periods of time. Initially, the IRS took the position that contingent rights to acquire additional stock constituted "boot" when received in connection with a reorganization. However, after the Tax Court held that such contingent rights did not constitute "boot" because they could generate nothing but stock, the IRS receded from its position. See *J. C. Hamrick*, 43 TC 21 (1964), acq.

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

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

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

Recently a corporation was willing to pay 100 shares of its stock for a new and untried business provided a certain earnings level was met within five years. However, it was not willing to pay more than 25 shares outright. An agreement providing for the contingent issuance of 75 shares would not have satisfied the 50% down payment requirement of Rev.

Sec. 356 Proc. 74-26, and placing 75 shares in escrow would not have satisfied the 50% requirement of Rev. Proc. 75-11. However, issuing 25 shares outright, placing 25 shares in escrow, and making 50 shares contingent appeared to satisfy the requirements of both Revenue Procedures.

Sec. 367

Sec. 367 clearance ruling need not be followed by taxpayer

The National Office of the IRS recently confirmed the position that a taxpayer who receives a clearance ruling under Sec. 367 regarding a complete liquidation of his wholly-owned foreign subsidiary may disregard the private ruling letter and treat the transaction as "taxable" under Secs. 1248 and 331 if such treatment is in fact advantageous. The situation may be illustrated as follows:

> In 1970, a U.S. parent corporation (*P*) acquired all of the stock of a Canadian corporation (*S*) for cash. The purchase price exceeded the book value of *S*'s assets. In 1974, *P* proposed to liquidate *S* and sought a clearance ruling under Sec. 367. Consistent with the terms of Rev. Proc. 68-23, the IRS conditioned its favorable response on the inclusion by *P* in its gross income, as a dividend deemed paid in money for its taxable year in which the distribution in liquidation occurs, of the portion of the accumulated earnings and profits, if any, of *S* for all taxable years of *S* properly attributable to *P*'s stock in *S*. Subject to this condition, the ruling letter held that the proposed liquidation of *S* was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes within the meaning of Sec. 367. The ruling letter also held that provided the requirements of Sec. 332(b) are met, no gain or loss would be recognized to *P* upon its receipt of the property distributed in complete liquidation of *S*.

Following the liquidation, *and the filing of its1974 return in accordance with the clearance ruling*, *P* determined that it was more advantageous to treat the liquidation of *S* as a taxable transaction and proposed to do so in an amended return. The reason for the change in position was that the overall gain if the liquidation was taxable would result in less tax under Sec. 1248 than the inclusion as a dividend of all the E&P of *S* during the period of *P*'s ownership under the ruling. (This will typically be true in a post-1962 purchase where the acquisition costs exceed book and there is no unrealized gain in the assets of the liquidated foreign corporation.)

In the favorable technical advice response, the IRS held that the entire ruling letter, including all of the conclusions contained therein, was expressly limited by the National Office to apply only upon compliance by *P* with the condition therein.

Since the Secs. 332 and 367 rulings were issued conditionally (i.e., that *P* comply with the condition in accordance with *P*'s representations), the Service clearly contemplated that *P* would be given an option to comply or not with the condition. If *P* complies with the condition, the ruling letter will remain in full force and effect; conversely, if *P* exercises its rights to not comply with the ruling letter, the ruling letter, *by its own terms*, becomes inoperative.

In the absence of the effectiveness of a Sec. 367 ruling, Sec. 367 operates to prevent a foreign corporation (S), a party to the exchange, from being treated as a corporation. Since Sec. 332 is applicable to *P* only if it receives property distributed in complete liquidation of another corporation, Sec. 332 cannot be applicable to *P* if *S* is not treated as a corporation. However, it is noted that since Sec. 367 does not apply to Sec. 331, *S* can be treated as a corporation for the purpose of an exchange described under that section. See Rev. Rul. 70-106.

It was therefore held that *P* can, by noncompliance with the condition, render the ruling letter inoperative. Noncompliance with the condition will subject the liquidation of S to the provisions of Secs. 1248 and 331 unless the Service applies Rev. Rul. 64-177 (which held that a taxpayer cannot use to its advantage its failure to secure Sec. 367 clearance), if it is subsequently determined that the IRS will benefit from having the liquidation subject to the provisions of Sec. 332. (But, of course, this would be without the toll charge as under Rev. Proc. 68-23.)

Moreover, the Sec. 367 ruling letter will not bar *P* from amending its income tax return with respect to 1974, an open tax year, in order to report and pay taxes with respect to the liquidation in accordance with the provisions of Secs. 1248 and 331.

Failure to obtain a ruling under Sec. 367

Sec. 367 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

Sec. 367 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.

Editor's note: In Rev. Rul. 76-90 IRS has reaffirmed its position in a transaction purporting to fall within Sec. 337.

Sec. 368 F reorganizations: basis of stock received

Taxpayers have recently been successful in the courts in treating certain tax-free transactions involving more than one corporation as F reorganizations for the purpose of permitting a carryback of post-merger operating and capital losses to pre-merger years. See also Rev. Rul. 75-561, in which the IRS has recently decided to follow such cases. The carryback is available under an F reorganization even though the transaction also constitutes an A reorganization or a Sec. 332 liquidation of a subsidiary. However, the type of reorganization may have a significant tax effect on the shareholders in the event of the subsequent disposition of their stock received in the reorganization. That is, the type of reorganization dictates the basis of the stock received. *Sec. 368*

If a single class of stock or securities is surrendered in a nontaxable reorganization consisting of securities acquired by the taxpayer at different dates and for different prices, determination of the Sec. 358 substituted basis for the stock or securities received in exchange therefor is ordinarily determined, if possible, by specific identification. That is, the basis of each lot of old stock is allocated to the new stock received in exchange therefor. See *Bloch*, CA-9, 150 F2d 540 (1945). If the basis of the securities surrendered cannot be determined by specific identification, the basis of the securities received must be determined either by the average cost method or the first-in, first-out method. In applying the above rule to securities acquired in a tax-free reorganization, it is important to recognize that a different basis will result depending upon which type of Sec. 368 reorganization occurred.

It has been held that the average cost method is to be used when stock of *another* corporation is received in a tax-free reorganization, for example an A, B or C reorganization. See *Von Gunten*, CA-6, 76 F2d 670 (1935). However, if only stock in the *same* corporation is received, for example in an E or F reorganization, the first-in, first-out method is to be used. See *Kraus*, CA-2, 88 F2d 616 (1937). In light of Rev. Rul. 75-561 and the cases cited therein, the question arises as to which of these rules applies when, as part of an F reorganization, an exchanging shareholder receives stock in *another* corporation.

Therefore, if it is decided to treat the transaction as an F reorganization to obtain the post-merger NOL carrybacks, the individual shareholder who contemplates selling or giving stock received in an F reorganization should be made aware of the possible effect of the type of reorganization upon the basis of the stock that is to be transferred.

Reorganizations: indirect continuity of interest

The continuity of interest doctrine is invoked to distinguish genuine readjustments of corporate structures required by

Sec. 368 business exigencies from mere sales of property. Requisite to a tax-free corporate reorganization is a continuity of interest on the part of the transferor or its shareholders (Regs. Sec. 1.368-2(a)).

In defining "shareholder" for purposes of determining which party must hold the continuity-preserving stock interest, the Service has recently focused on the "historic shareholder," i.e., the party whose long established and preexisting proprietary rights in the acquired corporation's stock legitimatizes it as the proper party to receive the consideration in the reorganization. When the historic shareholder disposes of its stock pursuant to a plan involving a corporate reorganization and a new and transitory shareholder receives stock of the acquired corporation, the Service, for advanced ruling purposes, has questioned the validity of the reorganization.

Assume corporation *P* owns 100% of the stock of *X* and *Y* corporations and *Y* owns 100% of the Z corporation. Pursuant to one plan, *Y* distributes the Z stock to *P* (Sec. 301 or Sec. 355) and then Z merges into *X* for *X* stock which goes to *P*, the current shareholder of Z. The Service focuses on the historic shareholder (*Y*) and concludes that *Y*, and not *P*, must end up with *X* stock. *P* is a transitory shareholder of Z, i.e., it received Z stock and immediately disposed of it in a purported Sec. 354 exchange pursuant to the merger of Z into *X*. Since the transferor (Z) or its historic shareholder (*Y*) did not end up with *X* stock, continuity of interest is violated and the transaction does not qualify under Sec. 368.

Assume the same fact pattern as that above except that *P* contributes the *X* stock to *Y*, and *X* then merges into Z for more Z stock which ends up in the hands of *Y*, the new shareholder of *X*. Continuity of interest is still violated in that the historic shareholder of *X* (*P*) did not receive stock in the reorganization. If *P* did in fact receive Z stock and then transferred it to *Y*, the Service would still conclude that continuity of interest is violated. However, if no Z stock is issued in the *X*-Z merger, the taxpayer can defeat the Service's arguments on indirect continuity of interest by characterizing the entire transaction as a merger under Sec. 368(a)(2)(D) of *X* into Z for *Y* stock which should be given to *P*.

Editor's note: Since the form of the transaction is apparently important to the Service, rather than the net result, the

Service's position appears questionable. Taxpayers, however, should be aware of this potential pitfall.

Use of voting trust in a "B" reorganization

A requirement of a "B" reorganization is that the acquiring corporation issue only voting stock in the exchange. A favorable private ruling illustrates that it may still be possible to restrict the voting rights of such stock through the use of a voting trust without disqualifying the "B" reorganization. In the situation involved in the ruling, the voting trust was necessary to carry out the agreement of the major shareholder groups of the acquiring and acquired corporations that their effective voting power be equalized for a maximum period of seven years.

The acquiring corporation (*X*) had a single class of voting common stock outstanding and issued such stock in the reorganization. The exchanging shareholders of the acquired corporation (the *Y* group) were to deposit the *X* voting stock received in the exchange into a voting trust in return for voting trust certificates. Under the terms of the voting trust agreement, the restrictions on the voting rights of the *Y* group varied with the nature of the voting issue. In certain votes, the *Y* group could vote a fraction (exceeding 50%) of a vote per share with the "minority fraction" to be voted by the trustee in accordance with the recommendations of the *X* board of directors. In other circumstances, the *Y* group could vote a fraction (less than 50%) of a vote per share, but the remaining "majority fraction" was not to be voted.

It is understood the Service would have ruled unfavorably had the majority of the voting rights received by the *Y* group ever been shifted to anyone outside that group.

"B" reorganization: release of shareholders' guaranty of corporate debt

In connection with a proposed "B" reorganization, an acquired corporation's (*X*) shareholders (*A* and *B*) were to be released from personal liability as guarantors for the payment of X's obligations to its sister corporation (Y), also owned by A and B. A local bank, to which Y was indebted, had required the shareholders to guarantee X's obligations. The acquiring corporation (Z) did not assume any of the personal liabilities of A and B for X's obligations.

The purpose of the release was not to confer any economic benefit upon A and B, but to protect them from potential liability for debts of X arising after the reorganization when they no longer would control its operations. The IRS concluded the release did not constitute "boot" (which would violate the "solely for voting stock" requirement in a "B" reorganization) paid by Z to A and B. The ruling was conditioned upon a representation that the release "is merely incidental to the reorganization and is not designed to give [A and B] anything in the reorganization other than voting [Z] stock."

In addition to the acquisition of X under the foregoing terms, the overall plan called for Z to acquire the Y stock for cash and for A and B to enter into employment agreements with X. As to A, his future compensation from X would be at about the preacquisition level, but B's compensation would be increased. With respect to the purchase of Y and the employment agreements, the ruling was conditioned on the following representations:

- The compensation to be paid B is a fair compensation for services to be rendered by him.
- The cash payment by Z for the Y stock is equal to its fair market value.
- The number of Z shares to be issued for the X stock is no different from the number that would have been issued if there had been no employment agreements or purchase agreement for Y stock.
- All transactions between X and Y have been on the same pricing terms as for unrelated parties, with no transfers of assets or other transactions between X and Y having been made in anticipation of the proposed reorganization.
- No amount of the intercompany debt owed by X to Y, as of the time proposed reorganization is consummated, would constitute an equity interest in X.

As the foregoing discussion indicates, a concurrent cash acquisition and an increased future compensation arrangement are permissible in connection with a "B" reorganization if they are made at arm's length—i.e., if they do not constitute, in whole or in part, disguises for other considerations which would violate the "solely for voting stock" rule. *Sec. 368*

Editor's note: IRS will also require that the corporation appear to be able to pay the indebtedness when due.

Reorganization or Sec. 351: which takes precedence?

P corporation acquires the assets and assumes the liabilities of *S* corporation solely in exchange for all the voting stock of *P*. At first blush there would seem to be little need to determine whether a transaction such as this qualifies as a reorganization or a Sec. 351 exchange since, in both situations:

- There is generally no gain or loss recognized, and
- The basis of the transferred property in the hands of the transferor carries over to the transferee.

However, it becomes significant to distinguish between these provisions in determining the tax attributes of the transferee; that is, whether or not these attributes carry over from the transferor. The following table illustrates some of the tax ramifications of a transaction which qualifies as both a "C" reorganization and a Sec. 351 exchange.

Tax aspect	*Sec. 351 exchange*	*"C" reorganization*
Gain or loss recognized	None	None
Method of accounting	New elections	Carryover of transferor method
Tax attributes (i.e., NOL, earnings and profits, inventory methods)	No carryover	Transferor's attributes carried over

The overlapping of Sec. 351 and the reorganization provisions could cause undesirable results. For example, assuming a corporation is on an onerous method of accounting which it wishes to change, a Sec. 351 exchange would be appropriate. If the exchange also qualifies as a "C" reorganization, the tax attributes, i.e., the onerous accounting method, could conceivably be carried over to the controlled corporation. It is suggested that in this setting the transferor corporation take

Sec. 368 back voting stock *and* "boot." In this manner the "C" reorganization provisions would be circumvented since the "solely for voting stock" requirement would be violated. Presumably, the small tax which the transferor would pay would be more than offset through the ability to make new accounting elections.

However, when a transaction is within the provisions of both Secs. 368(a)(1)(C) and 351, it is unclear which should prevail. In Rev. Rul. 68-357 the IRS seems to take the position that a transaction meeting the requirements of both will be treated as a reorganization rather than as a Sec. 351 transfer to a controlled corporation.

Editor's note: In Rev. Rul. 76-123 IRS reaffirmed the conclusion that the "C" reorganization will prevail.

Interest shares and the 50% requirement of Rev. Proc. 67-13

Most tax advisers are aware that the IRS takes the position that it will rule favorably on a proposed nontaxable acquisition involving contingent shares only if at least 50% of the total shares which may be issued are issued currently. (Rev. Proc. 67-13.) Furthermore, it is common knowledge that the imputed interest rules apply when and if the contingent shares are ultimately issued.

Some acquisition agreements provide a formula which results in the issuance of additional shares in payment of the imputed interest. The question arises: If the contingent shares, when combined with the interest shares, exceed 50% of the total shares ultimately issued, will the IRS issue a favorable ruling?

A good argument may be made that the interest shares should not be counted in applying the 50% test since these shares are not being issued in consideration for the acquired company's stock, but are, instead, being issued in payment of a calculated, taxable interest factor. The IRS, in Rev. Rul. 73-205, accepted a formula where maximum conversion of voting convertible preferred to voting common could result in twice the original shares plus interest shares. *Sec. 368*

Date of distribution for carryovers under Sec. 381

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 1974 but which will not be fully completed until February 1975. 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 1974, instead of 1975.

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.

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

Sec. 382

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

Sec. 382 however, the amount of the NOL available is limited in certain circumstances.

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

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

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

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

This essentially was the factual pattern in *Resorts International*, 60 TC 778, in which the Tax Court recast the transaction as a C reorganization rather than a liquidation under Sec. 332 because the liquidation was not a "separate and unrelated transaction," there having been no intention by the taxpayer to continue the operation of the business of the subsidiary as a separate corporation. The lapse of time between the acquisition and liquidation (up to nine months in some instances) was viewed as a matter of taxpayer's convenience.

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

Deferred compensation

Corporate qualified deferred compensation plans: prior service as partner or proprietor

Sec. 401

In Rev. Rul. 69-421 the IRS clearly spelled out the fact that, for purposes of participation in a qualified deferred compensation plan, partners and proprietors are not "to be credited for services rendered as partners or sole proprietors prior to becoming employees in a successor corporation, either for prior service benefits or for meeting eligibility requirements." Earlier, in Rev. Rul. 69-409, the IRS had indicated that if a former partner who converted to solo practice would grant his common-law employees credit for past service with their former employers, he could count his past service with his former partnership.

These two rulings made it obvious, as the IRS private ruling policy in this area already had, that the IRS did not take literally the language of Sec. 401(c)(1), which states, "*For purposes of this section*, the term 'employee' includes, for any taxable year, an individual who has earned income . . . for the taxable year." (Emphasis added.)

The logic of the quoted language is that a working partner or proprietor is an employee and that his partnership or proprietorship is the employer. And if his partnership or proprietorship is the employer, then a requirement in the plan of a successor corporation that eligible employees must have five years of service as an employee (within the meaning of Sec. 401) of either the corporation or its predecessor unincorporated entity would neither be discriminatory nor exclude the former partners or proprietor from being covered. But the IRS was not buying this type of interpretation, so such provisions were not written into plans generally, and the IRS view prevailed—at least for a time.

Now we have *Sherman Construction Corp.*, DC–Va., (1973), to remind us that there are still brave (or rash) souls who will not accept as gospel the IRS positions on qualified plans. *Sherman* points out that words mean what they say, at least sometimes, and not necessarily what

Sec. 401 the IRS would like to have them mean. The Court could see nothing wrong with treating W. A. Sherman as an employee for plan purposes for years during which he was sole proprietor of his contracting business—although his case involved pre-1962 years—when Sec. 401(c)(1) was not even in the statute. Said the Court:

> Nowhere in Section 401 is an employer precluded from also being considered as an employee. . . . The Government claims that the plan discriminates in favor of W. A. Sherman—our examination of the plan discloses that all employees are treated the same.

Interestingly, the government has announced that it will not file an appeal.

Editor's note: See also Farley Funeral Home, Inc., *62 TC 150 (1975) acq., for application to a partnership situation.*

Sec. 402 1974 pension law: double "rollover" of distributions

The 1974 pension reform law raises several problems in the area of tax-free "rollovers" for which there are no clear answers.

If an individual receives a lump sum distribution, as defined in Sec. 402(e)(4)(A), from a qualified pension or profit-sharing plan, he has taxable income in the year he receives the distribution. The taxable portion of the distribution will be divided into two parts. The amount which is taxed as long-term capital gain is based on the ratio of the number of years the individual was an active participant in the plan prior to January 1, 1974, to the total number of years of active participation. The ordinary income portion is based on the years of active participation after 1973. If a recipient qualifies, and he so elects, he may use a special ten-year forward-averaging tax calculation with respect to the ordinary income portion. This provision is relatively clear, although there are some questions under certain circumstances as to how the number of years of participation are to be calculated.

However, Sec. 402(a)(5) allows a recipient to "roll over" the taxable portion of a lump sum distribution into an individual retirement account (Sec. 408(a)), individual retirement annuity (Sec. 408(b)), retirement bond (Sec. 409), or another qualified plan (Sec. 402(a)(5)(B)(ii)), if the distribution (exclusive of the recipient's contribution) is transferred to one of the above on or before the 60th day after receipt of the distribution. If the individual makes such a transfer, the distribution will not be included in taxable income in that year.

The lump sum distribution rolled over into an individual retirement account (IRA) is required to be distributed to the recipient in the future under rules prescribed in the Code. When the amounts are distributed they are taxed as ordinary income. That is, they lose their eligibility for lump sum tax treatment; no part is considered as capital gain or eligible for the ten-year forward-averaging calculation.

Under the new law, provision is made for a further rollover of the distribution from an IRA into another qualified plan without immediate tax consequences.

Questions arise when the employee retires and receives a lump sum distribution from the last qualified plan.

> *Example.* Assume that *X* retired this year at age 55 and received a lump sum distribution from his employer's plan and transferred, under the rollover provision in Sec. 402(a)(5), the distribution (exclusive of his contribution) into an IRA. At age 58 he again is employed by an employer that has a qualified plan to which he transfers the assets in his IRA. He retires at age 65 and receives a lump sum distribution.

Is any portion of the final distribution to *X* from the qualified plan entitled to capital gain treatment or ten-year averaging?

Sec. 402(a)(2) states that the capital gain portion of a lump sum distribution is a ratio based on the number of years of active participation in such plan prior to 1974 to the total number of years in such plan. A literal interpretation of Sec. 402(a)(2) would seem to bar capital gain treatment for any portion of the lump sum distribution in this situation. One possible exception may be where an employee terminates his employment, "rolls over" his lump sum distribution into an IRA, is later rehired by the same employer, and "rolls back" his IRA into the same plan. It would seem that the employee may have active participation in such plan prior to 1974. However, if the rollover was into a different plan of a new employer, it appears that capital gain treatment would not be available upon a later distribution.

Is the ten-year forward-averaging available with respect to the final distribution to *X*? As stated above, this favorable tax

Sec. 402 treatment is not available for the ordinary income portion of the first lump sum distribution because it was rolled over into the IRA. However, a literal reading of the Code indicates that the ordinary income portion (probably 100% per above discussion) of the final distribution is again eligible for the ten-year forward-averaging. It should be noted however that if *X* retired from his last employment after less than five years of participation in the plan, Sec. 402(e)(4)(H) would appear to deny the ten-year averaging treatment.

Hopefully, regulations will help to answer these problems.

Losses: lump sum distribution of cash and depreciated securities from qualified plan

Because of the depreciation in values of stocks over the last few years, it is not uncommon for an employee to receive a lump sum distribution of cash and securities with a total value less than the amount he paid in to a contributory investment plan.

Example. *A* contributed $1,000 to a qualified plan. At his direction, $700 was invested in a fixed income fund and $300 in the employer stock fund. Upon termination of employment in 1974, *A* received a total distribution of $900, consisting of $800 in cash attributable to his investment in the fixed income fund and employer stock with a value of only $100. Thus, *A* sustained an economic loss of $100 ($1,000 less $900). Is the $100 loss deductible in 1974?

It is the IRS's position that the economic loss attributable to the decline in value of the employer stock (or any property) is not deductible until the disposition of the stock on the grounds that prior thereto there is no closed transaction. In Rev. Ruls. 71-251 and 72-15 the IRS held no deductible loss occurs when an employee receives a lump sum distribution consisting solely of employer stock (or any other property) with a value less than the amount of the employee's contribution.

In Rev. Rul. 72-328 the IRS ruled that where the lump sum distribution consists of worthless stock of a bankrupt employer, the employee's total contribution is deductible as an ordinary loss in the year of distribution. The IRS reasoned that since the employee's participation in the plan was a transaction entered into for profit and the worthless stock represented his entire interest in the trust, there is a closed and completed transaction. In Rev. Rul. 72-305, the IRS ruled that when a lump sum distribution consists only of cash and it is less than the employee's total contribution to the plan, the loss is recognized in the year of distribution.

The IRS, however, has not published a ruling which deals with the situation in the above example—i.e., where the distribution consists of cash and depreciated securities with a total value of less than the employee's total contribution to the plan. According to Rev. Ruls. 71-251 and 72-15, the IRS would probably conclude that *A* (in the above example) does not have a recognizable loss in the year of distribution. On the other hand, the IRS should not contend that *A* realized a taxable gain of $100 on the receipt of $800 from the fixed income fund since the distribution of cash and stock must be considered in its entirety as coming from one plan, not the various investment vehicles of the plan.

It is submitted that the cost recovery method should be applied to the distribution to *A*. Thus, *A* would not have any taxable gain or loss as a result of the distribution and the tax basis for the employer stock becomes $200. This amount is arrived at by treating the $800 cash distribution as a recovery of (1) the entire $700 investment in the fixed income fund and (2) $100 of the $300 investment in employer stock; thus, the unrecovered cost of the stock is $200—i.e., $300 less $100.

Assume *A* received only $600 from the fixed income fund plus the stock valued at $100. Has he sustained a deductible loss of $100 on his $700 investment in the fixed income fund or must he tack the $100 loss on to the $300 basis for the stock (thus giving it a $400 basis) and await a future disposition of the stock for reporting gain or loss? Again it would seem that no gain or loss should be recognized until there is a disposition of the stock. If *A* wishes to have the loss recognized currently, he should request the trustee to make the distribution only in cash rather than in cash and stock. Under Rev. Rul. 72-305, if the request is granted he would be entitled to deduct the loss as an itemized deduction.

ERISA: multiple distributions and distributions of annuity contracts

Although the 1974 pension reform law (ERISA) made changes which will lessen the tax burden on recipients of lump sum distributions from qualified retirement plans, it also contains provisions which can be a trap for the unwary. One of these potential traps is Sec. 402(e)(2) which requires aggregation of multiple lump sum distributions and distributions of any annuity contracts within any six-taxable-year period beginning after December 31, 1973, for purposes of computing the current year's tax. This is the so-called "look-back rule."

Lump sum distributions are defined in Sec. 402(e)(4)(A). A distribution does not constitute a lump sum distribution unless the entire balance to the credit of the employee is distributed. It is clear that only those lump sum distributions for which ten-year averaging is elected under Sec. 402(e)(4)(B) are subject to the aggregation rules. Sec. 402(e)(2) provides that distributions of annuity contracts are also subject to the aggregation rules. However, neither the statute nor the legislative history explicitly answers the question of whether an annuity contract distribution must be a distribution (or part of a distribution) of the entire balance to the credit of the employee before it is required to be aggregated. But Prop. Regs. Secs. 1.402(a)-1(a)(2), 1.402(e)-2(c)(2)(ii)(E)(*i*), and 1.402(e)-2(d)(1)(i) seem to require aggregation of an annuity contract whether or not it is the distribution (or part of a distribution) of the entire balance to the credit of the employee.

The potential adverse impact of this application of the aggregation rule can be illustrated as follows:

Example. In 1977, individual *A* receives a lump sum distribution from his employer's qualified noncontributory profit-sharing plan upon attaining age 59½. With respect to such distribution A elects ten-year averaging treatment. The ordinary income portion of that distribution is $125,000 and the capital gain portion is $250,000. Upon retirement in 1982, *A* receives an annuity contract with a current actuarial value of $125,000 from the above-described plan. The annuity contract does not represent the entire balance to *A*'s credit under the plan, since he also elected to receive periodic payments from the trust for a period of five years for the balance of his interest. For 1982, *A* will owe a substantial additional tax under Sec. 402(e)(2) because of the annuity contract so distributed even though payments under the annuity will still be fully taxable as they are received. Even if A were to receive the cash equivalent of the annuity contract's value to avoid the aggregation rules, he would accelerate ordinary income for such a distribution subject to tax at the normal rates.

Because of the potential adverse tax impact of aggregating multiple lump sum distributions and distributions of annuity contracts, in most cases it would be beneficial for a taxpayer to avoid such distributions during any such six-year period. In this connection, if an individual has received or expects to receive a lump sum distribution during the "lookback" period and currently has the option to receive either the distribution of an annuity contract or periodic payments from a qualified trust, the aggregation rules can be avoided by electing to receive periodic payments from the trust. *Sec. 402*

Profit-sharing contributions: accrual earnings vs. cash earnings

Sec. 404

Qualified profit-sharing plans may provide for contributions based on current or accumulated earnings or profits, subject to the limitations provided in Sec. 404(a)(3) and (7), as amended by ERISA. Such terms are usually defined in plans as amounts determined under generally accepted accounting principles.

Rev. Rul. 66-174 holds that a plan will not fail to qualify as a profit-sharing plan under Sec. 401 merely because it provides that employer contributions shall be made from current profits or accumulated earnings, as determined under generally accepted accounting principles and practices, without regard to whether the employer has current or accumulated earnings and profits for federal income tax purposes. Thus, under the facts in the ruling, a natural gas company, keeping its books and preparing its financial statements under methods of accounting prescribed by a regulatory agency and under general accounting principles, could base its contributions on its financial earnings even though it had no taxable income or accumulated earnings or profits for federal income tax purposes. Apparently, the company used the same method of accounting for financial and tax purposes but elected to deduct intangible drilling and development costs for tax purposes.

A question arose as to whether the rationale of this ruling would permit contributions to a qualified profit-sharing plan to be based on accrual-basis profits (as determined under generally accepted accounting principles), even though the company was on the cash basis for tax purposes. In other words, where different methods of accounting are used, can a company still base its profit-sharing contributions on the accrual-

Sec. 404 basis earnings, computed under generally accepted accounting principles, for financial statement purposes rather than on earnings determined under the cash method used for tax purposes?

The IRS *informally and unofficially* advised that any reasonable formula could be used—such as one based on the accrual method—even though resulting in contributions higher than contributions based on the cash method. In any event, where different financial and tax accounting methods are used, and contributions are based on financial earnings, the plan should clearly state this, especially where the books are kept on the cash basis but the financial statements are prepared on the accrual basis.

Accrual of profit-sharing plan contribution

An accrual-basis taxpayer is allowed a deduction for a contribution to a profit-sharing plan paid after the close of the year and not later than the time prescribed for filing a return if such a liability existed at year-end. The liability for a contribution to a qualified profit-sharing plan is established by the terms of the plan itself if the plan prescribes a definite formula for determining the profits to be shared. However, where a contribution is made in excess of the definite formula prescribed by the plan or if the plan provides for no definite formula, the taxpayer must establish his liability at year-end. One of the Service's requirements for establishing such a liability is that the plan participants be informed of the contribution before the year-end.

In a recent Tax Court memorandum decision, *Joe Coker Pontiac, Inc.*, TC Memo 1975-305, the Court concluded that the taxpayer properly accrued a contribution to a profit-sharing plan even though the plan participants were not notified of the contribution until after the close of the year. The Court saw no reason why notification of plan participants prior to year-end should be a prerequisite for establishing a liability in every instance.

On the other hand, Rev. Rul. 76-28 provides that general accrual conditions need no longer be met for such post-year-end contributions, pursuant to Sec. 404(a)(6), as amended by ERISA. However, this new provision applies to contributions on account of employer taxable years ending with or within plan years beginning after 1975 if the plan was in existence on January 1, 1974 (and the election under ERISA Sec. 1017(d) or (i) has *not* been made). Therefore, employer taxable years ending as late as November 30, 1976, could still be subject to the notification and other accrual requirements. Since we were *informally and unofficially* advised that the IRS will not follow the *Coker* decision, it is advisable—*in such cases*—to notify participants before year-end to avoid litigation. *Sec. 404*

H.R. 10 plans for directors under the 1974 Act

Under the 1974 pension reform law for taxable years beginning after December 31, 1973, the limits on deductions for contributions to an H.R. 10 plan on behalf of a company director, or any other self-employed person, have been increased. The maximum annual deduction is now the lesser of $7,500 or 15% of earned income. A minimum contribution of 100% (25% after 1975) of earned income up to $750 is also now allowed. An H.R. 10 plan may be established for anyone with self-employment income, such as director's fees, even if the self-employed person is also an employee who is covered by a corporate pension or profit-sharing plan.

Self-employed persons are also covered by the new ten-year averaging rule for lump sum distributions. The lump sum distribution from the H.R. 10 plan must be made after the self-employed person has reached age 59½ unless he dies or is disabled. All amounts that qualify for ten-year averaging must be combined into one lump sum distribution in a taxable year. After reaching age 59½, the election to combine all distributions can only be made once. Thus, it appears that a self-employed person who is also an employee would need to receive lump sum distributions from the H.R. 10 plan *and* the corporate plan in the same taxable year after reaching age 59½. Otherwise, both distributions would not qualify for ten-year averaging.

Care should be taken before recommending an H.R. 10 plan for an employee who also has self-employment income. When contributions are made, they will yield a federal tax savings of no more than 50% since the contribution offsets earned income. If the ultimate distribution(s) from the plan do not qualify for ten-year averaging, they could be taxed at more than 50%.

Sec. 404

Of course, earnings and capital gains accumulated by an H.R. 10 plan are untaxed until distributed. In addition, the self-employed person may receive a state tax deduction as contributions are made.

Sec. 408 IRAs: employee's voluntary withdrawal from qualified plan

The Employees Retirement Security Act of 1974 (ERISA) provides that an individual who is not an active participant in a qualified (or government) retirement plan may establish his own tax sheltered retirement fund, which is popularly referred to as an IRA.

Where an employee is an active participant in a qualified plan which will provide him with meager benefits, it could be to the employee's advantage to withdraw from the plan (or waive participation) to set up an IRA for himself.

This raises the question of whether an employee may unilaterally, without the plan making any provision in this respect, withdraw from the plan (or refuse to participate initially). If participation in the plan is not a condition of employment, it would appear that the employee can unilaterally withdraw from participation in the plan. In such case, it seems advisable for the employer to obtain a written statement from the employee to the effect that his nonparticipation is voluntary to preclude any question of coercion on the part of the employer.

However, voluntary nonparticipation by lower-paid employees could disqualify the plan by causing it to fail the percentage coverage test and also the nondiscriminatory classification test. Moreover, in the case of an H.R. 10 plan which covers owner-employees, the withdrawal of one employee would be fatal since all employees who have satisfied the service requirement must be covered by the plan. (It may be that, as a practical matter, lower-paid employees will not withdraw from an H.R. 10 plan since in most cases an adequate contribution, as a percentage of compensation, will be made by the employer for such employees.)

Therefore, an employer may wish to insist as a condition of employment that the employee participate in the plan so as to avoid its disqualification.

Exercise of stock options by U.S. executives employed abroad

Sec. 422

For the U.S. executive who is employed abroad by a foreign corporation and who has been granted qualified stock options in the U.S. parent corporation, the tax consequences of exercising such options must be carefully considered under foreign as well as U.S. law. For example, exercise of a qualified stock option in Canada will result, for the most part, in the difference between the option price and the fair market value of the stock on the date of exercise being treated as compensation subject to Canadian income tax.

Since the U.S. citizen must hold stock acquired under a qualified option for at least three years, he is not even in a position to sell such stock to raise funds to pay the Canadian taxes unless he elects to make a disqualifying disposition. In such event, the qualified option has lost much of its significance and provides little more than a compensation arrangement.

Therefore, after considering the tax rules of his country of residence, the U.S. executive might desire to avoid the exercise of a qualified option until he has been repatriated or to allow the qualified option to lapse and become a nonqualified option. The exercise of the nonqualified option upon return to the U.S. may actually result in a greater benefit than that which could have been derived from a qualified option. If the increment in the value of the stock over the option price arose entirely while the U.S. citizen was abroad, the compensation element arising from the exercise should constitute foreign source income. (Rev. Rul. 69-118.) To the extent the executive has unused foreign tax credits, such credits may be offset against the U.S. tax attributable to this foreign source income.

Transfer of qualified option stock to short-term trust as disqualifying disposition

To obtain capital gain treatment on the sale of stock acquired by the exercise of a qualified stock option, Sec. 422(a)(1) requires that no "disposition" of the option stock occur within three years from the date of its acquisition. Sec. 425(c)(1) states that " 'disposition' includes a sale, exchange, gift, or transfer of legal title but does not include . . . an exchange to which . . . Sec. 1036 . . . applies. . . ." Basically, Sec. 1036 provides for the nonrecognition of gain or loss if common stock in a corporation is exchanged for common stock of the same corporation (or preferred for preferred).

In Rev. Rul. 74-243, incidental to accepting a five-year assignment in Government service, *T* transferred option stock, which he had held for only a few months, to a blind irrevocable trust. Basically, the trust instrument provided that: the trust would terminate upon termination of *T*'s government service; upon such termination, the trustee was to deliver principal and any accumulated income to *T*; trust income was payable monthly to *T* and trust principal was payable upon demand; the trustee had broad management powers, including the powers to exchange or sell the trust property; and the trustee could not furnish *T* with any information concerning the trust's assets.

The ruling held there was a disqualifying disposition because of the "transfer of legal title" to the trustee. Three factual situations, presented in two prior rulings, were distinguished, namely:

- *Situation 1 (Rev. Rul. 57-451). T* endorsed option stock certificates in blank, and deposited them with a custodian (stock broker) under a written agreement providing that the stock was to be held or disposed of by such custodian for, and subject at all times to the instructions of, *T*, who remained the registered owner of the certificates on the corporation's books. It was held that there was no disposition since the transferee was merely a custodian who was not entitled to sell all incidents of ownership in the option stock.
- *Situation 2 (Rev. Rul. 57-451).* The facts are similar to those above except that *T*, the owner of the option stock, authorized the broker to "lend" the stock to customers of the broker. The broker had the stock certificates cancelled and new ones issued in his name. In this second situation, it was concluded that there was a transfer of title since all the incidents of ownership passed to the borrowing customer who presumably used the stock to cover short sales. Nevertheless, the ruling concluded, there was no "disposition" because the Sec. 1036 exception would apply if the broker satisfied his obligation to replace the certificates with shares of stock of the same kind and amount as originally transferred to him. The ruling further stated that the delivery of stock by *T* to his

broker and the satisfaction by the latter of the resulting obligation to replace them constitutes an exchange; a simultaneous delivery of property is not essential to an exchange; and if the parties so intend, title to property delivered on one side may pass even though the contract remains executory on the other. *Sec. 422*

• *Situation 3 (Rev. Rul. 73-30). T* delivered option stock to an agent with a power of attorney for the period of scheduled Government service. The power specified that *T* retained title to his option stock, but gave the agent authority to sell the stock and reinvest the proceeds. The power prohibited the agent from disclosing the assets held by him to the taxpayer. It was held that there was no disposition since the taxpayer retained title to the stock until it was disposed of by the agent.

The question has arisen whether a transfer of option stock to a short-term (10 year, one day) irrevocable trust constitutes a "disposition" if—as distinguished from Rev. Rul. 74-243 — the trust instrument requires the trustee to return the transferred shares upon the termination of the trust.

It is submitted that the facts are analogous to those in Situation 2 of Rev. Rul. 57-451, and therefore there is no "disposition." There may be a transfer of legal title to the trustee; however, since he must return (or replace) the option stock transferred to him, the Sec. 1036 exception to the definition of "disposition" is applicable.

Editor's note: The Tax Reform Act of 1976 generally repeals the present tax treatment of qualified stock options granted after May 20, 1976, and subjects them to the same treatment as nonqualified options.

Accounting periods and methods of accounting

Adoption of fiscal year by affirmative acts — Sec. 441

Rev. Rul. 68-125 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 practition-

Sec. 441 ers 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 yearend. Rev. Rul. 57-589 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 yearend. Late filing of a return for the initial period will not by itself preclude the adoption of the desired fiscal year.

Sec. 442 Achieving equity among partners on a change of year adjustment

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 clear-cut, 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 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 be obtained 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.

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)).

Sec. 446 "Year of transition" for purposes of Rev. Proc. 70-27: exceptions to general rule

Sec. 4.03 of Rev. Proc. 70-27 as clarified by Rev. Proc. 75-18 permits a taxpayer to request its application during an audit involving an issue of an accounting method change. In such event, the year of transition will *generally* be the most recent taxable year for which a return has been filed *at the time the agent begins his examination*. However, the IRS National Office has determined a transition year other than the one indicated under this general rule, citing the word "generally" in Sec. 4.03, in the following two cases:

- An earlier year (1963 instead of 1965) was substituted in order to allow certain amounts to be eligible for subsequent refund claims on an issue pending before the courts, since the National Office personnel had informally expressed the view that a ten-year spread *precludes* a subsequent refund claim regarding the issue under consideration.
- An earlier year (1965 instead of 1969) was substituted in order to prevent certain reserves of a life insurance company, erroneously deducted at a 24% effective tax rate, from being restored to income (over ten years) at a 48% rate.

Of course, the relief provided by these earlier transition years was somewhat tempered by reduced transitional adjustments (i.e., lesser amounts eligible for ten-year spreads).

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

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

When a corporation is acquired by another corporation in certain tax free exchanges, Sec. 381(c)(4) and the related regulations generally require the same method of accounting to be used in the future for both corporations; thus, one corporation may have to change its accounting method. Where such a change is required, the regulations make *no* provision for any possible ten-year spread of the bunched income resulting from the change. The Treasury is apparently unwilling to rule that the ten-year spread is available in this circumstance. *Sec. 446*

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

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

Are financial statements the taxpayer's "books"?

Sec. 446 provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." But what are the "books"? To be more specific, is it possible that a method could be used in keeping the books and records which differs from the method used in preparing the financial statements? And, if so, which method is the one pursuant to which the income tax return is to be prepared?

In two 1968 rulings (Rev. Ruls. 68-35 and 68-83), the IRS held that the cash basis could be used for tax returns even though books were maintained on an accrual basis, so long as the cash method had been consistently used, income was clearly reflected, and adjustments were readily verifiable on the permanent books and records.

More recently, however, IRS private rulings granting permission to change from the accrual to the cash method for tax purposes have required that the financial statements be on a cash basis, and informal conferences with IRS personnel have confirmed that they now view the financial statements prepared for general purposes as the "books" to which Sec. 446 refers.

Sec. 446

In one ruling situation, the IRS technician agreed that the taxpayer could insert a footnote to the cash basis financial statements indicating the amount of the "unbooked" accounts receivable—but was noncommittal as to whether the footnotes could also indicate what the accrual basis net income might be. He indicated that Lifo disclosure rules (Rev. Rul. 73-66) might be appropriate standards.

Most practitioners still appear to believe that a taxpayer who has initially adopted the cash basis (i.e., did not have to submit to IRS conditions in order to get permission to change) is fully justified in maintaining cash-basis books, preparing cash-basis tax returns, and preparing accrual-basis financial statements based upon worksheet adjustments to the cash-basis trial balance. If both the books and the annual financial statements are on the accrual basis, however, with worksheet adjustments being used to get to the cash-basis tax return, there is some apprehension that the IRS might challenge the taxpayer under Sec. 446.

The IRS might distinguish Rev. Rul. 68-35 on the basis that it dealt with quarterly and not with annual financial statements, and Rev. Rul. 68-83 on the basis that the change to accrual-basis books was required by a statute. Both rulings involved banks—one of which had changed to quarterly accrual reports for management purposes and one of which had changed to the accrual basis to prepare reports required by statute.

Editor's note: See IRS News Release 1125 (4/14/71) announcing that accounting method changes generally will not be approved unless the taxpayer agrees to use the new method for all financial reporting purposes.

Losses: book and tax conformity not expected

On its tax return, the taxpayer claimed a loss of $787,000, but in its books the $787,000 was set up as a deferred cost to be amortized over thirty years. Said the Tax Court, "Petitioner's treatment of the item on the books, however, is not dispositive of the issue for tax purposes. It is not at all uncommon to find that the book and tax treatment of a given transaction differ. Although losses may be amortized for book purposes, nothing in the Code permits such amortization for tax purposes." *Leslie Co.*, 64 TC 247 (1975).

Editor's note: In light of the immediately preceding article, the distinction should be made that in Leslie *the book and tax difference addressed a specific transaction and not a complete method of accounting.*

Ruling policy on change to the completed contract method

Until late last year, the IRS National Office granted permission to change from the accrual to the completed contract method of reporting income on a "cut-off" basis. Under that procedure, income from contracts in progress on the first day of the year of change would continue to be reported on the old (accrual) method. However, with respect to contracts entered into during the year of change, the Service required, as a condition of the change, that the taxpayer include in income for the year of change the difference between the amount of income that would have been reported for such year if the taxpayer continued to use its old method and the amount of income reportable under the new (completed contract) method. One-tenth of the amount of this so-called special adjustment then reduced income for each of the ten years beginning with the year following the year of change. This procedure was administratively convenient for taxpayers since it obviated calculations for contracts in progress as of the day before the beginning of the year of transition.

The Service has discontinued this "cut-off" procedure and currently requires calculation of the negative adjustment attributable to the change under Sec. 481(a), one-tenth of which is taken into account over each of the ten years beginning with the year of change. The IRS now believes that the "cut-off" procedure was not authorized under the Code.

The "cut-off" method generally required the taxpayer to include a lesser amount in income than the normal method change procedure under Sec. 481(a). However, a taxpayer who was at a disadvantage under the "cut-off" adjustment procedure may wish to consider a supplemental request seeking to modify the terms of the prior ruling and substitute the adjustment procedure under Sec. 481(a). Unless such a re-

Sec. 446 quest is made, the new position will not be applied to prior cases. However, it is uncertain whether the IRS will approve such a modification at this time.

Sec. 451 Constructive receipt: deferred compensation funded with life insurance

A corporation adopted a deferred compensation plan whereby certain employees could elect to defer to a future date certain amounts of compensation that would otherwise be available to them in the subsequent year. This effectively deferred the tax on the deferred amounts until the future year in which the compensation was received. Subsequently, the corporation amended the plan to provide an interest factor which was added to the compensation which was deferred under the plan. The taxation of the interest also was deferred until the time of receipt.

In order to increase the benefits of the employees, the corporation now proposes to amend the plan to allow the participant to request that a life insurance contract be purchased on his life with all or part of the deferred compensation. The employer corporation would be the owner and beneficiary of the policy, would exercise all rights and retain all interest in the policy, and the insured participant would have no rights whatsoever in it. Upon death of the insured, an amount equal to the proceeds of the policy plus the balance of the other amounts deferred and not used for the purchase of life insurance would be paid to the beneficiaries.

Under these circumstances it would appear that the insurance proceeds in the event of the death of the employee would become part of the general assets of the company subject to claims of creditors. Rev. Ruls. 72-25 and 68-99 permit the use of an annuity contract and a life insurance contract, respectively, as a means of funding unsecured agreements for the payment of deferred compensation to employees. That is, the employee was not in constructive receipt of income as a result of his employer's purchase of an insurance or annuity contract.

Nevertheless, the Service has taken the position that the right given the employee to determine the use to be made of the deferred compensation gives him control over the funds necessary to purchase the insurance. Therefore, according to the Service, there would be constructive receipt of income in this situation when the employee decides what use is to be made of the deferred compensation. It would appear that the Service could extend this principle to the extent that if the choice is available to the employee of how the funds should be used, even if he elects not to have the funds used to purchase insurance, he nevertheless has constructively received the amount which otherwise would be used in the purchase. *Sec. 451*

All purchase discount income can be deferred until merchandise is sold

The IRS issued a private ruling allowing a change in accounting method from recognizing purchase discounts when merchandise is purchased to including the discount in income when the merchandise is sold. This ruling is different from earlier rulings in two significant respects:

- The discounts in this ruling were cash discounts allowed for prompt payment of invoices; the earlier rullings involved trade discounts.
- The change was effected by valuing ending inventories net of actual cash discounts rather than by recording the original purchases net of discounts.

These rulings seem to indicate that the IRS will rule favorably on requests for permission to defer the recognition of either cash or trade discounts until the related merchandise is sold. In addition, valuing ending inventories net of discounts to accomplish the deferral is a simple way to effect the change.

Those considering this technique to defer income from purchase discounts will have to agree to use the same accounting method for all financial reporting as a condition to obtaining IRS permission to change.

Installment method: use of *Rushing* approach

Sec. 453

Where a corporation sells assets in exchange for the right to payments contingent on future earnings and then liquidates under Sec. 337, the Service will attempt to place a value on that right and attempt to tax it to the shareholders upon the liquidation at its "fair market value." Moreover, not only would the benefits of reporting the sale as an "open transaction" be lost, but any payments to the shareholders over and above the fair market value would be taxable as ordinary income unless the buyer is a corporation and the payments qualify as payments of corporate obligations.

What if the shareholders of the corporation were to sell their stock for the very same contingent payments? Here the Service has successfully contended in several cases that installment reporting is not available for such contingent payments. Neither would it treat this as an "open transaction" but would attempt to tax the rights in similar fashion to the liquidation.

The *Rushing* approach, *W. B. Rushing*, CA-5, 441 F2d 593 (1971), may help. It has been used in the past where a seller wishes to sell stock and take advantage of installment reporting and liquidate his corporation. In other words, the selling shareholders sell their stock on an installment basis to an independent third party. The independent third party (in *Rushing* it was an independent trustee) proceeds to liquidate the corporation and sell the assets to the buyer. Based on the authority of *Rushing*, the seller will have obtained installment treatment and is not taxable on the liquidation dividends.

Some practitioners are uncomfortable with the decision in *Rushing* although the decision does appear sound. See the decision in *C. B. Nye*, DC, N.C., 5/16/75, allowing installment treatment on a sale from a husband to a wife, and citing *Rushing* for support. However, in the event the *Rushing* approach does not hold up and the taxpayer is taxed on the liquidation dividends, he can still argue that the liquidation permits the shareholders to report the contingent payments on an open transaction basis. Thus, by using the *Rushing* approach, the taxpayer has added an extra string to his bow.

Will the sale of the stock at a fixed price jeopardize the taxpayer's argument (should the *Rushing* approach fail) that the contract rights received on liquidation cannot be valued and therefore must be treated as an "open transaction"? It would seem that the Service would be hard put to disregard on the one hand the sale of stock for purposes of defeating the *Rushing* approach, and at the same time recognize the sale for the evidentiary purpose of placing a value on contractual rights. Accordingly, such an argument should not deter use of the *Rushing* approach in this situation. *Sec. 453*

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 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.

Editor's note: See discussion of Rushing *at immediately preceding item.*

Sec. 453

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

In many cases, a purchaser of stock will find it desirable to acquire a corporation in a manner that enables the acquired corporation's assets to be used to satisfy part of the purchase price in a transaction sometimes referred to as a "bootstrap." (*Zenz*, CA-6, 213 F2d 914 (1954).)

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

In *Farha*, CA-10 483 F2d 18 (1973), the Court held that the transactions had to be considered together and therefore the sale of the stock did not qualify for installment sale treatment. The facts were particularly unfavorable to the taxpayer due to significant differences between the redemption price per share and the selling price per share (i.e., the seller apparently attempted through subterfuge to maximize the cash received in the year of sale). The Tax Court decision contains particularly strong language to the effect that the sale and redemption must be considered as one transaction for purposes of Sec. 453. While such a position may be subject to argument since the form of the transaction is that of two sales to two separate purchasers, the precedent of *Farha* cannot be ignored for planning purposes.

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. This position has been supported by a District Court and the Tenth Circuit in *Gralapp*, CA-10, 458 F2d 1158 (1972).

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 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 *Logan, Burnet*, 283 US 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. 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.

Sec. 453 *Editor's note: See also* Steen, *CA-9, 509 F2d 1398 (1975) for additional support for the IRS position that the benefits of Sec. 453 are not available in a contingent sales price situation.*

Installment sale and escrow deposits: Rev. Rul. 73-451 vs. 68-246

A real estate sale often raises conflicting objectives between the buyer and seller. The seller may want the tax advantages of installment reporting combined with a fully secured transaction. The buyer may require immediate unencumbered title to the property. In Rev. Rul. 73-451, the Service disapproved of one plan for reconciling these differences by ruling the installment basis was unavailable under the following facts:

> *S* sold land to *B* for $100,000. *S* received $10,000 at closing and was to receive payments of $15,000 per year for six years. *B* wanted clear title in the year of sale and therefore *S* had *B* deposit the $90,000 balance in escrow with a bank. The escrow was irrevocable and the payment schedule could not be accelerated by either party or the bank. *B* agreed to remain liable for any unpaid installments. In return, *B* received clear title to the property and interest at 5% per annum on the money he had left in escrow.

On the other hand, in Rev. Rul. 68-246, the Service permitted the purchaser to substitute a cash escrow deposit not subject to the unqualified demand of the seller as collateral for an installment sale obligation secured by a deed of trust. The seller was allowed to continue to treat the payments from the escrow account as payments on the original installment obligation. This ruling was distinguished in Rev. Rul. 73-451.

The distinguishing fact in the later ruling is that the escrow arrangement was made in the same year that the sale was made. It seems that this is an inconsequential difference where the terms of the escrow are the same. Why should a later substitution allow the taxpayer to use the installment method of reporting income, whereas a current escrow would deny the taxpayer these benefits?

The reason advanced for not permitting the installment method in Rev. Rul. 73-451 is that *S* was relying on the escrow deposits for his payment and not on *B*'s installment obligations—i.e., *S* did not regard *B* as being indebted to him. Why is this not just as significant in a later year?

Would this test be satisfied if the sale took place on December 31 and the escrow was substituted on January 2 of the following year? It appears that if there is a substitution of collateral in the form of an escrow account shortly after the date of sale, the subjective question of the parties' intent at the time of sale will determine which ruling is controlling.

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 the transferor:

Transferee	*Transaction*	*Related Section*
Donee	Gift	1001
Stockholder	Upon liquidation of corporation	331
Stockholder	Distribution not in liquidation	301
Beneficiary	Distribution from trust or estate (*Shannon*, 29 TC 702)	

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 corpora-

Sec. 453 tion 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 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.

Editor's note: See the discussion earlier under Sec. 333 for additional data concerning installment sales in liquidations. Also, note that when a decedent's installment obligations are distributed to a beneficiary, there is no taxable event to the transferor. The gain is income in respect of a decedent under Sec. 691.

Installment obligations passing at death

An interesting possibility for income tax planning in connection with the disposition of installment obligations is presented by the following facts:

Assume that a father owns all of the stock of an incorporated family business. Dividends paid on the stock (or constructively received at year-end if a subchapter S election is in effect) are taxed at the father's high rate bracket. Rather than making a gift of some or all of the stock to his children and paying a substantial gift tax, the father makes an installment sale of the stock to them at an arm's length price.

A few years after the installment sale, the father dies, and there remains unpaid the major portion of the sales price. Assume the father's will provides that any installment obligations unpaid at his death are bequeathed to each child who had executed the installment notes. Will any income be recognized by either the decedent or a child receiving his installment notes?

Sec. 453

The decedent. With respect to the decedent, the answer is clear that no income is recognized upon a bequest of the outstanding installment obligations. Sec. 453(d)(3) states that (except as otherwise provided in Sec. 691) the transmission of installment obligations at death is not a disposition of such obligations resulting in any gain or loss. Sec. 691 deals with the taxation of recipients of income in respect of decedents.

The children. With respect to the recipients of the installment obligations, the answer likewise would seem to be that no taxable income is recognized. Although the interest of the recipient as debtor and creditor would be merged, a taxable disposition of the installment obligation would not seem to occur under Sec. 691(a)(2) since that section excludes from its taxable disposition rules a transfer to a person pursuant to the right of such person to receive the amount by reason of the death of the decedent or by bequest. Although the regulations make it clear that such exclusion is designed to permit a tax-free transfer of the right to receive income in respect of a decedent upon the death of an intermediate holder, it also lends support to the above conclusion. See Regs. Sec. 1.691(a)-4.

The decision in *Jack Ammann Photogrammetric Engineers, Inc.*, CA-5, 341 F2d 466 (1965), also appears to support the conclusion by implication. In that case, a corporation's own installment obligations were transferred to it by its controlling shareholder. Although the Tax Court had held that when the corporation cancelled its own obligations it had disposed of them within the meaning of Sec. 453(d), the Fifth Circuit reversed, holding that the words "distributed, transmitted, sold, or otherwise disposed of" appearing in Sec. 453(d) limited the taxable disposition rules to transfers of property having a continuing existence. Although the transfer to the corporation might have been a taxable disposition by the controlling shareholder, the Court held that the debtor's receipt of its own notes did not constitute a taxable disposition by the debtor, whether or not the installment debt was thereby cancelled.

The principle of income arising from forgiveness of indebtedness similarly should not have any application to the assumed facts in view of the policy of Sec. 102(a) which excludes

Sec. 453 from income the value of property gratuitously received upon the death of the transferor.

Sec. 461 Pay contested liability prior to corporate liquidation

The limitations on deduction of contested liabilities, such as protested state income tax deficiencies, can have adverse tax consequences for the shareholders of a liquidating corporation.

Under the general rule of Sec. 461, the corporation will be denied a deduction for accrual of the tax. Further, a speculative or contingent liability will be disregarded in computing the shareholder's gain or loss on liquidation and a later payment of the debt by the shareholder will generate a capital loss under *Arrowsmith*, 344 US 6. It may take years for a large capital loss to be used, and, in any event, the tax benefit of a corporate deduction for the tax liability will be lost.

In appropriate circumstances, the problem can be solved by making corporate payment prior to liquidation. Under Sec. 461(f), a taxpayer can generally deduct a contested liability if money or other property is transferred to provide for the satisfaction of the liability. The benefits of a corporate deduction are illustrated by the following example:

Example. X corporation has $500,000 in assets available for distribution to shareholders in complete liquidation. *X* has no liabilities except for a contested state income tax deficiency of $20,000 and its final federal income tax liability. Taxable income reported on the final return of the corporation (exclusive of the contested liability) will be $100,000. The shareholders have no basis in their *X* stock, and are subject to a 25% capital gain tax on the liquidating gain.

	Liability not paid	*Liability paid*
Assets available	$500,000	$500,000
Contested liability	—	(20,000)
Federal income tax on $100,000 and $80,000 respectively	(41,500)	(31,900)
Distribution to shareholders	$458,500	$448,100
Capital gain tax	114,625	112,025
Net to shareholder	$343,875	$336,075
State tax deficiency paid	(20,000)	—
Capital loss benefit	5,000	—
	$328,875	$336,075

It can be seen that *X*'s payment of the contested liability resulted in a net tax saving of $7,200—$9,600 corporate tax savings less $2,400 capital gain tax thereon. If the capital loss were long term, and the shareholders had to apply it against ordinary income, only $10,000 (50% of the loss) would be deductible; the effect of this would depend on the shareholders' tax brackets.

Contested liabilities: no necessity for claimants to sign trust agreement

Taxpayers often find that an asserted liability is not deductible because it hasn't passed the "all events test" as to determining the fact and the amount of the liability. This is frequently the situation where litigation is pending as to the liability or where, for example, a taxpayer is contesting a state or local tax assessment. Sec. 461(f) was adopted in 1964 to provide relief to taxpayers, enabling them to deduct amounts transferred to provide for satisfaction of the contested liabilities, even if the contest continues after the time of the transfer.

Regs. Sec. 1.461-2(c)(1) sets forth the requirements that must be met in connection with the deduction and provides:

> A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, . . .

The Tax Court has recently decided that a transfer can be made in trust to a trustee without the knowledge or agreement of the person asserting the liability (or the beneficiary of the trust if the taxpayer loses the contest) and still meet the requirements of Sec. 461(f) so that it is deductible. The Tax Court in *Poirier & McLane Corp.*, 63 TC 570 (1975) (reviewed decision) held deductible the amounts transferred in trust by the taxpayer for the sole purpose of satisfying its possible obligations under suits filed for damages allegedly resulting from trespass and negligence in carrying out certain construction contracts.

The "beneficiary" of the trust was not aware of its existence and in fact the ultimate disposition of the asserted claim was

Sec. 461 made at no cost to the taxpayer. The Tax Court concluded that it was possible to satisfy the requirements of the above regulation for a written agreement among the parties without the knowledge of the "trust beneficiary." There were four dissents to the Tax Court's decision.

Taxpayers in the past have been reluctant to take advantage of Sec. 461(f) because no transfer funds to or with the knowledge of the adversary in a contest was viewed as admission of guilt or liability as to the contested matter. The decision in *Poirier* may provide a basis for obtaining these tax deductions without otherwise openly showing an adversary some expectations of loss.

Editor's note: The Second Circuit (11/23/76) reversed the Tax Court holding. It upheld the Regs. requiring the claimant to sign the agreement.

Sec. 463

Vacation pay: Sec. 463 election vs. change in business practice or accounting method

Accrual-basis employers should review the terms (forfeitable vs. nonforfeitable) of their vacation pay plans and the tax accounting method employed therefor. The addition of Sec. 463 to the Code in early 1975 creates tax pitfalls and planning opportunities for such employers, namely:

1. If the employer has been properly claiming deductions for forfeitable vacation pay on the accrual basis, it must change to the cash method for years ended after 1972 unless a timely Sec. 463 election is (was) made.
2. If an employer has been claiming deductions for vacation pay on a cash basis, it could start deducting such expense on an accrual basis for years beginning in or after 1974.

These pitfalls and planning opportunities will be discussed under the following headings:

- Election to continue accruing forfeitable vacation pay
- Election to start accruing forfeitable vacation pay
- Change from forfeitable to nonforfeitable plan
- Change from cash to accrual method for nonforfeitable vacation pay

General explanations of some key terms may be useful. A "plan" may consist of an oral or written communication to employees that they will receive vacation with pay (or pay in lieu of vacation). If an employee is unconditionally vested with the right to receive vacation pay, the plan is "nonforfeitable." If an employee could forfeit earned vacation pay upon the occurrence of some event (e.g., termination of employment before payment), the plan is "forfeitable." (See Rev. Ruls. 58-18 and 54-608.)

Election to continue accruing forfeitable vacation pay. In effect, Sec. 463 requires employers who have been properly accruing deductions for forfeitable vacation pay pursuant to the Technical Amendments Act of 1958 to either

—elect to continue doing so for its year ended in 1973, or

—change to the cash method of deducting vacation pay for such year and to continue using such method until a Sec. 463 election is made.

A Sec. 463 election should be made in the manner prescribed by temporary Regs. Sec. 10.2 by the later of July 21, 1975, or the due date (including extensions of time) of the return for the year beginning in 1974. (As to whether an employer has been "properly accruing" such deductions, see Rev. Rul. 75-224.)

Election to start accruing forfeitable vacation pay. Sec. 463 also permits an employer who has been deducting forfeitable vacation pay on the cash basis to start accruing such deductions for a year beginning in or after 1974. This election should be made in accordance with the aforesaid regulation by the later of July 21, 1975, or the due date (including extensions of time) of the return for the first year to which the election applies.

Ordinarily, the deduction for the first year of this election will be limited to the amount of vacation pay earned in such year. In general, the deduction for the liability for unpaid vacation pay at the preceding year-end (otherwise allowable on the cash basis in the year of election) will be deferred (held in a suspense account) until the year(s) in which (and to the extent that) payments of vacation pay exceed accruals.

In general if an employer's annual vacation pay expense is increasing, the election would be beneficial because it will accelerate deductions for the increases in year-end liabilities. If an employer's annual vacation pay is decreasing, the election will be neither beneficial nor detrimental. In any event an election should not be made before considering the factors discussed below.

Change from forfeitable to nonforfeitable plan. If an employer with a forfeitable plan desires to obtain a deduction for accrued vacation pay and also to avoid suspending the deduction for the unpaid liability at the beginning of the year of change, it should consider eliminating the forfeiture provisions from its vacation pay plan instead of making the Sec. 463 election. A change from a forfeitable to a nonforfeitable plan constitutes a change in business practice (see Rev. Rul. 58-340 and *Decision, Inc.*, 47 TC 58 (1966), acq.), rather than a change in accounting method requiring the IRS's consent. Therefore, dual deductions will be allowed in the year of change.

Example. At the end of 1974, *X* contingently owes its employees $100,000 for vacation pay earned in 1974. In 1975, *X* pays $98,000 of such liability, the $2,000 balance having been forfeited. In 1975, *X* adopts a nonforfeitable plan. During 1975, *X*'s employees earn $250,000 in vacation pay, of which $130,000 was paid during the year and $120,000 remained unpaid at the year-end.

X will be entitled to deduct $348,000 in 1975, determined as follows:

Amount paid in 1975 on account of 1974 forfeitable vacation pay	$ 98,000
Amount earned in 1975	250,000
Total	$348,000

If *X* did not change its vacation pay plan, the deduction allowable in 1975 would be limited to either:

- $228,000, if a Sec. 463 election is not made ($98,000 plus $130,000 paid in 1975 on account of amounts earned in 1974 and 1975, respectively) or
- $250,000, if a Sec. 463 election is made ($100,000 to be held in a suspense account).

Suppose *X* made a Sec. 463 election in 1975 and then changed to a nonforfeitable vacation pay plan in 1976, would the election bar *X* from claiming dual deductions in 1976 (balance in suspense account at beginning of 1976 plus amount earned in 1976)? Unless and until the IRS formally answers the question "no," an employer should delay making a Sec. 463 election while it is considering changing to a nonforfeitable plan.

Of course there are non-tax factors which should be evaluated by management before a nonforfeitable vacation pay plan is adopted. The tax advantages of making the change should influence but not control its decision. In this connection, note that the employer could eat his cake and have some left by providing that the vesting of vacation pay shall not occur until the last day of its taxable year.

Example. In order to discourage employees from leaving during the busy month of December, *Y* department store's nonforfeitable plan provides that vacation pay does not vest until the last day of its fiscal year ending January 31. *Y* is entitled to accrue a deduction for the amounts of vacation pay earned by all employees during its fiscal year—except for amounts forfeited by those employees who terminated within the year—even though every employee's vacation pay was subject to forfeiture until the last day of the year.

Change from cash to accrual method for nonforfeitable vacation pay. If an accrual-basis employer has been improperly claiming nonforfeitable vacation pay on a cash basis, it cannot change to the proper, accrual method of accounting without the prior consent of the IRS. (See Rev. Rul. 59-285.) Presumably, such an employer could start accruing deductions for vacation pay in 1974 or a later year by making a Sec. 463 election. Sec. 463(a) states that the amount accruable "*shall include* [vacation pay] which, because of contingencies would not [be otherwise deductible]." (Emphasis added.) Further the statute requires that "[*a*]*ll* payments with respect to vacation pay shall be charged to [a reserve] account." (Emphasis added.) The emphasized words imply that the amount accruable under Sec. 463 "shall include" nonforfeitable vacation pay.

As indicated above, however, the unpaid liability for vacation pay at the beginning of an election year (otherwise deductible on a cash basis in such year) will not be deductible until the year(s), if any, in which payments exceed accruals. Under these circumstances, instead of making an election, an employer should apply to the IRS for consent to change to the accrual method of accounting for vacation pay. (See Form 3115, Application for Change in Accounting Method, Schedule G.) If such consent is granted, the employer will be entitled to spread the "cash basis deduction" over a ten-year period beginning with the year of the change in accounting, and to accrue a deduction for the amount of vacation pay earned in the year of change. Thus, loosely speaking, "dual deductions" will be allowable over a ten-year period.

It has been suggested that since Sec. 463 prescribes specific

Sec. 463 rules (including the suspense account requirement) for changing to the accrual method of accounting for vacation pay, the IRS may take the position that it cannot grant consent to such a change under any other terms—i.e., permitting a ten-year deduction of the amount that Sec. 463 requires to be placed in a suspense account. However, neither the legislative history nor the statutory language support this suggestion. The committee reports make it clear that Sec. 463 was intended to extend the use of the accrual method to *forfeitable vacation pay*, not to deny the use of such method for *nonforfeitable* vacation pay. Moreover, by its terms, Sec. 463 is inoperative unless the taxpayer elects its application. Therefore, it is submitted, denial of an application for a change to the proper accrual method of accounting in accordance with the usual (ten-year spread) conditions would be arbitrary and clearly not justified (much less required) by the enactment of Sec. 463.

Sec. 471 Cost variances under full absorption regulations

Full absorption Regs. Sec. 1.471-11(d)(3) provides that a taxpayer may use the "standard cost" method of allocating inventoriable costs to ending inventory, provided that production cost variances are handled in the prescribed manner.

Clause (ii)(a) of this regulation generally requires that the taxpayer reallocate to goods in ending inventory, a pro rata portion of

—any net negative or net positive overhead variances and

—any net negative or net positive direct production cost variances for the year.

However, no reallocation is required if the sum of such variances (both direct production costs and overhead costs) are not significant in amount in relation to the taxpayer's total actual *indirect production costs* for the year, unless an allocation is made in the taxpayer's financial reports.

It should be understood that the nonapplication of variances under this de minimus rule goes to both indirect production costs and direct production costs. Heretofore, the IRS has never acknowledged that variances with respect to direct labor or materials need not be allocated to closing inventory. Further, there is no apparent reason why variances for both direct and indirect production costs are to be compared with only actual indirect production costs for the year.

In the case of a manufacturer whose indirect production costs are low in relation to total production costs, even a very small percentage variance for direct production costs may appear to be significant in relation to indirect production costs and therefore outside of the de minimus rule. For example:

Production cost category	*Standard costs*	*Actual*	*Variance*	*%*
Direct	$100,000	$102,000	$2,000	2
Indirect	25,000	26,000	1,000	4
Total	$125,000	$128,000	$3,000	

Under the de minimus rule of the full absorption regulations, the net positive variance of $3,000 must be related to only $26,000 of indirect production costs for the year, and the resulting 11.5% "variance" may be considered significant so as to require an allocation of all variances to the ending inventory. This result seems unreasonable in light of the low overall level of the variances, in relation to the overall standard costs, and it is hoped that such a literal reading of the regulations will not be applied by the IRS.

Full absorption: Sec. 481 adjustment period can be less than 10 years

Regs. Sec. 1.471-11(e) provides that taxpayers not using the "full-absorption" method of inventory costing must change to that method. If an election is made to adopt full-absorption costing during the two-year transition period, taxpayers will be able to receive up to a 10-year spread of any resulting Sec. 481 adjustment.

For taxpayers that have not elected full-absorption costing during the transition period, it should be noted that the Service has modified Rev. Proc. 70-27 (in Rev. Proc. 74-51) to provide that it will not apply to a taxpayer changing to the full-absorption method of inventory costing. As a practical matter, most changes to the full-absorption method for "under-absorbed" taxpayers after the transition period probably will be initiated by the IRS, and therefore no portion of any adjustment which is attributable to pre-1954 inventory balances would be taken into account. However, the "under-absorbed" taxpayer would be subject to adjustment for the earliest open year and would be denied a ten-year spread of the income-increasing adjustment.

Positive adjustment. Taxpayers who make the special election to change to full absorption during the transition period, and thus must include in income additional indirect production costs which result in a positive adjustment, are permitted to take any adjustment into account *ratably* over a period designated by the taxpayer at the time of such election, not to exceed the lesser of ten taxable years commencing with the year of transition or the number of years the taxpayer has been on the inventory method from which he is changing. During the early part of the transition period, the Service uniformly granted a ten-year transition period in its rulings to taxpayers who did not specifically indicate their desire for a shorter period and who had been on their old method for a period of greater than ten taxable years. During the later part of the transition period, however, the Service representatives specifically asked what period the taxpayer wanted to use for the adjustment if it was not indicated on the Form 3115. Those taxpayers who received a ten-year spread and wish to and are eligible to take the adjustment into income over a shorter period may want to file a supplemental request pursuant to Regs. Sec. 1.9100 designating a shorter period.

It should be noted that taxpayers will not be permitted to take the entire positive adjustment into income in the year of transition (e.g., to offset an expiring net operating loss). The Service has taken the position that the word "ratably" as found in Regs. Sec. 1.471-11(e)(3)(i) implies more than one year and, therefore, a taxpayer may only choose an adjustment period of from two to ten taxable years.

Negative adjustment. Where a taxpayer changes during the transition period to the full-absorption method from a method of inventory costing which is more inclusive of indirect production costs ("negative adjustment"), he may deduct the resulting Sec. 481 adjustment generally over ten taxable years commencing with the year of transition. In Rev. Proc. 76-8 (2/17/76), the Service held that a resulting negative adjustment may be taken into account over a period of less than ten years "where the taxpayer has been in existence for less than ten taxable years or has used the accounting practice that is being changed for less than ten taxable years." *Sec. 471*

IRS terms for approving inventory changes: clarification of prior item

On page 172 of *Working With the Revenue Code–1974*, we dealt with IRS terms letters approving inventory costing changes and the premature triggering of the transitional adjustment. We said that, based on a literal interpretation of current terms, letters and Regs. Sec. 1.471-11(e)(3)(i), the balance of the transition adjustment is triggered into income when the taxpayer's inventory decreases by a dollar amount which represents more than 33⅓% of the inventory amount at the beginning of the year of change. Such items are prescribed in letters issued pursuant to Rev. Proc. 70-27 allowing changes in inventory accounting methods under conditions which allow the tax cost of the step-up in inventory value to be spread over ten years.

We were informally advised that the IRS National Office interprets this condition to call for early recognition of the transitional adjustment only in the case where the dollar amount of the taxpayer's ending inventory is less than 66⅔% of the initial inventory amount. The original and modified interpretations can be simply illustrated as follows:

	Interpretations	
	Original	*Modified*
1. Beginning inventory—year of change—1/1/70	$ 30,000	$ 30,000
2. Transitional adjustment to be spread over ten years	10,000	10,000
3. Transitional adjustment included in 1970-1972 income	3,000	3,000
4. Unreported transitional adjustment at 1/1/73	7,000	7,000
5. Inventory at 1/1/73	100,000	100,000
6. Inventory at 12/31/73	89,000	89,000
7. Inventory decrease during 1973 (L. 5—6)	11,000	11,000
8. Transitional adjustment recognized for tax purposes	7,000	1,000

Sec. 471

Thus, under the original interpretation, the entire balance of the transitional adjustment at January 1, 1973 ($7,000), would be triggered into 1973 income, because the $11,000 decrease in inventory during such year exceeded 33⅓% (11,000/30,000 = 37%) of the opening inventory in 1970. This was true under the original interpretation even though the decrease in inventory within 1973 was small (11% of the 1/1/73 inventory) and even though the 1973 yearend inventory was almost three times the inventory at January 1, 1970.

Under the modified interpretation, however, the balance of the transitional adjustment does not have to be taken into 1973 income since the 1973 yearend inventory is at least 66⅔% (89,000/30,000 = 297%) of the opening inventory in 1970. Thus, the taxpayer is required to report only $1,000 of the transitional adjustment in 1973, and $1,000 in each subsequent year so long as the closing inventory at the respective yearend does not fall below $20,000 (66⅔% of $30,000).

Under the original interpretation, as indicated above, it is likely that a small decrease in inventory within a post-change year will constitute more than 33⅓% of the opening inventory in the year of change. Because of inflation and/or business expansion, the value of inventories in a future year—and hence any decrease within such year—will be disproportionate to the year-of-change inventory.

Undoubtedly, the risk of having the entire amount of a transitional adjustment triggered into income by a small decrease in one year's inventory would discourage taxpayers from voluntarily correcting inventory methods. Based on this advice the IRS terms letters and Regs. Sec. 1.471-11(e)(3)(i) should be applied by an examining agent in accordance with the modified interpretation.

Inventories: the average cost method

The only two methods of costing inventories specifically approved by the IRS are the Fifo and Lifo methods. Sometimes a taxpayer finds it impractical to use either of these methods and resorts to the average cost method. The IRS, however, generally takes the position that the average cost method is an improper method for costing inventories. Nevertheless, a recent ruling based on a request by a taxpayer under Rev. Proc. 70-27 gives some insight as to when the Service will find the average cost method acceptable. *Sec. 471*

The taxpayer, an importer and wholesale broker of meat products, requested that the IRS allow it to change its method of costing inventories to the average cost method. Due to the highly volatile nature of the price in the market place the inventory was turned over as rapidly as possible. As a result of such turnover, the taxpayer believed the average cost method to be the most practical method of valuing its inventories.

In discussing the ruling request with the taxpayer, the Service stated that it believed the average cost method was an improper method and indicated that it would approve a change to the Fifo method. The taxpayer, however, reemphasized that due to the fact the inventory turns over 20 to 25 times a year, it was impossible to arrive at an actual cost on the Fifo basis. The taxpayer further indicated, by submitting documentation, that the average cost method was a proper inventory valuation method under generally accepted accounting principles and can be used where it is impossible that other methods will result in a proper costing.

The Service accepted the taxpayer's position. It indicated that since the inventory had a significant turnover in excess of 10 to 12 times a year, the average cost method would be allowable. It concluded that due to the rapid turnover, the results obtained under the average cost method would be comparable to the results obtained under the Fifo method.

However, as a condition to allowing the change of method, the Service imposed a requirement that any item of inventory held for more than 12 months would have to be valued on the basis of its actual cost at the time of its purchase. Thus, these items would have to be specifically identified and their actual cost used, not the average cost of the items at yearend.

IRS suggests two separate adoptions of Lifo acceptable

Sec. 472

How many times can a taxpayer switch between Lifo and another inventory method without any problems? Experiences of some practitioners in this matter, and discussions with National Office personnel, suggest that two successive adoptions of Lifo for the same inventories should not cause any difficulties.

Sec. 472 The following comments are worthy of note:

• No adjustment is required on the initial adoption of Lifo (except that any prior write-down to market must be restored). Form 970 must be filed with the return, and the books and financial statements must be conformed.

• IRS permission must be obtained to discontinue Lifo. The general rules for a change of accounting method (Rev. Proc. 70-27) will apply. If a positive adjustment is required to be taken into taxable income as a result of changing from Lifo, there are Revenue Procedures in effect that may allow this adjustment to be spread over twice the number of years for which the Lifo method was used, up to a maximum of 20 years. Also, the IRS will state in its terms and conditions letter that permission is required to readopt Lifo.

• When the taxpayer requests permission to readopt Lifo, the adjustment referred to above must continue to be taken over the remaining years of the original adjustment period if it is a *negative* (income-reducing) adjustment. If it is a *positive* adjustment, however, the taxpayer readopting Lifo must take into income all the remaining balance of the adjustment in the year Lifo is readopted.

• It is not completely clear at this time whether the request to readopt Lifo must be filed in the first 180 days of the taxable year on a Form 3115. Some taxpayers have secured permission to readopt Lifo when the requests were filed after such date without a statement of reasonable cause for lateness attached. National Office's informal explanation is that the IRS is not granting a change of method under the usual rules but is granting permission for the taxpayer to change, if he desires, by electing with Form 970 on a timely-filed return. Therefore, the normal 180-day requirement appears inapplicable.

To discontinue Lifo the second time, the procedure should be similar to that described above.

Change to Lifo: amended return for prior year

Adoption of the Lifo method of valuing inventories has been the subject of numerous tax articles. Many questions and problems have arisen for which there seemingly are no official answers. One of these problems deals with market write-downs.

A major consideration in adopting Lifo is the existence of market adjustments in the closing inventory of the year preceding the year of change. The Lifo regulations require that the opening inventory for the year of the change be taken at cost. (Regs. Sec. 1.472-2.) In addition, Sec. 472(d) requires that the preceding year's closing inventory also be valued at cost. The relationship of these two provisions requires that a taxpayer file an amended return for the year preceding the Lifo election to restore to income any write-downs to market in that year's closing inventory.

One question that arises with regard to this issue is the due date of this amended return. The position of the IRS is that unless this amended return for the preceding year is filed prior to or concurrent with the return containing the Lifo election, the election could be considered invalid for lack of compliance with all the requirements incident to the election. While the Service's position on this issue is not firm and is subject to debate, a prudent course of action would be to file the amended return prior to or concurrent with the return electing Lifo.

Editor's note: Rev. Proc. 76-6, as revised by Ann. 76-95 (7/2/76), extended the time for filing the amended return to August 12, 1976, in addition to providing procedures for years closed by statute. Rev. Rul. 76-282 holds that the Sec. 472(d) adjustment applies to ". . . goods that are unsalable at normal prices or unusable in the normal way, as well as normal goods that have been written down to market value. . . ." Rev. Proc. 76-28 provides guidelines concerning Lifo and Sec. 1.471-2 inventory write-downs. The ruling and the procedure both exclude such goods disposed of before the beginning of the first taxable year commencing on or after September 24, 1976.

Lifo conformity requirements: subsidiary's earnings on parent's financial statements

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

Sec. 472

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

Lifo index method guidelines in embryonic state

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

The AICPA Federal Tax Division in their presentation of Lifo problems to the IRS on Feb. 21, 1975, asked that guidelines be issued on use of the index. The troublesome words in the regulations are "representative portion of the inventory" and "sound and consistent statistical methods." The regulations do not define either of these terms and so far there have not been rulings issued to serve as guidelines in this area.

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

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

IRS reluctant to rule on Lifo pools

One of the conditions imposed by the Code incident to the adoption of Lifo is the requirement that all inventories be valued at cost. The Lifo regulations add that the taxpayer may elect to determine cost under the "dollar-value" method. This method provides that base-year amounts or layers are expressed in terms of dollars, rather than quantity or price of specific goods, as a unit of measurement. When this method is used, the goods contained in inventory are grouped into a pool or pools. In each year subsequent to the adoption of Lifo, the incremental inventories are adjusted in relation to the base-year pool or pools as measured by the dollar value.

The regulations set forth the principles for the establishment of pools. Regs. Sec. 1.472-8(d) states that the appropriateness of the number and composition of pools used by taxpayers, as well as the propriety of all computations incidental to the use of such pools, will be determined in connection with the examination of returns.

According to some practitioners, the IRS is interpreting this regulation literally. In effect, the IRS is saying that it will not rule in advance on the method, number, composition, or propriety of pools utilized, as this responsibility is delegated specifically to the District Director in connection with the examination of returns.

What is the direct effect on the taxpayer of this position? Presumably, if all other requirements incident to the adoption and use of Lifo are satisfied, any adjustments proposed on examination because of improper pooling should not invalidate the Lifo election. However, any adjustment or realignment of pools might cause the invasion of some base-year layers which could have the effect of creating additional taxable income.

It is acknowledged that this may represent the extreme result. However, it does point out the problems that could be encountered and the necessity to plan carefully for the establishment of pools under the "dollar-value" method of determining costs. It is important to retain all relevant records so that pools may be reconstructed in the event the IRS does attack the taxpayer's approach, in addition to precluding any IRS attempt to invalidate the election.

Inclusion of manufacturing supplies in Lifo election

In connection with the increased interest in the Lifo inventory valuation method, there has been speculation as to whether Lifo can be elected for manufacturing supplies —e.g., fuel oil, coke, coal, packaging supplies, etc. Regs. Sec. 1.472-1(a) states in part that:

> Any taxpayer permitted or required to take inventories pursuant to the provisions of section 471, and pursuant to the provisions of §§1.471-1 to 1.471-9, inclusive, may elect with respect to those goods specified in his application and *properly subject to inventory* to compute his opening and closing inventories in accordance with the method provided by section 472. . . . (Emphasis added.)

It is therefore reasonable to conclude that if manufacturing supplies are properly "subject to inventory" (i.e., inventoriable) and if the taxpayer has consistently treated such supplies as inventory for tax purposes, a Lifo election should be available.

A determination of which supplies are inventoriable is critical. To make this determination, manufacturing supplies must be separated into two categories: those which will physically become a part of products intended for sale, and those which will be consumed in connection with the manufacturing processes.

A few examples may serve to illustrate this distinction. If a manufacturer of gear boxes packs its product with grease before sale, then this lubricant would be a physical part of the final product. Similarly, packaging materials for finished products become a physical part of the final product. However, grease consumed by the manufacturer to lubricate a grinding machine would not be considered a physical part of the manufactured product. Coking coal stocked by a steel producer to be used in the production of carbon steel should be considered a physical part of the steel since the carbon in coke is an ingredient of the steel. On the other hand, coal used by the steel producer to provide electricity would be considered a consumed supply.

Supplies that become a physical part of the product clearly qualify as inventoriable. As an inventoriable cost, these supplies should qualify for inclusion in a Lifo election. This conclusion is supported by the fact that the IRS acknowledges that these types of supplies are inventoriable. (Regs. Secs. 1.471-1 and 1.471-3(c).)

The applicability of Lifo to supplies consumed in the manufacturing process is not quite as clear. If a taxpayer accounts for consumed supplies as a prepaid expense under Regs. Sec. 1.162-3, the Service likely would conclude that the taxpayer cannot account for such supplies by using the Lifo method to identify the cost of materials consumed.

The Service's rationale and the inconsistent treatment of consumed manufacturing supplies can be traced to an apparent conflict in the regulations. Regs. Sec. 1.471-1 states that in the case of raw materials and supplies, inventory should include "only those [raw materials and supplies] which have been acquired for sale or which will *physically become a part of merchandise* intended for sale. . . ." (Emphasis added.) On the other hand, Regs. Sec. 1.471-3(c) defines the inventory cost of produced goods, in part, as "the cost of raw materials and supplies entering into *or consumed* in connection with the product. . . . " (Emphasis added.) The inclusion of consumed supplies in inventoriable costs is further supported by the "full absorption" regulations. Regs. Sec. 1.471-11(b)(2)(i) provides that "[d]irect material costs include the cost of those materials which become an integral part of the specific product *and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product.*" (Emphasis added.)

Regs. Sec. 1.471-1 and its predecessor provisions must be viewed in light of the substantially unchanged regulations preceding present Regs. Sec. 1.471-3(c). Since 1920, these regulations have stated that in the case of raw materials and supplies, inventory cost means the cost of raw materials and supplies entering into or consumed in connection with the product. In *Aluminum Company of America*, 24 F Supp 811 (DC–Pa., 1938), the Court commented on Article 1583 of Regs. 45 (the language of which is identical to Regs. Sec. 1.471-3(c)) as follows:

> If the scrivener of the regulations intended to limit the cost of materials in inventories to those supplies which were to become ingredients in the finished products, he surely would have written: "(a) the cost of raw materials and supplies entering into the product," and not "(a) the cost of raw materials and supplies entering into or consumed in connection with the product." . . .

In summary, a Lifo election is clearly available for supplies which become a physical part of finished goods, and a Lifo election may also be available for supplies which are consumed in the manufacturing processes. In view of the recent significant price increases for certain supplies which are consumed in the manufacturing or production processes, this tax planning opportunity for the expanded use of the Lifo method has become more critical.

Lifo and Sec. 334(b)(2) liquidations

Is the Lifo reserve triggered into income as a result of a Sec. 334(b)(2) liquidation? Suppose that *A* corporation purchased the stock of *B* corporation in 1974. *B* then elects Lifo for 1974. In 1975 or 1976, *A* liquidates *B* and steps up the basis of *B*'s assets under Sec. 334(b)(2).

B has been completely liquidated under Sec. 332. Sec. 336 provides for the nonrecognition of gain or loss on the distribution of property in complete liquidation of a corporation. Sec. 311(b), which provides for the recognition of gain on the distribution of Lifo inventory, does not apply to a distribution in complete liquidation.

Therefore, *B* would have received a permanent benefit for the Lifo reserve. *A* can elect Lifo for the inventory, depending on the conditions and prospects prevailing in the year of liquidation.

Adopting Lifo: previous change in inventory method and 33⅓% reduction problem

Prior method change. In deciding whether or not to change to the Lifo method of inventory valuation, the question often arises as to the effect the adoption of Lifo will have on a taxpayer already amortizing an adjustment (generally a "ten-year spread") from a previous change in inventory valuation method. The previous change in method would generally be pursuant to Rev. Proc. 70-27 (or its predecessor Rev. Proc. 64-16), or Regs. Sec. 1.471-11 in the case of a manufacturer changing to full absorption costing during the "transition period."

Will the adoption of Lifo cause the unamortized balance of the ten-year spread adjustment to be taken into income in the year Lifo is adopted? It is understood that the IRS position is that generally the balance of the adjustment will not be triggered if the adjustment relates to a change from one cost method of inventory valuation to another (e.g., prime cost to full absorption cost, or weighted average cost to Fifo). The term "cost method" for this purpose includes lower of cost or market methods and is not used in the strict Lifo sense of precluding write-downs to market. However, taxpayers sometimes utilized ten-year spreads to restore "unauthorized" write-downs to market (i.e., write-downs that were prohibited by IRS regulations). In such cases, the Service's position is understood to be that the balance of the adjustment must be taken into income in the year Lifo is adopted. This position is based on Regs. Sec. 1.472-2(c) which states that "restoration shall be made with respect to any write-down to market values resulting from the pricing of former inventories."

Sec. 472 *Reduction in inventory.* Although the above type of adjustment may not present a problem, the taxpayer may still have cause for concern. IRS letters granting permission to change inventory valuation methods generally attach conditions similar to those in Regs. Sec. 1.471-11(e)(3)(i). This regulation provides, in part, that the balance of the adjustment must generally be taken into income if the taxpayer's inventory is reduced as of the end of any taxable year by more than one-third of the inventory as of the beginning of the year of change. A question that arises is whether this one-third reduction is to be measured by valuing subsequent yearend inventories at Lifo. If so, the mere change to Lifo and, presumably, its resulting low inventory valuation, may result in a one-third reduction in taxpayer's inventory. The Service seems receptive to resolving this problem, and agrees that a "disposition criterion" (e.g., reduction in number of units) rather than a "valuation criterion" should be used for purposes of measuring the one-third reduction. However, there is some question as to the exact computations that would be involved, and a taxpayer might be faced with substantial administrative burdens in attempting to satisfy the IRS in this respect due to the lack of comparability of the inventory amounts.

A taxpayer currently amortizing an adjustment from a change in inventory valuation method and considering a change to Lifo may want to request a private ruling to confirm that the change will not trigger the balance of the adjustment into income and to clarify the reduction-in-inventory question.

Sec. 481 Retroactive capitalization of indirect in-house construction costs

Sec. 481 provides that when a taxpayer changes a method of accounting there shall be taken into account those adjustments necessary solely because of the change in order to prevent duplication or omission. In *Idaho Power*, 418 US 1 (1974), the Court required capitalization of expensed construction costs. Concern has been expressed that the IRS expansion of *Idaho Power* to treat capitalization of expensed construction costs as an accounting method has been confirmed by the decision in *Adolph Coors Co.*, CA-10, 519 F2d 1280 (1975). The Court held that the taxpayer's practice of treating in-house construction overhead costs as current expenses or cost of manufactured inventory was an erroneous accounting method which should be corrected under Sec. 481 by capitalizing similar expenditures erroneously deducted in prior years with respect to depreciable property still on hand in the beginning of the first open year.

No discussion appears either in the Tax Court or Circuit Court decisions as to the computation of these retroactively capitalized expenditures, e.g., whether any effect was given to retirements, selection of depreciation method, or investment credit entitlement. A review of the taxpayer's brief in the Court of Appeals indicates no argument on the capitalization of current year expenses only, as in the *Idaho Power* 418 US 1 (1974) and *Mountain Fuel Supply Company* CA-10, 449 F2d 816 (1971) cases.

In addition, no citation was made to the precedent of Rev. Rul. 70-318 under which the Sec. 481 income reporting, resulting from the retroactive capitalization of the expenditures, was taxed over the remaining useful life of the related (player contract) assets, thereby matching the amortization or depreciation deductions. Finally, no argument was made that the "duplication" requiring application of Sec. 481 was itself caused by the retroactive capitalization in the first open year of expenditures deducted in prior closed years; i.e., no duplication would be involved if a "cut-off" computation were used, capitalizing only current year expenditures.

It is understood that the petition for certiorari filed by the taxpayer includes no appeal on the Sec. 481 retroactive capitalization issue, presumably because of the large pre-1954 years' "untaxed" addition to the taxpayer's depreciation schedule. Unless the taxpayer prevails on another (collateral estoppel) argument rejected by the Tenth Circuit, the retroactive capitalization rule may become an established principle of tax accounting. In many cases, the pre-1954 years' property additions will be relatively small, and a substantial adverse result will occur when the taxpayer is required to pay an immediate tax in the first open year, then recover the offsetting tax benefit by depreciation spread over a long period of future years.

Sec. 481

The *Coors* case may be distinguishable, however, from the ordinary capital vs. expense question since the consistent inclusion of the construction overhead costs in beer production costs affected the taxpayer's inventory pricing. An inventory pricing method has always been considered an accounting method. If this distinction is not drawn, the disruptive effect of reconsidering capital vs. expense decisions over all years starting with 1954, and the resulting uncertainties as to depreciable basis, accumulated earnings and profits and general disregard of the statute-of-limitations principle, may be significant.

Sec. 482

Sec. 482: U.S. parent's guarantee of foreign subsidiary's indebtedness

It appears that the IRS is actively pursuing the issue raised in *Tulia Feedlot, Inc.*, 366 F Supp 1089 (DC–Tex. (1974)), as it relates to guarantees by U.S. parent corporations of indebtedness of foreign subsidiaries to third parties.

Tulia Feedlot involved a domestic corporation which paid a fee to its stockholders for their guarantee of its indebtedness to financial institutions. The amount of the fee which was allowed as an ordinary and necessary business expense of the corporation was 3% of the amount of the guarantee. In light of this development, the IRS is apparently taking the position that where U.S. parents guarantee loans of their foreign subsidiaries, a fee should be charged for this guarantee under Sec. 482.

The issue is complicated by the fact that the fees are apparently viewed as a payment for services rendered by the parent to the subsidiary. In this connection, the Sec. 482 regulations dealing with services appear to indicate that where services are rendered to a related party and the services are not "an integral part of the business activity" of either party, the fee charged need only include the costs or deductions incurred with respect to the services. (Regs. Sec. 1.482-2(b)(3).)

In view of the fact that there is no apparent cost to the parent rendering the service in this case, the question of the basis on which such a Sec. 482 adjustment should be made is open to question.

Editor's note: There is even more question now that Tulia Feedlot *has been reversed by CA-5, 513 F2d 800 (1975) cert. den. 96 SCt. 362.*

Setoff under Sec. 482 regulations

Sec. 482

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.

Editor's note: Rev. Proc. 70-8 prescribes the procedure to be followed with respect to claiming the set-offs.

Controlling income from deferred payment sales

Sec. 483

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

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

Illustration

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

Note that under Alternative I, Sec. 483 would still be applicable to the *buyer* pursuant to Regs. Sec. 1.483-2(b)(3)(ii). On the other hand, there would not be any interest *imputed* to the buyer at 7% (compounded semiannually) under Alternative II since there is *stated* simple interest of at least 6% per annum.

Exempt organizations

Exempt organizations: Unrelated trade or business income from partnership interests

Sec. 512

Sec. 511 imposes a tax on the unrelated business taxable income (as defined in Sec. 512) of organizations described in Secs. 401(a) and 501(c)—i.e., employers' qualifying pension and profit-sharing plans, and the typical exempt organizations. State colleges and universities are also subject to the unrelated trade or business income rules.

Sec. 512(c) states that if a trade or business regularly carried on by a partnership, of which an organization is a member, is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, *subject to the exceptions, additions, and limitations contained in subsection (b)*, include its share of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income. (Emphasis added.) See also Rev. Rul. 74-197.

It is important to note that the modifications provided by Sec. 512(b) eliminate many classifications of income from "unrelated trade or business income."

In general (except for foreign organizations, organizations described in Sec. 501(c)(7) or (9) (social clubs and voluntary employees' beneficiary associations), and veterans' organizations described in Sec. 501(c)(19)), unrelated trade or business income does not include the following:

- Dividends, interest, and annuities;
- Royalties;
- Rents from real property, and from personal property which is merely incidental to the real property, provided that no more than 50% of the lease income attributable to the property is attributable to the personalty; and
- Gains or losses from the sale, exchange, or other disposition of property other than that which would properly be included in inventory or held primarily for sale to customers in the ordinary course of a trade or business.

Note, however, that Sec. 512(b)(4) overrides the above exceptions and holds that if the property generating the income

Sec. 512 is "debt-financed" property (in general, income-producing property with respect to which there is acquisition indebtedness; see Sec. 514(b)), there shall be included as gross income from an unrelated trade or business the amount described in Sec. 514. In general, therefore, the income from debt-financed property is includible as unrelated trade or business income unless it is related to the exempt organization's exempt function. See Sec. 513.

Notwithstanding the above, if property is acquired by *bequest* or *devise* subject to a mortgage, income from property subject to such mortgage is not to be regarded as debt-financed income for the immediately succeeding ten years. If acquired by *gift*, property subject to a mortgage does not come under the debt-financed acquisition indebtedness rule during the immediately succeeding ten-year period so long as

—the mortgage was placed on the property more than five years before the date of gift, and

—the property was held by the donor for more than five years before the date of gift.

Note that these exceptions do not apply if the organization assumes and agrees to pay all or any part of the indebtedness secured by the mortgage or the organization makes any payment for the equity owned by the decedent or donor in the property. See Sec. 514(c)(2)(B). If the property is refinanced, apparently only the excess obtained will be regarded as new indebtedness. Prop. Regs. Sec. 1.514(c)-1(c)(1).

Based on the above, it is quite clear that before adequate tax conclusions can be reached, the underlying assets of the partnership must be analyzed to determine whether they are the type which will result in unrelated trade or business income of any exempt organization.

Corporations used to avoid income tax on shareholders

Sec. 531 Avoiding the accumulated earnings tax with Lifo

Having experienced a year of rapidly increasing costs of inventories, many companies will be making an election to value their inventories under the Lifo method. The most frequently considered reason for making this election is the cash flow benefit derived from the deferral of income taxes. However, there is another potential benefit which would be of significant importance particularly to the closely held corporation.

Sec. 531 imposes the accumulated earnings tax on accumulated taxable income of a corporation. Accumulated taxable income is defined as taxable income adjusted by a number of modifications. (Sec. 535.)

The closely held corporation has always been subject to particular scrutiny in this area because of the tendency by some of these corporations to retain their earnings rather than distributing them to the shareholders and subjecting them to the second-tier tax. A Lifo election presents an opportunity to retain significant amounts of cash in the corporation without increasing vulnerability with regard to the accumulated earnings tax on such retained amounts.

To illustrate, assume a corporation with a yearend inventory of $4,000,000 (under Fifo) has experienced a 10% increase in costs over the year. If the quantity levels are approximately the same at yearend as at the beginning of the year, the Lifo election for the year of change would reduce income before taxes by about $400,000 and after taxes by $208,000. Thus accumulated taxable income for purposes of the accumulated earnings tax would be reduced by this same amount as a result of the Lifo election. For the corporation with a potential accumulated earnings problem, this could be an election worth considering.

Editor's note: Lifo could have an adverse effect on the excess accumulations situation, where the taxpayer is relying on one of the formula approaches, e.g., Bardahl, *to reflect a deficit working capital situation. Lower average inventories would reflect a shorter operating cycle and a smaller working capital requirement, thus creating the opposite effect from that desired.*

Sec. 531: capital loss may create silver lining

Companies with a susceptibility to the accumulated earnings tax frequently own portfolio securities which are capital assets. As a result of today's depressed stock market, there may be unrealized depreciation in the portfolio.

Capital losses may create an unusual opportunity for reducing the basis upon which the Sec. 531 tax is imposed. Suppose a corporation sustains net capital losses during the calendar year 1975. These capital losses, in the absence of net capital gains, will create no income tax benefit because a net capital loss is not deductible. (Sec. 1211(a).) However, for purposes of computing "accumulated taxable income" for the Sec. 531 tax, a net capital loss will be deductible in accordance with Sec. 535(b)(5). If the investments held were desirable, reinvestment may be made in the same securities after 30 days, giving due regard to the wash sale provisions of Sec. 1091. Alternatively, other securities may be purchased at any time.

Assume that within the five-year carryover period for capital losses the stock market recovers, and the securities purchased in 1975 may be disposed of at a capital gain which will be *long-term*. For income tax purposes, the net capital loss sustained in 1975 may be carried over and used to reduce the long-term capital gain of the later year. Accordingly, for regular income tax purposes there is an offset. For the Sec. 531 tax, however, there is no "give-back" of the capital loss benefit. The amount of net long-term capital gain, *without* deduction for the capital loss carryover, will be a deduction in determining accumulated taxable income in the later year. Sec. 535(b)(6) expressly provides for this result.

It is true that Sec. 535(b)(7) provides that no allowance shall be made for a capital loss carryover (or carryback) in determining accumulated taxable income. This provision does not alter the result described above since, as has been noted, the deduction for long-term capital gains is determined without regard to such carryover, and the two merely offset. The example contained in Regs. Sec. 1.535-2(f)(2) makes the result clear. In summary, therefore, the capital loss reduced accumulated taxable income subject to Sec. 531 tax when the loss was incurred; and it did not increase accumulated taxable income when a later long-term gain was realized.

Example. Assume that corporation *A* had ordinary income of $100,000 in each of the years 1975 and 1976. There was a net capital loss of $40,000 in 1975 which was offset against $40,000 of long-term capital gain in 1976 for income tax purposes. Accumulated taxable income for these two years would be computed as follows:

Sec. 531

	1975	1976
Taxable income for normal tax and surtax	$100,000	$100,000
48% normal tax and surtax Sec. 535(b)(1)	(48,000)	(48,000)
Net capital loss—Sec. 535(b)(5)	(40,000)	
Long-term capital gain—Sec. 535(b)(6)		(40,000)
Capital loss carryover—Sec. 535(b)(7)		40,000
Accumulated taxable income	$ 12,000	$ 52,000

Thus the capital loss has resulted in a decrease in accumulated taxable income for 1975 without causing a corresponding increase in 1976. Economically, however, considering the two years together there was, from these transactions, a total increase in corporate earnings and profits of $104,000.

The above results would not be realized if the subsequent gain was short-term. In such a case there would be a "give-back" of the capital loss benefit. If, in the above example, the 1976 gain was short-term, accumulated taxable income would be $12,000 and $92,000, respectively, for 1975 and 1976, or a total of $104,000 for both years. The same answer would be obtained if the capital gain (either long-term or short-term) was realized in the same year as the capital loss.

Even the adjustment for taxes attributable to long-term capital gains, under Sec. 535(b)(6), works favorably for the taxpayer. For this purpose, the tax is computed *with* regard to the capital loss carryover and thus results in a smaller amount of tax, which reduces the reduction under Sec. 535(b)(6). This, too, is illustrated in the regulations example cited above. The only hitch in the above plan is that capital gains may not be able to be realized within a five-year carryover period. Nevertheless, the benefits from the realization of capital losses in 1976 may well warrant this risk if the corporation is a sitting duck for the Sec. 531 tax in this year.

Consolidated returns: the variable PHC test

Sec. 542

Slight changes in income mix can drastically affect the personal holding company (PHC) status of consolidated groups. Corporations filing consolidated returns may be tested for PHC status on a consolidated or individual basis depending

Sec. 542 on the type of income received in each taxable year. Each corporation is tested individually

• If any member of the affiliated group derives 10% or more of its adjusted ordinary gross income for the taxable year from sources outside the group, and at least 80% of this outside income is PHC income (Sec. 542(b)(2)); or

• If any member of the affiliated group is excluded from the definition of personal holding company (bank, finance company, life insurance company, etc. (Secs. 542(b)(3) and 542(c)). The PHC rules are applied to the consolidated income of the affiliated group if neither test is met.

Example. *P* corporation (owned by one individual) owns all of the stock of *S-1* and *S-2*. None of the corporations is an excluded member (finance company, etc.). Their 1974 income figures are as follows:

Type of Income	*P*	*S-1*	*S-2*	*Consolidated*
Interest	$100,000	$30,000	$20,000	$150,000
Non-PHC Income	60,000	10,000	40,000	110,000
Dividend from *S-2*	40,000			
	$200,000	$40,000	$60,000	$260,000

Each corporation received at least 10% of its adjusted ordinary gross income from sources outside the group. But less than 80% of this outside income is PHC income as shown below. (Note that the $40,000 dividend from *S-2* is excluded from *P*'s computation for the 80% test since it is not "outside" income.)

P	62½%—i.e., $100,000÷$160,000
S-1	75% —i.e., $ 30,000÷$ 40,000
S-2	33⅓%—i.e., $ 20,000÷$ 60,000

Since neither testing provision is applicable, consolidated income is the basis for determining PHC status. After eliminating intercompany dividends (Regs. Sec. 1.1502-14(a)(1)), the consolidated PHC income of $150,000 is less than 60% of $260,000 adjusted ordinary gross income. Therefore, the members of the group are not subject to the PHC tax, individually or collectively.

A slight change in the income mix would result in the consolidated group's being classified as a PHC. For example, assume the *S-2*'s $60,000 of taxable income consisted of $30,000 interest and $30,000 non-PHC income. Then the consolidated PHC income would be $160,000, which would be more than 60% of the consolidated adjusted ordinary gross income of $260,000.

Also noteworthy is that a small change in *S-1*'s income mix could make the individual testing rule applicable, with the result that *P* and *S-1* would be subject to the PHC tax. For example, assume *S-1* received $2,000 more of interest income and $2,000 less of non-PHC income, so that 80% ($32,000 divided by $40,000) of its outside income would be PHC income. On an individual basis, *S-1* would be a PHC since more than 60% of its adjusted ordinary gross income would be PHC income. Payments of dividends would eliminate *S-1*'s PHC tax but would merely aggravate *P*'s problem. The $40,000 dividend would apparently be included in *P*'s PHC income based on Rev. Rul. 71-531. *Sec. 542*

The revenue ruling concerns a wholly owned bank subsidiary that paid dividends to its parent. Separate testing for PHC status applied since the bank was an excluded member under Sec. 542(c). But the dividends were eliminated from the parent's PHC income, according to the ruling, because the subsidiary was "not required to avail itself of a dividends-paid deduction under Sec. 562(d) in order to avoid the personal holding company tax." On the other hand, since *S-1* would have to use the dividends-paid deduction to avoid PHC tax, the $40,000 dividend would not be excludible from *P*'s personal holding income.

Although *S-2* paid a dividend to *P*, the includibility of its dividends in *P*'s PHC income is questionable. *S-2* was not a PHC and therefore was not forced to pay the dividend. The rationale of Rev. Rul. 71-531 seems to permit excludibility of this dividend from PHC income. However, all intercompany dividends were included in PHC income under the old consolidated return regulations whenever the separate testing rules applied (Regs. Sec. 1.1502-30A(b)(4)). The consolidated return regulations, adopted in 1966, are still silent on this point.

Regardless of this uncertainty, the preceding examples illustrate the importance of reviewing and controlling the income mix of consolidated groups with members bordering on personal holding company status. In many situations, consolidated groups may be able to choose at will between consolidated and individual testing.

Option trading may avoid PHC status

Sec. 543

A corporation may avoid personal holding company (PHC) status by entering into option trading on the Chicago Board

 Options Exchange (CBOE) as a writer of call options. A writer of call options incurs an obligation to deliver the underlying stock at a predetermined price if and when the option holder elects to exercise his option. For incurring this liability, the writer is paid a premium. The writer is not taxed on the premium until the liability is terminated in one of three ways—exercise initiated by the holder of the option, expiration of the option, or a closing purchase transaction.

When the writer delivers stock on exercise against payment of the price specified in the call, he realizes capital gain or loss. The transaction is treated as a sale of the stock delivered. The premium is considered to be part of the proceeds of sale. The total proceeds, i.e., the premium plus the payment of the exercise price, are compared with the basis of the stock delivered to determine the amount of the gain or loss; the holding period of the stock that is delivered to cover the option determines whether the gain or loss is long or short term.

If the holder allows the call option to expire unexercised, the writer includes the premium in ordinary income on the expiration date. The writer of an option can also enter into a closing purchase transaction any time before he receives an exercise notice; that is, he can purchase an equivalent call on the CBOE designating it as a closing purchase transaction. The writer realizes *ordinary* income or loss measured by the difference between the premium received and the cost of the closing purchase.

Therefore, a writer of a call option may end up with ordinary income, ordinary loss, capital gain, or capital loss, depending on how the transaction is closed. Since a writer of options has considerable control over how his option position will be closed, there are many opportunities available for tax planning.

One of the requirements for a PHC is that 60% or more of the corporation's adjusted ordinary gross income be PHC income. PHC income consists of dividends, interest, royalties, and rents with certain exceptions. For this purpose, capital gains or losses realized by the option writer will not be included in adjusted ordinary gross income. Ordinary income resulting from CBOE transactions, however, would be included in adjusted ordinary gross income and, thereby, reduce the percentage of PHC income. Accordingly, a corporation which might otherwise qualify as a PHC may escape such status if it is able to generate sufficient ordinary income through option trading. *Sec. 543*

PHCs: avoiding tax with deficiency dividends **Sec. 547**

Sec. 547 allows a deduction for deficiency dividends, which enables a corporation to eliminate a personal holding company tax liability by making a special distribution of dividends within 90 days after a "determination." In addition, a claim for a deficiency dividend deduction must be filed within 120 days of such "determination." These special dividends must also be paid prior to filing this claim, which must be prepared in duplicate on Form 976.

A "determination" is defined by Sec. 547(c) to mean

—a final judicial decision, judgment, decree, or other order;

—a closing agreement made under Sec. 7121; or

—an informal agreement between the taxpayer and the District Director, or other authorized official, relating to the taxpayer's liability for personal holding company tax.

This informal agreement is made on Form 2198 which cannot be filed unless the taxpayer has also executed a waiver of restrictions on assessment and collection of the tax deficiency on Form 870 or an offer of such a waiver on Form 870-AD in Appellate Division proceedings. (Rev. Procs. 59-1 and 63-1.)

It should be noted that a deficiency dividend deduction does *not* eliminate interest, additional amounts, or assessable penalties which are computed with respect to the personal holding company tax (prior to the allowance of the deficiency dividend deduction). These other charges remain payable as if Sec. 547 had not been enacted.

The current interest rate is 7%. In addition, the monthly penalty of one-half of 1% of the unpaid tax (up to the 25% maximum) would also be imposed under Sec. 6651(a)(2).

Nevertheless, a deficiency dividend might still be the way to avoid the 70% PHC tax on undistributed personal holding company income. For example, assume that personal holding company tax liability is discovered after the end of the

Sec. 547 company's year. If no dividends were paid during that year, the special relief provision for dividends paid within "75 days" of the yearend would not be available (since Sec. 563(b)(2) limits such relief to 20% of the dividends paid *during* the year). Consent dividends (permitted by Sec. 565) may not be desirable since they constitute a mandatory reinvestment of *after-tax* dollars by the shareholders. Thus, in such a case, a deficiency dividend could be attractive.

However, Sec. 547(g) denies a deficiency dividend deduction if any part of the personal holding company tax deficiency is due to fraud with intent to evade tax or to willful failure to file an income tax return within the prescribed time.

For these reasons, a ruling was requested as to whether the IRS would deny a deficiency dividend deduction if a completed Schedule PH was filed with Form 1120, but computation of the tax was excluded from Form 1120 and the amount of the personal holding company tax was not remitted since liability for the personal holding company tax was doubtful. The filing of the completed form would nevertheless start the running of the six-year statute of limitations for assessment of personal holding company tax under Sec. 6501(f).

The ruling received concluded that the deficiency dividends deduction would be available to the taxpayer under the circumstances set forth, provided the determination defined in Sec. 547(c)(3) (informal agreement) was made.

Note that if assessment was not made within the six-year period, however, the Service would be barred from ever collecting the tax (assuming an absence of fraud).

Sec. 562 PHCs: dividends paid in appreciated property

In order to avoid the special tax of 70% on the undistributed income of a personal holding company under Sec. 541, it is necessary to distribute dividends. Undistributed personal holding company income is reduced by the dividends-paid deduction as defined in Sec. 561. See Sec. 545(a). Sec. 561 requires that the rules set forth in Sec. 562 are applicable in determining dividends eligible for the dividends-paid deduction. Regs. Sec. 1.562-1(a) provides that "if a dividend is paid in property (other than money) the amount of the dividends-paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution." This regulation was found to be contrary to the law in *H. Wetter Manufacturing Co.*, CA-6, 458 F2d 1033 (1972), in which the company distributed appreciated stock of another company. The Court refused to follow the regulation and held that the proper measure of the dividends-paid deduction was the fair market value of the property at the time of the distribution. The Court found no ambiguity in the statute and observed that "the Commissioner has no more power to add to the Act what he thinks Congress may have overlooked than he has to supply what Congress has deliberately omitted." *Sec. 562*

Recently the Court in *Gulf Inland Corp.*, (DC–La., 1975), citing *Wetter*, came to the same conclusion, again with respect to appreciated stock of another company.

The successful use of appreciated property probably would require litigation since the IRS has not acquiesced in the above decisions. On the other hand, the use of depreciated securities should be allowed by reason of the regulation. The IRS has stated informally that it is still following Regs. Sec. 1.562-1(a) and will issue rulings in accordance therewith. Thus, personal holding companies that own appreciated or depreciated property are afforded a tax planning opportunity.

Editor's note: The Commissioner recently won a victory in Fulman, *DC–Mass., 407 FSupp 1039 (1/22/76), wherein the Court disagreed with the Sixth Circuit's reasoning. This has been on the prime issues list since 1974.*

PHC may reduce individual's tax on dividends from depreciated stocks

A personal holding company (PHC) can be a useful tool in family tax planning.

At present, the market value of many securities is substantially below the prices at which they were purchased. Tax benefits may be derived by contributing such high tax basis-low value securities to a PHC. By channeling the dividends derived from the securities through a PHC, the corporate dividends-received deduction can be utilized to minimize the PHC's income tax liability; also, by distributions of high-basis

Sec. 562 securities equal to the amount of the undistributed PHC income, the PHC penalty tax can be avoided. Moreover, the shareholder's personal income tax liability would be kept relatively low because the securities have a low value.

Regs. Sec. 1.562-1(a) provides that in the case of a property distribution, the dividends-paid deduction shall be the *adjusted basis* of the property at the time of distribution. Thus, if the PHC distributed securities with a high tax basis carried over from the incorporation equal to its undistributed PHC income, the PHC tax is avoided. The shareholder, on the other hand, will be required to include in his income the substantially lower fair market value of the distributed securities. (Sec. 301(b).)

Example. A, an individual, who is in the 70% income tax bracket, transfers stocks with a high cost basis and a low value in a tax-free (Sec. 351) transaction to his newly formed corporation. The stocks annually generate about $300,000 in dividend income.

If *A* had received the dividends directly, he would pay $210,000 in taxes. The PHC, however, will incur only about $15,000 in income taxes because the dividends-received deduction would reduce its taxable income to $45,000. (The PHC tax computation is based on a $25,000 surtax exemption, and assumes deductions and other income offset each other.)

Undistributed PHC income would be $285,000 ($300,000 less $15,000 income tax). The PHC distributes securities with a tax basis of $285,000 and a fair market value of $100,000. The PHC avoids the penalty by such distribution. *A* would have to pay a tax of $70,000 on such a distribution. Thus, by running $300,000 in dividends through the PHC, *A* has reduced his current tax liability by $125,000, determined as follows:

Tax if the dividends are received directly by *A*		$210,000
Taxes payable on dividends if received indirectly by *A*:		
PHC's income tax	$15,000	
A's tax	70,000	85,000
		$125,000

Of course, *A*'s basis for the securities will be reduced by $185,000 ($285,000 less $100,000); but at best this will probably be academic to him and at worst this will someday create a capital gains tax of some $65,000.

However, it should be noted that the Sixth Circuit has concluded that Regs. Sec. 1.562-1(a) is invalid, holding that the fair market value, not the tax basis, of property distributions should be used in computing the dividends-paid deduction. (*Wetter Mfg. Co.*, CA-6, 458 F2d 1033 (1972).) Apparently the IRS will not follow this decision, having classified the question as a prime issue. (Internal Revenue Manual, MT 1277-8, 11/19/74.) *Sec. 562*

Additional advantages can also be achieved through the transfer of high basis-low value securities to a PHC.

- The high basis of the undistributed securities will be preserved within the PHC structure even after the death of the contributing shareholder.
- The incorporator could take only voting preferred stock in the PHC; the value of such stock will be fixed at redemption value (or perhaps less) for estate tax purposes. The PHC's common stock could be issued to the incorporator's children for cash in the incorporation transaction. Thus, any future appreciation in the PHC's portfolio will redound to the benefit of the children.
- Shares of the PHC's voting stock could be purchased by or gifted to the children or others in such amounts as to leave no one individual with a controlling block. This may produce a substantial discount for gift and estate tax valuations. (*Clark*, DC–N.C., 5/16/75.)

It must be recognized, of course, that the IRS may seek to deny the tax benefits described above on several grounds. For example, the IRS may possibly decide to follow the *Wetter Mfg. Co.* case, above, and amend Regs. Sec. 1.562-1(a) accordingly. Or Sec. 269 might be invoked to allocate the dividends to the incorporators or to deny the dividends-paid deduction to the PHC. The IRS might contend that "control" of the PHC was "acquired" for the "principal purpose" of securing the benefit of such a deduction. (*Borge*, CA-2, 405 F2d 673 (1969).)

Or the IRS might assert that the PHC serves no business or financial purpose, and therefore it should be treated as an alter ego of the shareholder and its existence disregarded for tax purposes. (*Glenn*, 3 TC 328.)

Careful planning and complying with all of the formalities should blunt the IRS ax, however. As to requiring that a business purpose be established, the very nature of a PHC is such that few, if any, PHCs could satisfy the test.

Editor's note: See discussion of article immediately preceding for current status of distribution deduction for appreciated securities.

Sec. 563 Contemplation-of-death dividend strategy for personal holding companies . . .

For estate tax purposes, the value of stock in a personal holding company (PHC) is usually determined primarily by reference to market quotations of its underlying securities. However, a PHC also presents certain difficulties—and opportunities—which require attention.

In the typical PHC, there is at any time during the taxable year an amount of undistributed income which has not yet been declared as a dividend. This amount, except for the 20% leeway for dividends paid after the close of the year pursuant to Sec. 563(b), must be paid out as a dividend during the PHC's taxable year. In other words, the full value of the PHC's net assets will enter into the date-of-death valuation of the PHC's stock even though it is mandatory that an amount be paid out as dividends. When those dividends are paid, two adverse consequences occur:

- There is no Sec. 691(c) deduction, and
- There results a distribution in pre-death earnings of the PHC, with adverse effect upon the alternate valuation date.

Under Regs. Sec. 20.2032-1(d)(4), a dividend paid during the period between the date of death and the alternate valuation date represents "included property" to the extent that it is paid from earnings accumulated prior to death. Accordingly, to such extent, the dividend will be included as an item to be valued on the alternate valuation date. In contrast, dividends paid out of earnings accumulated after the decedent's death do not constitute "included property" since they do not cause the shares held on the alternate valuation date to be unrepresentative of the shares as they existed at the date of death.

For PHC purposes, of course, it is the actual payment of dividends that counts. On the other hand, as the preceding item has indicated, the declaration date and the record date have great significance in matters affecting a decedent's estate.

A PHC should therefore consider declaring dividends on or shortly after the close of each month in an amount approximately equal to the taxable income, less taxes and other adjustments under Sec. 535(b), which has been realized during that month. The dividends can be paid shortly before the end of the corporation's taxable year (or even later to the extent of the 20% leeway). The dividend would be payable to holders of record on the date of declaration. Sec. 563

Under such an arrangement, the dividends would be valued as a separate item of property for any shareholder who dies during the PHC's taxable year. Since the dividends would constitute liabilities of the PHC as of the deceased shareholder's death, there should be a reduction from the market value starting point for valuing the PHC's net assets at that date. On payment, there would be no risk that the dividends were paid out of pre-death earnings. Moreover, the dividends would generate a Sec. 691(c) deduction for income tax purposes, and cause a realization of income tax benefits on the estate tax attributable to the amount of the dividend included in the gross estate as a separate item.

The process could be continued during the period from the date of death to the alternate valuation date. Dividends declared during this period out of earnings realized in the same period will not constitute "included property." Here is another "free ride," since the PHC must pay out its earnings in any event.

Presto! one dividend distribution, two deductions

The proper timing of a dividend distribution can result in a double benefit to a corporation when it is vulnerable with respect to the accumulated earnings tax in one year and becomes a personal holding company or a subchapter S corporation in the next year.

Under Sec. 563(a), a corporation's distribution on or before the 15th day of the third month after the close of its taxable year will be treated as having been paid during such taxable year for purposes of determining the Sec. 561 dividends paid deduction for accumulated earnings tax purposes. If, in the subsequent year, the corporation becomes a personal holding company (which can happen, for example, when the corporation sells its business in the preceding year), the distribution used in determining the dividends-paid deduction for purposes of the accumulated earnings tax will also be allowed in

Sec. 563 determining the Sec. 561 dividends paid deduction in computing undistributed personal holding company income.

Example. Based on a "Bardahl" formula computation, *X* corporation determines that it has accumulated excess earnings subject to tax under Sec. 531 for 1974 of $150,000. On or before March 15, 1975, *X* pays a dividend of $150,000, thereby avoiding the accumulated earnings tax penalty. In 1975, *X* becomes a personal holding company because of a sale of its business at the beginning of the year. In computing its undistributed personal holding company income for 1975, it can again take the $150,000 dividend payment into account since it was not a personal holding company in 1974.

The double deduction treatment would also apply if *X* became a subchapter S corporation in 1975, instead of a personal holding company. Even though the dividend distribution was made within 75 days after the end of 1974, it will also be treated as a deduction in computing *X*'s undistributed taxable income under Sec. 1373(c) for 1975, assuming the requisite amount of current E&P. This double deduction allowance in both situations has received the blessing of the IRS in Rev. Rul. 72-152.

Sec. 565 PHC: filing date of consent dividend election

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

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

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

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

Banking institutions

Interest on day-of-deposit to day-of-withdrawal accounts

Sec. 591

The IRS has recently issued a Technical Advice Memorandum relating to a savings and loan association reporting on the cash method of accounting. The association posted interest credits to withdrawal savings accounts on the 15th day of each

Sec. 591 month. In the event a depositor withdrew his account, interest was allowed from the day of deposit to the day of withdrawal.

The association deducted interest on its corporation income tax return for the period December 15 through December 31, but did not report this interest on the information return Forms 1099-INT issued to the depositors. The IRS concluded that the claimed interest was deductible based upon the decision in *Hudson City Savings Bank*, 53 TC 70 (1969).

A savings and loan association or savings bank which deducts interest under Sec. 591, and allows interest to depositors based on the exact period from day-of-deposit to day-of-withdrawal should consider amending its return to deduct interest expense which has accrued on such savings accounts to year-end.

Estates, trusts, beneficiaries and decedents

Secs. 651-63 Distribution in kind by fiduciaries: the vanishing capital gain

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

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

(1) the amounts of income for the taxable year which are required to be distributed currently and

(2) any other amounts properly paid, credited or required to be distributed for such taxable year.

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

As a general rule, no gain or loss results to the fiduciary from a distribution in kind, and the beneficiary takes the same tax basis as the property had in the hands of the estate or trust. However, there are two exceptions to the general rule. *Secs. 651-63*

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

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

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

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

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

Secs. 651-63 could then be distributed during the final short period of the trust with a carryover of the trust's basis to the beneficiaries.

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

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

Postmortem tax planning: new pitfall

The amendment to Regs. Sec. 1.661(a)-2 on September 26, 1973, eliminates the inconsistency between the regulations and the court decisions involving the payment by the executor of amounts commonly called a "widow's allowance" or a "family allowance."

Two cases, *Cummings*, DC–Cal., (1969) and *Estate of Lawrence McCoy*, 50 TC 562, held that a "family allowance" or a "widow's allowance" is deductible by the estate even though it is paid out of and charged to the estate's principal account. The regulations prior to the amendment were inconsistent with these decisions inasmuch as they stated that the allowance was deductible only if payable out of *income* of the estate.

As to the tax treatment in the hands of the recipient of allowances paid out of principal, there were tax planners who, relying upon the pre-amended regulations, said that a tax advantage could be attained in certain cases if the payment was specifically chargeable to either principal or income. Before the 1973 amendment, the regulations provided that the allowance was includible in the income of the recipient only to the extent payable out of and chargeable to income. There apparently had been no litigation on this point.

The amended regulations now no longer require a determination of whether the amount paid is chargeable to income or principal. Now, *any* amount paid, or required to be paid, by a decedent's estate as an allowance or award for support of the decedent's widow or dependent is deductible. The deduction, of course, is limited to the widow's or dependent's share of distributable net income. Also, now the allowance in *all* instances is included in taxable income of the recipient to the extent deductible by the estate. Although the amendment is retroactive to 1954, the IRS has stated, in Rev. Rul. 73-4, that, as a general rule, returns filed for taxable years ended before September 26, 1973, will not be disturbed. *Secs. 651-63*

If, in connection with estates with years ending after September 25, 1973, it is planned to treat a widow's allowance as a distribution from principal and thus not taxable to the widow because she is in a high tax bracket, immediate steps should be taken to prevent the distribution from constituting taxable income to her. Some possible steps would be:

- Where the decedent's death was recent, select a short taxable year for the first fiduciary return;
- Stop the widow's allowance in those cases where the widow did not require the money; and
- Pay expenses of administration in the current year to reduce distributable net income.

Editor's note: Rev. Rul. 75-124 provides that widow's and dependent's support allowances will be treated as distributions to beneficiaries notwithstanding treatment as debts of the estate under local law.

"Grandparent trusts" can trigger income to parent

A trust established by a parent will not effectively shift the trust's income away from the parent if the income is used to satisfy the parent's obligation to support his children. Sec. 677(b). It is seldom pointed out, however, that the parent can also be taxed in connection with trusts, such as educational trusts, established by grandparents for the benefit of the children.

If the parent is made trustee of such a trust, the income will be taxed to the parent to the extent trust income is applied in satisfaction of the support obligation. Sec. 678(c). The parent can also be subject to tax without even being a trustee. Regs. Sec. 1.662(a)-4 provides that trust income used in satisfaction of a legal obligation of any person is included in the gross income "of such person." It is under this regulation that income from "grandfather trusts" can trigger income to the parent without the parent even being named in the trust instrument.

Secs. 651-63 The extent of a parent's legal support obligation, including education, is a question of local law that should be referred to counsel. Questions relating to a parent's support obligation must be considered when a grandparent, as well as a parent, establishes a trust for the benefit of the children.

Sec. 691 Income in respect of decedent: deducting estate tax on capital gains

Income in respect of a decedent (IRD) is subject to federal estate tax and is also subject to income tax when received. Sec. 691(c) provides some relief from this double taxation in the form of an income tax deduction based upon the estate tax attributable to the IRD. A question which is not answered in the Code, however, is "from what" the Sec. 691(c) deduction should be taken.

In the usual case, the IRD is taken into income and the estate tax deduction is taken as an itemized deduction. However, when the IRD consists of capital gains, as in the case of an installment sale, questions have arisen as to the proper handling of the estate tax deduction. Specifically, the conflict centers on whether the deduction should be allocable first against any gross capital gains (i.e., before applying the 50% Sec. 1202 deduction), or whether it is deductible from the *net* capital gains or other ordinary income.

Where capital gains are involved, the most advantageous method of taking the estate tax deduction may vary depending upon an individual's particular tax position. The IRS, however, has tried to minimize the benefit of the estate tax deduction by limiting the manner in which the deduction may be taken. Where a taxpayer does not use the alternative capital gains tax, the IRS has claimed that the estate tax deduction should first be used to reduce the gross capital gains before applying the 50% capital gains deduction. Under this approach, half of the deduction would be lost. The courts, however, have allowed taxpayers to take their 50% capital gains deduction first and then take the estate tax deduction. (*Goodwin*, Ct. Cls., 458 F2d 108 (1972).)

Where a taxpayer computes his tax using the alternative capital gains tax, the IRS has taken the position that the estate tax deduction can only reduce ordinary income and capital gains taxed at regular rates. The courts, however, have again sided with the taxpayer. In *Read*, CA-5, 320 F2d 550 (1963), the Court held the deduction could be applied in full to reduce long-term capital gains subject to the alternative tax. In *Meissner*, Ct. Cls., 364 F2d 409 (1966), the Court permitted the taxpayer to first offset ordinary income by the deduction and then to use any balance of the deduction to offset capital gains, where this method proved more advantageous to the taxpayer. *Sec. 691*

A case, *Quick*, CA-10, 503 F2d 100 (1974), may finally have resolved the question. In a factual situation similar to the *Goodwin* case, above, the Court again held for the taxpayer. In doing so, it reviewed the prior cases and concluded that the common theory linking those decisions was that a taxpayer should be allowed to have the full benefit of the deduction. In effect, the Court sanctioned the use of the "most advantageous principle" by taxpayers.

Consequently, a practitioner should be alert, when there are IRD capital gains and estate tax attributable to that income, to the most advantageous way of taking the deduction. If there is any question on a return as to where the deduction should be taken, the tax should be computed each way possible to determine the maximum benefit to the taxpayer.

Editor's note: For subsequent taxpayer triumphs see Bridges, *64 TC 968 (1975) and* Sidles, *65 TC 873 (1976).*

Partners and partnerships

Two partnerships or preference class partners

Sec. 704

A taxpayer may inquire of his tax adviser whether a partnership syndicate can permit investors to choose between the following:

- Large depreciation deductions coupled with potential capital gains.
- Large current income.

One technique for achieving this flexibility involves the formation of two partnerships, with the first partnership owning the improved real estate, claiming the depreciation on the building, and leasing the real estate to the second partnership. The lease rent is set at a level to provide a reasonably predictable income return to members of the second partnership, based upon the spread between rent received from the sublessee-occupants and the base rent paid to the first partnership.

The effect is to allocate all of the depreciation and all of the potential gain to members of the first partnership, and current income and recovery of initial investment to members of the second partnership. In effect, this resembles the dual mutual funds which issue both capital and income shares. The "guaranteed" return of initial investment (similar to the income share par value) is achieved by an agreement between the partnerships that a specified dollar portion of the selling price for the entire property will be allocated to the leasehold owned by the second partnership. It should be noted that profits from sale of the property may be partly reportable by members of the first partnership as ordinary (depreciation recapture) income.

A second technique involves the use of a partnership with two classes of partners, the first a preference class (usually limited partners) entitling its partners to the following:

- Priority allocation of partnership earnings up to a specified percent of investment in the partnership by that class.
- Priority allocation of refinancing or sale proceeds equal to the same investment, or other agreed price.

If the partnership sustains an overall operating loss, it is allocated to this class in the ratio of its participation, but not to exceed the original investment by the class, adjusted for withdrawals and prior year profits and losses.

The second class, composed either of general partners or a junior class of preferred limited partners, is charged with all partnership losses (not allocated to the preference class), and credited with partnership earnings in excess of the preference return. The second class is also entitled to all retirement or sale proceeds in excess of the specified amount allocable to the first class. Typically, depreciation deductions are exclusively allocated to the second class. This exclusive allocation is sometimes coupled with a similar allocation of all preoperating deductions (property taxes, constructing loan interest, sales tax on materials, etc.) to the second class.

The general partner typically holds a developer's participation in the partnership where there are both senior and junior preference limited partner classes, or is a member of the general partner class where only one preference limited partner class is present. Typically, the partnership pays a current or prepaid management fee (guaranteed payment) to the general partner or the developer member of the general partner class (see discussion below). *Sec. 704*

It has been argued that the two-partnership approach better assures the desired tax results. However, it appears that the exclusive allocation of depreciation and construction period deductions to the second class in the two-class partnership is acceptable, since the members of that class bear the economic burden or economic reality of the allocation through charges to their capital accounts, which affect ultimate entitlements upon termination of the partnership. However, it should be noted that the "make-up" reallocation from the second class to the first class, which must be made upon termination if the capital balance of the first class is less than the original investment, etc., will produce a Sec. 741 capital loss to the second class and a capital gain to the first class, and may have the same effect as to the second partnership and first partnership respectively, depending on the price for which the total property is sold.

Sec. 1250 depreciation recapture income can constitute an unrealized receivable, reclassifying, to that extent, as ordinary income what would have been a Sec. 741 capital gain. However, this should not apply to the preference class, since all depreciation was claimed by the second class.

Editor's note: The Tax Reform Act of 1976 requires that special allocations have "substantial economic effect," a codification of the requirements in the Regulations under Sec. 704.

Income in respect of a deceased partner — Sec. 706

Sec. 706(c), providing that a deceased partner's share of current partnership income is includible 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.

Sec. 706 As with many remedial provisions in the Code, this one can be detrimental in some circumstances. Where 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 includible 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)).

Sec. 707 Guaranteed payments: a fresh look at their deductibility

At one time, the deductibility as "guaranteed payments" of all payments by a partnership to a partner for services or use of capital was permitted, based upon the provisions of Sec. 707(c). Recent developments in this area and a change of the Service's position, however, now make "guaranteed" deductibility questionable where the payments are for an expenditure which would otherwise be capitalized. The present position of the IRS, and of the one court which has clearly considered the issue, is that a guaranteed payment under Sec. 707(c) must qualify as an ordinary and necessary business expense under Sec. 162(a) to be currently deductible.

The regulations under Sec. 707(c) seem to envision that guaranteed payments are intended merely to represent a specifically designated portion of the ordinary income of the partnership. This theory can be extended to create a loss where a partnership's total ordinary income is less than the ordinary income distributed (allocated) to a partner under Sec. 707(c).

The legislative history of Sec. 707(c), as set forth in committee reports on the 1954 Code, provides that payment of a fixed or guaranteed amount for services shall be treated as salary income of the recipient and allowed as a business deduction to the partnership. Neither these committee reports nor the regulations discuss the question of payments for capital costs. In several widely circulated private rulings, payments to partners for services which might otherwise be capital in nature were held to be deductible in the year accrued or paid. For example, in 1971, two private rulings held a fee, equal to 15% of the initial capital contributed to the partnerships, which was paid for the acquisition of undeveloped land and future management services was currently deductible.

In Rev. Rul. 69-180, the IRS concluded that once a payment qualifies as a guaranteed payment "it is deductible by the partnership from ordinary income as a business expense." The ruling seems to imply that no attention need be directed to whether the payment is an ordinary and necessary business expense or a capital expenditure. It should be emphasized that Rev. Rul. 69-180 dealt with the allocation of the total ordinary income realized by a partnership while the private rulings involved the creation of income to a partner and a net loss to the other partners.

Probably because of the widespread use of guaranteed payments in the structuring of many tax shelter partnerships in the early '70s, the IRS changed its position in 1973 with respect to guaranteed payments. The IRS National Office issued a Technical Advice Memorandum which stated that guaranteed payments were only deductible "*to the extent permissible under Section 162 of the Code* . . ." (emphasis added). Thereafter, the IRS took the issue to court and its viewpoint was sustained in *Cagle*, 63 TC 86. In that case, the Tax Court upheld the Service where a partner was paid a fee for (1) conducting a feasibility study of a proposed officeshowroom facility, (2) obtaining financing, and (3) developing a building for the partnership.

Having decided that Sec. 707(c) payments must run the gauntlet of Sec. 162(a) in order to be deductible, the Tax Court then separately analyzed the services involved and determined that they were rendered in connection with the acquisition of a capital asset and were, accordingly, capital in nature. It should be noted that the Court expressly reserved determination of such a question under Sec. 736(a)(2) relating to payments made to a retiring or deceased partner. The *Cagle* case is now on appeal in the Fifth Circuit Court of Appeals.

See also Rev. Rul. 75-214 where the IRS held, consistent with its position in *Cagle*, that payments by a limited partnership to its general partner for his services rendered in organizing the partnership, although payments described in Sec. 707, are not deductible under Sec. 162 because they constitute capital expenditures under Sec. 263.

Although Sec. 707(c) applies to payments to partners for services or the use of capital, the controversy should be limited to payments for services because payments for the use of capital are analogous to interest, which should make them deductible in all events (unless a Sec. 266 election is in effect), provided they are reasonable in relation to the value of the capital supplied to the partnership.

Because of the change in position by the IRS, taxpayers can expect Revenue Agents to challenge the deductibility of guaranteed payments for services which may be capital in nature. Where the services are clearly capital in nature, it is very unlikely that a taxpayer can prevail at the agent level.

The ultimate resolution of the question may be that the nature of the services performed and not their designation or treatment by the partnership agreement controls the current deductibility of guaranteed payments. Therefore, careful consideration should be given to documentation concerning the nature and purpose of the services performed for which payment is made. If the description of these services in the partnership agreement is incomplete or misleading, these matters should be clarified. With imaginative tax planning, any payments or fees may be able to be structured so that they are made for purposes which ensure their current deductibility by a partnership.

Sec. 707

A postscript also to be considered is the holding in *Pratt*, 64 TC 203, that management fees based on gross rentals do not constitute a guaranteed payment under Sec. 707(c). Here the Court reasoned that such a fee is based on partnership income and, therefore, falls without the mandate of Sec. 707(c) that guaranteed payments must be amounts "determined without regard to income." Therefore, in drafting agreements calling for such payments, be wary of this late development.

Until the ambiguity of Sec. 707(c) is eliminated either through legislative action (as proposed in 1975) or by court decisions, deductions for payments to a partner as guaranteed payments can be claimed, but, if the payment may be capital in nature, *all* partners should be apprised of the risks and effects of disallowance by the IRS.

Partnerships: hazards of termination by the 50% rule

Sec. 708

Sec. 708(b)(1)(B) provides that a partnership is considered terminated if, within a 12-month period, there is a sale of 50% or more of the total interest in partnership capital and profits. A sale or exchange does not include a reallocation of partnership interests which may result if a new partner pays in money or property directly to a partnership, or if a partner withdraws. (Rev. Rul. 75-423, IRB 1975-40,8 confirms this fact.) Regs. Sec. 1.708-1(b) also provides that a sale or exchange does not include a transfer by gift, bequest, or inheritance.

The best known consequence of such a termination is that the ensuing "new" partnership is not entitled to continue the fiscal year being employed by the "old" partnership. Accordingly, the new partnership must employ a calendar year unless all partners utilize the same fiscal year (which is very unlikely), or unless a good business purpose can be shown in support of an application on Form 1128 to adopt a fiscal year.

Specifically, Regs. Sec. 1.708-1(b)(1)(iv) provides that upon the sale or exchange of the 50% or more interest there is a constructive complete liquidation of the old partnership followed immediately by contribution of the properties deemed distributed to a new partnership. This termination and reconstitution results in many other tax consequences to the part-

Sec. 708 ners and the partnership. These consequences may be favorable or unfavorable:

- There may be bunching of income if the old partnership employed a fiscal year and the new partnership must use the calendar year.
- Depreciable assets lose their "original use" character, so that certain accelerated methods of depreciation may not be used. (Rev. Rul. 56-256.)
- A different method of tax accounting may be adopted by the new partnership without IRS permission.
- Since the new partnership is a new taxpayer it must affirmatively make "first year" elections. Otherwise, valuable elections such as Lifo or the expensing of intangible drilling costs could be lost.

Specific consideration must be given to the optional-adjustment-to-basis-of-partnership-property election which is contained in Sec. 754. It should first be noted that since the new partnership is not bound by elections of the old partnership, there is no automatic carryover of any Sec. 754 election previously made, under which the basis of partnership property was adjusted in accordance with the provisions of Secs. 734 and 743. Also, the constructive termination and reconstitution of the partnership means that there will be no future effect of such prior election in any event, since the basis of all partnership property to the new partnership will be determined by reference to the aggregate of all the partners' bases in all the partners' interests. Accordingly, from the standpoint of the partner purchasing the 50%-or-more interest, there is no need to have the new partnership make a Sec. 754 election in order to assure that his basis will be reflected in partnership depreciation, since it will be so reflected in any event. A new partnership is thus free to determine whether it will make a Sec. 754 election at such future time when, for the first time, it becomes pertinent.

A further interesting question arises with respect to apportionment among the partners of depreciation, gain, and loss with respect to assets the basis of which has changed as a result of the termination and reconstitution. In a simple case, where capital interests and profits interests correspond, Sec. 704(c)(3) might apply so that depreciation, depletion, and gain or loss on sale will follow the respective partners' bases. However, capital interests and profits interests may not continue to coincide; furthermore, the applicability of Sec. 704(c)(3), even in the circumstance of the simple case, is not clear. It thus seems advisable to amend the partnership agreement specifically to deal with the difference in basis of properties constructively contributed to the new partnership. *Sec. 708*

The constructive termination of a partnership is a matter that must be examined thoroughly by tax practitioners. With the current state of the real estate market, such transactions are likely to occur with increasing frequency.

Interest in joint venture's profits received for services: when taxable?

Sec. 721

Sec. 721 provides that no gain or loss will be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. Regs. Sec. 1.721-1(b)(1) provides that this rule does not apply where a partner "gives up any part of his right to be repaid his [capital] contributions (*as distinguished from a share in partnership profits*) in favor of another partner as compensation for services," and that the value of an interest in partnership capital so transferred constitutes income to the transferee partner. (Emphasis added.)

The emphasized parenthetical distinction between the transfer of an interest in partnership capital and a share in partnership profits seems to clearly imply that the transfer to a partner of an interest solely in future partnership earnings results in no immediate realization of income to the transferee partner. At least this seemed to be the clear implication of the regulation until the recent Tax Court decision in *Diamond*, 56 TC 530.

In *Diamond*, *T*, a mortgage broker, performed services, obtaining a mortgage loan, for a purchaser of a building. In return for his services, *T* received an interest in the future earnings (and would share in future losses) of the building which was represented by a 60% interest in a land trust which held title to the property. Less than three weeks after acquiring the interest in the land trust, *T* sold that interest for $40,000.

The Tax Court found that the interest received by *T* had a fair market value of $40,000 when he received it, and held that such amount is includible in ordinary income as compensation for services upon receipt of the interest. The Tax Court reasoned: Nothing in Regs. Sec. 1.721-1(b)(1) "explicitly states that a partner who has received a partnership interest

Sec. 721 like the one before us in exchange for services already performed comes within the provisions of Section 721." The parenthetical clause is "obscure" and, at most, would have only limited application, thus potentially eliminating reliance upon that provision to exclude from gross income the receipt of an interest in future partnership profits in exchange for services.

In light of the *Diamond* case, cash basis taxpayers who receive interests in future partnership earnings for the performance of services (e.g., mortgage brokers, banks, attorneys, and promoters) could be subject to tax on the present value of such interests. It may be, however, that the result in *Diamond* is limited to the facts of the case, since the taxpayer there received more than a mere interest in future earnings of what the Court regarded (with some uncertainty) as a partnership. His receipt of an interest in the land trust seemed to be fatal.

It should be noted that the Treasury Department reaffirmed its position regarding the transfer of an interest in partnership profits in the proposed amendments to Regs. Sec. 1.721-1(b)(1), which provide that a transfer of an interest in partnership capital after June 30, 1969, will be treated as a transfer to which Sec. 83 applies. The proposed amendments include a parenthetical clause identical to that contained in the current regulation.

Editor's note: Diamond *was affirmed by CA-7 in 1974. Although the decision has substantial impact, in many cases careful planning can avoid adverse effects.*

Sec. 743 Does the Sec. 743 adjustment have to be reflected in the partnership return?

Regs. Sec. 1.743-1(b)(1) provides that where a partnership interest is transferred either by sale or exchange or as a result of a death of a partner, and an election is made under Sec. 754, the basis of the partnership property allocable to the transferee partner shall be increased or decreased, as is prescribed. Based upon the language of that regulation, it appears that a partnership is technically required to reflect the increased or decreased basis as an asset in the partnership return.

There are many situations in which transferee partners are reluctant to have the basis adjustment reflected in the partnership return because they don't want the other partners to know either the amount paid for the partnership interest or the manner in which any variance between purchase price and basis was allocated and amortized. Also, where there has been a transfer of a minority interest, the majority partners may not be anxious to accommodate the minority by keeping records of the basis adjustment at the partnership level. As a result, many practitioners have adopted a practice of showing all details regarding the basis adjustment and amortization or depreciation of such adjustment only in the return of the transferee partner. Informal contact with the IRS National Office resulted in an unofficial opinion that the reporting of the adjustments, and related depreciation or amortization, in the return of the transferee partner will be acceptable and will not jeopardize the Sec. 754 election which the partnership has made in its return. *Sec. 743*

However, there may be practical problems where the basis adjustment is not reflected in the partnership's records. After a number of years the basis adjustment may be overlooked and/or the amount forgotten.

When the adjustment is recorded, it is preferable that the basis adjustment be reflected in special and separate accounts for each asset so adjusted, with an offsetting credit (if basis is increased) for the total adjustment in a special-basis capital account for the transferee partner. It is also preferable to reflect this in the return of the partnership.

However, as stated, the alternate procedure of not booking or reporting the adjustment in the partnership return but rather in the return of the individual transferee partner seems to be acceptable.

Partnership distributions vs. sale of partnership property

Sec. 751

If an individual contributes substantially appreciated land held for investment (capital asset) to a newly formed partnership, and if the other partner provides as his contribution the funds necessary for subdivision operations, an interesting question arises if the individual partner withdraws partnership funds during the first months of partnership operations. Assume the following facts:

> Individual *A* and insurance company *X* formed a partnership *P*. *A* contributed land with a fair market value of $1,000,000 and a tax basis

of zero; *X* contributed $1,000,000 cash. Both partners received a 50% interest in partnership profits and capital. During the early months of operations, *A* withdrew $500,000 cash, and his partnership interest was consequently reduced to 25%. By this time, the partnership land was subdivided with the intent of selling the individual land parcels to customers in the ordinary course of business.

The question is whether the distributions to *A* should be considered partnership distributions or, in the alternative, a sale of half of *A*'s land to either the partnership or to *X*.

If the distributions are construed as partnership distributions, Sec. 751(b) would impose partial ordinary income treatment, because the subdivided land constitutes substantially appreciated inventory in the partnership's hands. However, if the distributions are considered as proceeds from the sale of the property, *A* would be entitled to capital gain treatment.

Treatment as partnership distributions. In general, Sec. 751(b) treats a distributee partner as first receiving his proportionate share of both Sec. 751 property (unrealized receivables and substantially appreciated inventory items) and non-Sec. 751 property, and then selling back to the partnership the property at its fair market value that he does not actually receive.

Thus, under the above facts, *A* would be considered as having received $250,000 of cash and $250,000 of inventory, and immediately thereafter, as selling back to *P* the inventory item for $250,000 (25% of the land value of $1,000,000). Since the inventory item has a carryover basis of zero, *A* would recognize $250,000 of ordinary income on the notional sale to *P*. The receipt of *A*'s proportionate share of cash, $250,000, would result in capital gain under Sec. 731(a)(1) ($250,000 less his partnership basis of zero). Therefore, the net result, assuming Sec. 751(b) applies, is the recognition of $500,000 gain of which $250,000 is ordinary income and $250,000 is capital gain.

Treatment as land sale. If, on the other hand, the partnership distribution is treated as a sale of appreciated land to *P*, *A* would be entitled to a $500,000 capital gain. Regs. Sec. 1.731-1(c)(3) provides, in part:

> If there is a contribution of property to a partnership and within a short period: (i) before or after such contribution other property is

> distributed to the contributing partner and the contributed property is retained by the partnership, . . . such distribution may not fall within the scope of Sec. 731.

Sec. 751

The regulation further states that Sec. 731 does not apply to a distribution of property if such distribution is made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Under these circumstances, the transaction will be treated as a sale or exchange of the property.

Resolving the question. In determining whether a distribution under the foregoing facts should be treated as a sale or exchange of the property or a partnership distribution subject to Sec. 751(b), there appears to be a question of "substance over form." The timing of the distributions may be critical. If the distribution is concurrent with and a part of the organization of the partnership, sale or exchange treatment of the land should prevail. If, however, the distribution is made after substantial land development by the partnership, the withdrawals would probably be treated as partnership distributions subject to Sec. 751(b) which would partially convert potential capital gains into ordinary income.

Losses in excess of investment in two-tier partnerships

Sec. 752

Most practitioners are aware that Sec. 752 and the regulations thereunder permit a partner to use his share of the partnership's debt in calculating his own "tax cost basis" of his partnership interest. Consequently, a partner can deduct partnership losses in excess of the cash he had actually contributed or is obligated to contribute to the partnership. A limited partner is permitted to use his share of partnership liabilities only to the extent the partnership has nonrecourse debt. (Regs. Sec. 1.752-1(e).)

A question arises as to the application of this rule in a two-tier partnership situation. For example, *X* and *Y* form an investment partnership, *P-2*. *P-2* buys an interest in *P-1*, a real estate syndication. *P-1* proceeds to generate tax losses in excess of the cash which has been contributed to it by all of its partners.

Sec. 752 In technical parlance, *P-1* is called the "first-tier" partnership; *P-2* is called the "second-tier." The example given above is a simple one. For various business reasons, arrangements arise which encompass three or more tiers of partnerships and property-holding entities. In a broader form, the same question exists in these arrangements.

It is clear that *P-2* can use its share of *P-1*'s mortgage liability as a basis for deducting its share of *P-1*'s "excess" loss. But does this loss flow through to *X* and *Y*, where *P-2* itself has no liabilities? In other words, does the *P-1* liability flow through both partnerships, or is the test applied separately at each partnership level?

The answer is unclear. There is little, if any, legislative, judicial or administrative authority directly in point. We understand that the IRS is giving at least some favorable private rulings in this area, pending publication of proposed regulations to deal with the question.

Editor's note: The Tax Reform Act of 1976 eliminates the use of nonrecourse debt to increase allowable losses by providing that a partner's adjusted basis does not include any partnership liability with respect to which the partner has no personal liability. The new law applies to liabilities incurred after December 31, 1976, and does not include in its coverage partnerships engaged principally in real estate (other than mineral property) activity.

Sec. 754 Partnerships: planning for benefits under Sec. 754

Frequently a group will form to launch a business venture and the question will arise as to the proper entity to own and operate the venture, depending on the tax circumstances of each participant.

The potential advantage of the elective optional adjustment to basis of partnership property under Sec. 754 is an important consideration in deciding whether to conduct a business in partnership or corporate form. This is particularly true when the business property is expected to appreciate in value and future changes in ownership are probable.

Contrast the tax effects of situation (1) where the business is conducted as a corporation with situation (2) where the business is in a partnership:

Situation (1). The balance sheet of corporation *X*, owned by three equal shareholders, is as follows:

	Tax basis	*FMV*
Assets		
Depreciable property	$100,000	$600,000
Liabilities	0	0
Shareholders' equity		
Capital stock and retained earnings	100,000	600,000
	$100,000	$600,000

Assume that one of the shareholders' stock is redeemed by the corporation for $200,000 cash, borrowed by the corporation from an outside source. The balance sheet of *X* after the redemption would be as follows:

	Tax basis	*FMV*
Assets		
Depreciable property	$100,000	$600,000
Liabilities		
Loan payable	200,000	200,000
Shareholders' equity		
Capital stock and retained earnings	(100,000)	400,000
	$100,000	$600,000

Clearly there has been no change in the tax basis of the corporation's property even though a price of $166,667 in excess of the basis of one-third of its property was paid to the one-third shareholder, and that shareholder in turn paid tax on the difference between the $200,000 he received and his tax basis of the corporate stock. Consequently, the remaining shareholders will not have the tax benefit of depreciation on the $166,667 of excess of redemption price of the stock over the corporate tax basis of one-third of its assets.

Situation (2). Assume the same facts as situation (1) except that the business property is owned by a partnership which has three equal general partners. The partnership's balance sheets prior to and after the "redemption" are as follows:

	Prior to redemption		*After redemption*	
	Tax basis	*FMV*	*Tax basis*	*FMV*
Assets				
Depreciable property	$100,000	$600,000	$100,000	$600,000
Optional basis adjustment elected under Secs. 754 and 734	0	0	166,667	0
	$100,000	$600,000	$266,667	$600,000
Liabilities				
Loan payable	0	0	200,000	200,000
Partners' equity				
Capital—partner A (⅓)	33,333	200,000	33,333	200,000
Capital—partner B (⅓)	33,333	200,000	33,333	200,000
Capital—partner C (⅓)	33,334	200,000	0	0
	$100,000	$600,000	$266,667*	$600,000

*Total partners' capital before redemption	$100,000
Cash paid out in redemption	(200,000)
Optional basis adjustment—booked	166,667
Remaining partners' share of partnership liabilities	200,000
	$266,667

Any of the partners could be an individual or closely held corporation or a publicly held corporation, at the discretion of the beneficial owner.

By qualifying for the optional basis adjustment as in situation (2), a substantial tax benefit for the remaining partners, namely potential depreciation on $166,667 of additional tax basis of depreciable property, has been attained.

Partnership vs. co-ownership for investment real estate

Sec. 761

Frequently, a tax adviser encounters resistance by investors to the filing of a partnership return for their syndicate, or even a "bobtail" return under Sec. 761(a) to elect out of the partnership reporting provisions. This resistance often reflects a concern that filing a partnership tax return exposes all members of the syndicate, as partners, to obligations incurred by every other member of the group.

It may be helpful to review the income tax pros and cons of filing a partnership return compared to independent reporting by each co-owner of his portion of each income and deduction item.

There are many advantages to filing a partnership return, including the following:

• A corporate member using the overall accrual method of accounting, and reporting on a fiscal yearend, can follow the partnership's calendar yearend cash method reporting, including the deduction for prepaid interest expense, by virtue of the partnership elections under Sec. 703(b). Compare this to co-ownership reporting, where the organization's income and deduction information must be recast on a fiscal year closing and the accrual method of accounting for reporting by such a corporate member.

• A partnership accelerated depreciation method election survives changes in participation aggregating less than 50% within one year. This permits an "inbound" partner to take advantage of the DDB depreciation being used by the partnership on its original basis, and if a Sec. 754 election is in force, to claim straight line depreciation (125% DDB for certain residential property) for his additional investment beyond the partnership's adjusted basis. Similarly, the remaining partners can claim a basis adjustment under Sec. 734 in the event of a premium price distribution to a withdrawing partner. Compare this to a co-ownership, where any new member of the organization is a "second user," and must use straight line depreciation for his entire depreciable investment (125% DDB for the 20-year or longer life residential property).

• A formal partnership agreement and return filing permits a special allocation of depreciation and property sale gain under Sec. 704(c) for contributed property, and under Sec.

 704(a) as to various deductions and incomes, if the economic reality test is satisfied. Again, co-ownership is less desirable; the non-property-contributing members are limited in their depreciation basis to their participation in the adjusted basis of the property of each contributing member. Furthermore, no special allocations of other deductions, e.g., oil and gas well IDC costs, are available.

• A partnership return permits the use of a guaranteed payment to shift income away from investor limited partners to the active general partner. A prepaid partnership management fee has been used as a technique for enlarging the investors' deductions in the early year(s) of a tax shelter partnership. See earlier item relating to guaranteed payments and discussion of *Cagle* case and Rev. Rul. 75-214. In a similar fashion, a formal partnership agreement and partnership return permits the use of a two-class partnership.

• A formal partnership agreement and partnership return are consistent with placing record title to the organization's property in the name of the partnership. If the partnership agreement provides for reconstitution after the death of a partner, the legal conflicts attending the death of a co-owner can be avoided. On occasion, a co-ownership resolves this difficulty with record ownership in the land trust, or a nominee partnership, but these bring tax conflicts and exposure of their own.

Co-ownership, on the other hand, has some advantages over partnership reporting. These include the ability of each member to adopt his own depreciation method and useful life (with caution as to the practical implications) for the organization's property. Each co-owner can make his own carrying charge election under Sec. 266.

It is occasionally argued that the co-ownership reporting avoids the partnership level $50,000 investment-credit-qualifying-property ceiling for used assets under Sec. 48(c). However, this position appears untenable in view of Rev. Rul. 65-118 and the case of *Bryant*, CA-5, 399 F2d 800 (1968). These authorities also should remind the tax adviser, if the organization is actually a partnership, that the non-subchapter K provisions of the Code are still operative, such as the stock ownership attribution rules for partners.

If the carrying charge election under Sec. 266 is paramount, consideration should be given to reporting as a co-ownership up to a date immediately prior to occupation and use of the property, then reporting as a partnership thereafter. *Sec. 761*

It has been suggested that a formal partnership agreement and partnership return may be worthwhile for an investor who is concerned about his exposure to liabilities created by another investor in the group. The formal partnership agreement can specify the business relationships among the members, and restrict their agency to incur liabilities for each other. Again, compare this to a co-ownership agreement, which is silent on this point, and which may be construed by the local courts to constitute a partnership, with no standards or rules specified as to each investor's exposure.

Regulated investment companies and real estate investment trusts

REITs: possible loss of status if warrants expire **Sec. 856**

A number of real estate investment trusts (REITs) have financed part of their activities with the proceeds from the sale of warrants. It now appears that many warrants may expire unexercised. The IRS has taken the position in Rev. Rul. 72-198 that if the warrants lapse without exercise, the amount paid in for such warrants constitutes ordinary income. Regs. Sec. 1.1234-1(b) is cited as authority for this conclusion.

Sec. 856(c) lists the types of income which must make up the major portion of the trust's income in order for it to qualify as an REIT. Because the income from lapsed warrants does not constitute eligible income under Sec. 856(c), there is the possibility that many REITs will lose their tax status.

This problem has been brought to the attention of the IRS and the Treasury. However, they feel that there is no way to grant relief under the present law, and that legislation is required to correct the problem.

We understand that the IRS has ruled favorably on a request which in effect defers the problem for an REIT whose warrants are to expire this year. In this case, there was no

Sec. 856 provision for extension of the exercise period. The REIT proposed to extend the exercise period for ten years and asked the IRS to rule that if such action was taken, the REIT would not be considered to realize income at the time of the original expiration date. The IRS ruled favorably because, as we understand, the REIT was able to demonstrate an adequate business reason for the extension. Presumably there would not have been a need for the ruling request if a provision for the extension had been incorporated in the warrants when they were issued.

A restrictive view by the IRS of what constitutes an adequate business reason for granting an extension could accelerate the merger trend in the industry, as REITs seek the shelter of qualified gross income from nonissuers of warrants.

Tax based on income from sources within or without the United States

Sec. 861 Foreign tax credit: IRS not relying on Prop. Regs. Sec. 1.861-8

On Sept. 19, 1975, the IRS issued a manual supplement to its field agents entitled, "Procedures for Handling Cases with Potential IRC 861(b) Issues." The substance of the manual supplement which was marked "urgent" was to provide uniform standards and procedures for cases involving the determination of U.S. source taxable income in connection with foreign tax credit limitations under Sec. 904. It notes that Prop. Regs. Sec. 1.861-8 on computation of taxable income from sources from within and outside the U.S. was issued on June 18, 1973, and that the regulation has not yet been adopted. It also notes that considerable time will be required to resolve certain matters involving the proposed regulation. As a consequence, the manual supplement directs IRS personnel to continue to develop cases as they did prior to the issuance of the proposed regulation and not to develop issues under the principles of the proposed regulations nor use them as authority for any adjustments.

As a result of this development, where IRS agents have proposed foreign tax credit adjustments based on the proposed regulations, they will apparently have to drop those issues because of the directive in the manual supplement. This clarifies an area which has caused confusion about the foreign tax credit limitations during the past two years. However, it does not get to the central issue—the proper rules for determining the allocation of expenses. It appears that the final regulations released in 1957 are to be used by revenue agents, but these provide no specific guidance to revenue agents or taxpayers.

It would appear that until new regulations are issued, taxpayers will be in an area of uncertainty with regard to the foreign tax credit limitations. It would seem desirable for those interested in this subject to direct comments to the Treasury Department so that some type of rules can be formulated and promulgated.

Editor's note: The IRS proposed new regulations on Sec. 861 on Nov. 8, 1976. These regs. were finalized on Jan. 3, 1977.

Employee returning from abroad: source of moving expense reimbursement

Rev. Rul. 75-84 attempts to clarify the treatment of moving expenses incurred by employees transferred abroad, or returning to the U.S., and their related expense reimbursement. The ruling, *inter alia*, provides rules for determining the source (within or without the U.S.) of both the moving expenses and the reimbursement based on the location of the new principal place of work, if any.

Generally, in the case of moving from the U.S. to a foreign assignment, the reimbursement and moving expense will be treated as foreign-source, and on the return to the U.S. they will be treated as U.S.-source. Rev. Rul. 75-84 states an exception to this general concept, however, where the employee works abroad for one employer, quits, and returns to work in the U.S. for another employer. Here the reimbursement from the first employer will be foreign-source while the moving expense will be U.S.-source: the expenses are attributable to the taking up of employment in the new U.S. principal place of work but the reimbursement is deemed

Sec. 861 attributable to past foreign services. Interestingly, Rev. Rul. 75-84 does not clarify the question of whether one is considered to have changed employers by merely changing from one employer to another within the same related group.

Is it necessary for the employee to quit abroad for his return moving expense reimbursement to be considered foreign source? It is submitted that the reimbursement should be considered foreign source regardless of whether the employee returned to work in the U.S. for the same or another employer. This conclusion is supported by either of two premises. First, the reimbursement for the return trip is generally guaranteed upon the taking up of the foreign assignment in order to assure the employee that he will not be stranded abroad. Second, a guarantee of the employer to pay return expenses is required by many countries in order for the employee to obtain a commercial visa to enter the foreign country. Where there is a guarantee, either explicit or implicit, for reimbursement of return moving expenses, such reimbursement, being compensation, is connected with the foreign service which triggered the reimbursement payment. It seems illogical to conclude that it is U.S.-source, since the reimbursement is typically a product of corporate policy to make overseas temporary tours of duty more attractive. In Rev. Rul. 75-84, the IRS may have recognized the validity of the above conclusion as a further exception to the mechanical test of matching the source of the reimbursement with the source of the expense, in the following language:

> Since moving expenses are allocable to or chargeable against income to be derived from an employee's performance of services at a new principal place of work, a reimbursement received by an employee from his employer for such expenses will generally, *in the absence of evidence to the contrary*, also be attributable to such services. (Emphasis added.)

Accordingly, taxpayers returning to the U.S. to work either for the same employer or another should enjoy the tax benefits of treating the reimbursement as foreign-source and treating the moving expenses as U.S.-source (and thus fully deductible within limits of Sec. 217). The benefit of treating the reimbursement as foreign-source is, of course, to obtain the use of the Sec. 911 exclusion for income earned abroad or, at least, to use such income as an additional limitation for absorbing excess foreign tax credits principally generated because foreign earnings were excluded from U.S. tax under Sec. 911. *Sec. 861*

Except in the case where the employee is not working for the same employer on his return, he should be prepared to prove that such reimbursement was indeed part of his compensation package for undertaking the foreign services. It would be advisable that such an employee secure a written guarantee of such reimbursement at the time he begins his foreign assignment absent a written corporate policy to such effect. In light of Rev. Rul. 75-84, however, it must be anticipated that the IRS will not readily accept the employee's argument.

Sec. 883: U.S. tax trap for ship leasing

Sec. 883

In recent years various financial institutions have become active in purchasing and leasing ocean-going cargo vessels in international commerce. Invariably these vessels are placed in separate foreign organized subsidiaries and the income earned from shipping activities has escaped both U.S. and foreign income tax, either because of local law exemption or tax treaty exemption. The IRS is now seeking to tax at least a portion of this income as rental income rather than shipping income.

The statute. Sec. 883(a)(1) provides that U.S. source earnings of a foreign corporation are exempt from U.S. tax when the earnings are derived from the operation of a ship documented under the laws of a foreign country which grants an equivalent exemption to U.S.-organized corporations.

There are basically three types of charter contracts used in the commercial shipping trade:

Time charter. The contract provides for the use of space in a vessel for a period of time. The owner of the vessel remains in control of the navigation and management of the ship, paying and being responsible for the crew, supplies, repairs and

Sec. 883 maintenance, provisions, insurance, fees, etc. The time-charterer controls the cargo that will be accepted and the destination of the vessel.

Voyage charter. This arrangement is similar to a time charter except that the vessel is chartered for a specified voyage instead of a specified period of time.

Bareboat charter. The contract provides for the performance of functions by the charterer which are normally performed by the owner of the vessel, such as furnishing the crew and supplies, and the charterer is in complete possession, control and command of the vessel. The owner of the vessel bears none of the expense or responsibility for operating the vessel.

IRS ruling. Rev. Rul. 74-170 held that earnings derived by owners from voyage and time charters, but not from bareboat charters, constituted shipping income under Sec. 883. It held that payments received by the owner from a bareboat charter are in effect rents received for the use of property by a third party. The ruling also held that bareboat charter income can only be considered as shipping income where the owner of the vessel is actively engaged in the shipping business and merely leases a vessel to another person as an activity *incidental* to his shipping business.

Thus, the income derived by an owner from bareboat charter hire is not ordinarily exempt from U.S. income tax under Sec. 883, and a foreign corporation is subject to U.S. tax on that portion of its bareboat charter hire income derived from U.S. sources. Such fact is likely to create a, burdensome record-keeping obligation to determine when a particular vessel is operating in U.S. waters. Furthermore, since bareboat charter hiring ordinarily does not constitute doing business in the U.S. but rather is merely the rental of tangible personal property, a requirement to withhold tax at 30% would be imposed on the charterer under Sec. 881. Since the charterer may not know what portion of the charter hire is U.S. source income, he may feel obliged to withhold 30% of all charter hire payments made to the vessel owner. The owner would then be required to file a claim for refund with the IRS.

The problem is further magnified by Regs. Sec. 1.6012-2(g) which requires a foreign corporation to file a U.S. corporation tax return even if it claims that its U.S. source income is exempt from tax under Sec. 883 or the provisions of a tax treaty.

Foreign retaliation. To add further to the dilemma of ship-leasing operations, it is not entirely unlikely that foreign countries will retaliate. Whereas foreign countries have invariably recognized bareboat charter income as shipping income and exempt from taxation under either local law or by virtue of a tax treaty, a natural consequence of this ruling would be for those countries to tax a portion of bareboat charter hire to the extent derived by U.S. shipowners from their territorial waters.

It should also be noted that since there is no effective date mentioned in the ruling, it could conceivably be enforced retroactively to the inception of the 1954 Code. If U.S. tax returns were not filed for the intervening years, the statute of limitations would not have tolled, and assessments could be made by the IRS.

Tax treaties. An additional question is whether the pertinent articles of the tax treaties with foreign countries exempting shipping income from tax would shelter the bareboat charter income from U.S. tax. It must be remembered that Rev. Rul. 74-170 does not recognize bareboat charter hire as shipping income but rather treats it as ordinary rental income. Accordingly, the exclusion for shipping income under the respective tax treaties would not come into play.

Incidental leasing. One final point relates to the fact that this ruling claims to recognize bareboat charter hire as shipping income where it is merely incidental to a shipping business, but does not define the term "incidental." For example, assume there are 50 ships in a fleet with each one in a separate foreign corporation owned by a U.S. financial institution. Three ships are on long-term bareboat charter hire contracts and 47 vessels are time chartered. The bareboat charter hire would not be incidental to the business of the three corporations even though it might be incidental to the operation of all 50 ships. Under Rev. Rul. 74-170 the bareboat charter income would not be considered incidental to this shipping business. To be incidental to the shipping business, the bareboat char-

Sec. 883 ter hire must occur in a temporary period between time or voyage charter hires. It would be quite unusual for an owner to bareboat charter a vessel for a short period of time. Thus, there would be few instances in which bareboat charter hire would be incidental to an owner's shipping business, especially where each vessel is owned by a separate corporation.

Impact of ruling. The U.S. shipping industry has been steadily declining in recent decades and Rev. Rul. 74-170 will no doubt have a substantial impact on this trend unless this U.S. government position is changed. The ruling is logical on technical grounds but shipping industry trade associations are wondering whether it makes political and economic sense in our worldwide commercial relationships.

Sec. 902 Foreign tax credit: U.S. citizen resident in Canada

A common tax planning maneuver for taxpayers with excess foreign tax credits is to increase foreign source income, thereby increasing the amount of the credits that can be used.

It is quite probable that U.S. executives resident in Canada will have excess foreign tax credits due to higher Canadian tax rates and the U.S. exemption for income earned abroad under Sec. 911. Many of these executives may have a unique opportunity to take capital gains tax-free as a result.

Canadian law provides that Canadian residents take a new basis in their investments owned on December 31, 1971, or at such later time as they become resident in Canada. Although there are alternative methods of computing the new basis, in many cases it will exceed the taxpayer's cost. Thus, it is quite possible that some investments could produce a loss in Canada but a gain in the U.S.

Consequently, taxpayers could sell such stock without incurring a tax in Canada. Moreover, if the transaction was consummated in Canada the gain recognizable in the U.S. would be foreign source income. This would mean that substantial gains might be realized for U.S. purposes without increasing the overall tax liability. In some cases even a reduction in the overall tax liability could be achieved.

Sec. 902

To accomplish this result, however, it would be necessary to have the sale take place in Canada. Using a Canadian broker would not necessarily produce this result since the place of title passage would govern the source of the gain. (Regs. Sec. 1.861-7(c)) Thus, title to stock traded on the New York Stock Exchange would pass in New York. To avoid this problem, it would be necessary to sell to a Canadian buyer (broker, bank, etc.) who purchases as a principal, not as an agent.

However, the IRS might assert that the title passage rule does not govern where the substance of the transaction occurred elsewhere. See Regs. Sec. 1.861-7(c), above. In this respect, U.S. executives resident in Canada would seem to be in a strong position. The negotiations and arrangements for sale would probably take place in Canada in the normal course of events. To bolster the Canadian substance, the proceeds could be reinvested through Canadian brokers. Clearly, the most important aspect of proving the matter upon later audit is to obtain, at the time of sale, proof of the Canadian purchaser as principal.

Full absorption method and the deemed paid foreign tax credit

The adoption of Regs. Sec. 1.471-11, requiring manufacturers to use the full absorption costing method for valuing inventories, has received considerable attention in tax literature recently. Nevertheless, many practitioners may not be aware that the regulation can have a major impact on corporations with foreign manufacturing subsidiaries, since the use of the full absorption method would tend to reduce the parent corporation's deemed paid foreign tax credit under Sec. 902.

The Sec. 902 credit is generally available to a domestic corporation receiving dividends from a foreign corporation in which it owns at least 10% of the voting stock. The touchstone of the Sec. 902 credit is the foreign subsidiary's "accumulated profits" and it is generally advantageous, for purposes of Sec. 902, to attempt to reduce the subsidiary's "accumulated profits." The full absorption costing would tend to have a nega-

Sec. 902 tive impact on the Sec. 902 credit by increasing the foreign subsidiary's "accumulated profits." This might, however, be mitigated by electing Lifo in measuring the subsidiary's "accumulated profits."

More specifically, Regs. Sec. 1.902-3(c) relates "accumulated profits" under Sec. 902 to the foreign entity's earnings and profits (E&P). Certain taxpayers have "regulatory guidance" in determining the E&P of the foreign subsidiary under Regs. Sec. 1.902-3(c)(5). With modifications, this regulation basically gears the calculation of E&P to the rules of Regs. Sec. 1.964-1, and is optional in certain cases but mandatory in the event of a minimum distribution election under Regs. Sec. 1.963-1(c)(1).

It seems clear that taxpayers subject to the rules of Regs. Sec. 1.964-1 will have to determine the "accumulated profits" of the foreign manufacturing subsidiary in accordance with the full absorption costing rules of Regs. Sec. 1.471-11. Regs. Sec. 1.964-1(c)(1)(ii) provides that "[i]nventories shall be taken into account in accordance with the provisions of Secs. 471 and 472 and the regulations thereunder." Regs. Sec. 1.471-11(e)(3)(i) provides that the taxpayer may elect to take the adjustment required by the change to full absorption costing into account ratably over a specified period (generally ten years) and apparently this election would also apply in determining "accumulated profits." Under Regs. Sec. 1.964-1(c), it also appears that any adverse effect of Regs. Sec. 1.471-11 might be mitigated by electing Lifo with respect to inventories.

It seems reasonably clear, therefore, that taxpayers subject to the rules of Regs. Sec. 1.964-1 for purposes of Sec. 902 will have to contend with the possible negative impact of Regs. Sec. 1.471-11, requiring full absorption costing for manufacturers. The effect of Regs. Sec. 1.471-11 on taxpayers not subject to the rules of Regs. Sec. 1.964-1 is less clear and this subject is beyond the scope of this discussion. While a Lifo election had been suggested as possibly advantageous under Sec. 902, there are, of course, other considerations involved in making such an election. For example, consideration must be given to the tax provisions of the foreign country involved, the effect of a Lifo election on the financial reports of the parent, possible changes in pricing structure on intercompany sales, Rev. Proc. 74-21 concerning the Lifo election and a change to full absorption costing, and especially on the foreign tax credit carryover position of the company. *Sec. 902*

Foreign tax credit limitation in consolidated tax returns

Sec. 904

Rev. Rul. 72-281 holds that in computing the numerator of the applicable limiting fraction under Sec. 904(a) for foreign tax credit purposes, the not-specifically-allocable expenses of each member of a consolidated group are to be apportioned to foreign and U.S. source gross income on a company-by-company basis, and not by aggregating the gross income on a consolidated basis. Thus, group income and expenses of members of the group that do not have income from foreign sources are not included in the computation. This produces two interesting results.

In those situations where a domestic corporation in the group may have a high amount of foreign source income, the expenses incurred by that member will be allocated in large measure for foreign source income, thereby producing a detrimental effect on the limitation on the foreign tax credit. This, for example, is the result produced when a domestically incorporated international finance subsidiary has been utilized by the group, borrowing funds abroad and having more than 80% of its gross income from foreign sources.

On the other hand, where a member of the consolidated group has a large amount of foreign source gross income but a small amount of expenses attributable to it, a significant amount of foreign tax credit limitation may be produced. This opens up planning possibilities in the foreign tax credit area.

Note that Sec. 482 applies to companies in a consolidated tax return to make sure that all members deal with each other on an arm's length basis.

Paying balance of tax due with Form 1040-ES to avoid interest . . .

Sec. 911

How can a U.S. citizen having earned income from sources outside the U.S. pay his federal income tax liability to stop the running of interest, where the individual citizen has not yet qualified for the Sec. 911 exclusion and the initial due date for filing his return has passed? Consider the following example:

> *T*, a U.S. citizen, leaves the U.S. to commence work in Tokyo on Aug. 1, 1974. *T*'s 1974 federal income tax return is due on April 15, 1975, but is automatically extended to June 15, 1975 under Regs. Sec. 1.6081-2. An application for extension (Form 2350) was timely filed, and approval received from the IRS. *T* expects to qualify under Sec. 911 on Jan. 1, 1976. *T*'s 1974 federal income tax liability will exceed his withholdings and estimated payments, after applying the Sec. 911 exclusion for the appropriate period in 1974.

Regs. Sec. 1.911-2(e)(1) provides, in effect, that any return filed *before* completion of the period necessary to qualify under the bona fide residence or physical presence tests shall be filed *without* regard to Sec. 911 exclusion. The regulations further state that the taxpayer may file a claim for refund if he subsequently qualifies for the exclusion.

It is generally unrealistic to expect a taxpayer to pay federal income taxes which will be refunded after qualifying for the exclusion. There is no vehicle for a taxpayer to use in paying his tax liability once the initial due date (April 15) has passed. A tax payment could have been made in conjunction with the filing of Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return) prior to the initial due date of the return, but in the usual situation, Form 4868 would not be filed.

Our solution in *T*'s case for minimizing interest charges is to have *T* file a *1974* January 15 Estimated Tax Voucher (Voucher No. 4) as soon as possible and attach a check in the amount of the balance of tax due after application of Sec. 911. The interest charges would then be limited to the period from April 15, 1975, to the date of payment. This recommendation is based on discussions with representatives of the Office of International Operations, who indicate that such a procedure has been utilized by taxpayers and that the Philadelphia Service Center will process such Estimated Tax Vouchers and credit payments to the appropriate tax year, even though the voucher is filed subsequent to its due date.

Quick count of days present in foreign country

Sec. 911(a)(2) provides an exemption from gross income of up to $20,000 of income earned while physically present in a

First full day	Month beginning in JAN	FEB	MAR	APR	MAY	JUNE
1	June 30	July 31	Aug 31	Sept 30	Oct 31	Nov 30
2	July 1	Aug 1	Sept 1	Oct 1	Nov 1	Dec 1
3	2	2	2	2	2	2
4	3	3	3	3	3	3
5	4	4	4	4	4	4
6	5	5	5	5	5	5
7	6	6	6	6	6	6
8	7	7	7	7	7	7
9	8	8	8	8	8	8
10	9	9	9	9	9	9
11	10	10	10	10	10	10
12	11	11	11	11	11	11
13	12	12	12	12	12	12
14	13	13	13	13	13	13
15	14	14	14	14	14	14
16	15	15	15	15	15	15
17	16	16	16	16	16	16
18	17	17	17	17	17	17
19	18	18	18	18	18	18
20	19	19	19	19	19	19
21	20	20	20	20	20	20
22	21	21	21	21	21	21
23	22	22	22	22	22	22
24	23	23	23	23	23	23
25	24	24	24	24	24	24
26	25	25	25	25	25	25
27	26	26	26	26	26	26
28	27	27	27	27	27	27
29	28	28	28	28	28	28
30	29	29	29	29	29	29
31	30	30	30	30	30	30
Number of days to spare	36*	36	39	38	39	38

* If the "first full day" falls in January, add one day if February 29 is included within the 18-month period. If the "first full day" is August 30 or August 31, the days to spare are 38 and 37 respectively.

Month beginning in

First full day	JULY	AUG	SEPT	OCT	NOV	DEC
1	Dec 31	Jan 31	Feb 28	Mar 31	Apr 30	May 31
2	Jan 1	Feb 1	Mar 1	Apr 1	May 1	June 1
3	2	2	2	2	2	2
4	3	3	3	3	3	3
5	4	4	4	4	4	4
6	5	5	5	5	5	5
7	6	6	6	6	6	6
8	7	7	7	7	7	7
9	8	8	8	8	8	8
10	9	9	9	9	9	9
11	10	10	10	10	10	10
12	11	11	11	11	11	11
13	12	12	12	12	12	12
14	13	13	13	13	13	13
15	14	14	14	14	14	14
16	15	15	15	15	15	15
17	16	16	16	16	16	16
18	17	17	17	17	17	17
19	18	18	18	18	18	18
20	19	19	19	19	19	19
21	20	20	20	20	20	20
22	21	21	21	21	21	21
23	22	22	22	22	22	22
24	23	23	23	23	23	23
25	24	24	24	24	24	24
26	25	25	25	25	25	25
27	26	26	26	26	26	26
28	27	27	27	27	27	27
29	28	28	28	28	28	28
30	29	29	29	29	29	29
31	30	30	30	30	30	30
Number of days to spare	39	39*	36	37	36	37

* If the "first full day" falls in January, add one day if February 29 is included within the 18-month period. If the "first full day" is August 30 or August 31, the days to spare are 38 and 37 respectively.

foreign country or countries for 510 full days during any 18-month period. The charts on pages 229 and 230 permit quick counts of the 18-month period and the maximum number of days within such period which may be spent outside of a foreign country or countries.

To determine the 18-month period:

- Locate the month in which physical presence began in the foreign country, in the horizontal "Month" column at the top;
- Then locate the first full day of physical presence in the "Day" column, the first vertical column on the left; and
- Finally, read across and down to find the month and day on which the 18-month period ends.

Example. The first full day is June 16. Find June in the top horizontal column and the 16th in the vertical column. Read across and down to the junction of the columns, which shows that the 18-month period ends on December 15.

To determine the number of days for which physical presence in a foreign country is not required during the 18-month period, use the number at the bottom of the column below the month in which the physical presence began.

Example. For a period beginning in June, the number of "spare" days is 38.

Sec. 911 exclusion: bona fide residence?

U.S. expatriates on temporary assignment overseas often claim "noninhabitant" or nonresident status for purposes of determining their tax liability to the foreign jurisdiction in which they are temporarily located. The IRS recently issued a favorable technical advice memorandum which concludes that, in the circumstances presented, the filing of a nonresident return for Belgian purposes is not "a disqualifying statement" within the meaning of Sec. 911(c)(6).

Sec. 911(c)(6) states, in relevant part, that a statement by an individual who has earned income from sources within a foreign country to the authorities of that country that he is not a resident of that country, if he is held not subject to the income tax of that country by its authorities with respect to such earnings, shall be conclusive evidence with respect to such earnings that he is *not* a bona fide resident of that country for purposes of Sec. 911(a)(1). Therefore, the exclusion provided by Sec. 911(a) would be inapplicable.

Example. Good Faith, an executive of an international corporation, was assigned to Brussels, Belgium. He had a residence permit, a home in Belgium, and generally met all the requirements of being a bona fide resident of Belgium within the meaning of Sec. 911.

He filed a tax return labeled "nonresident" with the appropriate Belgian authorities. Under Belgian law, inhabitants of Belgium who have their house, their family, or their center of economic interest outside of Belgium may be considered "noninhabitants" of Belgium and, therefore, eligible for certain tax benefits designed to compensate them for the extra expenses incurred because of the temporary nature of their stay; it is required that such noninhabitants have been assigned temporarily to Belgium by a foreign concern or have been recruited outside of Belgium by a Belgian subsidiary of a non-Belgian company to work temporarily in Belgium.

Under Belgian law "noninhabitants" are required to file so-called nonresident returns, and are, with the exception of certain concessions, taxed the same as residents. Good Faith was *not* limited under the laws of Belgium to any definite period of stay. Furthermore, while a letter from his employer indicated that his stay in Belgium was temporary, it did not indicate a definite time when he would leave.

Regs. Sec. 1.911-1(a)(2) states, in relevant part, that whether an individual citizen of the U.S. is a bona fide resident of a foreign country shall be determined by the application, to the extent feasible, of the principles of Sec. 871 and the regulations thereunder.

Regs. Sec. 1.871-2(b) states, in relevant part, that an alien actually present in the U.S. who is not a mere transient or sojourner is a resident of the U.S. for income tax purposes. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere fleeting intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the U.S. and has no definite intention as to his stay, he is a resident. One who comes to the U.S. for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the U.S., he becomes a resident, even though he may intend to return to his domicile abroad.

Good Faith's purpose was such that an extended stay in Belgium was necessary for its accomplishment, and to that end he made his home temporarily in Belgium. Therefore, he was a resident of Belgium within the meaning of Regs. Sec. 1.871-2(b). Although he filed a nonresident return on which he claimed to have noninhabitant status, the technical advice determined that the filing of such return was *not* a disqualifying statement within the meaning of Sec. 911(c)(6). Such filing was recognized as the appropriate method under Belgian law for claiming the special tax concessions to which a noninhabitant is entitled.

The IRS's technical advice recognizes that both the object and effect of the special concessions are to place the foreigner working temporarily in Belgium, whose purpose is of such a nature that an extended stay may be necessary for its accomplishment, in parity with the permanent resident of Belgium.

Foreign tax credit: pension payment as foreign-source income

Corporate executives who retire after many years of foreign service will often be in an excess foreign tax credit position. Thus, it is to their advantage to allocate their pension distribution to foreign-source income in order to use these credits. Rev. Rul. 72-149 indicates that an employer's contribution to a pension plan with respect to wages earned abroad constitutes compensation for labor or personal services performed without the U.S., and is treated as derived from foreign sources. However, the employee in the ruling worked abroad during his entire employment period.

How does one compute the foreign source income of an employee who works abroad during only part of his career? There appears to be no authority for such a computation. The following approach might be considered:

1) Determine the annual contribution made by the corporation each year the employee was covered by the plan.

2) For each year, determine the number of days worked outside the U.S. and the total days worked during the year. Days worked outside the U.S. include extended employment overseas and business trips made outside the U.S. while employed within the U.S.

3) Compute the foreign source portion for each year as follows:

$$\text{Employer contributions (1)} \times \frac{\text{Number of days worked outside U.S.}}{\text{Number of days worked}} = \text{Annual foreign source contributions}$$

4) Total the annual foreign source contributions.

5) Compute the foreign source portion of the pension distribution as follows:

$$\text{Taxable portion of distribution} \times \frac{\text{Total foreign source contributions (4)}}{\text{Total contributions}} = \text{Foreign source taxable portion of pension distribution}$$

With respect to the above computation, the taxable portion from the pension plan includes the corporation's contribution to the plan and the plan's earnings. It is possible that the Service could argue that the plan's earnings are not foreign source income. Thus, the foreign source income could be reduced to that extent.

Sec. 911 exclusion applied to self-employed persons: IRS view

Apparently commencing with calendar year 1969, in its audits the IRS adopted a "new" position in the application of Sec. 911 (exemption from tax of earned income of U.S. citizens residing in foreign countries) to self-employed persons. Under the new position, the dollar limitations ($20,000 or $25,000) of Sec. 911 are first applied to a self-employed's gross income and then a proportionate reduction is made to the otherwise deductible expenses. In pre-1969 years, the IRS applied the limitations to the net profits of the sole proprietor and to a partner's distributive share of partnership net income.

Example. X is a sole proprietor of a business in which capital is not a material income producing factor. X has been residing and operating in country Y for over three years. For 1973, he has gross income of $100,000, business expenses of $75,000 and net income of $25,000. Under the old position, the net income of $25,000 would be totally excluded. Under the new position, only $6,250 of the net income would be excluded, determined as follows:

1. Gross income	$100,000
2. Limitation on exclusion	25,000
3. Gross income after limitation	75,000
4. Ratio of L. 3 to L. 1	75%
5. Otherwise deductible expense	75,000
6. Expenses deductible under Sec. 911 (L. 4 x L. 3)	56,250
7. Taxable income (L. 3 less L. 6)	18,750
8. Excludible portion (maximum amount of $25,000 less L. 7)	$ 6,250

In several cases, revenue agents have proposed adjustments as a result of this "new" position which has now been formalized in Rev. Rul. 75-86.

It is submitted that the limitation of Sec. 911 should be applied to *net income* of self-employed persons. It should be noted that the IRS has taken this position to determine what portion of the net earnings from self-employment may be considered earned income for Sec. 401 purposes. (Rev. Rul. 70-491.) This inconsistency in IRS position will have to be tested in court.

Editor's note: Rev. Rul. 76-163 apparently reaffirmed the IRS "gross income" position. The ruling covered a case where there was foreign salary and partnership loss, and presented lengthy calculations to determine the available exclusion using the "gross income" method applied to the partnership loss. Shortly thereafter the "gross income" position was rejected by the Court of Claims in Vogt *(6/16/76), because the Court would not allow IRS to apply Rev. Rul. 75-86 retroactively. The decision specifically excluded consideration of prospective application.*

The Tax Reform Act of 1976 reduces the exclusion to $15,000 for years beginning after 1975.

Sec. 931 Foreign investments by Possessions Corporations

One of the recent developments in the international tax field is the utilization of Possessions Corporations not only for manufacturing operations in U.S. possessions but also as a base for branching out into investments abroad.

Basically, a Possessions Corporation's income from sources without the U.S. is exempt from U.S. taxation if it meets the 80%-50% gross income tests specified in Sec. 931. In addition to U.S. tax exemption, the company would normally seek exemption from local taxation by conducting manufacturing operations entitled to a tax holiday in that area (e.g., Puerto Rico).

A Possessions Corporation is exempt from U.S. income tax on all of its foreign source income, even though a portion of such income may not be from sources within a U.S. possession. To the extent that the company meets the definition of Possessions Corporation, it could have as much as 20% of its gross income from nonpossession foreign sources without jeopardizing its Possessions Corporation status. This then presents tax planning possibilities for companies with Possessions Corporation affiliates by permitting tax free funds to be invested outside the U.S., thus generating profits that would be exempt from U.S. taxation under Sec. 931. Since a U.S. corporation is involved, such investment income will not be taxed locally because it is foreign to the possession.

Sec. 991 DISC and receivables from its operating affiliate

Many tax advisers feel that the critical problem for continuation of DISC status and deferral of accumulated DISC income centers upon satisfaction of the 95% qualified export assets test. Some DISCs originally planned to satisfy this test with producer's loans and certain obligations of the Export-Import Bank and Foreign Credit Insurance Association, but encountered practical difficulties. The producer's loans frequently were effective only for the first year, and became unsatisfactory in later years because of the increased investment requirement prescribed by Sec. 993(d)(3).

The Ex-Im Bank obligations are not eligible unless acquired directly from the Bank (within 90 days of the bond issue date) or from the exporter originating the transaction financed by the obligation. The volume of offerings fluctuated; as a result, the DISC might have found it difficult to locate available qualified obligations or was forced to pay a premium for those in short supply.

Purchase by the DISC from its parent of export receivables, qualified under Sec. 993(b)(3), now seems to be the preferable technique for satisfying the 95% assets test. Typically, the DISC functions as a commission agent, rather than a reselling distributor, and purchases customer receivables taken by the parent from foreign customers or an operating affiliate.

Receivable transactions between the DISC and the operating affiliate generally are subject to the Sec. 482 arm's length interest imputation rules. (Regs. Sec. 1.994-1(e)(3) and (5).) This requirement facilitates an attractive opportunity for enlarging the portion of the overall export income reportable by the DISC; i.e., the DISC should purchase the export receivables at a discount from the face amount equivalent to that which a factor or other independent financing entity would exact. The resulting discount income realized by the DISC upon collection of the receivables constitutes qualified export receipts under Sec. 993(a)(1)(F), as well as shifting additional income from the operating affiliate to the DISC.

Where numerous foreign customers are involved, instead of purchasing specific receivables, it may be desirable for the DISC to purchase a participation in a pool of export receivables maintained by the operating affiliate. It is understood that in one favorable private ruling approving the pool participation technique, the IRS required that upon its request the DISC furnish a listing of the total qualified receivables held by the operating affiliate as of any specific date. The purpose of this requirement is to ensure that the receivables on hand covered the participation investment carried as a DISC asset. It would appear that the discount can be mechanically achieved by providing a stated discount rate on the fluctuating balance from time to time of this participation. Rev. Rul. 73-96, relating to allocation of export promotion expense to the DISC from the operating affiliate's computer-maintained accounting records, further supports the export receivable pool participation technique.

Sec. 991 *Editor's note: Rev. Rul. 75-430 provides that export receivables bought at arm's length are qualified export assets, and that any discount income realized upon collection is a qualified export receipt.*

Sec. 993 DISC: energy products after 1975 TRA

The 1975 Tax Reduction Act amended Sec. 993(c)(2) to provide that receipts from sales of "products of a character with respect to which a deduction for depletion is allowable (including oil, gas, coal, or uranium products)" made after March 18, 1975, are no longer qualified export receipts. Also excluded are "primary" products from such minerals. In order to qualify non-primary product derivatives from these minerals, at least 50% of the fair market value of such product must be attributable to manufacturing or processing. (Processing does not include extracting, handling, packing, packaging, grading, storing or transporting.)

A question arose regarding the qualification of products such as urea, sulphuric acid, phosphoric acid, ammonium phosphate, diammonium phosphate (DAP), compound fertilizers (NPK), phosphate rock, potash, propane, butane, sulphur, and ammonia (NH_3).

It seems clear that sulphur, as a direct basic product which is produced by the "Frash" process, will no longer qualify since it falls squarely within the definition of a depletable product. However, sulphur is also produced as a by-product in the processing of other depletable minerals.

If the products enumerated above, other than sulphur, are "primary" products, they will no longer qualify for DISC treatment. If they are not primary products, but are by-products, they will qualify if they meet the 50% test. If they are treated as chemicals which are neither primary nor by-products, they will continue to qualify irrespective of the 50% test.

The term "primary product" is not defined in the statute or in the accompanying committee reports. In an amendment made by the Tax Reform Act of 1969, foreign tax credits relating to foreign mineral income were generally reduced for percentage depletion allowed for U.S. tax purposes. Foreign mineral income is defined as "income derived from . . . mines, wells, or other natural deposits [and] the processing of such minerals into their primary products. . . ." Sec.

901(e)(2). Both the Joint Committee Report and the applicable regulations clearly state that "income attributable to the manufacture, distribution, and marketing of petro-chemicals is not to be treated as mineral income." Regs. Sec. 1.901-3(b)(1). *Sec. 993*

Accordingly, since the term primary product in the 1975 TRA is used in substantially the same context as used in the 1969 amendment (i.e., addressed to products derived from processing minerals), it appears clear that petro-chemicals are not to be considered primary products.

The Oil and Gas Division of the U.S. Interior Department was contacted as to whether the products specified above (except sulphur produced under the Frash process) constitute "petro-chemicals." It was *informally and unofficially* indicated that they would be considered "chemicals" and thus eligible for DISC benefits since they are neither primary products nor petro-chemicals.

Nevertheless, until further clarification is provided by the IRS, the following was suggested:

- The DISC should no longer export the Frash sulphur.
- Another subsidiary DISC should be created to export the above products (except the sulphur) to insulate the present DISC from possible disqualification.

Editor's note: The Tax Reform Act of 1976 modified the 1975 Tax Reduction Act to allow DISC benefits for exports of depletable natural resources made after March 18, 1975, but before March 19, 1980, pursuant to a fixed contract. In addition, the provision of the 1975 Act which terminated DISC benefits for those natural resource products subject to the allowance for cost depletion, is now modified to terminate DISC benefits for products subject to percentage depletion.

Reincorporating a DISC for state tax considerations

Sec. 995

The amount of state taxes imposed on a Domestic International Sales Corporation (DISC) can have a significant effect on selecting the state in which the DISC should be incorporated.

A review of the tax laws of various states indicates that they differ in their taxation of DISCs. Some states tax DISCs the same as other corporations, while others do not tax them at

Sec. 995 all. Thus proper planning can yield substantial yearly state tax savings.

Suppose a DISC is already incorporated in a state that has relatively unfavorable tax laws for a DISC? Can anything be done to rectify this situation? The answer is clearly "yes." A DISC incorporated in a state which imposes a burdensome tax on DISCs can be reorganized and reincorporated in another state having more favorable tax laws. But due to the serious tax implications of terminating a DISC or its taxable year, care should be exercised in effecting the reincorporation.

Sec. 995(c) and the related committee reports provide that an "F" or a "B" reorganization can be effected without triggering recognition of the deferred DISC income. In addition, proposed Regs. Sec. 1.995-4(c)(2) provides for nonrecognition of deferred DISC income where the DISC is involved in a transaction described in Sec. 381(a) and continues to exist as a separate entity.

However, the use of other than a "B" or an "F" reorganization will terminate the year of the DISC and accelerate the taxability of the deemed distribution of that year's DISC income. Also, if a transaction is consummated which causes the DISC to cease to exist, all of the deferred income of the DISC will be realized for income tax purposes.

A private ruling was recently obtained from the IRS on the reincorporation of a DISC via an "F" reorganization. A DISC had been formed in a state that had unfavorable tax laws. The parent of the DISC formed a new corporation, also qualifying as a DISC, in another state imposing no taxes on DISCs. The old DISC was then merged into the new DISC in a transaction that qualified as a statutory merger under the laws of both states involved. The Service ruled that the transaction qualified as an "F" reorganization. Therefore, the DISC's yearend was not terminated and its deferred income was not taxed.

Gain or loss on disposition of property

Sec. 1001 Sale of escrowed stock: IRS ruling policy

In a recent situation, an individual proposed to sell stock for a small down payment and a two-year 8% note for the balance of the purchase price. The shares sold were to be escrowed to secure the payment of the note under an agreement which provided that in the event of default the escrowed shares would be sold at a public or private sale. It was further provided in the agreement that the seller could be the purchaser of such shares in any such sale by the escrow agent. Inquiry was made as to whether a ruling might be obtained stating that the entire gain on sale would be recognized upon the receipt of the down payment. *Sec. 1001*

We were advised that a ruling would be issued only where the seller represents that he will not buy back the stock, directly or indirectly, in the event it is sold by the escrow agent in case of a default on the note. It was indicated that in taxable sales coming under Secs. 1001 and 1002, the IRS ruling policy is similar to its ruling policy in cases of redemptions. Rev. Proc. 69-6, section 3.01-5, indicates an IRS "no ruling" policy in redemption of stock under Sec. 302(b) where the consideration given in redemption by the corporation consists entirely or partly of its notes payable, and the shareholder's stock is held in escrow as security for payment, with the possibility that the stock may be returned to him upon default.

Community property: planning for division in divorce

Sec. 1002

As a result of the Supreme Court decision in *Davis*, 370 US 65 (1962), a transfer by a husband of appreciated property to his wife pursuant to a divorce decree results in a taxable gain to him in non-community property states. The wife is treated as receiving the property in exchange for releasing the husband from his marital obligations toward her. Since the exchange is assumed to be arm's length, the value of the marital obligations is deemed to be equivalent to the market value of the property transferred. Therefore, the gain to the husband is the difference between the market value of the property at the time of the transfer and its basis.

The spouses in a community property state, however, by dividing the property equally, can defer all gain on community property used in a marital property settlement. (*Walz*, 32 BTA 718; *Wren*, TC Memo 1965-52.)

Two recent Tax Court decisions, however, point out the importance of properly planning property settlements in community property states, and of not going outside the community property for funds to buy out the interest of one spouse.

In one case, taxpayers owned a $400,000 residence as their principal community asset. The divorce decree divided the community property equally, awarding the residence to the husband. He borrowed $200,000 (went outside the community) and gave it to his wife in exchange for her interest. The Tax Court found this exchange a taxable sale of the wife's half interest in the single community asset, and distinguished *Walz* where there were two assets (house and cash). Nontaxable exchange provisions could have applied to a portion of the proceeds, but there was not a timely reinvestment in a new residence. (*May*, TC Memo 1974-54.)

In the second case, the Tax Court also found a taxable exchange in a divorce settlement where a doctor gave his wife his note for $10,000 in payment for her community interest in accounts receivable. (*Showalter*, TC Memo 1974-40.)

Compare a recent U.S. District Court decision involving Colorado (a non-community property state) marital rights consisting of a "species of common ownership." A substantial part of the family estate consisted of stock in a corporation. Under the property settlement agreement, the wife received a new class of stock in that corporation and half the stock in two other corporations. The Court held the settlement was a division rather than an exchange. (*Imel*, (DC–Colo., 1973).)

The Tax Court and District Court opinions indicate some do's and don'ts in arranging community property settlements as equal divisions, not exchanges:

- *Do* divide assets 50-50 (or as close to it as possible).
- *Do* state in the agreement that the division recognizes the present, existing, and vested rights of the spouses in the property.
- *Don't* use words of bargain, sale, or exchange.
- *Don't* go outside the community to obtain funds to buy out the interest of one spouse.

Editor's note: For a further example of these rules see Carrieres, *64 TC 91, where wife's exchange of her community property interest in family company was a nontaxable division to the extent she received her husband's interest in other com-*

munity property—but was a taxable sale to the extent she received his separate property. Sec. 1002

IRS finally announced its position regarding divisions of community property in Rev. Rul. 76-38, which provides that an equal division of the community property agreed to by the parties will not be disturbed.

Gifts to taxpayer contemplating death

Sec. 1014

Discussions of gifts in contemplation of death are generally in terms of the estate tax consequences of gifts *from* the taxpayer contemplating death. (Sec. 2035.) However, if the taxpayer contemplating death has a nominal or small estate, it may be possible to make gifts *to* such a taxpayer at little or no gift tax cost (e.g., the specific exemption, gift splitting) or estate tax cost in anticipation of eventually getting the property back from the donee's estate. The tax benefits of such gifts are that the donor may get the property back with a stepped-up basis under Sec. 1014 and also may eliminate "taints" from the property. For example, Regs. Sec. 1.306-3(e) indicates that the Sec. 306 "taint" terminates when the stock takes a new basis under Sec. 1014. (For possible contra argument by the IRS, see Sec. 306(c)(1)(A) and Regs. Sec. 1.306-3(c).)

It should be noted that the tax benefits of such gifts are not restricted to situations of the donor personally receiving the property back under the donee's will. For example, it might be anticipated that the donor's children would receive the property.

Gifts to a taxpayer contemplating death may raise such tax considerations as: the requirements of a completed gift (i.e., was the donee capable of taking the gift); the possibility of an IRS "sham" attack; and the concern with the statute of limitations in regard to refund of any gift tax if the gift should eventually be held a sham. While it is not possible to discuss the related issues adequately here, it is submitted that such gifts when properly planned should be sustainable.

There are, of course, nontax factors to consider, such as the possibility of subjecting the property to the claims of the donee's creditors. Executor's and legal fees may be increased by such gifts. There is also the possibility of the donor or his

Sec. 1014 family not receiving the property from the donee's estate if, for example, the other beneficiaries successfully contest the will.

While gifts to a taxpayer contemplating death raise several tax and nontax issues, there should be circumstances where the nontax risks are minimal and an IRS attack, even if successful, would simply put the donor back in his original position.

Editor's note: Not applicable to deaths after 12/31/76.

Sec. 1031 Like-kind exchange of oil and gas interests

T and P (TP) were co-owners of certain interests in five producing oil, gas, and mineral leases. They entered into an exchange agreement whereby they agreed to exchange their entire working interest in such leases, along with certain associated oil and gas production equipment, to XYZ Partnership for a 7.5% of $^{11}/_{16}$ overriding royalty to be carved out of certain oil and gas leases. Both the leasehold interests conveyed and the overriding royalty interests received by TP are co-extensive with the life of the particular oil and gas leasehold properties involved.

The lease interests assigned and exchanged to XYZ and the overriding royalty interests assigned and exchanged to TP are all located in the same field and all such assignments pertain only to the production from a certain formation. T and P are to share such overriding royalty in proportion to their respective ownership of the interest exchanged. The exchange agreement stipulates that the fair market value of personal property, wells, fixtures, and equipment conveyed to XYZ is $80,000.

A private ruling was requested that

—the exchange of oil and gas lease interests by TP will be treated as a like-kind exchange of property under Sec. 1031; and

—except for the $80,000 value of the personal property comprising the oil and gas producing equipment, no gain or loss will be recognized by TP as the result of the exchange.

With respect to whether the oil and gas leaseholds to be conveyed to XYZ and the overriding oil and gas royalties to be conveyed to TP are properties of a like kind, the IRS held that it was apparent that these were both interests in real property. See Rev. Ruls. 68-226 and 72-117. Thus, these properties were of a like kind within the meaning of Sec. 1031.

Accordingly, the private ruling concluded that the exchange of the oil and gas lease interests will be treated as a like-kind exchange of property under Sec. 1031, and that, except to the extent of the fair market value of the oil and gas production equipment, no gain or loss will be recognized by TP.

Equalizing liabilities before tax-free exchange of partnership interests

Since the 1972 Tax Court decision in *Estate of Rollin E. Meyer, Sr.*, 58 TC 311, (non acq.) it appears that under Sec. 1031, a general partner's interest in a partnership can be exchanged tax-free for a general partner's interest in another partnership, at least when the underlying assets are of the same type. (Presumably, under the same circumstances, a limited partnership interest may be exchanged for another limited partnership interest.) However, the *Meyer* case was silent as to the tax treatment of the liabilities of a partnership, which under Sec. 752(a) are treated as additional basis of the partner in his partnership interest. Sec. 752(d) states that in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities that are connected with the sale or exchange of property not associated with partnerships.

This means that there should be a balancing of underlying liabilities applicable to the exchanged partnership interests, or else the partner whose partnership interest has the largest applicable liabilities will be unable to offset those liabilities fully. Excess liabilities will be taxed as "other property or money" in accordance with Regs. Sec. 1.1031(b)-1(c).

Allocation of basis in Sec. 1031 exchange

It frequently happens that more than one property is acquired in a "like-kind" exchange that qualifies under Sec. 1031. If mortgages are involved in such a case, the question arises as to how to allocate basis between properties. To illustrate the problem, assume the following facts:

T owned property with a basis of $250, which was subject to a mortgage of $150. *T* exchanged this property, which then had a fair market value of $400, for two properties (*A* and *B*). The data with respect to the acquired properties were as follows:

	Total	*A*	*B*
Fair market value	$400	$200	$200
Mortgage	150	100	50
Net value	$250	$100	$150

Since there was no differential in mortgage amounts, or any other boot, no gain or loss was recognized on the exchange, pursuant to Sec. 1031. There is no question that the basis of properties *A* and *B* total $250, the basis of the property given up. However, the question arises as to whether the apportionment should be made on the basis of the gross fair market values (*before* reduction for the mortgages) or the net fair market values (*after* reduction for the mortgages). A comparison of the methods follows:

	Total	*A*	*B*
1. Gross (before-mortgage) approach:			
a. Fair market value	$400	$200	$200
b. Percent to total	100%	50%	50%
c. Allocation of gross basis of $250	250	125	125
2. Net (after-mortgage) approach:			
a. Excess of fair market value over mortgage	250	100	150
b. Percent to total	100%	40%	60%
c. Allocation of net basis of $100 ($250 less $150 mortgages)	100	40	60
d. Mortgages	150	100	50
e. Total basis (2c+2d)	$250	$140	$110

No precedent can be found as to which method should be used for purposes of Sec. 1031. It is interesting to note that the after-mortgage approach is used in determining the basis of property on which a lien exists in liquidations falling under Secs. 333 and 334(b)(2).

Although both approaches may perhaps be supported by some degree of logic, it appears that the before-mortgage approach is sounder. This view is supported by the fact that Sec. 1031 does not prevent the exchange, without recognized gain, of property which is subject to a mortgage in excess of basis, assuming that there is no boot (including a mortgage differential) in the transaction. If, in the above example, the property given up had a basis of $100 instead of $250 (the $100 being less than the mortgage of $150), there would be a "negative basis" to be apportioned under the net value approach. Thus, a negative basis would render the net value approach impossible of practical application. (Note that this situation cannot exist in basis determinations under Secs. 333 and 334(b)(2).) *Sec. 1031*

Additional benefits by acquiring controlled company

Sec. 1033

Under Sec. 1033 it is possible to defer gain realized on involuntary conversions by acquiring either property "similar or related in service or use" or by acquiring control of a corporation which owns such property. Assume that a factory building with an adjusted basis of $1 million is destroyed and that the insurance recovery is $5 million. If another factory building is purchased for $5 million, no gain is recognized. However, the basis of the new factory building is $1 million (equivalent to the original basis) since no gain was recognized.

However, suppose that the above taxpayer, instead of acquiring another factory building directly, purchased at a cost of $5 million all the stock of a corporation whose sole asset was a factory building with an adjusted basis of $5 million. The acquisition of this stock results in full reinvestment under Sec. 1033 and no recognition of gain. Of course, the basis of the *stock* of the acquired company is $1 million. But, there appears to be nothing in the tax law which would cause a reduction in the adjusted basis of the property owned by the acquired company. Accordingly, the acquired company can continue to depreciate the full $5 million over the remaining life of its building.

Sec. 1033 applies to all taxpayers, individual, corporate, or other. However, a corporate taxpayer may be able to secure still further benefits. For example, if handled properly, the low basis of the parent in the subsidiary will never have any tax effect. There might be a future liquidation of the subsidiary under Sec. 332. In such an event, the $1 million basis will never be relevant and the parent could continue to depreciate the remaining undepreciated $5 million cost to the subsidiary—provided, of course, that the liquidation occurred more than two years after the purchase of the stock so that Sec. 334(b)(2) was not applicable.

In addition, it appears that the new subsidiary may immediately join in any consolidated return filed by its new parent without any loss of depreciation. No portion of the subsidiary's depreciation appears to be a "built-in deduction," which would cause a possible disallowance under Regs. Sec. 1.1502-15.

The decision in *John Richard Corp.*, 46 TC 41 (1966) held that the results described above could be achieved even if a subsidiary were formed (with cash paid in by the parent company) to purchase the replacement property! However, the IRS, in 1974, announced its nonacquiescence in that decision (1974-2 CB 5), and withdrew an earlier acquiescence.

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 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 30 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 30 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. *Sec. 1033*

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. (Rev. Rul. 68-394 and Rev. Rul. 73-120.)

Qualifying replacement under Sec.1033(g): an easy test?

Where real property held for productive use in trade or business or for investment is disposed of in condemnation, the most liberal replacement rules apply. Sec. 1033(g) provides, in effect, that either property of like-kind or property similar or related in service or use will qualify as replacement property. Generally, one or the other of these tests will be easily satisfied; therefore, it may come as a surprise when analysis of a reinvestment in real estate discloses that it does not qualify under either.

Consider the following situation: The taxpayer owned undeveloped land which was held for long-term investment. The property was sold to a local government under threat of condemnation. Within the statutory period for replacement, the taxpayer constructed a building on undeveloped land which had been already owned for a period of time. The land and new building were leased to a tenant under a long-term lease and constituted property held for investment. Based upon prior experience with condemnations, the taxpayer assumed that replacement of one real estate investment with another would qualify the sale for nonrecognition of gain. However, he was advised that it would be necessary to look elsewhere for qualifying replacement property.

First consideration was given to qualification as similar or related in service or use. Following the rationale of *Liant Record, Inc.*, CA-2, 303 F2d 326 and Rev. Rul. 64-237, the determination will be made in the case of investment properties based upon the similarity in the relationship of the services or uses which the original and replacement properties have to the taxpayer-owner. Because the property taken by involuntary conversion was undeveloped land held for investment, a replacement with property held for the production of rentals will not qualify as similar or related in service or use. This differs from the result in Rev. Rul. 71-41 where both properties were held for rental purposes.

Next, consideration was given to qualification as property of "like-kind." Under the generous provisions of Regs. Sec. 1.1031(a)-1 (made applicable by Regs. Sec. 1.1033(g)-1), the taxpayer need not be concerned with the use of the property. Further, "like-kind" is said to have reference to the nature or character of the property, rather than its grade or quality. Therefore, improved and unimproved properties are considered to be of like-kind. Unfortunately, although improved and unimproved land are considered like-kind, land and a land improvement are not. Rev. Rul. 67-255. The mere fact that the term "real estate" is used to describe land and improvements does not, in the eyes of the IRS, make them alike. Under this ruling, the building constructed upon land already owned does not qualify as like-kind. Thus, the taxpayer's investment fell between two rules and failed to qualify under either.

Editor's note: The IRS position in Rev. Rul. 67-255 was rejected in Davis, *DC-Hawaii, 4/9/76), wherein the Court allowed Sec. 1033(g) treatment for improvements to land already owned by taxpayers.*

New rules for the sale of old residence

Sec. 1034

Sec. 1034 provides that any gain realized by a taxpayer on the sale of his old residence is recognized for income tax purposes only to the extent that the adjusted sales price of the old residence exceeds the cost of a new residence acquired within a specified period of time. Prior to Jan. 1, 1975, the new residence had to be purchased within *one year* before or after the sale of the old residence. For a sale of a personal residence after Dec. 31, 1974, however, the Tax Reduction Act of 1975 lengthened the required reinvestment period for purchasing a new residence to *18 months* before or after the sale of the old residence.

In the case of the construction or reconstruction of a new residence rather than an outright purchase, the old rules provided that the construction or reconstruction had to begin either before the sale of the old residence or within *one year* after the sale, and the taxpayer had to occupy the new residence within *18 months* after the sale in order for the new residence to qualify as a reinvestment under Sec. 1034. The new rules established by the Tax Reduction Act of 1975, effective Jan. 1, 1975, now provide that the construction or reconstruction of a new residence must commence either before the sale of the old residence or within *18 months* after the sale, and the taxpayer must occupy the new residence within *two years* after the sale in order to qualify the new residence under the reinvestment rules.

The determination of the gain realized on the sale of an old residence and the qualified reinvestment in a new residence has been somewhat clouded in the past when multiple taxpayers were involved in the transactions. However, two such situations have been clarified by the Service in recent rulings.

In Rev. Rul. 74-250, the Service held that where a husband and wife sold their jointly-owned old residence and agreed to live apart, and separately purchase new replacement residences, each was entitled to defer the recognition of his share of the gain on the sale of the old residence to the extent of his separate reinvestment in a new residence pursuant to Sec. 1034. Conversely, Rev. Rul. 75-238 holds that where a husband and wife each sold an old residence owned separately prior to marriage and jointly reinvested the combined sales proceeds in one new replacement residence acquired after

Sec. 1034 their marriage, Sec. 1034 applies to defer recognition of gain on the sales of both old residences.

The extended time periods now provided for reinvestment in a new residence, together with the latitude allowed by the Service in interpreting the applicability of Sec. 1034 in multiple-taxpayer situations, should enable most individual taxpayers to successfully defer the tax on any gain from the sale of an old residence by timely reinvesting in a new one.

Sec. 1034 planning: replacement of principal residence with vacation home

This tax planning opportunity can be better explained in light of a simple case study.

> *Example.* A married couple jointly owns a principal residence in Connecticut from which the working spouse (for liberation's sake, say *W*) happily commutes to and from her job. In 1975, *W* purchased a vacation home in Virginia, to which *W* and *H* retreat on vacations and weekends and to which they plan to retire when *W* reaches age 62. The vacation home is also placed in joint tenancy. The principal residence has a tax basis of $35,000 and a fair value of $75,000. The vacation home cost $80,000.

W mentioned these facts to her tax accountant, Alert Tax Adviser (*A.T.A.*), while giving him tax data for the preparation of 1975 tax returns.

A.T.A. pointed out to *W* that he could see a capital gain liability in her future which is avoidable by proper tax planning. That is, the gain on the sale of the Connecticut residence would be taxable, even though more than the sale proceeds had been invested in their future principal residence, because the vacation home would not have been purchased within 18 months of the sale of the principal residence. However, *A.T.A.* cheered up *W*, advising that the gain could be deferred by taking the following steps:

- Place the Virginia residence solely in *H*'s name. (After the marital deduction, lifetime exemption and gift tax exclusion, the gift tax would be nominal.)
- Within 18 months after the sale of the Connecticut residence, *W* should purchase the vacation home from *H* at its fair market value. At the time of the purchase, for income and gift tax reasons, consideration should be given to providing for payment of the purchase price on the installment basis.

• Within the 18-month period, the former vacation home should be occupied by *H* and *W* as their principal residence.

• They should file a Form 2119, consenting to adjustment of the tax basis of their new principal residence.

Incidentally, *W* was advised, terminating the joint tenancy for the Connecticut residence did not appear to be necessary as a technical matter. For federal tax purposes, only *W* (who provided all the consideration) owned the Connecticut residence and the proceeds from its sale, since no election had been made to treat the creation of the joint tenancy as a taxable gift. Thus, taxwise, solely *W* (not *W* and *H* jointly) would be the seller of a residence wholly owned by her and the purchaser of a residence owned solely by *H*.

A.T.A. advised *W*, in laylady's language, that there is no authority which precludes the purchase of a replacement residence from one's spouse or any other related party. In fact, the letter and spirit of the legislative history and regulations support the proposition that Sec. 1034 will apply so long as one (or both) spouse replaces a principal residence owned by the other (or both) spouse.

The Conference Report to the 1951 Revenue Act (1951-2 CB 310) states:

> Regulations are to be issued under which the taxpayer and his spouse acting singly or jointly may obtain the benefits of the bill even though the spouse who sold the old residence was not the same as the one who purchased the new one, or the rights of the spouses in the new residence are not distributed in the same manner as their rights in the old residence. These regulations are to apply only if the spouses consent to their application and both old and new residence are used by the taxpayer and his spouse as their principal residence.

Regs. Sec. 1.1034-1(f)(1) provides:

> If the taxpayer and his spouse file the consent referred to in this paragraph, then the "taxpayer's adjusted sales price of the old residence" shall mean the taxpayer's, or the taxpayer's and his spouse's, adjusted sales price of the old residence, and the "taxpayer's cost of purchasing the new residence" shall mean the cost to the taxpayer or to his spouse or to both of them, of purchasing the new residence, whether such new residence is held by the taxpayer, or his spouse, or both (Sec. 1034(g)). Such consent may be filed only if the old residence and the new residence are each used by the taxpayer and his same spouse as their residence.

Moreover, Example 2 of Regs. Sec. 1.1034-1(f)(3) specifies that Sec. 1034 applies where a wife and husband sell a jointly owned residence and the wife purchases the replacement residence with her own funds and takes title in her name only.

Note that the fact that the presently owned vacation home will become *W* and *H*'s principal residence at a future date does not make it their principal residence of today. While the facts are distinguishable, there is language in *C. W. Belin*, DC-PA, 313 F Supp 715 (1970) which makes this clear, i.e.:

T occupied Residence No. 1 as his principal residence. At the same time he was reconstructing Residence No. 2, which he had occupied previously and regarded as his principal residence of the future. He sold Residence No. 1 at a gain. He treated the reconstruction costs of Residence No. 2 (which exceeded the sale proceeds of Residence No. 1) as the cost of replacing Residence No. 1 for Sec. 1034 purposes.

The IRS contended Sec. 1034 was inapplicable because Residence No. 2 remained *T*'s principal residence since it was the place which he would have occupied if physically possible and the place he left with the finally realized intention of returning.

The District Court rejected the IRS contention, reasoning:

> While the Government makes many interesting technical arguments justifying this position, I prefer a common sense, practical approach. No doubt [*T* intended to regard Residence No. 2 as his] principal residence in [the] future, but during the critical period involved here [Residence No. 1] was his principal residence. . . . .

Sale of residence: Sec. 1034(d) tax trap

In our increasingly mobile society it is not uncommon to find executives being transferred from one city or location to another. Moreover, due to inflation many transferred executives often find they have realized a large gain when they are required to sell their homes. Usually this presents no problem because Sec. 1034 provides that the realized gain is not recognized for tax purposes if the taxpayer purchases or constructs a comparable replacement home within a specified period.

Consider the situation, however, where for one reason or another an executive is required to move, and thus sell his residence, more than once within an 18-month period. For example, suppose *T* sells his old residence on March 15, 1974, at a gain and purchases another residence on July 15, 1974, at a cost in excess of the sales price of the old residence. Further, on January 15, 1975, *T* sells the residence he acquired on July 15, 1974, at a gain and then invests an amount equal to the sales price in another residence on February 15, 1975. *Sec. 1034*

The popular impression is that Sec. 1034 would be applicable and thus gain would not have to be recognized on either sale. However, this is not the case. Sec. 1034(d) provides that the nonrecognition provisions of Sec. 1034 will not apply with respect to the sale of a taxpayer's residence if within 18 months before the date of such sale the taxpayer sold at a gain other property used by him as his principal residence, and any part of such gain was not recognized by reason of Sec. 1034. (Regs. Sec. 1.1034-1(d).) Accordingly, the gain from the March 15, 1974, sale would go unrecognized; however, the gain from the sale of the second residence on January 15, 1975, would have to be recognized by virtue of Sec. 1034(d). This result often comes as an unpleasant surprise because the provisions of Sec. 1034(d) are frequently overlooked.

Taxpayers should note that tax planning in such a situation is complicated by the fact that the application of Sec. 1034 is mandatory, and therefore they cannot elect which sale is to go unrecognized. Consequently, taxpayers should be alert to the limitations provided by Sec. 1034(d) when contemplating moving several times within an 18-month period.

Planning for foreclosures: interplay between Secs. 1038 and 1231

Sec. 1038

A depressed economic climate can cause an interesting problem for those (excluding certain financial institutions) who have made an installment sale of a piece of real estate used in trade or business where a substantial gain is realized and the taxpayer has elected the installment method of reporting gain under Sec. 453(b). It is possible that upon reacquisition a substantial Sec. 1231 gain will be recognized under Sec. 1038, assuming generally that the gain previously reported is less than the cash and other property received (subject to certain other limitations).

Sec. 1038

Sec. 1038 is not elective but is mandatory where an original seller reacquires real property in partial or complete satisfaction of a debt secured by the property and the debt arose from the original sale of the property. Consequently, if the property's fair market value is substantially less than its recomputed basis under Sec. 1038, a subsequent sale of the reacquired property by the original seller could trigger a loss. Sec. 1231 should apply to both the reacquisition and the subsequent sale as it is consistent with the intent behind Sec. 1038 as follows: the holding period of the reacquired property specifically includes the period the property was held by the original seller prior to sale, Regs. Sec. 1.1038-1(g)(3); the character of the gain on reacquisition is determined by reference to the gain on the original property, Regs. Sec. 1.1038-1(d); the basis is determined in whole or in part by reference to the basis of the property sold, Regs. Sec. 1.1038-1(g); and the general intent underlying Sec. 1038 is to nullify the original sale, Regs. Sec. 1038-1(g)(3). Further, any gain or loss on a sale is not excluded from the application of Sec. 1231 under the definitions within that section. However, it should be noted that subsequent actions indicating a different intent by the original seller in holding the property subsequent to reacquisition could change the character of the subsequent income or loss. For example, if the property was further developed or held for investment and/or appreciation, its character could be ordinary income or capital gain property.

Since Sec. 1231(a) requires the netting of gains and losses occurring during a particular taxable year, a substantial tax benefit (i.e., an ordinary loss for net Sec. 1231 losses) may be obtained by careful planning to allow Sec. 1231 gains on reacquisition to occur in a different taxable year than the potential Sec. 1231 loss on subsequent resale. Attention must also be given to other Sec. 1231 gains and losses.

Gain on reacquisition could be increased if the original vendee made improvements to the property during his ownership which could be considered "other property" under Sec. 1038(b)(2)(B). This view is supported by *H. H. Smith*, 58 TC 874 (1972), wherein buildings constructed by the vendee were treated as not part of the original property for purposes of tacking on the holding period of such buildings, although the apparent increase in the gain resulting from the fair market value of the improvements at the time of the reacquisition was not discussed in the decision. The corresponding increase of basis would increase any subsequent Sec. 1231 loss. *Sec. 1038*

Wash sale rules inapplicable to commodity futures contracts

Sec. 1091

The prices of certain commodity futures (e.g., pork bellies) fell sharply at the end of 1975. Suppose a taxpayer holding such futures for inventory stabilization purposes sold them at a loss and, within 30 days before or after such sale, bought futures identical in quantities and delivery dates. Would the wash sale rules prevent a 1975 loss deduction?

The wash sale provisions of Sec. 1091 disallow a deduction for a loss on the sale or exchange of "stock or securities" if within 30 days before or after such sale or exchange, a taxpayer acquires "substantially identical stock or securities." Sec. 1091, in general, is designed to prevent the realization of a tax benefit without a substantive change in investment position.

Finding that commodity futures contracts are not "stock or securities" within the meaning of Sec. 1091, and with the view that a new futures contract is not "substantially identical" to a prior contract, the Tax Court and the Second Circuit have held that the wash sale rules do not apply to commodity transactions. See *Corn Products Refining Co.*, 350 US 46 (1955). Consistent with its reasoning in the *Corn Products* decision, the Tax Court in 1957 again found that the wash sale rules do not apply to futures contracts. See *Sicanoff Vegetable Oil Corp.*, 27 TC 1056 (1957). In a prior decision to the contrary, the Sixth Circuit in 1945 reversed a similar Tax Court case, finding that futures contracts are "securities" in the sense in which the term is generally used and thus fall within the wash sale rules. See *Trenton Cotton Oil Co.*, CA-6, 147 F2d 33 (1945). As previously stated, the Tax Court has consis-

Sec. 1091 tently held that Sec. 1091 does not apply to commodity futures, and the 30-year-old Sixth Circuit finding that the wash sale rules do apply has never been followed.

Although the above court decisions have differed as to the applicability of the wash sale rules to commodity futures, the IRS in Rev. Rul. 71-568 holds that such transactions are not within their purview, since commodity futures contracts are not "stock or securities" within the meaning of Sec. 1091. This position is reiterated in Rev. Rul. 72-457. Thus, the possibility appears remote that an agent would attempt to apply Sec. 1091 to commodity transactions in the face of official IRS published positions to the contrary.

However, consideration should be given to the possibility of an IRS challenge arguing that a sale and related purchase lack economic substance, which might result in loss disallowance as a sham transaction. Although generally limited to prearranged plans for sale and repurchase between related parties at a stipulated price, a sale of futures under a prearranged plan at a loss with a purchase of identical futures immediately thereafter from an unrelated party might be challenged on the ground that in substance no bona fide sale occurred. Due to the risk factor introduced by the volatility of most commodity markets, a proper timing of sale and repurchase of relatively short duration should prevent in whole or in part the lack of economic substance argument, without, it is hoped, a material adverse effect on the taxpayer's investment position. Nevertheless, this factor should be weighed before any decision is made.

Based on the weight of case law and particularly in light of the IRS's published rulings' position, taxpayers appear to have a sound basis for ignoring the wash sale rules when planning their commodity transactions. Thus, whether commodity futures are held as capital assets, for the stabilization of inventory prices, or as true hedges against inventory price fluctuations, taxpayers should be able to successfully realize significant tax savings in a falling market while maintaining a substantially constant investment position in futures contracts. Of course, this result depends upon the absence of any successful IRS challenge of the loss deduction under the sham transaction doctrine.

Capital gains and losses

Short sale held to be disposition of option stock

Sec. 1201

The technique of executing a short sale of identical securities to freeze unrealized appreciation on shares acquired under a qualified stock option plan will result in a disqualifying disposition of the option stock. At least this is the position taken by the IRS in Rev. Rul. 73-92, with respect to short sales executed after February 20, 1973.

Shares acquired by exercising a qualified stock option must be held for over three years to be eligible for the favored tax treatment granted such plans. The risk of a declining market price, while waiting out the required period, is an often mentioned disadvantage of qualified options. Apparently, some shareholders have executed short sales in an attempt to minimize this risk.

Under the facts outlined in the ruling, the IRS held that a short sale of borrowed securities identical to those acquired by exercise of a qualified stock option resulted in a "disposition" of the option stock. The Treasury's stated basis for this conclusion is that the apparent congressional intent was that an employee acquire a "stake in the business" under a qualified option.

The ruling specifies that the only shares of the corporation held at the time the short sale was executed were those acquired under the qualified option plan. Later, additional shares were purchased and were delivered at the end of the three-year period to close the short sale. In the IRS's view, the individual did not have the required "stake in the business" immediately after the short sale. Accordingly, it was ruled, the short sale caused a disposition of the option shares. Treatment as a premature disposition means that the individual must include in his ordinary income for the year of disposition, an amount equal to the spread that existed between the option price and market value at the earlier date of exercise. The basis of the option shares is also increased by this amount.

The ruling seems to leave several questions unanswered, including the following:

- What would be the result if, at the time of a short sale, the individual owned shares purchased in the open market

Sec. 1201 equal to or in excess of the shares acquired under a qualified option plan? That is, would the short sale be considered as a disposition of all or some of the option shares?

- Since the ruling does not revoke (or even mention) Rev. Rul. 59-242, which held that purchasing a "put" during the six-month period following exercise of a restricted stock option was not a disposition, is it still possible to use the "put" technique in certain situations to freeze profits without triggering a disposition of option shares?

The answers to these questions are not yet apparent. Some authors have indicated that the Treasury's conclusion appears arbitrary and unwarranted. Any action in these areas should be considered carefully until all the ramifications of Rev. Rul. 73-92 become clear.

Sec. 1212 Capital loss carryback effects

Under Sec. 1212(a)(1), a corporation may carry back a capital loss to its three preceding taxable years. Sec. 1212(a)(1)(A)(ii) provides that the capital loss may not be carried back if the effect would be to create or increase a net operating loss (NOL) in the year to which carried back.

Example. In 1970, *X* corporation had net capital gains of $1,000 and an excess of ordinary deductions over ordinary income of $2,500. *X* would have had an NOL of $1,500 for 1970. In 1973, *X* sustained a net capital loss of $2,000. The 1973 capital loss could not be carried back.

But for the limitation of Sec. 1212(a)(1)(A)(ii), the capital loss would have been carried back and would have reduced to zero the capital gain of $1,000 and would have had the effect of increasing the NOL for 1970 to $2,500.

It should be noted that the prohibition is only against the carryback to a year where an NOL would be created or increased. There is no prohibition against a carryback to a year in which an NOL has been deducted rather than sustained. This can have various effects, including causing an NOL previously used to lapse or causing an NOL to be carried forward to a later year, as the following examples will show.

Example (lapse of NOL). *Y* corporation had an NOL carryover from 1965 of $10,000. This carryover would lapse at December 31, 1970. Even though the company attempted to generate taxable income in order to prevent the loss from lapsing, it could produce net ordinary income of only $1,000 in 1970. However, it could, and did, realize a capital gain of $9,000. Thus, the entire NOL carryover was utilized, since an NOL carryover can be used against either capital gain or ordinary income. *Sec. 1212*

In 1973 *Y* corporation sustained a capital loss of $8,000. This loss is carried back to 1970 and applied against the $9,000 capital gain. This produces a revised taxable income (before NOL deduction) of $2,000, consisting of $1,000 of ordinary income and $1,000 of capital gain remaining after the carryback. Thus, after such application, the NOL carryover from 1965 was ultimately used only to the extent of $2,000, and $8,000 lapsed. The 1973 capital loss carryback of $8,000, having been applied in 1970, may not be carried to 1971, 1972 or any of the five years subsequent to 1973.

Example (carryforward to later year). Z corporation in its first year (1970) sustained an NOL of $12,000. In 1971, Z had zero ordinary income or loss, but realized a capital gain of $12,000. The $12,000 gain would be offset by the $12,000 NOL, with the result that none of the 1970 NOL would be carried to 1972.

In 1972, Z corporation realized ordinary income of $20,000 (but no capital gain or loss) on which it paid a tax, since at the time of filing its 1972 return there was no NOL carryover.

In 1973, Z sustained a capital loss of $9,000. This loss can be carried back against the 1971 capital gain of $12,000. Since the taxable income of 1971 is now $3,000 (before NOL deduction), the 1970 NOL was reduced in 1971 by only $3,000 (as now adjusted as a result of the capital loss carryback from 1973). Accordingly, the realization of a *capital loss* in 1973 resulted in an NOL carryover to 1972 of $9,000, representing the $12,000 NOL of 1970 reduced by the revised income of 1971 (the intervening year) of $3,000. Thus a refund is in order with respect to 1972.

As may be seen from the above examples, the interplay of the capital loss carryback and the NOL can create a wide range of unusual circumstances both good and bad, which good tax planning may capitalize on or avoid. To be anticipated is a concomitant group of problems with respect to the application of the statute of limitations.

Shareholder's and subchapter S corporation's Sec. 1231 transactions

Sec. 1231

A taxpayer must net all of his Sec. 1231 transactions for the year. If a net gain results, it is treated as a capital gain; if a net loss occurs, it is deductible as an ordinary loss.

Sec. 1231

If a taxpayer is a member of various partnerships, his share of each partnership's Sec. 1231 transaction is reported independently of any capital gain or loss transactions from the same partnership. That is, his Sec. 1231 transactions from all of his partnerships are added to his own personal transactions to determine if he has a net Sec. 1231 gain or loss.

The result will be different if one of his businesses is conducted as a subchapter S corporation rather than as a partnership. In that case, the final determination is made at the corporate level. A corporate net Sec. 1231 loss becomes part of the shareholder's ordinary subchapter S loss and need not be combined with the rest of his personal and partnership Sec. 1231 gains. Similarly, any subchapter S, Sec. 1231 gain is reported by the shareholder as a *capital* gain and will not be offset by any personal or partnership Sec. 1231 losses.

IRS rationalizes that tax benefit rule's rationale requires recapture of R&D expenses

With respect to the tax benefit rule, Congress enacted a specific *recovery exclusion* rule (Sec. 111) for the taxpayer's benefit; the judiciary has approved a general *recovery inclusion* rule for the IRS's benefit. The *inclusion* version of the tax benefit rule provides that if an amount properly deducted with a tax benefit in a prior year is recovered, the recovery constitutes taxable income.

By administrative proclamations, the IRS has been invoking the tax benefit rule to effectively amend the Internal Revenue Code, i.e.:

- Rev. Rul. 61-214 effectively amends Sec. 337, nonrecognition of gain on sales made pursuant to a 12-month plan of liquidation.
- Rev. Rul. 74-396 effectively amends Part II of subchapter C, corporate liquidations.
- Rev. Rul. 72-528 effectively amends Sec. 1231 (capital gain treatment for depreciable property) and/or Sec. 174 (expensing research and development costs).

This discussion will be primarily devoted to the last ruling but first a background briefing of the first two rulings and their judicial history is in order.

Background. In Rev. Rul. 61-214, the IRS held that proceeds from the Sec. 337 sale of expensed properties (e.g., coal and small tools) were taxable under the tax benefit rule. Thus, the IRS increased the exceptions to the nonrecognition of gain rule provided by Sec. 337. See Sec. 337(b). The courts have upheld the ruling. For example, in *Anders*, 414 F2d 1283 (1969), the Tenth Circuit held that the proceeds from the Sec. 337 sale of expensed uniforms, which were rented out by a laundry, constituted taxable income under the tax benefit rule.

Sec. 336 specifies (subject to an exception not relevant here) that a corporation shall not recognize gain or loss on a distribution of property. Nevertheless, Rev. Rul. 74-396 holds that the tax benefit rule requires the recognition of gain on the distribution of expensed properties (tools and dies) pursuant to a Sec. 334(b)(2) liquidation. In *Tennessee Carolina Transportation Inc.*, 65 TC 440 (1975), a sharply divided (seven judges dissenting) Tax Court sustained the position taken in the ruling.

Expensed R&D. Between the above rulings, the IRS issued Rev. Rul. 72-528. It holds that fire insurance proceeds received on account of the destruction of a "pilot model" of a machine is taxable as ordinary income to the extent the proceeds do not exceed the construction costs which had been previously expensed as research and development (R&D) expenses under Sec. 174.

Unfortunately the ruling is cryptic. The text does not state the character of the property or the exact issue. However, both are apparent from the Sec. 1231 classification of the ruling (before the headnote) and the factual statement that the fire occurred more than six months after the pilot model was placed in service: that is, such classification and statement imply that the pilot model constituted Sec. 1231 property and that the issue was whether the proceeds (presumably all gain) were taxable entirely as capital gain under Sec. 1231 or only to the extent the proceeds exceeded the previously deducted costs.

The ruling relies on the tax benefit rule. The IRS cites court decisions which hold that the gain on a Sec. 337 sale of an expensed property is recoverable as ordinary income under the tax benefit rule. (See *Anders*, above.) However, the ruling fails to acknowledge that those "tax benefit" cases deal solely with whether income should or should not be recognized, not whether admittedly taxable income should be characterized as capital gain or ordinary income.

As additional support for its position, the IRS cites itself—i.e., Rev. Rul. 68-104. This ruling holds that the proceeds from the sale of expensed baby diapers were taxable as ordinary income to a laundry. The diapers did not qualify as Sec. 1231 property because they were not depreciable property (their average life was less than one year). The 1968 ruling concludes, "Accordingly, the [sale] proceeds represent a recovery of amounts previously deducted from gross income and are taxable as *ordinary* income to the extent of any prior tax benefit." (Emphasis added.)

It is puzzling why Rev. Rul. 68-104 bothers to rely on the tax benefit rule for concluding that the sale proceeds constitute ordinary income rather than capital gain; the baby diapers did not qualify as Sec. 1231 property and assumably did not constitute a capital asset. In any event, with respect to the quoted sentence, it does not necessarily follow that because a recovery is taxable, it is taxable as *ordinary* income. The sentence is simply a non sequitur.

Returning to Rev. Rul. 72-528, the net effect of it is that the tax benefit rule overrides Sec. 1231. In essence, by administrative proclamation, the IRS has promulgated a recapture rule for expensed R&D expenses, even though Congress has seen fit not to do so. Since Congress has precisely provided for the recapture of specific deductions, it cannot be inferred that Congress's failure to provide for the recapture of R&D deductions was inadvertent. For Code provisions dealing with recapture of deductions, see Secs. 1245 and 1250 (depreciation of personal and real property), 1251 (certain farming deductions) and 617 (mining exploration expenditures).

Significantly, in dicta, two Tax Court judges have indicated their disapproval of extending the recapture rules beyond the items covered specifically by legislation.

In *Tennessee Carolina*, above, in a dissenting opinion, Judge Tannenwald stated:

> . . . I think it is of some significance that the recapture of depreciation deductions which Congress has seen fit to impose in corporate liquidations . . . does not compel recovery of expensed items under like circumstances. In fact it appears that section 1245 does not extend to expensed as distinguished from depreciable property . . . a

> position which is in accord with the concept that a deduction for ordinary and necessary business expenses is not the same animal as a deduction for depreciation.

Sec. 1231

In *Kingsbury*, 65 TC No. 91 (1976), the IRS argued that the tax benefit rule required that amounts received on account of the termination of an agreement (construed to be a lease) be taxable as ordinary income rather than as capital (Sec. 1231) gain. Referring to this argument, Judge Irwin stated, "In this regard, we note that petitioner reported the full amount of the payments received . . . as gain. Respondent has invoked the tax benefit rule, therefore, not to increase the amount of petitioner's income . . . but merely to characterize a portion of it as ordinary income rather than capital gain. In our view, there is a more direct way [i.e., under Sec. 1245(a)(3)] in which a portion of the payments can be characterized as ordinary income."

While the dictum in *Kingsbury* does not expressly reject the IRS argument, its tone does indicate that the judge is less than enthusiastic about stretching the tax benefit rule to serve as a recapture rule.

If Rev. Rul. 72-528 is correct, the gain on the sale of Sec. 1245 property may be recaptured as ordinary income not only to the extent of depreciation deductions (under Sec. 1245 itself), but also to the extent that repairs were expensed (under the tax benefit rule). This is simply a logical extension of illogical Rev. Rul. 72-528.

Editor's note: In December 1976 the IRS acquiesced in the Kingsbury *decision.*

Extension of stock purchase warrants

Sec. 1234

The IRS has taken the position that upon the lapse of any stock purchase warrants, ordinary income will be recognized to the issuing corporation. See Rev. Rul. 72-198 which applies the general rule of Regs. Sec. 1.1234-1(b), regarding the tax consequences to the grantor, on the failure to exercise an option.

Sec. 1234 In order to avoid the adverse effects of this position, some taxpayers have extended the expiration dates of their outstanding warrants. It is our understanding that the Service will rule favorably on the gratuitous extension of outstanding warrants for a period of no more than one year. (Compare Rev. Rul. 73-160 where the mere extension of the maturity date of notes was held not to be a taxable transaction.)

Similar extension might be utilized as a successful tax planning technique by many business organizations such as REITs, which have a large number of such warrants currently outstanding.

Sec. 1236

The double-edged sword of Sec. 1236

Securities in the hands of a dealer may be treated either as inventory, such as any other stock in trade, or as investment, i.e., capital assets. The obvious tax benefits to be derived from classifying a security as one type of asset as opposed to another was, prior to 1951, evident to many dealers and, as a result, significant tax savings were accomplished by shifting securities from the inventory to investment account and vice versa. The unimpeded and liberal mode of identifying and transferring securities enabled a dealer to practically assure himself of capital gains treatment on securities sold at a gain and ordinary loss treatment on those sold at a loss.

In order to prevent such manipulation of securities between accounts to achieve the most beneficial tax treatment, Congress enacted certain rules which a dealer must adhere to in identifying and determining the tax character of a security. These rules were adopted in 1951 and are presently in effect in the same form in Sec. 1236 of the 1954 Code, as amended. Portions of the section follow:

> Sec. 1236. Dealers in Securities.
>
> (a) Capital gains.—Gain by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless—
>
> (1) the security was, before the expiration of the 30th day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or if acquired before October 20, 1951, was so identified before November 20, 1951; and

> (2) the security was not, at any time *after the expiration of such 30th day*, held by such dealer primarily for sale to customers in the ordinary course of his trade or business.
>
> (b) Ordinary losses.—Loss by a dealer in securities from the sale or exchange of any security shall, except as otherwise provided in Section 582(c) (relating to bond, etc., losses of banks), in no event be considered as loss from the sale or exchange of property which is not capital asset *if at any time* after November 19, 1951, the security was clearly identified in the dealer's records as a security held for investment. (Emphasis added.)

Gains. In effect, Sec. 1236 has set forth two conditions which must be complied with if capital gains treatment is to be given to a sale of securities by a dealer. The first one, identification, must be met within 30 days from the beginning of the holding period of such security, and the second one must be met for the entire holding period with the exception of the first 30 days. According to the literal language of Sec. 1236(a)(2), a shifting between the investment and inventory accounts appears to be permissible and will not endanger the capital gain treatment so long as the security was in the investment account at the end of the 30th day and at no time afterwards was the security held for sale to customers. On the other hand, the regulations under this section indicate that if at any time either within or without the 30-day period, the security is held for sale to customers in the ordinary course of business, the gain will be taxed at ordinary income rates. See Regs. Sec. 1.1236-1(a)(2). For purposes of identification, the Code permits the dealer the entire 30-day period in which to make his decision, whereas the regulation would look to an earlier date if the dealer had by then taken sufficient action to identify the security for investment purposes.

Consequently, the regulations do not give the dealer the opportunity of transferring securities between accounts prior to the 30th day without endangering the preferential capital gains treatment.

Losses. The Code rules pertaining to losses are more limiting as to the availability of favorable tax treatment. Sec. 1236(b) states that a loss on the sale of a security which was at *any time* during the holding period clearly identified as a security held for investment will be treated as a loss from the sale of a capital asset. The 30-day rule is inapplicable in loss situations

Sec. 1236 and the fact that the asset, when sold, was being held for sale to customers in the ordinary course of business is irrelevant. Once a security is identified for investment purposes, this identification is binding on the dealer for all loss transactions. See Regs. Sec. 1.1236-1(b).

In summary, Sec. 1236 provides the IRS with a double-edged sword with which to deal with dealers in securities. It does not permit the dealer the flexibility he once had. Consequently, a dealer should defer, to the limit allowable, any identification as an investment account security until he has made a firm decision as to the potential appreciation of the security. The decision as to identification must be prudently made and timed.

Sec. 1239 Percentage of shares outstanding may not indicate percentage of value

In the usual case to which Sec. 1239 applies, there is a sale of depreciable property by a *shareholder to a corporation* in which he owns *more than 80%* of the stock. Where applicable, Sec. 1239 causes any gain realized by the shareholder to be taxed as ordinary income. Due to the rapid increase in values of property, particularly real property, a substantial gain could be involved with a corresponding substantial tax.

Note that Sec. 1239 applies if the transaction is "between an individual and a corporation" and the necessary ownership is present. Thus, although a less common transaction, Sec. 1239 is also applicable to a sale *by a corporation to a shareholder*. Of course, if the property is not of a character which is subject to depreciation in the hands of the shareholder (e.g., a building which will be used as the shareholder's residence or an automobile which will be used for nonbusiness purposes), Sec. 1239 does not apply.

With respect to the required ownership by the shareholder, Sec. 1239 applies if "more than 80% in value of the outstanding stock" is owned directly or constructively (see last paragraph) by an individual. If the ownership measured by the number of shares is substantial but less than 80%, for example 70%, it is essential that the *80% in value test* be made. As to this test, each case must be based upon its particular facts and circumstances. For cases illustrating the problems that may arise with respect to application of the "more than 80% in value" test, see *Trotz*, CA-10, 361 F2d 927 (1966) and *Chu*, CA-1 486 F2d 696 (1973).

A recent inquiry by a client involved a proposed sale to a shareholder by a corporation of a factory building which it occupied and which it would lease back. Numerically, the shareholder owned only 75% of the corporation's outstanding shares. Thus, Sec. 1239 would not apply unless 75% of the number of outstanding shares represented more than 80% of the value of the total stock shares outstanding.

The corporation was profitable and had a substantial intangible value not reflected on the books. Investigation revealed that the remaining 25% of the outstanding shares were owned by key employees who were obligated by contract:

- To sell the shares to the company at book value upon termination of their employment or
- To first offer the shares to the company at book value if they were to sell at any time prior to termination.

Based upon value, it was determined that the 25% of the shares owned by the key employees represented only about 16% of the value of all shares because of the restriction on their sale; consequently, the 75% of the shares owned by the principal shareholder represented about 84% of the value of all shares. Thus, any gain on the depreciable property would have been ordinary income to the corporation.

Two cases can be cited on this point. In *Trotz*, TC Memo 1967-139 (on remand from the Tenth Circuit decision cited above), the selling shareholder owned 79% of the stock. The Court found that no market existed for the stock, that the value of the stock was the value of the corporation's underlying assets and that the corporation had no goodwill. Hence, the Court concluded that 79% of the number of shares outstanding represented 79% of the value of the total stock.

In *Parker*, CA-5, 376 F2d 402 (1967), the selling shareholder owned exactly 80% of the oustanding shares (i.e., not "more than 80%"), so that superficially Sec. 1239 did not apply. However, the Court found that due to the restrictions on the transfer of the minority stockholder's stock and his lack of control, the value of his shares was less than 20% and the value of the shares owned by the selling shareholder was more than 80% of the value of all outstanding shares. Accordingly, Sec. 1239 was held to apply.

Sec. 1244 Incorporation of a partnership and 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 partnership 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 first procedure above. (*Prizant*, TC Memo 1971-196.)

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.

Sec. 1244

Even under the circumstances prescribed in method 2, the IRS may raise Rev. Rul. 70-239 to disallow a Sec. 1244 loss. The ruling provides that the partnership is the transferor in a corporate organization to which Sec. 351 applies regardless of whether it is the actual transferor, it terminates and the partners transfer distributed assets, or the partners transfer their interests to the corporation. The purpose of the ruling appears to define the Service's position relating to the 80% post-transfer control requirements of Sec. 351. The tax practitioner must, however, be aware of potential sources of attack.

Installment method: sale of partnership interest where Sec. 1245 applies

Sec. 1245

A sale of a partnership interest is often considered as being subject only to capital gain treatment under Sec. 741. This is indeed the case unless the sale comes within Sec. 751 which provides that the portion of the gain attributable to the sale of an interest in partnership unrealized receivables, including Sec. 1245 property, and substantially appreciated inventory is considered to be realized from the sale of a noncapital asset and therefore treated as ordinary income.

It is generally understood that when the Sec. 453 installment reporting provisions are elected and the gain includes depreciation recapture, the gain included in the installment proceeds must be treated as all ordinary income until the full amount of the recapture is reported, the remaining gain being reported as a capital gain. See Regs. Sec. 1.1245-6(d)(1). However, if the installment method is elected for reporting a sale of a partnership interest, the ordinary income portion resulting from Sec. 751 is reported concurrently with the capital gain portion.

A recent ruling, Rev. Rul. 75-323, states that where the sales agreement allocates the purchase price among the several classes of assets (including Sec. 1245 property), the income portion of the down-payment and cash installment payment must be allocated between the interest in the Sec. 1245 assets and the interest in the partnership's other assets. The amounts so allocated should be reported concurrently.

Sec. 1248 The long arm of Sec. 1248

When the stock of a foreign corporation is sold or exchanged at a gain by a "U.S. person," a portion of that gain may have to be reported as dividend income pursuant to Sec. 1248. A "U.S. person" is one who, *inter alia*, owns 10% or more of the stock of a controlled foreign corporation.

An unusual situation can arise with respect to a group of U.S. shareholders which points out the long reach of Sec. 1248.

Assume nine brothers each own 8% of the stock of a foreign corporation. The remaining 28% is owned by an unrelated party. Further, assume that the stock of the foreign corporation is to be acquired by its operating subsidiary, also a foreign corporation, in a downstream "D" reorganization. Although the transaction would normally be tax free (see Rev. Rul. 57-465), by application of Rev. Proc. 68-23, Sec. 367 and Sec. 1248, post-1962 earnings are required to be included in gross income of the U.S. shareholders unless a closing agreement can be entered into. See TIR-978 (5/24/68) and TIR-1354 (3/26/75).

By application of the attribution rules of Sec. 958(b), the foreign corporation is a controlled foreign corporation. That is, more than 50% of the voting stock is considered to be owned by the father of the nine children. See Sec. 957(a). However, only shareholders who own 10% or more of the voting stock of a controlled foreign corporation, directly or indirectly, are required to include in gross income the "tainted" income. Thus, the father would not pick up any income since he does not own any stock of the foreign corporation. In this case, only the 28% shareholder would include in gross income his portion of the tainted income. The nine children, since they own less than 10% of the stock directly or constructively, do not include in gross income any ordinary income (there is no attribution to brothers or sisters under Sec. 318(a) which is made applicable by Sec. 958(b)).

When the stock of the controlled foreign corporation is sold, Sec. 1248 is similarly applicable with respect to the 28% shareholder.

Sec. 1253 Trade name vs. noncompete payments

The tax adviser will note continuing frequent litigation in disputes on the deductibility of payments by the purchaser of a business for a covenant not to compete where (1) the seller has inconsistently treated the payments as proceeds from the sale of goodwill, (2) the IRS questions the likelihood of competition by the seller, i.e., the value of the covenant to the buyer, or (3) the amount allocated to the covenant was not the product of informed bargaining by the parties. Representative cases include *J. Leonard Schmitz*, CA-9, 457 F2d 1022 (1972); *Freeport Transport, Inc.*, 63 TC 107 (1974); and *Max J. Epstein*, TC Memo 1964-192. *Sec. 1253*

If the payments labeled as noncompete consideration are treated as goodwill, the purchaser loses his deduction and can recover the amount capitalized as purchased goodwill only upon abandonment or resale of the business. A purchaser wishing to achieve more certainty for his deduction should consider an agreement with the seller for a separately stated trade name purchase under Sec. 1253. The legislative history of this provision shows a focus upon the transfer of a distributorship or another similar exclusive contract arrangement to operate or conduct a trade or business.

Nevertheless a literal application of Sec. 1253 should provide an ordinary deduction to the buyer and ordinary income to the seller if the payments are contingent on the buyer's sale volume, or if the seller has the right to terminate use of the trade name or maintains other controls over the buyer's conduct of the purchased business. If a lump sum payment is made (and the seller maintains control, etc.) the seller apparently has ordinary income in the year of receipt and the buyer has a deduction amortizable over a ten-year period starting with the year of the payment.

Editor's note: Sec. 1253 covers transfers of franchises, trademarks, and trade names, and attempts to qualify for the above treatment must be cast in appropriate form.

Readjustment of tax between years and special limitations

Mitigation provisions: avoid them where possible

Secs. 1311-15

A taxpayer can take advantage of the mitigation provisions of Secs. 1311-1315 and obtain a refund, even though the statute of limitations would otherwise have expired, if one of the circumstances set out in Sec. 1312 is present. The seventh circumstance listed is captioned "Basis of property after erroneous treatment of a prior transaction." See Sec. 1312(7).

The Great Falls National Bank, DC-Mont., 388 F Supp 577 (1975), involved the sale of cattle which had been acquired in 1960 in what the taxpayer reported as a nontaxable transaction. The Tax Court subsequently determined that the transaction was taxable and that the fair market value of the cattle had to be reported as income. The deficiencies were paid in 1969. The taxpayer filed refund claims for the intervening years based, among other things, on the fact that income in those years was overstated since the cattle acquired in 1960 had a higher tax basis than had been used in calculating gain on their sale on the returns originally filed.

The IRS argued that the caption of the exception in Sec. 1312(7) meant that only years before the Tax Court could be considered. But the District Court looked to the purpose of the mitigation provisions and commented, ". . . all that Congress was trying to say was that where a determination changes a base, the treatment of the taxpayer and the Government in all matters affected by the base should be consistent."

The IRS also advanced another technical argument. The Tax Court's findings and conclusions were filed on Dec. 12, 1967, but the Rule 50 (now Rule 155) computations were the subject of further argument, and so the actual decision of the Tax Court was not entered until Jan. 14, 1969. The refund claims involved were filed later in 1969. The one-year limitation of Sec. 1314(b) started to run on Dec. 12, 1967, argued the IRS, and thus the refund claims filed in 1969 were too late. The Court also rejected this argument.

What is the moral? When settling a tax case, try to wrap up agreement on all of the years involved in an effort to avoid resort to the complex mitigation provisions. For example, protective refund claims covering the intervening years could perhaps have been filed when it became clear that 1960 was going to be involved in a controversy. They would then have been associated with the active case, and agreement on their disposition entered into with the Appellate Division prior to filing the final papers with the Tax Court in connection with its entry of the decision.

Mitigation may not be available as to audit adjustments

Secs. 1311-15

The mitigation sections of the Code (Secs. 1311-1315) basically provide that when "a determination" is made which causes an item to be treated in a taxpayer's return in a manner which is inconsistent with the treatment of the same item in that taxpayer's earlier return (or a related taxpayer's return), an adjustment can be made to such other return to correct the inconsistent treatment. This adjustment can be made even if the statute of limitations has run. A determination is defined to include

—a closing agreement made under Sec. 7121,
—a final decision of the Tax Court,
—a final decree, judgment or order of other courts, or
—a final disposition of a refund claim.

A taxpayer may agree to a proposed adjustment at the agent level or at Appellate, in the expectation that mitigation will be available as a result of such agreement. If the statute of limitations has run as to any of the years for which mitigation relief is sought, the taxpayer may find that mitigation is not available, unless the form executed by the taxpayer in his agreement to the proposed adjustments is a closing agreement form.

Sec. 7121 does not define a closing agreement. Regs. Sec. 301.7121-1 sets forth the procedures for entering into a closing agreement and states that "[a] closing agreement may be entered into in any case in which there appears to be an advantage in having the case permanently and conclusively closed."

The only authority which seems to set forth a specific definition as to what constitutes a closing agreement is Rev. Proc. 68-16. It provides generally that a final determination of tax liability pursuant to Sec. 7121 is reflected on Form 866, "Agreement As To Final Determination of Tax Liability." Final determinations of specific matters are reflected on Form 906, "Closing Agreement As To Final Determination Covering Specific Matters." As to closing agreements which relate to specific issues for a taxable year as well as general tax liability for a taxable year, Rev. Proc. 68-16 refers to a hybrid form which is to be used.

It should be noted that Rev. Proc. 68-16 specifically pro-

Secs. 1311-15

vides that one of the circumstances for entering into the above closing agreements is to provide determinations or disposition of cases involving Secs. 1311-1315. Since Rev. Proc. 68-16 limits a closing agreement to one of the three forms stated above, taxpayers who want to apply the mitigation statutes should insist on executing a closing agreement as part of the settlement in addition to signing any other forms which have been submitted as part of the settlement.

Sec. 1341 Salary repayment agreements may backfire

To cover the possibility that officers' salaries may be held by IRS to be excessive, tax advisers often suggest salary repayment agreements. The objective of such agreements—which may be included in an employment contract, corporate minutes or bylaws—is to reimburse the corporate payor for the nondeductible portion of the compensation and to enable the officer to deduct the repayment. But such agreements may backfire.

Example 1. Smith, president and controlling shareholder of *X* corporation, is paid $100,000 a year. A salary repayment agreement, covering his annual salary for 1968, 1969 and 1970, provides that any amounts disallowed by IRS must be repaid to the corporation. In 1971, Smith sold his *X* stock to *C*, a conglomerate corporation. Late in 1971, the IRS descended on *X* and disallowed $30,000 of Smith's annual salary for each of the years 1968, 1969 and 1970. *C*'s auditors dug out Smith's repayment agreement, which he had not fully understood and which he had forgotten existed. He grumbled, but finally wrote out a check to *C* in 1971. Yes, he got a tax deduction, but the tax benefit was considerably less than the tax paid on the $90,000 in 1968-1970. "Who can afford the cost of such deductions?" (See the discussion below concerning Sec. 1341.)

Example 2. Jones was paid $210,000 per year by his controlled corporation. In 1973, the IRS knocked the salary down to $160,000 per year for the three years under audit. As a result, Jones became obligated to pay his own corporation $150,000. But where was Jones, who had little in the way of liquid assets, to get the $150,000? So Jones arranged for the corporation to cancel the repayment agreement in 1973.

Tax result: a $150,000 dividend increased his adjusted gross income, while the deduction had to be itemized in arriving at net income. One adverse tax effect was that Jones' medical expense deduction (medical expenses over 3% of adjusted gross income) was cut by $4,500. Moreover, there was a reduction of the percentage of his taxable income treated as earned income for purposes of the 50%

maximum tax on earned income. That change increased Jones' 1973 tax bill by $6,500. "Who needs such tax planning?"

The situation might be different if the officer-stockholder could determine the tax benefit of the repayment under Sec. 1341. But the IRS position as to wage repayment agreements (Rev. Rul. 69-115) is the same as it is on expense reimbursement repayment agreements (Rev. Rul. 67-347)—i.e., the deduction is allowable only in the year of repayment. Thus, the officer cannot get a tax reduction equal to the tax attributable to the repaid amount in the year it was reported as income. In the one reported case dealing with a repayment agreement (*Oswald*, 49 TC 645), the Sec. 1341 question was apparently not put in issue.

It appears that the corporation realizes no income from the repayment. But what is the effect of the repayment on earnings and profits (E&P)? Backtracking one step, the payment of the "excessive" salary was a reduction in E&P. Disallowance of the excess as a tax deduction does not, in itself, restore anything to E&P since the effect on both the corporation and the shareholder is the same as a dividend. However, a dividend paid deduction would not be allowable under Sec. 561 if the excess is deemed preferential under Sec. 562(c) because it was not pro rata among the shareholders (*Henry Schwartz Corp.*, 60 TC 728).

The repayment would apparently be treated by most accountants as a credit to retained earnings. Could it be argued that for tax purposes the repayment is a contribution to capital rather than a credit to E&P? But a contribution to capital by a shareholder invariably involves an increase in the tax basis for his stock. For this "contribution to capital," he takes a deduction! It seems difficult to support the capital contribution argument, so it appears that the repayment probably increases the corporation's E&P—and thus, in the event of later dividends or a Sec. 333 liquidation, the repayment may result in another round of ordinary income to all the shareholders, not necessarily solely to the shareholder involved.

Conclusion: In practice, stockholder-officer salary repayment agreements may not turn out to be what they are cracked up to be in theory.

Editor's note: See earlier discussion at Sec. 274 for additional pitfalls of such repayment agreements.

Sec. 1348 Social Security benefits and the earned income syndrome

For individuals with earned income in excess of $2,760 in 1976 and $3,000 in 1977, Social Security benefits are reduced or eliminated depending on the excess and the months during which earned. However, self-employed persons may still be entitled to full benefits, regardless of the amount earned, if the services they perform in generating the excess income are not "substantial."

The following factors are considered in determining if substantial services are performed:

- The amount of time devoted to the business, including time spent in planning and managing as well as doing physical work;
- The kind of services performed;
- A comparison of the services with services performed in past years of active work; and
- Other circumstances in the particular case (such as need for capital investment, type and seasonal nature of business, etc.).

In addition, as a general rule more than 45 hours of service will be considered substantial unless the contrary is proved. Therefore, generally, 45 hours or less time devoted to a business will not be considered to be substantial. However, as little as 15 hours of services in a month could be substantial if they were spent in the management of a sizeable business or in a highly skilled occupation.

Sizeable benefits were reaped for the following taxpayers who had assumed that their excess earnings barred Social Security benefits.

Case 1. For years, *X*, a manufacturer's agent, had serviced a number of accounts and earned substantial income. Because of failing health and advancing age, he hired an assistant and "substantially retired" (i.e., he devoted less than 45 hours per month to the business). He continued to receive commissions; in fact, his net income increased over a three-year period. His net self-employment income was in excess of $20,000 each year. At age 68, *X* applied retroactively for Social Security benefits, and received prior year benefits of over $6,000 as well as current monthly benefits.

Case 2. *Y*, another manufacturer's representative, "substantially retired" but continued to receive commission income in excess of $25,000 each year. He did not hire an assistant. At age 70, *Y* applied for and received Social Security benefits of over $9,700 for back years plus current monthly benefits.

Taxpayers receiving income under consulting agreements requiring little services to be rendered also would appear to qualify for benefits regardless of the amount of income received.

Case 3. Z, who is over 65, sells his business to *P*. As part of the deal, *Z* enters into the standard consulting agreement under which he will receive $25,000 a year for five years and will perform services only when requested by *P*. *Z*'s actual time devoted to the business is less than 45 hours per month and is substantially less than the time he put in prior to the sale when he was a full-time executive. *Z* should qualify for the monthly Social Security benefits.

Maximum tax planning for earned income in respect of a decedent

The 50% maximum income tax on earned income is usually thought of as benefiting individual taxpayers only. Tax advisers should not, however, overlook its availability to estates and trusts.

While an estate or trust itself cannot normally earn income, it can receive substantial "earned income in respect of a decedent"; thus, the maximum tax constitutes another tax saving tool available in after-death estate planning.

Essentially, income in respect of a decedent includes all items of gross income to which the decedent was entitled at his death but which was not properly reportable on his income tax returns under the applicable method of accounting. Thus, accrued but uncollected salary and bonuses earned by a cash basis decedent constitute income in respect of a decedent when collected by his estate or any beneficiary. Such income retains the same character as it would have had if the decedent had received it. If the accrued income would have been eligible for maximum tax treatment by the decedent if he had lived, his estate can also utilize the maxi-tax provisions when the income is collected.

In fact, the estate may find that the use of the maxi-tax on income in respect of a decedent can result in greater tax savings than if the decedent himself had received the income. This can result where the earned income in respect of a decedent would have represented only a fraction of the decedent's adjusted gross income but represents all or substantially all of the estate's gross income for the period in which received. See "Tax planning steps" below.

Sec. 1348

While the 50% maxi-tax will often provide estates with savings for modest amounts of earned income in respect of a decedent, the tax benefits will usually be substantial for estates of decedents who were highly paid corporate executives. The estates of such individuals will often include the rights to substantial executive compensation benefits which may qualify as earned income. For example, the restrictions imposed on nonqualified stock options, restricted stock, etc., normally will expire on death. The estates of such individuals will often include the rights to substantial executive compensation benefits which may qualify as earned income. For example, the restrictions imposed on nonqualified stock options, restricted stock, etc., normally will expire on death. The estate exercising its rights under such compensation plans will be treated as having received compensation in the amount of the spread between the option price and the fair market value of the stock on the date the option is exercised. The amount of this compensation, which will often be considerable, constitutes income in respect of a decedent since he had performed the required services prior to death. Regardless of when the income is received by the estate, it will not constitute deferred income but will be eligible for maxi-tax benefits. (Prop. Regs. Sec. 1.1348-3(b)(3)(iii)(b).)

Tax planning steps. Some of the tax planning steps which could increase the tax savings on earned income in respect of a decedent include the following:

- Close the first taxable year of the estate shortly after receiving the earned income, thus reducing the ratio of earned and unearned income in that short year, which in turn increases the portion of earned income in respect of a decedent that will qualify as earned taxable income. Furthermore, although the earned taxable income will be taxed at the 50% rate, the tax rate on the unearned income is pushed up by the amount of earned income; thus it could be advantageous to have the unearned income taxed in a year other than that in which the earned income is received.
- For the same reasons, elect to report the increment in value of Series E U.S. savings bonds as income on the decedent's final income tax return if the executor plans to redeem such bonds early in administration. This action will eliminate the reporting of such unearned income in respect of

a decedent on the fiduciary income tax return when the bonds are redeemed.

- In the year in which the income in respect of a decedent is received, keep capital gains and other items of tax preference for the year below $30,000 in order to avoid a reduction in earned taxable income. (The estate, although a new taxable entity, must consider the tax preferences realized by the decedent in making the computation of the alternate offset of the average of tax preference items in the current and preceding four years.) If it is necessary to sell property which will produce a capital gain—and all sales of the decedent's property made by the estate will be treated as a long-term capital gain, even if held less than six months after death—the use of the installment method should be considered. Another approach to be considered is to utilize the alternate valuation date election, which would avoid capital gains tax on post-death appreciation of property sold by the estate during the first six months.
- Elect to deduct administration expenses paid during that first short year for estate tax rather than for income tax purposes. Deductions of these expenses on the income tax return would, of course, reduce earned taxable income subject to the maxi-tax.

Finally, of course, the executor must keep in mind that he will be entitled to an income tax deduction for the estate tax attributable to the earned income in respect of a decedent.

Editor's note: The Tax Reform Act of 1976 extends maximum tax treatment to pension and annuity income, and eliminates the $30,000 exemption to the preference offset.

Maximum tax: deductions recovered and nonresident aliens

Recovery of deductions. In determining the 50% maximum tax on earned income under Sec. 1348, "personal-type" deductions (those which are subtracted from adjusted gross income in order to arrive at taxable income) are apportioned between earned income and other gross income which does not constitute earned income. This has the effect of limiting to the 50% maximum rate the tax benefit of such deductions apportionable to earned income.

Recoveries of such deductions may be realized in later years. Common types of such recoveries include refunds of state income taxes or insured medical expenses. These recoveries (after application of the recovery exclusion rule of Sec. 111) will constitute gross income in the later years. Recoveries representing gross income apparently do not constitute "earned income" for the purpose of the maximum tax, even though a part or even all of the related deductions may have reduced earned income in the past. Accordingly, gross income from such recoveries is subject to a tax of as high as 70% (after, of course, reduction for some "personal-type" deductions, allocated away from earned income, in the year of the recovery).

Benefiting from deductions at a tax rate of 50% while incurring tax at a rate of up to 70% upon their recovery is bad business. The recovery exclusion rule does not seem to ameliorate this situation. Taxpayers subject to the maximum tax should attempt to minimize payments of deductions which may lead to future recoveries.

Married nonresident aliens. An interesting question arises as to whether the maximum tax applies to earned income of nonresident aliens. Regs. Sec. 1.1348-3(a)(1)(ii) clearly implies that a nonresident alien is entitled to avail himself of the benefits of the maximum tax. However, Sec. 1348(c) states that a married individual may avail himself of the maximum tax only if he and his spouse make a joint return for the taxable year. And, in accordance with Sec. 6013(a)(1), a joint return may not be filed by a married couple if either spouse is at any time during the taxable year a nonresident alien. It therefore appears that the married nonresident alien never even gets a chance to "step into the batter's box" with respect to the maximum tax. There is nothing in Sec. 6013 similar to Sec. 2(b)(2)(C), which, for the sole purpose of the head of household definition, provides that a taxpayer shall be considered as not married at the close of the taxable year if at any time during the taxable year his spouse is a nonresident alien. More salt is rubbed into the nonresident alien's wounds by reason of Rev. Rul. 72-413, which forces him to use the highest tax rate tables—that is, those for married individuals filing separate returns.

Election of certain small business corporations as to taxable status

Subchapter S: do corporations acting as business partners meet the ten shareholder requirement?

Secs. 1371-79

In a recent situation, a subchapter S corporation with ten shareholders wished to attract additional individual investors for an expansion of its business, but still wished to preserve its status under Sec. 1371. It was not feasible to conduct the business as a partnership composed of individuals. Therefore, it was proposed that several corporations be formed to conduct the business as a general partnership, each with no more than ten shareholders. A private ruling was requested that formation of a partnership to conduct the business would not result in the failure of any of the corporate partners to satisfy the no-more-than-ten shareholder limitation of Sec. 1371(a)(1) in the event any of the corporations wished to elect or continue subchapter S treatment.

After a delay of approximately nine months, the IRS National Office representatives decided that the requested ruling would not be issued. Factors cited for declining to issue a favorable ruling were:

- Apart from the desire to meet the ten shareholder limitation of Sec. 1371(a)(1), there was no reason to have multiple corporations even if the corporations were recognized to have substance and not to constitute shams;
- Each of the corporations did not have a necessary "quantum" of business activity by merely managing its partnership interest; and
- The legislative intent of subchapter S was to allow no more than ten individuals to participate in a *single* business enterprise, although no authority was cited for this proposition.

The facts were distinguished from Rev. Rul. 71-455, which is the only other ruling touching on this area, on the basis that there the subchapter S corporation conducted an active business enterprise directly as well as owning an interest in a partnership.

Of course, it should be understood that the refusal to rule in this instance is not necessarily indicative of whether the National Office would take an adverse position if a similar question were presented in the form of a technical advice request.

Editor's note: The Tax Reform Act of 1976 has expanded the subchapter S corporation provisions to permit a small business corporation which has elected subchapter S status for a period of five consecutive taxable years, to have as many as 15 shareholders.

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.

Immediate Sec. 334(b)(2) liquidation saves subchapter S status

S, a subchapter S corporation, purchased the stock of *X* corporation with the view of liquidating *X* in accordance with

Sec. 334(b)(2). The same day *X* was acquired, the plan of liquidation was adopted; immediately thereafter, the liquidation was completed. The question arose as to whether the momentary affiliation with *X* would terminate S's subchapter S election. (Secs. 1371(a) and 1372(e)(3).)

In a letter—which was not issued as a determination letter—the District Director, Manhattan, advised that S's momentary ownership of all of the *X* stock in connection with a Sec. 334(b)(2) liquidation would not preclude or terminate a subchapter S election by S.

This conclusion is supported by Rev. Rul. 72-320. In that ruling, *Z*, a subchapter S corporation, transferred part of its assets to *Y*, a newly created corporation, in exchange for all of *Y*'s stock. Immediately thereafter, *Z* exchanged all of the *Y* stock for all of the *Z* stock held by one of its shareholders. (The transactions constituted a tax-free split of *Z* (Secs. 355 and 368(a)(1)(D)).) The IRS ruled that since *Z* never contemplated more than momentary control of *Y*, the affiliation would not be considered as terminating *Z*'s subchapter S election.

Editor's note: See Rev. Rul. 73-496 wherein IRS ruled that the acquisition of all of the stock of a subsidiary and its liquidation within 30 days under Sec. 332 and Sec. 334(b)(2) will not terminate the acquiring corporation's subchapter S election.

Reelection of subchapter S status within the five-year waiting period

A subchapter S election is effective for the taxable year for which it is made and for all succeeding taxable years unless it is terminated or revoked. Once the election is terminated, whether voluntarily or involuntarily, the corporation cannot make a new election for five years—i.e., not for a year before the fifth taxable year beginning after the first year for which the termination or revocation was effective—unless permission is obtained from the Commissioner of Internal Revenue. Regs. Sec. 1.1372-5 specifies:

- If a more-than-50% change in ownership of the corporation occurs after the year of the termination, it will tend to establish that the Commissioner should grant consent to an early subchapter S reelection; however,

- If there is no such change in ownership, consent will ordinarily be denied unless the taxpayer can demonstrate that the events causing termination were not reasonably within the control of the corporation or the shareholders and were not part of a plan to terminate the election.

In Rev. Rul. 67-382, the IRS ruled that permission to reelect subchapter S within the five-year period would not be granted to a corporation which held investment assets in addition to being engaged in an active trade or business, and which became inactive in order to avoid public confusion with a partnership with which the shareholders of the corporation were also associated. The Service reasoned that the event causing termination (excessive passive income) was within the control of the corporation and its shareholders since they could have either allowed the corporation to continue its active conduct of business or caused the corporation to dispose of the investment assets.

Under facts distinguishable from those in Rev. Rul. 67-382, permission to reelect was recently received for a corporation whose subchapter S election was terminated because its passive rental income was in excess of 20% of its gross receipts. During the year of termination, the corporation, which was engaged in the construction business, could not operate by reason of a depressed local economy.

In this case, it was established that the events which led to the involuntary termination of the construction corporation's subchapter S election were not part of a plan to terminate the election and were neither within the control of the shareholders or the corporation nor foreseeable by them. Therefore, the National Office granted permission to the corporation to reelect its subchapter S status within the five-year waiting period.

Subchapter S: repayment of debt created to absorb NOLs

The basis of debt owed by a subchapter S corporation to a shareholder may substantially increase the amount of corporation net operating loss (NOL) the shareholder may effectively utilize. See Sec. 1374(c)(2)(B). In any given year, the NOL pass-through to a shareholder is limited to his basis in stock and indebtedness held as of the end of the corporation's taxable year (assuming the shareholder held stock at the end of the year). As provided by Regs. Sec. 1.1374-1(b)(4), by having a shareholder make loans to the corporation prior to the year end, a NOL which would otherwise be permanently unavailable to him because of basis limitations can be salvaged.

However, if this tax planning device is availed of, it is important that its consequences be fully understood. In subsequent years if all or a portion of the loan is repaid, a taxable event will take place. This holds true even if the basis of the debt has not been reduced to zero. Additional loans will not restore the basis of prior loans. To the extent the NOL is utilized by a shareholder in an amount that exceeds the adjusted basis of his corporate stock, his loan basis is permanently diminished. Subsequent increases in stock basis due to subchapter S profits also have no impact on debt basis.

Each debt repayment made will be considered to represent both return of capital and taxable gain in the ratio of current loan basis to original principal amount. If the indebtedness is evidenced by a formal note, the resultant gain is capital gain. See Rev. Ruls. 64-162 and 68-537. Repayment of loans made on open account generate ordinary income. See Rev. Rul. 68-537.

The possible triggering of income upon loan repayment mandates the the shareholder be apprised of the consequences of inserting debt into a subchapter S corporation, as well as the consequences of repayment.

Editor's note: See immediately following item for comparison to capital contributions.

Capital contributions superior to loans to subchapter S corporation

A problem centers around loans and/or advances made to a subchapter S corporation where these loans and/or advances are being used to absorb subchapter S losses. Subsequently, none of the loans and/or advances, whose bases have been reduced below their face value under Sec. 1376(b)(2), can be repaid to the shareholders without some tax effect to the shareholders.

As held in the case of *Smith*, CA-9, 424 F2d 219 (1970), repayments by the corporation in reduction of such indebted-

Secs. 1371-79

ness are allocable in part to return of basis and in part to income. A formula for allocation may be found in Rev. Ruls. 64-162 and 68-537. (In some instances an argument could be made for using the cost recovery method (*Darby Investment Corp.*, CA-6, 315 F2d 551 (1963).) Unlike subchapter S stock, once the basis of the indebtedness has been decreased, there are no provisions for increasing that basis. (*Cornelius*, CA-5, 494 F2d 465 (1974).) Thus, there appears no way to avoid the adverse consequences to the shareholders upon repayment while still utilizing debt to absorb losses.

One alternative is to transfer existing loans to capital or to make a capital contribution instead of a loan. The result, as in the case of a loan in the same amount, is to increase basis available for absorption of losses under Sec. 1374(c) and reduce basis to the extent the losses are absorbed under Sec. 1376(b). But, unlike the case of a loan, the basis of stock will be increased by any future undistributed taxable income of the corporation under Sec. 1376(a). Therefore, the capital contribution may later be repaid to the shareholders without any tax consequences if there are no accumulated E&P pursuant to Sec. 1377(a). The distribution would, under Sec. 301, merely reduce the basis of the stock.

Subchapter S dividends: proper planning on death of shareholder

One of the traps in subchapter S lies in the fact that the ability to receive UTI tax free dies contemporaneously with the individual stockholder. See Regs. Sec. 1.1375-6(a)(4). This is true even though there is a 2½-month grace period allowed for actual distribution of UTI for each year, as the following illustrates:

> A calendar year decedent who died on Feb. 1, 1976, owned stock in a calendar year subchapter S corporation which did not distribute any of its 1975 earnings until March 1, 1976. The decedent's share of the corporation's undistributed 1975 earnings was taxable as a constructive dividend on his 1975 return under Sec. 1373. Ordinarily, under Sec. 1375 (f), the March 1, 1976 distribution would be tax free to the stockholder since a distribution within 2½ months after a subchapter S corporation's year-end is deemed to have been paid from the preceding year's undistributed taxable income.
>
> However, this 2½-month rule applies only if the recipient of such a distribution was a shareholder on the last day of the prior year. The

recipient in this case, the decedent's estate, was not the shareholder on Dec. 31, 1975—the decedent was. The estate, a new shareholder, had no UTI which it could receive tax free; the decedent's UTI "died" with him. Therefore, the distribution, under the regular rules governing subchapter S, would be deemed to come from 1976 income and would be taxed again, assuming 1976 profits, as an actual (rather than a tax-free) dividend to the estate.

This trap is a strong factor in favor of maximizing *current* distributions of subchapter S income.

In addition, current year's income can be turned into "income in respect of a decedent" where a shareholder dies during the year. This is accomplished by declaring dividends each month payable at or near the end of the year. If a shareholder dies before payment of the dividends his estate will qualify for a Sec. 691 deduction when the dividends are received.

Another subchapter S booby trap

There is one trap into which subchapter S corporations continue to fall, although its existence has been well posted. This trap is encountered when the corporation is seeking to distribute previously taxed income and results from failure to recognize the order in which income is deemed to be distributed to shareholders when made in the form of cash.

All tax advisers are familiar with the treatment of undistributed taxable income (UTI) which is deemed to be a constructive dividend to the subchapter S shareholders as of the last day of the corporation's year. Where cash distributions are made to shareholders during the corporation's year, their taxability depends upon a six-tier calculation. Generally, cash distributions are deemed to come from the following sources in the following order:

(1) Current year's taxable income,

(2) Current year's E&P in excess of current taxable income,

(3) Previously taxed income (PTI), that is, undistributed taxable income of prior years,

(4) Accumulated E&P from years prior to subchapter S status,

(5) Return of capital to the extent of basis, and

(6) Capital gain.

Secs. 1371-79

There is one exception to the general rules for determining the source of distributions. Cash distributions made within two and one-half months after the close of the corporation's year are deemed to have been made *first* from (and to the extent of) UTI for that year; any excess distribution will be treated in accordance with the general rule.

Because of the failure to fully understand rules (2), (3) and (4), cash distributions in excess of the current year's taxable income are often erroneously considered to be attributable to PTI and therefore nontaxable. Instead, the excess amount winds up being fully taxed.

The following example demonstrates how the failure to recognize the interplay of rules (2) and (3) may cause a distribution to result in more taxable income for the shareholders than was anticipated.

Example. S, a calendar year subchapter S corporation, has PTI of $10,000 at December 31, 1972. For 1973, S had taxable income of $40,000 and tax free interest of $20,000. During 1973, after March 15, S distributed $50,000 to its calendar year shareholders. They will be taxed in 1973 on the full $50,000—the current year's taxable income of $40,000 plus the excess distribution of $10,000. The latter amount is deemed to have been paid from the $20,000 of E&P in excess of taxable income for the current (1973) year rather than from PTI. Of course, the exempt interest loses its tax free character at the shareholder level.

In connection with the application of rules (3) and (4), it is easy to overlook the fact that a shareholder's share of PTI, according to Regs. Sec. 1.1375-4(d) is limited to the "amounts included in [his] gross income . . . under Sec. 1372(b) for all his taxable years ending before the distribution. . . ."

If a corporation's yearend differs from a shareholder's, the regulation can defer the transformation of UTI into PTI until the shareholder's year after the one in which a distribution is made. As a result, a purported distribution of UTI may in fact be a distribution of E&P accumulated before the subchapter S election was made. The following example illustrates this subchapter S trap.

Example. X had UTI of $25,000 for its first subchapter S taxable year ended January 31, 1973, and zero taxable income and no current E&P for the year ended January 31, 1974. X had accumulated $20,000 of E&P on January 31, 1972, prior to its first subchapter S year. During 1973, after April 15, X distributed cash of $20,000 to its sole calendar year shareholder. On his 1973 return, X's shareholder will be taxed on $45,000, consisting of the $25,000 of UTI for the year ended January 31, 1973 (which ends within his 1973 year), plus the entire cash distribution of $20,000. Secs. 1371-79

The E&P accumulated before the first subchapter S year will be deemed to be the source of the $20,000 distribution since X's UTI for the year ended January 31, 1973—although taxable on the shareholder's 1973 return—would not become PTI to him until 1974, the year after it had been "previously taxed" in his 1973 return.

If the shareholder's taxable year had ended on January 31, then $25,000 of X's UTI for the year ended January 31, 1974, would have been taxed to him on his return for the same yearend. Therefore, the post-April 15, 1974, distribution of $20,000 would be deemed to have been paid out of PTI. Under these circumstances the UTI of $25,000 became PTI on April 16, 1974, which falls within the shareholder's year ended January 31, 1975.

Editor's note: Cash distributions within the two and one-half-month rule are tax-free only to the extent of UTI of the immediately preceding year. PTI accumulated in earlier years cannot be bailed out until all of the current year's (year of actual distribution) E & P is distributed.

Consolidated returns

Affiliated group established through preferred stock

Sec. 1502

One of the principal advantages of filing consolidated returns is the ability of profitable members of the affiliated group to offset their profits with the losses of nonprofitable members. This benefit may be recaptured upon disposition of the stock of the nonprofitable members of the group through the application of the excess loss account rules. (Regs. Sec. 1.1502-19.) However, the regulations prescribing the "negative adjustments" that reduce the basis of stock of a subsidiary (and eventually create excess loss accounts) essentially allocate any deficits in the subsidiary's earnings and profits to common stock. (Regs. Sec. 1.1502-32(b)(2).) Negative adjustments with respect to preferred stock are limited to certain distributions made by the subsidiary. (Regs. Sec. 1.1502-32(c)(2).)

Consider the following possibility. A parent owns 100% of a subsidiary's voting preferred stock with 100% of the voting common stock held by parties outside the affiliated group. The voting rights are such that the parent's preferred stock represents "80% of the voting power of all classes of stock" under Sec. 1504(a). It is apparently not necessary to own 80% of each class of voting stock, but merely to own stock that represents 80% of the total voting power. (Rev. Rul. 69-126.) This arrangement appears to literally satisfy the Sec. 1504 definition of "affiliated group" and should entitle the parent to deduct the subsidiary's operating losses on a consolidated return. Yet, the regulations apparently do not require negative adjustments to the basis of the stock since only preferred stock is held within the affiliated group.

The IRS almost certainly would look upon such a result with disfavor and is not without means of attacking such arrangements. For example, Regs. Sec. 1.1502-80 provides that Secs. 269 and 482 apply in a consolidated return context. Also, where affiliation serves no business purpose it is conceivable that the consolidated return privilege may be denied. Moreover, it is understood that the Service will not rule an affiliated group exists where less than 80% equity investment is represented within the group.

While IRS resistance is almost certain, perhaps such an arrangement could be sustained in certain circumstances.

Like-kind exchanges between members of an affiliated group

Ordinarily, when, during a consolidated return period, one member of an affiliated group sells property to another, any gain or loss is deferred under Regs. Sec. 1.1502-13(c) since it is from a "deferred intercompany transaction." However, it is to be noted that the deferral treatment applies only to gains which would otherwise be recognized.

An interesting situation arises when members exchange properties held for productive use in trade or business in a transaction under Sec. 1031, relating to the nonrecognition of gains or losses on exchanges of like-kind property. If neither member realizes boot (in the form of cash, other property, or an excess of liabilities "given up" over liabilities assumed), there will be no gain to be the subject of deferral under Regs. Sec. 1.1502-13(c). Each company will proceed on its own way, with its own substituted basis. If only one of the properties is sold in later years, the cost of the property sold will be determined by reference to the original cost of the property which still remains within the affiliated group.

The situation becomes even more interesting if one member receives boot and therefore recognizes gain. It seems clear that this gain would otherwise be recognized and therefore is deferred under Regs. Sec. 1.1502-13(c). However, this gain is attributable to the property disposed of by the member with the gain and will therefore be recognized to such member whenever the property given up is disposed of (including the disposition by depreciation) by the other member. On the other hand, if the property acquired by the member realizing the gain is disposed of, its basis would be determined by reference to the original basis of the property given up without triggering any further amount of intercompany gain because the property given up was still within the affiliated group.

Example. Member *A* transfers Property I to Member *B* in exchange for Property II and $1,000 of cash. *A*'s original basis in Property I was $3,000 and it had a fair market value of $5,000. *B*'s original basis in Property II was $1,500 and its fair market value was $4,000 (thus accounting for the $1,000 of cash).

After the exchange, *A*'s basis in Property II is $3,000, and *A* realized a gain of $1,000, the cash received. However, this gain is deferred, because it resulted from a deferred intercompany transaction, so long as *B* holds Property I.

After the exchange, *B*'s basis in Property I is $2,500, representing the $1,500 original basis of Property II plus the $1,000 cash.

If, some years later (and ignoring depreciation for the sake of simplicity), *A* sells Property II to an unrelated person for $7,000, *A* realizes a gain of $4,000 ($7,000 less $3,000). *A* continues to defer the $1,000 gain with respect to the sale of Property I to *B* because Property I is still within the affiliated group. Note that if the Sec. 1031 exchange had never taken place and *B* had sold Property II to the unrelated person for $7,000, *B* would have been taxed on a gain of $5,500 ($7,000 less $1,500).

Consolidated returns: built-in deduction pitfall for 1975

With the repeal of Sec. 1562, many affiliated groups will file consolidated returns for the first time in 1975. Losses or de-

Sec. 1502

ductions of a member which accrued economically during a year in which a Sec. 1562 election was in effect and which are recognized in a later consolidated-return year, or are recognized in a separate return year and are carried forward into a later consolidated-return year in the form of a net operating or capital loss carryover, are subject to the "built-in deduction rules" of Regs. Sec. 1.1502-15(a). Thus, those deductions or losses may be claimed on the consolidated return only to the extent of the separate taxable income of the member which incurred them (SRLY limitation).

The limitation will not apply to assets held by the group for at least ten years prior to the year in question. This exception, when applicable, will apply to deductions currently realized but economically accrued in Sec. 1562 years. However, the more commonly relied upon de minimis exception—namely, that the adjusted basis of the assets acquired from a transferor or brought into a group by a new member did not exceed their fair market value by more than 15%—is not applicable to built-in deductions arising out of SRLYs by virtue of an effective Sec. 1562 election. This follows since there is neither a new member of the group nor any assets acquired from a transferor.

If one is aware that the built-in deduction rules apply, their effect can usually be avoided by transferring tainted assets to profitable members or by merging profitable members into those members which have the tainted assets or losses.

Consolidated returns: deemed-dividend election proposed regulations

Electing a deemed dividend is a technique whereby a parent corporation which is a member of an affiliated group filing consolidated returns may increase the basis in its wholly-owned subsidiary's stock by electing to treat the subsidiary as having made a distribution of its accumulated earnings and profits (E&P), with the parent immediately contributing such E&P to the capital of the subsidiary. The basis in the subsidiary's stock, however, is not increased to the extent that any of the subsidiary's accumulated E&P were accumulated in pre-affiliation years (any year where the subsidiary was not a member of the group for each day of its taxable year).

On Jan. 4, 1973, IRS proposed changes to Regs. Sec. 1.1502-32. The effect of the proposed regulations, if finalized, will be to reduce the benefits of a deemed-dividend election by reducing the basis of the subsidiary's stock by E&P which were accumulated in separate return limitation years (SRLY) of the subsidiary. Principally, this change would apply to E&P accumulated during affiliated years when the group had elected multiple surtax exemptions under Sec. 1562. The following example demonstrates the effect of such change. *Sec. 1502*

Example. On July 1, 1967, corporation *P* formed corporation S with an initial investment of $100,000. Both *P* and S adopted June 30 fiscal years. From July 1, 1967, to June 30, 1974, *P* and *S* filed separate tax returns electing multiple surtax exemptions under Sec. 1562. For the year ended June 30, 1975, it is anticipated that *P* will elect to file, and *S* will consent to be included in, a consolidated return. On June 30, 1975, *S* has accumulated E&P of $1,500,000 including $200,000 of current E&P for its year ending June 30, 1975.

Under the current regulations, if a deemed-dividend election were made with the first consolidated return, *P* would increase its basis in S by the accumulated E&P at June 30, 1974 ($1,300,000). *P*'s basis in the stock of S would be computed as follows:

Initial investment	$ 100,000
Deemed dividend July 1, 1974	1,300,000
June 30, 1975 investment adjustment	200,000
Total	$1,600,000

The proposed regulations would deny any increase in basis by use of the deemed-dividend election on the ground that all of S's accumulated E&P were accumulated in separate return limitation years when the group had elected multiple surtax exemptions. Under the proposed regulations, the basis of the S stock would be computed as follows:

Initial investment	$100,000
Deemed dividend	0
June 30, 1975 investment adjustment	200,000
Total	$300,000

The proposed regulations have not been made final. Therefore, affiliated groups with wholly-owned subsidiaries who are filing consolidated returns should consider making a deemed-dividend election if they have E&P accumulated in affiliated years where the group had a multiple surtax election in effect.

Should regrouped affiliates' SRLY NOL carryover be fragmented in SRLY computation?

Subject to exceptions and modifications not relevant to this discussion, Regs. Sec. 1.1502-1(e) and (f) collectively define a separate return limitation year (SRLY) as a year for which a member of a group (i) filed a separate return or (ii) joined in the filing of a consolidated return by another group.

Insofar as is relevant to this discussion, Regs. Sec. 1.1502-21(c)(1) and (2) collectively provide:

> In the case of a net operating loss of a member of the group arising in a separate limitation year . . . of such member . . . the amount which may be included . . . in the consolidated net operating loss carryovers and carrybacks to a consolidated return year shall not exceed . . . consolidated taxable income . . . minus such consolidated taxable income recomputed by excluding the income and deductions of such member. . . .

In simpler tax jargon, the regulation limits the NOL carryover from a member's separate return limitation year to that member's contribution to consolidated taxable income.

If two (or more) members of a group have NOL carryovers from a year in which they joined in another group's consolidated return, the question arises as to whether the SRLY limitation on the regrouped members' NOL carryovers should be computed on a:

- Fragmentized basis (i.e., apply the SRLY limitation to each member individually and then total such limitations), or
- Unified basis (i.e., compare the members' aggregate share of the old group's consolidated NOL to their aggregate contributions to consolidated taxable income).

This question would be consequential where

—two or more members of an old group have NOL carryovers, and

—one such member's NOL carryover is less than its contribution to the consolidated taxable income, and the other member's is more.

Example. As the following simple example will illustrate, neither fragmentizing nor unifying the NOL carryovers of regrouped members will necessarily produce a more favorable result to the taxpayer or the tax collector.

On Jan. 1, 1974, an individual forms *P* (manufacturing corporation) and *S* (selling corporation), with *S* as a wholly-owned subsidiary of *P*. For 1974, *P* and *S* filed a consolidated return. On Jan. 1, 1975, the individual sells all the *P* stock to *N-P*. The new parent (*N-P*), *P* and *S* file a consolidated 1975 return. The incomes and NOLs of the old and new groups (assuming alternative amounts for 1975), and the effects on the consolidated NOL deduction of applying the fragmentized and unified methods of computing the SRLY limitations, are set out below:

		Alternative 1975 facts	
	1974	Case 1	Case 2
Old group			
P	\$(600)	\$ 400	\$ 400
S	(300)	700	(100)
N-P		2,000	2,000
	\$(900)	\$3,100	\$2,300
Fragmentized method			
P's 1974 NOL or 1975 income, whichever is less		\$ 400	\$ 400
S's 1974 NOL or 1975 income, whichever is less		300	—
Consolidated NOL carryover		\$ 700	\$ 400
Unified method			
P-S's consolidated 1974 NOL or 1975 income, whichever is less		\$ 900	\$ 300

As the foregoing example indicates, the fragmentized method produces a smaller NOL deduction (\$700) than the unified method (\$900) under the facts of Case 1, i.e., where

—the old group members' "consolidated" NOL carryover is less than their combined contribution to consolidated taxable income, and

—one member's NOL carryover is less than its contribution to consolidated taxable income.

On the other hand, the unified method will produce a smaller NOL deduction ($300) than the fragmentized method ($400) under the facts of Case 2, i.e., where

—one member's NOL carryover exceeds its contribution to consolidated taxable income, and

—the other member sustains a NOL in the deduction year.

Which method should be used? A literal reading of Regs. Sec. 1.1502-21(c)(1) indicates that the SRLY rules should be applied on a fragmentized basis, despite the fact that, in effect, the members were included in a consolidated return for both the loss and income years.

However, fragmenting a group's NOL carryover merely because its members have been regrouped is contrary to the basic principle underlying the consolidated return regulations—i.e., "taxing as a business unit what in reality is a business unit." (1918 Senate Finance Committee Report.) Obviously, *P* and *S* were the same business unit in both 1974 and 1975. Moreover, they joined in the filing of a consolidated return in both years, though as members of different groups.

In *Midland Management Co.*, 38 TC 211 (1962), involving the pre-1966 regulations, the taxpayer contended that "the business unit" concept required that a consolidated NOL carryback should include the NOL of an affiliate which was formed by a member of the group after the deduction year. The Tax Court rejected the taxpayer's contention, but the IRS stipulated to a reversal of the decision and adopted the taxpayer's position in Rev. Rul. 64-93. This view is reflected in Regs. Sec. 1.1502-21(b)(1). Thus, in effect, the IRS conceded that the SRLY rule does not apply on a member-by-member basis where the form of a business unit (one corporation) has been fragmented (into two corporations).

Literally, Regs. Sec. 1.1502-1(e) and (f) treat the regrouping of affiliates as a disaffiliation event, triggering the SRLY limitation on NOLs. This is inconsistent with sections of the regulations which do not regard regrouping of affiliates as a disaffiliation event when a consolidated return is filed for the year in which the acquisition occurs. For example, if there was a deferred gain on an intercompany transaction between *P* and *S*, the sale of *P*'s stock to *N-P* would not trigger recognition of such gain. See Regs. Sec. 1.1502-13(f)(2)(i)(a).

Similarly, the sale of *P*'s stock to *N-P* would not be treated as a disaffiliation event for the purposes of

—restoring any initial inventory adjustment (assuming *S*'s opening inventory reflected profits on purchases of goods from *P*) under Regs. Sec. 1.1502-18(c)(4)(i); or

—recognition of gain on account of any excess loss account (negative basis for *S* stock and advances) under Regs. Sec. 1.1502-19(g)(1)(i).

Therefore, the application of the SRLY regulation, as it seems to literally read, to a regrouping of affiliates is not only contrary to the basic principle of the consolidated return regulations ("taxing as a business unit what in reality is a business unit") but is also inconsistent with several provisions of the regulations which do not regard regrouping as a disaffiliation event (as between or among the regrouped affiliates).

Consolidated returns: allocation of new member's foreign tax credit

When determining the amount of foreign tax credit allowed to an affiliated group for foreign taxes paid or accrued during a consolidated return year, the credit is computed on a consolidated basis. Under both the per-country limitation and the overall limitation, the numerator in the formula for determining the amount of the consolidated tax liability allocable to the foreign source income is calculated by combining the separate foreign taxable income of each member. But what happens if a member joins the group during the year and such member accrues its foreign tax credit at the end of its year? In general, a foreign tax accrues when all the events that fix the amount and liability of the taxpayer have occurred, which is normally at the end of the year. However, in accordance with Rev. Rul. 75-532, the corporation will be required to allocate its foreign tax credit.

For example, suppose *ABC*, an affiliated group, acquired all of the stock of *X*, a U.S. corporation, on July 1, 1975. All of the companies are on the accrual method of accounting and file their returns on a calendar year basis. *X* is in the export business, deriving all of its income from its branch in Spain. *X* filed a tax return with the Spanish authorities and accrued the Spanish taxes for book purposes.

In accordance with Regs. Sec. 1.1502-76(b)(1) and (2), *X* must report its 1975 taxable income from Jan. 1 through June 30 in a separate return and its income from July 1 through Dec. 31 in *ABC*'s consolidated return. Regs. Sec. 1.1502-76(b)(4) states that the taxable income reportable on each such return shall be determined on the basis of *X*'s income shown on its permanent records (including workpapers). Otherwise, an allocation formula must be used, based on the following fraction:

$$\frac{\text{Number of days covered by return}}{365}.$$

Likewise, under Rev. Rul. 75-532, the Spanish tax liability that accrued on Dec. 31, 1975, must also be allocated between *X*'s separate return and the consolidated return. The ruling further states that the amount of foreign income tax liability to be allocated to the consolidated foreign tax credit is limited by the following ratio:

$$\frac{X\text{'s taxable income included in consolidated return}}{X\text{'s total 1975 taxable income}}$$

X's taxable income for this purpose is determined in accordance with U.S. standards.

Consolidated returns and Lifo inventories

The growing popularity of Lifo has raised a number of interesting questions with respect to the effects of Lifo upon intercompany profits in inventory in the context of a consolidated federal income tax return. Fortunately, there is specific reference to the Lifo method contained in Regs. Sec. 1.1502-13(f)(1)(i), which states that the determination of whether inventory (with respect to which an intercompany profit had been realized) is disposed of outside the group shall be made "by reference to [the owning company's] method of inventory identification (e.g., first-in, first-out, last-in, first-out, or specific identification)." Further in this vein, Regs. Sec. 1.1502-18(a) includes this section by reference for the purpose of the operation of the rules with respect to the "initial inventory amount" and the "unrecovered inventory amount." It therefore seems reasonable to assume that the LIFO assumptions as to what goods are on hand are applied to all situations in which the identification of inventories could be relevant.

Assume a situation in which an affiliated group has been in existence for many years. The group has filed separate returns up through 1974 but will file a consolidated return for 1975. One member (the "selling company") has for many years been selling goods to another member (the "owning company") at a profit. Comments with respect to the various possibilities follow. It is to be borne in mind that the entire focus of Regs. Secs. 1.1502-13 and -18 is upon the selling company and generally it is by reference to the selling company that all computations are made. However, the inventory method employed by the owning company will determine the treatment by the selling company.

Addition of initial inventory amount to taxable income. Under Regs. Sec. 1.1502-18(b), a selling company is required to include in its income for any consolidated return year the intercompany profits attributable to goods upon which it had realized intercompany profits in years prior to the consolidated return. This inclusion takes place *when the related goods are disposed of outside the group* (or when the owning company becomes a nonmember). In a first-in, first-out situation, the intercompany sales usually, though not necessarily, occur in the most recent separate return year, and the disposition outside the group usually, though not necessarily, occurs during the first consolidated year. Application of this section in a Lifo context results in the following observations:

- If the owning company adopts Lifo for the first time for calendar year 1975, there will be no addition to the selling company's income for the initial inventory amount unless and until there is a reduction in the inventory quantity of the owning company from the level existing at Jan. 1, 1975.
- If the owning company had employed Lifo for several years, the initial inventory amount would be determined by reference to the profits realized in the year or years in which the owning company's Lifo layers were built up, and there would be no inclusion of such initial inventory amount in income until those Lifo layers were liquidated.

Recovery of initial inventory amount. The same principles would be applied under Regs. Sec. 1.1502-18(c). Notice, however, that when the owning company is using Lifo, the inclusion of the initial inventory amount in taxable income of the selling company would always occur in the same taxable year in which an ordinary loss is allowable under Regs. Sec. 1.1502-18(c)(2)(i) by reason of the intercompany inventory amount for such taxable year being lower than the initial inventory amount. It is such lower amount which, as noted above, is necessary in order to require the inclusion in income of the initial inventory amount.

Deferral of gain from deferred intercompany transactions. Intercompany profits realized by the selling company on sales to an owning company which uses the Lifo method during 1975 or any future consolidated return year will not be deferred unless there is an increase in the owning company's inventory. Without such an increase, all goods purchased by the owning company are deemed, under the Lifo method, to have been disposed of during the same taxable year. Only if there is an increase in the owning company's inventory could there be a deferred intercompany transaction which would result in the deferral or elimination of gain. In the simple case of computing Lifo by reference to specific units of raw materials (e.g., pounds of copper) as described in Regs. Sec. 1.472-1(c), whether there is gain to be deferred will be dependent upon whether any purchases from the selling company were included in those purchases by reference to which the Lifo inventory increases are valued (i.e., earliest purchases, latest purchases, or an average of all purchases for the year), pursuant to Regs. Sec. 1.472-2(d)(1)(i).

Special problems of statistical Lifo methods. Assume that the owning company first made a Lifo election in 1975 under the double-extension method of dollar-value Lifo, as described in Regs. Sec. 1.472-8(e)(2). It appears logical that the results obtained should be assimilated to those obtained in the case of Lifo by reference to specific units of raw material. Accordingly, there would be no addition to income of initial inventory amount unless there is a reduction in inventory quantity (expressed in base-year cost) of the owning company from the level existing at Jan. 1, 1975, even though in fact the closing inventory contained no intercompany goods and the "base-year cost" and "current-year cost" extensions contained no intercompany purchases. Also under this approach, there would be no deferral of gain from intercompany sales during a consolidated return year when there was no increase in inventory expressed in base-year cost, even though significant intercompany goods may have been included in the owning company's closing inventory or intercompany purchases were taken into account in determining the "current-year cost" extension.

It seems appropriate to treat intercompany goods and profits thereon by a proportionate approach in the case of either additions to layers or liquidations of layers. For example, if 10% of a Lifo inventory layer was liquidated, it seems appropriate to deem that there was also a 10% reduction in the intercompany profit contained in such layer. Similarly, if there was a new layer added, it seems reasonable to determine intercompany profit on the basis of the proportion of intercompany purchases to total purchases during the year. However, an alternative might be to use the proportion of intercompany goods included in the closing inventory, or even the proportion of intercompany purchases included in the determination of "current-year cost" in the case of the double-extension method.

In the case of either the link-chain method or the retail method, reference to the proportion of intercompany goods contained in the year-end inventory would seem appropriate to determine the amount of intercompany profit included in a new Lifo layer. Liquidations of layers could be made on a proportionate approach as in the case of the double-extension method.

Consolidated returns: excess loss account trap

An affiliated group of corporations filing a consolidated tax return can offset the losses of its loss members against the taxable income of its profit members. However, a potential trap lurks in the background. This is the annual investment adjustment that is required to reflect a subsidiary's NOL included in consolidated taxable income for the year. This adjustment reduces the parent's basis in the subsidiary's stock.

 When the basis drops below zero, an excess loss account is created. The excess loss account is, in essence, equivalent to negative basis.

The sale or other disposition of the stock of a subsidiary to an unrelated person triggers recapture of the negative basis. Immediately before the disposition of the stock of the subsidiary, the parent must include in income the amount of the excess loss account for such stock. The income realized as restoration of the negative basis generally is treated as capital gain from the sale of stock.

However, if the subsidiary is insolvent, recapture of the excess loss account may be triggered without a sale of stock. Where the subsidiary is insolvent, the entire excess loss account is taxed as ordinary income to the extent of insolvency; any remainder of the excess loss account is taxed as a capital gain. A "disposition" of stock in a subsidiary is considered to have occurred in the following situations (even though the stock has not been transferred):

- The stock has become wholly worthless;
- A debt of the subsidiary was forgiven without realization of income due to insolvency;
- 10% or less of the subsidiary's obligations are recoverable by its creditors at maturity;
- A member of the consolidated group transferred an obligation of the loss subsidiary to a nonmember at a discount of 75% or more;
- Either the parent or subsidiary are no longer members of the consolidated group; or
- A consolidated return is no longer filed.

For the time when such income is deemed to be realized, see Regs. Sec. 1.1502-19(b)(2).

A recent Tax Court case, *Covil Insulation Co., Inc.*, 65 TC 364 (1975), upheld the regulations requiring a parent corporation filing a consolidated return to reduce its basis in its subsidiary's stock to a figure below zero and to include in its income the amount of the excess loss account of an insolvent subsidiary in one of the circumstances listed above.

The Court indicated that since the regulations allow a consolidated group to use losses in excess of basis in a loss subsidiary, the requirement that the excess loss account be included in the group's income when the subsidiary is disposed of merely brings the tax results in line with the economic results of the group's ownership of the subsidiary. This is based on the theory that the losses are temporary since the possibility of an economic turnaround exists. The losses, therefore, must be treated as income by the group where the subsidiary is disposed of prior to this economic turnaround.

The Court reasoned, in addition, that when insolvency occurs, the corporation no longer has assets susceptible to its shareholders' claims. The economic loss generated by the insolvent subsidiary is borne by someone other than the shareholders, namely the creditors. When the group utilizes these losses, it receives a deduction against ordinary income, unrelated to its then extinct capital investment. Therefore, the excess loss account is justifiably converted to ordinary income.

Some of the steps which may be taken to avoid the triggering of an excess loss account's conversion to ordinary income include the following:

- A contribution to capital of intercompany loans to the extent of the excess loss account;
- An election to reduce the basis of loans to the loss subsidiary by the excess loss account pursuant to Regs. Sec. 1.1502-19(a)(6);
- A deemed dividend election (the effect of which will be, generally, to increase the basis in the stock to the extent of pre-consolidated but post-affiliated earnings and profits);
- Tax-free liquidation of the subsidiary into the parent (this may require capitalizing loans by the parent since the subsidiary must be solvent in order to have a tax-free liquidation); and
- Merger with a profitable affiliate (the effect of which will be to increase the basis of the loss subsidiary stock by the basis of the profitable affiliate).

Note that if the excess loss account is recaptured, the parent corporation will be allowed a bad debt deduction to the extent that any loans outstanding are worthless.

Consolidated returns: NOL carryover offsetting ordinary income vs. capital gain

The question of whether, under certain circumstances, a net operating loss (NOL) can, in effect, be carried over and

Sec. 1502 deducted from consolidated capital gain or consolidated ordinary income is best illustrated by a simple example.

> *Example.* Corporation *A* owns a number of subsidiaries and on January 1, 1975, it acquired all of the outstanding stock of Corporation *X*. *A* and its subsidiaries have filed consolidated returns and intend to do so for 1975. *X* has a $100,000 NOL carryover available in 1975 from prior years. The business operations of *X* during 1975 were at a break-even point; however, during 1975 *X* had a long-term capital gain of $100,000. Can the NOL carryover of *X* be used in the 1975 consolidated return and if so is it used only to offset the long-term capital gain of *X*?

Deductibility. The question of deductibility is answered by the consolidated regulations. The NOL carryover was incurred prior to the acquisition of the *X* stock by *A*, therefore, such loss is a separate return limitation year (SRLY) loss. The general rule applies, that is, the consolidated NOL deduction is equal to the sum of any consolidated NOLs of the group plus any NOLs sustained by members of the group in separate return years which may be carried over to the taxable year. Regs. Sec. 1.1502-21(c)(2) sets forth the limitation on NOL carryovers from a SRLY. In essence, the carryover loss of *X* which is allowable in the consolidated return is limited to the taxable income of *X*. Thus, the regulations allow the $100,000 NOL of *X* to be deducted in the 1975 consolidated return.

Ordinary income vs. capital gain. Having established the deductibility, the tax computation is based upon consolidated figures, that is, consolidated gross income, which includes consolidated long-term capital gain, and consolidated deductions, which includes the consolidated NOL deduction. The alternative tax computation under Sec. 1201 is available based upon the consolidated figures. Thus, in the above example, the long-term capital gain is taxed at the alternative rate of 30% and the NOL carryover of *X* is, in effect, deducted from the taxable ordinary income of other members of the consolidated group.

This treatment has been challenged in at least one instance by an examining agent who contended that since the NOL carryover is allowable only because of the existence of the net capital gain income of *X*, it should be used as an offset to such gain with the result that such gain is not a part of the consolidated taxable income. By reason of a request for technical advice, the National Office in at least one case has held that the alternative tax computation used by the taxpayer was correct.

Consolidated return: basis adjustment on sale of subsidiary

A question was recently raised involving a possible basis adjustment under Regs. Sec. 1.1502-32(g) in the following case:

> On January 15, 1974, the stock of subsidiary *X* (included in consolidated group *A*) was sold to consolidated group *B*. Both groups file calendar year returns. *X* elects under the 30-day rule to be included in the consolidated return of *B*, as if *X* had become a member of *B*'s group on January 1, 1974. (Regs. Sec. 1.1502-76(b)(5)(i).) Thus, the January 1-15 period will be included in *B*'s consolidated return even though *A* still legally and beneficially owned the *X* stock during that period.

In this case, Regs. Sec. 1.1502-32(g) seems to require a basis write-down of *X* stock as of the first day of the first separate return year of *X* (which by definition includes a year a corporation joins in the filing of a consolidated return of another group).

Generally, the basis write-down of Regs. Sec. 1.1502-32(g) does not apply to situations involving the sale of all of a subsidiary's stock because on the date of sale the former parent does not own any subsidiary stock that the basis write-down could apply to.

On the other hand, where the 30-day rule is applicable, the parent does own the stock of the subsidiary on a day or days it is included in another consolidated return; thus a basis adjustment might appear to be required. This anomalous result is apparently avoided by the language of Regs. Sec. 1.1502-76(b)(5)(i), which suggests that if the 30-day rule is elected, *X* will be treated for all purposes of Sec. 1502 as if owned by *B* on and after January 1, 1974.

In any event, a deemed dividend election (Regs. Sec. 1.1502-32(f)(2)) should effectively eliminate any potential adjustment under Regs. Sec. 1.1502-32(g).

Sec. 1502

Consolidated return: time for payment of tax on new member's pre- and post-affiliation income

When a new member is acquired by an affiliated group during a year for which the group is filing a consolidated return, the general rule is that

—the new member's income for the short period commencing on the first day of its normal taxable year and ending on the date of acquisition is included in a separate return, and

—the new member's income for the short period following the date of acquisition to the close of the affiliated group's taxable year ending thereafter is included in the consolidated return for that year.

However, if either short period is 30 days or less, it may be disregarded at the taxpayer's option; thus the new member's *entire income* from the beginning of its normal taxable year to the close of the first consolidated return ending after the acquisition would be included in or excluded from such return. (Regs. Sec. 1.1502-76(b).)

When the short period for which the new member must file a separate return is less than four months, questions arise as to the time for payment of the new member's tax liability on its income for such period and for the period during which its income is included in the consolidated return. Consider the following facts:

> *P* and *S-1*, members of an affiliated group having a fiscal year ending March 31, have filed consolidated returns for several years. As of the close of business of December 31, 1973, *P* acquires for cash all of the stock of *S-2*, whose normal taxable year ends September 30. For the short period ended December 31, 1973, the taxable income of S-2 is $1,000,000; for the period after December 31, 1973, to the end of the group's taxable year (i.e., January 1-March 31, 1974), S-2's taxable income is $3,000,000.

When must the tax liabilities of *S-2* for the two periods be paid?

Tax on consolidated return income. After a group has filed a consolidated return for two consecutive taxable years, apparently, it must pay its estimated tax on a consolidated basis for each subsequent consolidated return year. (Regs. Sec.

1.1502-5(a)(1).) When estimated tax payments on a consolidated basis are required, the group is treated as a single taxpayer for the purpose of the exceptions to the penalty for underestimation provided in Sec. 6655(d)(1) and (2), relating to estimates based on the prior year's tax liability or taxable income.

If the estimated tax payments are based on the actual tax liability of the group for the preceding year, there is no underestimation penalty, even though a member included in the group for the preceding year has left the group or a new member has been added to the group during the current year. (Regs. Sec. 1.1502-5(c), Examples (2) and (3).) Thus, assuming *P* and *S-1* based their estimated tax payments on the consolidated return liability for the year ended March 31, 1973, no additional estimated tax would have to be paid on the $3,000,000 earned by *S-2* after December 31, 1973.

Of course, no estimated tax would be payable by the group as such on the $1,000,000 earned by *S-2* in the short period ended December 31, 1973, because that three-month period is a separate taxable "year" of *S-2* for which a separate return will be filed. (Regs. Sec. 1.1502-5(c), Example (3).) Thus, the tax for the three-month period ended March 31, 1974, would not become due until June 15, 1974, the due date for filing the group's consolidated return for the year ended March 31, 1974; under Sec. 6152, the group could elect to pay the tax in two installments, the first on June 15, and the second on September 15, 1974.

Tax on separate return income. *S-2* should not have to pay any estimated tax for the three-month short period ended December 31, 1973, since Sec. 6154(b) provides that a corporation's first installment of estimated tax is not due until the 15th day of the fourth month of the taxable year. *S-2*'s taxable year, being only three months in duration, ended before the first installment was due. This conclusion would have been certain prior to the repeal of Sec. 6016, which had required the filing of declarations of estimated income tax by corporations. See Regs. Sec. 1.6016-4(a)(2)(i), which provided that corporations need not file declarations for periods of less than four months.

However, the repeal of Sec. 6016, effective May 31, 1968, has made the above mentioned regulations inapplicable so that now, in effect, there are no regulations relating to the

Sec. 1502

payment of estimated taxes by corporations for such short years. It is difficult, however, to see how a corporation could be required to pay estimated tax for the first time on the 15th day of the fourth month of its taxable year when the taxable year is only three months long. Furthermore, the legislative history indicates that the repeal of Sec. 6016 was not intended to change the due dates for making payments on account of estimated taxes. (See the committee reports, 1968-2 CB 782.)

Assuming that S-2 need not pay any estimated tax for the short period ended December 31, 1973, when must the tax be paid? Sec. 6151 provides that the tax shall be paid "at the time and place fixed for filing the return (determined without regard to any extension of time for filing the return)."

Normally, a corporation's short period return, required because of a change in accounting period, must be filed by the 15th day of the third month following the end of the short period. However, when a consolidated return is to be filed and the short period return of the subsidiary is required in order to conform the subsidiary's accounting period to that of the parent, the initial due date of the short period return is the earlier of the following dates:

- The date on which the subsidiary would be required to file the return for its normal taxable year or
- The date on which the consolidated return is filed. (Regs. Sec. 1.1502-76(c)(1) and (2).)

Thus, if the consolidated return of the *P* group for the year ended March 31, 1974, were filed on June 15, 1974, that date would also be the due date of S-2's short period return and, under Sec. 6151, would also be the date on which the tax for the short period is required to be paid.

However, if the *P* group were to obtain a double extension of time to December 15, 1974 (which also would be the due date of S-2's return for its normal taxable year ended September 30, 1974), S-2's short period return and the tax shown thereon would not be due until that date. (Regs. Sec. 1.1502-76(c)(1).) Under Sec. 6152, S-2 might elect to pay the tax in two installments, the first "on the date prescribed for the payment of the tax, and the second on or before three months after such date." Thus, the tax would be payable in two installments on December 15, 1974, and March 15, 1975.

The aforementioned provisions of the consolidated return regulations coupled with Secs. 6151 and 6152 appear to provide an opportunity to defer the payment of tax for the short period of a new member of a consolidated group through judicious timing of the acquisition (assuming such timing is otherwise feasible) and obtaining extensions of time for filing the group's consolidated return for the year during which the acquisition occurred. *Sec. 1502*

Consolidated returns: foreign corporation trap under Sec. 367

Sec. 1504

A potential trap awaits the unwary affiliated group which elects, under Sec. 1504(d), to include a Canadian or Mexican subsidiary in a consolidated return. It is understood that the Service views such an election as a transfer of assets from a foreign corporation to a domestic corporation and will tax any gain on such transfer unless advance clearance under Sec. 367 is obtained. Similar clearance would be required upon termination of the Sec. 1504(d) election.

Requesting a ruling under Sec. 367 in making or terminating a Sec. 1504(d) election will require a taxpayer to agree to "tollgate charges" as provided by Rev. Proc. 68-23. The "toll" on making the election will be a "pick-up" by the domestic parent of the accumulated earnings and profits of the foreign subsidiary as a dividend from a foreign corporation. The "toll" on terminating the election would be on a domestic tax on the unrealized appreciation on the "tainted" assets that would be prohibited from out-of-country transfer under Sec. 351 pursuant to Rev. Proc. 68-23.

It is not clear whether the Sec. 367 ruling must be obtained before the first day of the taxable year for which the election is to be made.

Controlled corporations

. . . maximizing surtax exemptions

Sec. 1561

The maximization of tax benefits arising from proper utilization of the corporate surtax exemption has always been an important tax planning goal. With multiple surtax exemptions no longer available, members of a controlled group will be limited to a single surtax exemption. However, proper tax planning may increase the allowable exemptions when an affiliated corporation is acquired, sold, or liquidated.

Acquisition of related corporation. A corporation is not limited to its allocated share of the surtax exemption of the controlled group with which it is affiliated on December 31 if it has been a member of such group for less than one-half of the days in its taxable year which precedes December 31. For example, assume both *P* and *S* are calendar year corporations and neither is a member of a controlled group. If *P* acquires 100% of the stock of *S* on July 15, 1977 (i.e., one month later), share a single surtax exemption in computing their respective 1977 income tax liability, since *S* has been a member of the controlled group for at least one-half of the days in its taxable year which precedes Dec. 31, 1977. However, if *P* acquires 100% of the stock of *S* on July 15, 1977 (i.e., one month later), each will be entitled to its own exemption since *S* has been affiliated with *P* for less than one-half of the days in its taxable year which precedes Dec. 31, 1977.

Sale of related corporation. Even though a corporation is not a member of an affiliated group on December 31, it may nevertheless be limited to its allocated share of the surtax exemption if it has been a member of an affiliated group for one-half or more of the days in its taxable year that precedes December 31. For example, assume *P* and *S* are calendar year corporations that are not affiliated with any other corporations. *P* owns 100% of the stock of *S*. If *S* is sold to an unrelated individual who owns no stock in any other corporation on June 15, 1977, *P* and *S* will each be entitled to surtax exemptions in computing their 1977 income tax liability since *S* has been affiliated with *P* for less than one-half of the days in its taxable year which precedes Dec. 31, 1977. However, if *S* is sold to the same individual on July 15, 1977 (i.e., one month later), *P* and *S* will each be limited to their share of a single surtax exemption in computing their respective 1977 income tax liability, since *P* was affiliated with *S* for more than one-half of the days in its taxable year which precedes Dec. 31, 1977.

Liquidation of related corporation. When a component member of a controlled group is no longer in existence on

December 31, it does not affect the surtax exemption allowed other members of the controlled group for that December 31. For example, *P* and *S* are calendar year corporations and the only members of a controlled group. On Dec. 1, 1977, *S* is liquidated. *P* will be entitled to a surtax exemption in computing its 1977 income tax liability even though *S* has been affiliated with *P* for more than one-half of the days in its taxable year which precedes Dec. 31, 1977.

When a member of a controlled group of corporations is liquidated prior to December 31, resulting in a short period, it is also entitled to a pro rata portion of the controlled group's exemption determined as of the last day of its short taxable year. This exemption is in addition to the normal exemption allowed surviving members of the controlled group. For example, assume *P* and *S* are calendar year corporations and neither is a member of a controlled group. *P* acquires 100% of the stock of *S* on April 1, 1977. If *S* is liquidated on April 30, it will be entitled to a full exemption in computing its income tax liability for its short taxable year ended April 30, 1977, since *S* was a member of a controlled group for less than one-half of the days in its taxable year which preceded April 30, the date of liquidation. However, if *S* is liquidated on Nov. 30, 1977, its surtax exemption would be limited to one-half in computing its income tax liability for its short taxable year ended November 30, since it had been a member of a controlled group for at least one-half of the days in its taxable year which preceded Nov. 30, 1977. *P* will be entitled to a full exemption on December 31 if *S* has been liquidated by such date.

Surtax exemption: what a difference a day makes

Obtaining the benefit of an additional surtax exemption is usually not an overriding consideration when a taxpayer acquires the stock of a corporation. However, timing of the acquisition or effecting an accounting period change can produce a benefit that otherwise may be lost.

Suppose *A*, an individual, owns all the stock of calendar-year corporations *P* and *S*. On July 31, 1975, *A* acquires all of the stock of *T* corporation which uses a March 31 accounting period and is not a component member of a controlled group

Sec. 1561 prior to the acquisition. If *T*, an extremely profitable company, changes its accounting period to November 30, it can avoid being treated as a component member of a controlled group of corporations for *T*'s short taxable year ended Nov. 30, 1975. (If *T* were treated as a component member for its short taxable year, Sec. 1561(b) would require an allocation of one-third of a single surtax exemption to *T* for its short taxable year.)

In discussing short taxable years, Sec. 1561 provides that the last day of the short taxable year (November 30) will be substituted for December 31 in determining *T*'s component member status under Sec. 1563(b). For *T* to be considered an excluded member, and entitled to a full surtax exemption in computing its short-period taxable income, *T* must have been a member of the *P/S* group for less than one-half the number of days in its short taxable year preceding Nov. 30, 1975.

Examples in Regs. Sec. 1.1563-1(b)(4) indicate that *T* should not be treated as a member of the *P/S* group on the day it was acquired. Thus, a comparison of the number of days between April 1 and July 31, inclusive (122 days), and the number of days between August 1 and November 29, inclusive (121 days), results in *T* being treated as an excluded member for its short taxable year.

Sec. 1563 Multiple surtax exemptions through partnership

From a business standpoint the ownership of multiple operating corporations by several individuals may be more desirable through a partnership rather than a corporation. Also, under certain circumstances, the ownership of a group of corporations by a small number of investors may be more advantageous from a tax standpoint if the ownership is through a partnership rather than through a corporation. For example, assume a group of individuals plan to purchase all of the stock of a number of retail outlets, each separately incorporated. The initial reaction is to have the individuals form a corporation and have the newly-formed corporation acquire all of the stock of the retail corporations. It may be more advantageous, however, to have the individuals form a partnership (or use an existing partnership) and have the partnership acquire all of the stock of the retail corporations.

For taxable years beginning with the calendar year 1975 the privilege of a controlled group of corporations to elect multiple surtax exemptions has been repealed. All parent-subsidiary and brother-sister controlled groups are now limited to one $50,000 surtax exemption, as well as one $150,000 accumulated earnings credit. See Sec. 1561. *Sec. 1563*

If a corporation were used to acquire the retail corporations, the parent company and the retail subsidiaries would be members of a controlled group and would be entitled to only one surtax exemption. This is true regardless of the number of shareholders of the holding company parent. However, if a partnership is used, instead of a corporate holding company, to hold the stock of the retail corporations, it may be possible to obtain multiple surtax exemptions. The result depends upon the number and ownership interests of the partners. The ownership of the underlying corporations is attributed to the partners (having an interest of at least 5% in capital or profits) through the partnership. See Sec. 1563(e)(2). If five or fewer individuals own stock (directly or indirectly) possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and if this group owns more than 50% taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each corporation, then the corporations constitute members of a brother-sister controlled group. See Sec. 1561(a)(2). Note that both tests must be met. If the 80% test is not met, the corporations are not a controlled group and are entitled to multiple surtax exemptions.

Thus, to meet the test would require at least seven partners with the top five holding partnership interests totalling no more than 79%.

It is interesting to note that if the recent case, *Fairfax Auto Parts*, 65 TC No. 69 (1976), is good law, Regs. Sec. 1.1563-1(a)(3) with respect to ownership of brother-sister corporations is more restrictive than Congress intended. Hence, some brother-sister controlled groups that were precluded from using multiple surtax exemptions under the regulations may be eligible to do so.

Editor's note: See also T. L. Hunt, Inc., *TC Memo 1976-221 (7/14/76) for a taxpayer victory on the same point as* Fairfax. *Also,* Fairfax *is on appeal to CA-4.*

Estate and gift taxes

Sec. 2031 Private annuity clauses in wills

The recent Tax Court decision in *Estate of Lloyd G. Bell*, 60 TC 469, dealing with private annuities, may be the first step in the determination of the validity of Rev. Rul. 69-74. However, the Court bypassed this issue on the ground that the annuity in *Bell* was amply secured while the annuity in the ruling was not. At present, the tax effect of exchanging appreciated property for an annuity remains uncertain, and private annuity transactions may be inhibited.

In any event, one type of private annuity transaction seems to present no problems. This is the situation where the surviving spouse enters into an annuity contract with the trustee of her husband's testamentary trust. Typically, the property she is transferring has a date-of-death tax basis, and thus there is little or no unrealized appreciation to be subject to taxation, the problem with which Rev. Rul. 69-74 and its predecessor Rev. Rul. 239 are concerned. The widow gets an annuity exclusion and the property is out of her taxable estate. Any actuarial gain goes to the beneficiaries of her husband's trust, usually their children, while any actuarial loss comes out of the trust; this accords with the decedent's intent, which usually is to make sure that his wife has adequate income for life.

But without advance planning, there will usually be either no private annuity for the widow or there will be valuation problems. Few trustees are eager to enter into annuity transactions, since they fear potential liability to the ultimate beneficiaries of the trust. If they do, they are unlikely to feel comfortable determining the annuity amount under the now low interest rate tables prescribed in the income and estate tax regulations. Yet those are the tables to be used unless a strong case can be made that they are arbitrary and unreasonable under the circumstances. (*Dix*, John C.W., CA-4, 392 F2d 313 (1968).)

The solution is to insert language into the will and the trust instrument which directs that the sale of a private annuity be made if requested by the surviving spouse, with the amount of the annuity payment to be made determined in accordance with Regs. Sec. 20.2031-10 or subsequent provisions. On one hand, such language does not bind the surviving spouse to request that a private annuity be sold her; on the other hand, it does make possible the use of this device if it seems appropriate under the circumstances existing following the husband's death. *Sec. 2031*

Ready reference table for dividends declared before death

Sec. 2032

The handling of dividends declared before, but payable after, the date of death of a decedent-stockholder is a matter which requires careful review each time it arises. The following table has been designed to act as a ready reference guide in this matter.

There are three possible different periods of time with respect to such dividends. Death may occur during the period:

I. From the declaration date to the day before the stock sells "ex-dividend" (or before the record date in the case of shares not listed on an exchange);

II. From the ex-dividend date to the day before the record date (not applicable to shares not listed on an exchange); or

III. From the record date to the day before the payment date.

Based upon Rev. Ruls. 54-399, 60-124, and 68-610, and citations therein, the tax treatment to be accorded to each of these three possibilities may be summarized as follows:

	Dividend falling in time category		
Tax aspect	I	II	III
Includible in gross estate as a separate item (which is "included property" for the purpose of the alternate valuation)	No	No	Yes
Not includible in gross estate as a separate item but is added to the quoted market in order to determine fair market value	No	Yes	No
Collection gives rise to Sec. 691(a) income	No	No	Yes

Sec. 2032

Collection gives rise to Sec. 691(c) deduction	No	No	Yes
Collection gives rise to income which is not Sec. 691(a) income	Yes	Yes	No

Parallel rules apply for determining the fair market value of the shares on the alternate valuation date.

Sec. 2033 Estate tax: wrongful death proceeds not includible in gross estate

With the publication of Rev. Ruls. 75-126 and 75-127, the Service has apparently conceded that wrongful death proceeds are not includible in the gross estate.

As was pointed out in Rev. Rul. 75-127, there are two types of state wrongful death acts—"survival acts" and "death acts." The "survival acts" permit the institution of a suit, which the decedent could have brought, by the executor or administrator. The "death acts" permit a new cause of action to be brought by the executor for the benefit of the beneficiaries, not the estate.

In Rev. Rul. 54-19, the Service acknowledged that the proceeds from a "death act" suit are not includible in the estate because no cause of action existed until after the decedent's death. It did, however, try to include the "survival act" proceeds in the estate under Sec. 2033 or Sec. 2041. The IRS's argument was that since this is the survival of a suit which the decedent could have brought, he had either an interest in or a power of appointment over the proceeds. After having lost several cases on these grounds the IRS has conceded that even under the "survival act," no cause of action existed prior to death; therefore, nothing is includible in the estate.

Taken together, the three Rev. Ruls. apparently rule out the inclusion of the proceeds in the estate. Therefore, any executor may proceed with any lawful suit without worrying about whether it is for the benefit of the beneficiaries or the estate.

One word of caution is in order. The rulings specifically exclude amounts for pain and suffering from the exemption. These amounts will have to be included in the gross estate. If the suit covers these amounts as well as wrongful death proceeds, the executor should be sure that the dollar amount of each is specified. Otherwise, there could still be a disagreement as to the amount to be included. *Sec. 2033*

Estate tax: Sec. 2039(a) and employee's joint annuity with survivorship rights

Sec. 2039

Employers, particularly closely-held corporations, frequently enter into retirement contracts with key employees. A typical contract might provide for paying an employee $25,000 per year for twenty years upon the earliest of death, disability, or normal retirement. If, after disability or retirement, the employee dies prior to the expiration of the twenty-year period, the payments would go to his surviving spouse until the earlier of her death or the expiration of the original twenty-year period. In essence, this contract is a joint annuity with survivorship rights for the employee's spouse.

Assume an employee and his employer enter into a contract with the terms described above, and the employee dies at age 67 after receiving annuity payments for two years. Also, assume at the employee's death that his spouse is age 62. The survivorship annuity would be included in the employee's gross estate under Sec. 2039(a). The value attached to the annuity would be an actuarial value of approximately $228,000 computed under Regs. Sec. 20.2031-10(e). The estate tax on this amount could be significant.

Two cases, *Kramer*, Ct. Cls., 406 F2d 1363 (1969), and *Est. of Fusz*, 46 TC 214 (1966), acq., suggest a partial alternative to this unfavorable estate tax result. In lieu of the annuity arrangement, the employee and employer could enter into two separate contracts. The first contract would be an employment contract for part-time services, and for a definite period, such as five years, but subject to renewal. The intent would be that the contract be renewed at least several times or until the employee's death. The second contract would provide for death benefit payments to the employee's spouse upon his death. The exact terms of the two contracts together could be such that the employer's economic obligation to the employee would be essentially the same as in the annuity arrangement described above.

The benefit of the *Fusz* and *Kramer* approach is that upon the employee's death, the value of the two contracts would not be included in his gross estate. Since the payments under the employment contract cease at the employee's death, there would be no value relating to this contract included in his estate. With regard to the death benefit contract, two basic requirements must be satisfied if the death benefit contract is to be included in the employee's gross estate:

- There must be an "annuity or other payment receivable by the beneficiary by reason of surviving the decedent."
- An annuity or other payment also must have been payable to the decedent or he must have possessed the right to receive the payment.

The first requirement is obviously satisfied in our case. The issue in the *Fusz* and *Kramer* cases involved whether or not the second requirement was also satisfied. In those cases, the only payments the decedent received or had a right to receive were in the form of compensation for services rendered. These payments were held by the Courts not to be an "annuity or other payment" under Sec. 2039. In *Fusz*, the Court stated: "the phrase 'other payment' is qualitatively limited to post-employment benefits which, at the very least, are paid or payable during decedent's lifetime."

In spite of case law, a risk exists that the Service would assert that these two contracts in substance are a joint annuity contract with survivorship rights. The key is whether the employment contract actually holds up as a contract for services. If the employee works a significant number of hours per week until his death, the contract would probably not be questioned by the Service. If the employee dies after reaching the normal retirement age for the majority of the employer's employees and is only involved with the company on a part-time advisory basis at the time of his death, the status of the employment contract becomes less certain. If the employee is confined to a nursing home for the last ten years of his life, the employment contract would probably be considered a sham by the Service.

Still, the rationale of the *Fusz* and *Kramer* cases suggests a valuable tax planning alternative in the unqualified retirement contract area. How successful the technique will ultimately be in a particular situation depends largely upon facts which will occur subsequent to the implementation of the necessary contracts. In evaluating the *Fusz* and *Kramer* approach in the retirement contract situation as an alternative to a joint annuity with survivorship rights, it appears that an employee has much to gain in attempting to implement the *Fusz* and *Kramer* approach and very little to lose. *Sec. 2039*

Editor's note: The Courts might view both agreements as one. See Eichstadt, *DC-ND-Cal, 354 F Supp 484 (1972;) and* Bahen, *Ct. Cls., 305 F2d 827 (1962).*

Lifetime vs. testamentary general power of appointment over marital trust

Sec. 2041

The tax adviser will frequently be called upon to review the marital trust provision in a client's will. Occasionally, the will draftsman has provided either an unlimited lifetime general power of appointment, or a "5% or $5,000" limited lifetime power of appointment, over the marital trust in favor of the surviving spouse beneficiary of the trust or a limited power permitting the surviving spouse to withdraw each year, on a noncumulative basis, trust principal in the greater amount of $5,000 or 5% of such principal. Factors which should be considered in providing a power exercisable by the surviving spouse during her life, rather than in her will, include the following:

- The surviving spouse may be more susceptible to influences from remarriage, friendships, and importuning relatives, if she holds a power of appointment which is currently exercisable. Disposition of property under such a lifetime exercise may conflict with the decedent's estate plan. Exercise in the surviving spouse's will is more apt to reflect reasoned decisions by the surviving spouse.
- If the surviving spouse holds an unlimited lifetime general power of appointment, all capital gains of the marital trust will be taxable on her individual return rather than on the fiduciary income tax return of the trust. If the surviving spouse holds a limited lifetime general power of appointment exercisable, typically, over the family trust, in the annual noncumulative greater amount of $5,000 or 5% of the family trust fund, capital gains of that trust will be taxable to the surviving spouse up to that amount. Furthermore, the family trust will be included in the surviving spouse's estate to the extent of this 5% or $5,000 amount as of the time of her death.

Editor's note: The primary considerations usually concern the potential estate tax liability of the survivor's estate. Properly

Sec. 2041 *drafted a "5 or 5" power generally results in taxation only of the unexercised portion in the year of the survivor's death, while an unrestricted general power (lifetime or testamentary) will usually result in inclusion of all property subject to the power.*

Another alternative is an "ascertainable standard" invasion power to meet the survivor's lifetime needs, with a testamentary power limited to a specific class of beneficiaries. Income and capital gains would then be taxed as distributed, there would be no additional estate tax, and the survivor would retain some measure of control.

Sec. 2053 Interest on estate tax installments as administration expense

The IRS has issued Rev. Rul. 75-239 concluding that interest paid by a decedent's estate on estate tax installments does not constitute a deductible administration expense under Sec. 2053 (a)(2). The IRS relied upon the 1939 Code decision in *T. S. Ballance*, CA-7, 347 F2d 419 (1965), where the Court held that interest paid on delayed estate tax payments under a hardship extension should be considered part of the tax itself. The 1939 Code referred to interest on an extended estate tax "as part of such amount" of the tax and a similar provision applied to interest on an estate tax deficiency.

This 1939 Code phrasing does not appear in the 1954 Code Sec. 6601(b) which simply states that "interest shall be paid at the rate of . . ." (but see Sec. 6601(e)(1)). This change in wording, coupled with the holding in the case of *James S. Todd, Jr. Estate*, 57 TC 288 (1971), acq., suggests that the IRS position may be erroneous. The *Todd* case reasons that the deductibility of interest under Sec. 2053 depends on whether such interest is allowable as administration expense under the local law of the jurisdiction where the estate administration is effected.

In view of the dispute as to the administration expense deductibility of interest under Sec. 6601(b), consideration should be given to borrowing funds from a third party for immediate payment of the estate tax. Interest paid on this financing should be deductible under Sec. 2053(a)(2), based upon the IRS acquiescence in the *Todd* case.

Employment taxes

Employment taxes: incentive compensation

Sec. 3121

Many corporations have adopted an incentive compensation plan to reward key management employees for their performance. Typically, an incentive compensation reserve fund will be established for an amount which is dependent upon corporate profits. The covered employees and the amounts to be paid them are decided by a compensation committee. The amounts so awarded may be paid currently or deferred for payment (in the discretion of the committee) after employment is terminated. The amounts deferred are credited by the corporation in shares of its common stock. That part (together with dividend equivalents thereon) is then paid in stock or cash equivalent to the individual employee in equal annual installments (ranging from 10 to 20 depending upon the employee's age), beginning in the year following the year in which the employee terminates his employment with the corporation. There are some plans which pay out the dividend equivalents currently.

Employment taxes. The employment tax regulations provide that FICA tax is required to be withheld on the payment of wages with regard to the employee's portion (Regs. Sec. 31.3102-1(a)) and the employer's portion (Regs. Sec. 31.3111-1).

Payments made to an employee under a plan or system established by an employer, which makes provision for his employees generally or for a class of his employees, on account of retirement are excepted from the definition of wages for FICA purposes (Sec. 3121(a)(2)(A)). It is the position of the IRS that the payments made under the incentive compensation plan described above are not on account of retirement but are made for past services rendered (Rev. Rul. 69-286). Thus, this exception would not apply to deferred payments.

However, excepted from the definition of FICA "wages" are payments made by an employer to an employee which are paid upon termination of an employment relationship (other

Sec. 3121 than a payment which would have been paid if the employment relationship had not been terminated) because of:

- Death;
- Retirement for disability; or
- Retirement after attaining an age specified in the plan for which the payments are made or in a pension plan of the employer.

In addition, the plan must make a provision for the employees generally or a class or classes of employees of the employer (Sec. 3121(a)(13)). Accordingly, if the incentive compensation plan does not specify a retirement age, the deferred payments would not be subject to FICA withholding if the employment relationship has been terminated because of retirement at an age specified in the corporation's pension plan, death, or retirement for disability.

If the plan allows the employee to elect to defer, SSR 75-2 provides that the amounts to be paid upon termination of employment are constructively received for FICA purposes. Accordingly, payments after termination will not be subject to FICA taxes.

The FUTA requirements are the same as those for FICA withholding. Accordingly, if the payments are not wages for FICA purposes, they are also not wages for FUTA purposes.

Withholding. For federal income tax purposes, Sec. 3401(a) and the regulations thereunder define wages as "all remuneration for employment." Sec. 3402(a) provides that every employer making payment of wages shall deduct and withhold taxes on such wages. Remuneration for services, unless such remuneration is specifically exempted by the statute, constitutes wages even though paid at the time the relationship of employer and employee no longer exists between the company in whose employ the services were performed and the individual who performed them (Regs. Sec. 31.3401(a)-1(a)(5)).

The income tax regulations (Regs. Sec. 31.3401(a)-1(b)(1)(i)) exempt from the definition of wages subject to withholding amounts paid to an employee upon retirement, which are taxed as annuities. (There are other exceptions, but they would not apply.) Regs. Sec. 1.72-2(b)(2) states that in order to qualify as an "amount received as an annuity" under Sec. 72, all the following tests must be met:

- The amount must be received on or after the "annuity starting date";

• The amount must be payable in periodic installments at regular intervals; and *Sec. 3121*

• The total of the amounts payable must be determinable at the annuity starting date.

Since the payments in the incentive compensation plan described above are to be made in stock or cash equivalent, valued at date of payment, the third test is not met. Thus, payments would not be excepted from withholding as an annuity.

In this case parent's officers not employees of subsidiaries where no substantial services performed

Sec. 3401

The IRS has often taken the position that individuals who are officers of both a parent corporation and its subsidiaries may be considered employees of the subsidiaries even though they do not receive compensation from the subsidiaries, with the result that the group is liable for duplicate amounts of FICA and FUTA taxes. But taxpayers should be apprised that there is a difference in treatment between "dual" officers who perform "substantial" services for a subsidiary and those who perform only "nominal" services for a subsidiary.

In a recent case, the three top officers of a parent corporation were also the officers of several wholly-owned subsidiary corporations. The officers were involved in negotiating most of the contracts of the parent and some of these contracts were assigned to the subsidiaries for completion. Each subsidiary had its own management personnel who performed the day-to-day operations in accordance with policies established by the parent, and independently made bids on small contracts entered into directly by the subsidiaries.

The three executives were compensated solely by the parent corporation and their services on behalf of the subsidiaries were limited to formal duties such as signing corporate minutes, tax returns, and other legal documents.

In a technical advice memorandum on this case, the IRS National Office pointed out that under Regs. Secs. 31.3121(d)-1(b) (FICA taxes), 31.3306(i)-1 (FUTA taxes), and 31.3401(c)-1 (income tax withholding), an officer of a corporation who performs only minor services for the corporation and who neither receives nor is entitled to receive, directly or

Sec. 3401 indirectly, any remuneration from the corporation is not considered to be an employee of the corporation. Based on the facts in this case, the IRS concluded that the individuals were not employees of the subsidiaries for employment tax purposes because they were not compensated by the subsidiaries and did not perform *substantial* services for them. The position taken by the IRS in the technical advice memorandum has been reflected in Rev. Rul. 74-390.

Sec. 3402 Withholding on real estate salespersons

Changing job relationships in the real estate industry may cause real estate salespersons to be considered employees for withholding tax purposes, according to some IRS personnel.

Such comments are in line with a trend in the courts, which have recently held that taxi drivers and go-go girls were employees rather than "contractors." The Second Circuit has held that Avis "car shuttlers" (persons who occasionally transported Avis cars from one location to another) were employees rather than contractors, *Avis Rent-A-Car System, Inc.*, CA-2, 503 F2d 423 (1974). The significance of this case can hardly be overlooked, since the IRS asserted a deficiency of nearly $200,000 for federal income tax that should have been withheld. Had Avis properly withheld, its cost would have been zero, since the money that should have been withheld was paid out as compensation. There is no way of knowing how many of these payments for "casual labor" were properly reported to IRS on tax returns of the recipients—possibly most of them, but Avis will have the burden of proof. And imagine the problem of attempting to prove that literally thousands of small payments were properly reported to IRS.

According to one IRS official, "real estate salespersons are employees when they work under circumstances that make them subject to supervision and control over details of their work." He indicated that some of the control factors determining the employer-employee relationship included payment of a salary or guaranteed "draw," fixed hours or days of work, such as at a model home site, a requirement that nearly all work be done on the broker's premises, or the right of the broker to interrupt work or set the order of services. Others include requirements by the broker of instruction or training, that a salesperson report on activities, the right of a broker to have first call on a salesperson's time and efforts and to discharge, or the right of a salesperson to terminate. *Sec. 3402*

Many brokers conduct a continuing training program, weekly sales meetings and weekly openhouse caravan tours, all of which a salesperson is required to attend. Some brokers require salespersons to wear distinctive articles of clothing, name tags, and display the firm name on personal vehicles. All of these things may indicate an employer-employee relationship.

For ruling purposes, the National Office still is issuing rulings based upon Mim. 6566 (1951) which holds essentially that real estate salespersons are not employees. This does not mean that at some point in the future the Service may not decide to change its policy based upon the *Avis* line of cases, but it does mean that controversy on this point can be avoided by getting a private ruling.

Private foundations

Qualifying distribution rules dictate careful planning for "pass-through" foundation

Sec. 4942

Private foundations are maintained by many taxpayers to serve solely as a conduit for annual charitable contributions. This procedure provides a great convenience for charitable contributors who rely on the use of low basis-high fair market value securities for fulfilling charitable obligations. Securities can be contributed to a private foundation, sold, and the proceeds distributed to a number of public charities with a good deal less effort and expense than incurred through a multiplicity of transfers, deliveries, and sales.

In order to avoid having the contribution deduction reduced by 50% of the long-term capital gain under Sec. 170(e)(1), Sec. 170(b)(1)(E)(ii) requires that qualifying distributions (as defined in Sec. 4942(g)) equal to 100% of the value of the property contributed be made by the foundation by the 15th day of the third month following the close of the foundation's year. This requirement gives rise to several ques-

Sec. 4942 tions regarding the definition of "qualifying distributions" and a need for careful planning to preserve the full deduction.

For years beginning after Dec. 31, 1972, Regs. Sec. 53.4940-1(f)(1) provides that property is to be treated as held for investment purposes, even though disposed of by the foundation immediately upon its receipt, if it is property which generally produces interest, dividends, or capital gains (through appreciation). This results in the gain from the sale of the property being subjected to the private foundation 4% excise tax on investment income. Because the foundation assumes the donor's basis, a gain will always exist. To the extent of the resulting excise tax, proceeds from sale of the securities will not be available for distribution and it seems clear that payment of the excise tax does not constitute a "qualifying distribution" under Sec. 4942(g).

The proceeds of sale are further reduced by commissions and other expenses of sale. Whether these disbursements are qualifying distributions is not clear. Regs. Sec. 53.4942(a)-3(a)(2) defines the term to include reasonable and necessary administrative expenses paid to accomplish the charitable purposes of Sec. 170(c)(2)(B). If expenses of sale of investments are administrative expenses, no problem exists. However, the point is debatable and no guidance on the question has been found.

Because of the importance of preserving the entire fair market value deduction for the donor, the following procedure is recommended. The donor should make tax deductible cash contributions to the foundation in sufficient amount to pay the foundation excise tax on investment income. The donor should also make a tax deductible cash contribution equal to the difference between the fair market value of the donated property (as deducted on the donor's return) and the net cash proceeds of sale of the property. In this way the foundation can make the necessary qualifying distributions to recognized public charities within the allowable two and one-half month period.

Sec. 4943 Excess business holdings of private foundation: valuation of closely held stock by CPAs

A private foundation which is required to dispose of stock in order not to be liable for the tax on excess business under Sec.

4943 can, by reason of the saving provisions of section 101 of the Tax Reform Act of 1969, dispose of such shares to a disqualified person without causing the disqualified person or the foundation managers to be subject to the self-dealing tax under Sec. 4941. The foundation, however, must receive an amount which equals or exceeds the fair market value of such shares at the time of disposition or at the time when a contract for such disposition is previously executed, provided the transaction would not constitute a prohibited transaction under Sec. 503(b) or corresponding provisions of prior law.

Fair market value, of course, can be a most imprecise and illusive amount. In many cases, it is only determined after negotiation with the IRS. However, an adjustment which is agreed to with the IRS could mean that the saving provisions of section 101 would not apply, resulting in a self-dealing tax payable by the disqualified person and possibly the foundation managers. Recognizing this problem, Regs. Sec. 53.4941(e)-(1)(b)(2)(iii) provides that the "amount involved" subject to the self-dealing tax if the fair market value is subsequently determined to be higher than the amount the foundation received for its shares would only be the "excess of the fair market value of the property transferred by the private foundation over the amount which the foundation receives, but only if the parties have made a good faith effort to determine fair market value." Good faith ordinarily will be considered to exist where

—the person making the valuation is not a disqualified person and is both competent to make the valuation and not in a position to derive economic benefit from the value utilized, and

—the method utilized in making the valuation is a generally accepted method for valuing comparable property.

The only example of a good faith effort to value shares of stock which are not publicly traded is a value determined by an investment banker in accordance with accepted methods of valuation (Example 5 of Regs. Sec. 53.4941(e)-(1)(b)(4)).

Suppose, however, that the foundation and the disqualified person engage an independent CPA to determine the fair market value of closely held stock. Will the IRS recognize the valuation as having been made by a person competent to make the valuation provided he employs a generally accepted method for valuing the stock? In a recently issued private ruling, the IRS has held that such a valuation made by an

Sec. 4943 independent CPA will constitute a good faith effort to value the stock of a company whose shares are not publicly traded.

Qualified pension, etc., plans

Sec. 4972 Rollovers to H.R. 10 plans may be excess contributions

Practitioners should be aware of a potential pitfall where an individual wishes to roll over a lump-sum distribution or other qualified rollover amount to an H.R. 10 plan, either directly or via an individual retirement account.

There are no restrictions that would prevent the rollover from being a tax-free transfer under Sec. 402(a)(5). However, if the individual is an owner-employee with respect to the H.R. 10 plan, it appears that the rollover could be an "excess contribution" under Sec. 4972(b), to the extent it exceeds the maximum amount permitted for employer and employee contributions during the year. An excess contribution is subject to a 6% annual excise tax under Sec. 4972(a) until eliminated. There is no provision in Sec. 4972 which specifically excludes a qualified rollover to an H.R. 10 plan from the definition of an excess contribution. Compare the case of a rollover to a qualified individual retirement plan under Sec. 4973, which specifically excludes qualified rollover amounts from the definition of an "excess contribution."

A recent private ruling held that a qualified rollover under these circumstances is not an excess contribution because it is not deductible at the time of transfer by the contributor, and therefore is not subject to tax under Sec. 4972. To date this very liberal position has not been officially announced by the Service.

Procedure and administration

Sec. 6012 Nonresident aliens: gross income exempt but return required

Assume that a Dutch resident employed by a Netherlands subsidiary of a U.S. parent works in the U.S. for less than 184 days during 1975. His income from services rendered in the U.S. will be wholly exempt from tax under Article XVI of the U.S.-Netherlands Treaty. However, he will have to file a tax return for 1975—Form 1040NR. *Sec. 6012*

Recently amended Regs. Sec. 1.6012-1(b) states that nonresident aliens are required to file tax returns if engaged in a trade or business in the U.S. *even though* the alien has no income which is effectively connected with a U.S. trade or business; has no U.S. source income; or has income which is exempt from tax by reason of a treaty or exclusion under the Code.

It appears that this regulation exceeds the statutory requirements for filing returns as stated in Sec. 6012. Sec. 6012(a)(1)(A) provides that individuals, including nonresident aliens, are required to file a U.S. tax return, if, for the taxable year, they have a gross income of $750 or more. In addition, as applicable to nonresident aliens, this section provides that:

- A tax return is not required if a nonresident alien is not married and his gross income is less than $2,450 for 1976, and
- The IRS may prescribe regulations under which a nonresident alien subject to U.S. tax under Sec. 871 may be *exempted* from filing a tax return.

Properly, the regulations should recognize the exception under Sec. 894 which provides that "income of any kind, to the extent required by any treaty obligation of the United States shall not be included in gross income and shall be exempt from taxation."

Since the present regulations do provide that an alien having no gross income need not complete the return schedules but must attach a statement indicating the nature of the treaty or other exclusions claimed, the filing requirement is not onerous; but is it properly authorized by the regs.?

Tax planning for marriages to nonresident aliens

Sec. 6013

Most tax practitioners are aware that two single taxpayers, earning approximately the same amount of income, may increase their aggregate federal income tax liabilities if they get married. Is this "anti-marriage policy" of the tax laws limited to "equal income" couples, or might it extend to couples whose incomes vary widely?

Sec. 6013 Assume that a world-traveling sales manager earns a salary of $100,000 per year. In early 1973, on one of his foreign trips, he meets and marries a peasant girl. While single, he was taking advantage of the 50% maximum tax rates on earned income. His tax for 1972 was about $43,000. Now that he's married, he expects to pay lower taxes in 1973—but:

- Because his new wife was a nonresident alien during a part of the taxable year, they will be unable to file a joint return (Sec. 6013(a)(1));
- Further, as a married person filing a separate return, he becomes subject to tax rates which are higher than the single-person rates which applied to him in 1972; and
- Moreover, he will not be eligible for the 50% maximum tax provisions in 1973. Sec. 1348(c) allows maximum tax benefits to married individuals *only* if they file a joint return, but a joint return *can't* be filed in this situation. The pertinent committee reports merely state that the purpose of this restriction is "to preclude manipulation." Thus, presumably, the discouraging of marriages to nonresident aliens is an unintended consequence.

The marriage will cause this unfortunate salesman's tax bill to increase from $43,000 to $53,600. Had he been less impetuous and consulted a professional tax adviser before getting married, he might have saved some $10,000 in taxes. The tax counsel he should have received is, "Defer your marriage until early 1974; in the meantime, make sure your fiancée becomes a resident of the U.S. during 1973."

Sec. 6151 Requirements for using "flower bonds"

The use of qualified U.S. Treasury bonds ("flower bonds") for payment of federal estate taxes can be a very important estate planning tool because qualified bonds are redeemable at par rather than market value to the extent they are used to pay federal estate taxes. Only certain bonds issued on or before March 3, 1971, are eligible for redemption at par for this purpose.

Flower bonds must be valued at par in the decedent's gross estate. This results in a saving to the estate of the difference between the cost of the bonds and their par value reduced by the federal estate tax on such difference.

The Treasury Department appears to have recently become more restrictive in enforcing the requirements for eligibility of qualified bonds for redemption. Treasury regulations set forth the conditions which must be met before the bonds will be accepted. These conditions are that the bonds must have Sec. 6151

—been owned by the decedent at the time of his death, and

—thereupon constituted part of his estate, as determined by applying specified rules in the case of joint ownership, partnership, and trust holdings. The rules in the case of trust holdings require close review because they provide that the bonds will qualify only if ". . . (a) the trust actually terminated in favor of the decedent's estate, or (b) the trustee, as such, is required to pay the decedent's federal estate taxes under the terms of the trust instrument or otherwise, or (c) the debts of the decedent's estate, including administration costs, state inheritance and federal estate taxes, exceed the assets of his estate without regard to the trust estate" (31 CFR Section 306.28(b)(iii)). Schedule T of Treasury Department Form PD 1782 reflects the Treasury regulations concerning trust ownership of bonds in requiring that the grounds for qualification of bonds held in trust be stated.

It is important when planning the use of qualified bonds to make sure that the requirements of these regulations are met. For example, a provision in a trust which owns qualified bonds stating that the trustee "may pay" the federal estate tax liability will not in itself satisfy the requirements of the regulations since the obligation of the trustee, as such, is not clear, direct and unconditional. Tax apportionment provisions of trust instruments and wills together with federal and state laws regarding tax apportionment should be reviewed to make sure they do not result in disqualifying the bonds. Care should also be taken that the bonds are effectively owned by the entity which is intended to have ownership and that any changes affecting ownership which take place after death qualify under Treasury regulations.

Editor's note: In a community property state care must be taken to insure that sufficient bonds are purchased. IRS ruled in Rev. Rul. 76-68 that only one-half of bonds purchased with community funds could be used to pay death taxes at par. The basis of the survivor's community one-half is fair market value at date of death, not par (redemption) value.

Sec. 6212 Statutory notice of deficiency irrevocable

A deficiency was proposed by a revenue agent. The taxpayer mailed a protest to the district director within the required 30-day period. The protest was mailed with a request for return receipt which was received by the taxpayer and duly acknowledged. A few days later the taxpayer received a "90-day letter" giving him 90 days to pay the deficiency or to file a petition in the Tax Court.

The taxpayer contacted the district director to find out why the 90-day letter was issued before he was given his district conference and appellate conference as requested in the protest. It was then determined by the District Director that the protest had been lost after being received. The District Director agreed to give the taxpayer his conference, but said he could not rescind the 90-day letter, although admitting that it was erroneously issued.

The District Director's opinion seems to be supported by the Code and the National Office. Apparently neither the Commissioner nor the District Director has the power to rescind a 90-day letter, even when erroneously issued. Thus, the taxpayer is faced with the alternative of the 90-day letter before he goes to the district conference.

Sec. 6402 Tax assessed and paid after normal limitation period: possible refund

These days it is common for the IRS examination of tax shelter partnerships to be a long, drawn-out affair. A formal protest of disputed issues and final agreement with the taxing authorities may not take place until several years after the year under examination. Generally, the individual partners are asked to extend the statute of limitations for the examination and assessment of tax on their individual returns which reflect the partnership distributive items. In these circumstances, once in a while the Service will fail to secure a signed timely waiver of the statute. Nevertheless, assessment may proceed as usual; the taxpayer receives a bill and pays the tax which has been erroneously assessed because the statute of limitations has expired.

In Rev. Rul. 74-580, the Service, as expected, confirmed previous statements by Commissioner Donald C. Alexander.

Mr. Alexander had said that a voluntary payment of tax barred by the statute of limitations is an overpayment which will be refunded upon the filing of a timely claim for refund. Mr. Alexander's statement in April, 1974, arose in connection with former President Nixon's 1969 tax return. Assessment of tax due for 1969 was barred by limitations but Mr. Nixon announced he would voluntarily pay the additional tax due. Prior to Rev. Rul. 74-580, the Service generally took the position, as supported by *Thompson*, DC–Mich., 5/12/71, and other cases on point, that voluntary tax payments made after the expiration of limitations on assessment effectively "waived" the statute of limitations. *Sec. 6402*

Our experience indicates the Service is now acting on these claims for refund after some delay. Accordingly, the situation described above should be kept in mind; it may be wroth the tax adviser's time to review recent paid assessments of clients made after the normal three year statute of limitations. Investigation may disclose there is no record of having signed a timely waiver of the statute and accordingly, a claim for refund should be filed to determine whether the Service can produce such a waiver indicating authority for the delayed assessment. Any refund claims filed must be filed within two years from the date of the erroneous payment.

Abatement of penalties

Sec. 6404

Clients are often assessed civil penalties for various alleged violations of the Code. Some of these penalties can be assessed without the issuance of a notice of deficiency. Once assessment occurs, the Service is free to seek payment. If such penalty is proper only where the failure was due to willful neglect and not to reasonable cause, the taxpayers are often informed by the Revenue Officer that they should pay the tax and file a claim for refund if they do not agree with the penalty.

An alternative to paying the penalty first is to file a Claim for Abatement (Form 843) where the taxpayer believes reasonable cause exists. See Sec. 6404; Regs. Sec. 301.6404-1(c).

For example, Sec. 6651(a)(1) refers to the penalty for failure to file a return on time and Sec. 6651(a)(2) refers to the penalty for failure to pay the amount shown as tax on any return on time. Both penalties are proper unless it is shown that the

Sec. 6404 failure was due to reasonable cause and not to willful neglect. Often these penalties are assessed even before the taxpayer has been contacted to see if, in fact, reasonable cause exists as opposed to willful neglect. In such cases serious consideration should be given to filing Form 843 which is normally filed as a refund claim. In filing such form the Collection Division should be informed of the action being taken and told that all collection proceedings should cease until administrative hearings have taken place with the Service as to the merits of the claim for abatement of the penalty. If the Revenue Officer resists such delay in collection, it is advisable to seek a hearing with his group supervisor and, if that is not sufficient, with the Chief of Collection.

It is important in discussing the question with the Service to emphasize that Congress by statute has set up a procedure for the abatement of penalties before they are collected if the taxpayer chooses to take that route. The fact that statistically it may be beneficial for a particular Revenue Officer to have his case closed is completely irrelevant to the issue and little sympathy should be given to such an argument.

Sec. 6654 Exceptions to estimated tax penalty based on current income: partner vs. shareholder of subchapter S corporation or DISC

The penalty for underpayment of estimated income tax will not be imposed if an individual comes within one of the exceptions in Sec. 6654(d). In determining the applicability of the exceptions in Sec. 6654(d)(2) and (d)(3), a member of a partnership must determine his taxable income for the months in the partnership taxable year ending with or within the partner's taxable year which precede the month in which the installment falls due by taking into account

—his distributive share of partnership items under Sec. 702,

—the amount of any guaranteed payments under Sec. 707(c), and

—gains or losses on partnership distributions which are treated as gains and losses on sales of property.

Example. Assume that X, a calendar-year taxpayer, is a member of a partnership having a taxable year ending June 30, 1976. X's distributive share of Sec. 702 items for the partnership's year is $25,000 per quarter. In determining his taxable income for purposes of applying Sec. 6654(d)(2) or (d)(3) to the installment due on April 15, 1976, X must take into account his distributive share of Sec. 702 items for the period from July 1, 1975, through March 31, 1976, or $75,000 of income. *Sec. 6654*

However, in computing estimated tax and penalties for underpayment by a stockholder in a subchapter S corporation, a stockholder's pro rata share of undistributed taxable income of the corporation is includible in his income as a dividend distributed on the last day of the corporation's taxable year. Therefore, for purpose of the Sec. 6654(d)(2) and (3) exceptions, the stockholder need not include his share of undistributed taxable income for any estimated tax payment due for a period prior to the end of the corporation's taxable year.

Example. Assume a subchapter S corporation has a June 30th taxable year and undistributed taxable income attributable to X is $100,000 for the year. X need not include his share of the corporation's undistributed taxable income in computing his first two estimated tax payments due April 15 and June 15. However, such income ($100,000) should be included in determining X's remaining estimated tax installments due September 15, and January 15 of the following year. See Rev. Rul. 62-202.

We have been informally advised by the IRS National Office that the same rules should be followed by the shareholders of a DISC, in determining their shares of the undistributed earnings and profits of the DISC that will be taxed to them under Sec. 995, for any estimated tax payments due for a period prior to the close of the taxable year of the DISC.

Former subchapter S corporation's estimated tax deposits

Sec. 6655

Liability of a corporation, which had previously reported under a subchapter S election, to make estimated tax deposits for its first year as a "straight" corporation may depend upon whether the subchapter S election is terminated (or revoked) in the first or the last month of the year.

Sec. 6655 Rev. Rul. 72-388 states that a corporation which revoked its subchapter S election during January 1971 would meet the underestimation charge exception provided in Sec. 6655(d)(2) only if timely estimated tax deposits were made in 1971 computed by applying the 1971 rates to the taxable income shown on the taxpayer's 1970 Form 1120-S, line 28.

In subsequently issued Rev. Rul. 73-25, the IRS considered a corporation whose election terminated during the last month of its taxable year as a result of its becoming a member of an affiliated group. The ruling concludes that no estimated tax deposits were required for the termination year, notwithstanding the substantial taxable income of the corporation for that year and preceding year, because liability to make the payments under Sec. 6154(a) did not arise before the first day of the twelfth month of the year. This reasoning would also appear applicable to a corporation whose election had been terminated by issuance of a second class of stock, etc., in the final month of its taxable year.

It is submitted that in requiring any estimated tax deposits Rev. Rul. 72-388 is questionable. Sec. 6655(d)(2) speaks of the facts shown (subchapter S election in effect) on the return for the prior year, and the law applicable (Sec. 1372(b)(1) corporate tax exemption) for that year; under such facts and law, no deposits are required. The Technical Advice (later published as Rev. Rul. 73-25), however, reiterated the IRS position in Rev. Rul. 72-388.

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.

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 (*Madison*, 28 TC 1301). 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. 301.7502-1(c)(1)(iii)(a). *Sec. 7502*

Another point to be borne in mind is that a timely postmark made other than by the U.S. Postal Service (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 (*Leventis*, 48 TC 353). 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 *Fishman*, 51 TC 869.

For this purpose, only domestic service of the U.S. Postal Service (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 (*Cespedes*, 33 TC 214). It is also a requirement that the mail be properly addressed and postpaid.

Timely mailing can be extremely important. For example, in *Feldman*, 47 TC 329, 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.

IRS access to accountants' tax contingency workpapers

Sec. 7602

The federal District Court in Denver recently refused to enforce a Sec. 7602 summons for the audit plan and tax contingency workpapers prepared by Coopers & Lybrand for use in auditing the financial statements of Johns-Manville Corporation. (*Coopers & Lybrand*, DC-Colo., (1975).)

The tax contingency workpapers were not used by the auditors to prepare income tax returns, or to reconcile the books and financial statements to the tax returns, but rather con-

Sec. 7602 tained evaluative materials, including predictions as to controversial areas in tax reporting, the likelihood of administrative settlements or litigation results, and other taxpaper "thought processes." The IRS wished to explore these tax contingency workpapers to identify possible issues.

The Court in declining enforcement reasoned that the taxpayer had a reasonable expectation of privacy in its confidential disclosures to auditors and that the IRS therefore had to satisfy standards of need, relevance, and public policy, which were not met.

Auditors should arrange their workpapers to segregate the evaluative tax contingency workpapers accumulated to assess the adequacy of the taxpayer's income tax provisions in its financial statements from those workpapers required to link the taxpayer's book and financial statements to the income tax returns. In similar fashion, evaluative materials should not be intermingled with substantive audit workpapers used to verify factual data and financial transactions. There appears no doubt that the IRS has the authority under Sec. 7602 to summons factual and transactional data as well as information required to correlate the books of account and income tax returns.

Sec. 9100 Extensions of time for making certain elections

There still may be time to make that late election! If the regulations set the time for making an election, the IRS has the authority to grant a reasonable extension under Regs. Sec. 1.9100-1. Even where the election date has passed, a request for the extension can still be made.

The regulations permit the IRS, in its discretion, to grant the extension upon a showing of good cause provided that

—the election time is not expressly prescribed by law;

—the extension request is filed before the time fixed by the regulations for making the election, or within such time thereafter as the IRS may consider reasonable under the circumstances; and

—the IRS is satisfied that the interests of the government will not be jeopardized.

What constitutes good cause is left up to the IRS. However, since this is a relief provision, the IRS should be expected to exercise its authority where the taxpayer can show a valid reason for not having previously made the election, and that the interests of the government will not be jeopardized. A lack of knowledge by the taxpayer or reliance upon a tax adviser should be acceptable reasons for being late, especially if the taxpayer could not in any way benefit from the delay, such as by using hindsight. Obviously, the IRS's receptivity will be greater if the request is made promptly after discovery of the oversight. If an IRS agent comes across the "missed election" (not statutorily prescribed), it may be best to immediately submit a formal request.

The interests of the government would not be jeopardized if the granting of the election would put the taxpayer and the government in the same positions as if a timely election had been made. On the other hand, a jeopardy situation would exist where the late election could cost the government tax dollars in excess of that which would have resulted from a timely one.

An example of where the cited regulation might be helpful would be in the making of a partnership election under Sec. 754 to adjust the basis of partnership assets upon the transfer of a partnership interest by sale or exchange or by the death of a partner. The statute does not fix a time for the Sec. 754 election to be made; however, Regs. Sec. 1.754-1(b) requires it to be made in a timely filed partnership return for the first taxable year to which the election applies. As a result of a 1970 amendment to Regs. Sec. 1.9100-1, that regulation can be applied to an election required to be made in or with an original income tax return on or after November 20, 1970. The IRS would, in all probability, welcome the opportunity to grant relief and avoid further litigation on the timing of the Sec. 754 election. See *Allison*, DC–Pa., 6/18/74 and *Neel*, DC–Ga. 1967; 266 F Supp 7, which held the Regs. Sec. 1.754-1 time limit invalid. Compare *Dupree*, CA-5, 391 F2d 753 (1968).

This relief provision may save a tax adviser and his client the anguish of a "missed election." While admittedly it is somewhat limited in its application, there is no limit on its value when it can be used.

Court cases cited

Revenue rulings

Revenue procedures

Index

A

B

C

D

E

F

G

H

I

L

M

N

P

R

S

T

U

V

W