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The two years that have passed since the enactment of the Internal Revenue Code of 1954 have provided taxpayers with an opportunity to become familiar with its general provisions. This should permit us to dispense with a detailed explanation of the various sections and to concentrate now on a review of some of the significant problems that have developed, as well as on the possible solutions to those problems.

PREPAID INCOME AND DEFERRED EXPENSES

Nothing in the new Code created more excitement than the ill-fated sections that would have permitted the deferral of prepaid income and the deduction of provisions for estimated expenses. They entered the income-tax scene under the best of auspices. In his 1954-budget message, the President recommended that tax accounting should be brought more closely in line with accepted business accounting. When this recommendation was adopted by Congress in the enactment of the new Code, the resulting sections 452 and 462 were acclaimed as a significant step in the struggle to bring some rational rules to tax accounting.

Despite the almost unanimous approval of these sections, when it became apparent that they might result in a substantial loss of revenue, they were promptly repealed. Even while recommending repeal, however, the Senate Finance Committee was careful to explain that it was not abandoning their basic principles and that it expected to make a future report of legislation dealing with the problem.

There seems to be little disagreement as to whether there is actually a problem. Both the 1939 Code and the 1954 Code provide that a taxpayer's method of accounting shall clearly reflect his income. While this seems to be a simple concept, it has been largely ignored by the courts in the development and application of the claim of right doctrine to prepaid income and of the principle that deductible expenses must be represented by fixed and determinable liabilities. The result has been that there is no longer any apparent resemblance between tax accounting and business accounting.

Within the last few years there has been an encouraging trend in the decisions in this area. In a recent opinion in the Schuessler case, the Court of Appeals for the Fifth Circuit reversed the Tax Court and held that a taxpayer who sold furnaces with a guarantee to turn them on and off for five years could deduct the estimated cost of meeting the terms of the guarantee. In its opinion the Court emphasized the proper measurement of income for the year rather than any necessity that the liability be absolutely determinable. In stating the importance of accurately reflecting income, the Court noted with approval recent decisions of the Fourth, Ninth, and Tenth Circuits that have been decided on the basis of similar reasoning.

This trend is gratifying but it probably will not provide a satisfactory solution to the problem. For one thing, it may take too long to develop to the point where the primary necessity of a clear reflection of income is completely accepted. Furthermore, it should be recognized that most of these decisions dealt with situations where there were liabilities or fixed obligations to perform certain services, even though the extent and cost of performance was not subject to exact determination. It is not clear that the decisions would have been the same if the liability element had been absent. Only the Tenth Circuit appeared to abandon an old rule completely when it disregarded the usual application of the claim of right doctrine and permitted the deferral of prepaid subscription income.

The solution seems to lie in another attempt to obtain corrective legislation. It is not unreasonable to hope for early and favorable action. There is every indication that major tax legislation will be considered in the next session of Congress, and the Senate Finance Committee has already indicated that it will be favorably disposed to some reasonable settlement. A further indication of Congressional interest lies in the recent announcement by Senator Byrd that the Joint Committee on Internal Revenue Taxation has started a series of studies that includes reconsideration of the treatment of prepaid income and estimated expenses.

One of the most troublesome problems created by the rise and fall of the provision for estimated expenses has been the treatment of vacation pay. When the Code was enacted, deductions for vacation pay were accruable both where there was a fixed liability to the employee because of his vested rights, and where he had earned the vacation and it was reasonable to expect that it would be granted, but there was no absolute liability on the part of the employer. With the enactment of the estimated expense provisions, it no longer seemed necessary to permit employers to deduct for earned but unvested vacation obligations. Partly because of this and partly because the Treasury Department was concerned as to the correctness of the ruling that granted this privilege, it was announced that the privilege was to be withdrawn. Shortly after this announcement the estimated expense provisions of the Code were repealed, thus leaving taxpayers with no basis for accrual other than where vacation rights were vested. Recognizing this problem, the Treasury has made a number of temporary extensions of the old rules. The current extension applies to taxable years ending prior to January 1, 1957.

While Congress may correct the situation at its next session, there is no certainty that any new legislation will be completely satisfactory. It is entirely possible that the old rules will be withdrawn without any appropriate substitute in the Code. In view of this possibility, those taxpayers who are basing their vacation-pay deductions on the current ruling should reconsider the problem before the end of this year and take any steps that might be practicable to place their vacation payments on a vested-rights basis.

STATUS OF CHANGES IN TAX-ACCOUNTING METHODS

The procedure for changing an established tax-accounting method, together with the adjustments incident to such a change, represents another area of controversy at the present time. In the years preceding 1954, the courts gradually developed the rule that where changes of accounting method are involuntary, the taxpayer should be permitted to compute his income on a consistent basis for the year of change without recognition of items that might escape taxation because of the change. Although taxpayers were enjoying fairly consistent success in these cases, they were still being contested by the Treasury Department, and Congress decided to settle the controversy by establishing statutory rules. The apparent effect of the new provisions was that adjustments should be made in the year of a change in order to prevent amounts from being duplicated or omitted, except that no adjustments should be made with respect to 1953 and prior years. While this seemed satisfactory at the time, a number of problems have arisen in the application of the new section with the result that it has not yet been interpreted in the regulations.

It is no secret that the Treasury Department is dissatisfied with this part of the Code and is experiencing difficulty in developing acceptable regulations. Meanwhile, taxpayers have not been able to obtain approval for changes in accounting methods except in the simpler situations where no adjustments are involved, and except where taxpayers have voluntarily waived their rights to avoid adjustments of pre-1954 items.

One of the problems is whether the rule should be applied to a voluntary change of accounting method as well as to an involuntary change even though the change is from an incorrect method to a correct method. There is no apparent distinction between the two types of changes either in the Code or in the related Committee reports, but there is some thought that those who drafted the new provisions intended that the 1954 cut-off should apply only to involuntary changes. If this was the intention, it was not made clear in the Committee explanations. If it should be held that the cut-off should apply to voluntary changes, there is a further question as to whether the Treasury could prevent a taxpayer from making a change from an incorrect to a correct method. This is further complicated by the fact that the Code now recognizes hybrid methods as well as the strict cash or accrual methods.

In view of these problems and others that have not been mentioned, it would be dangerous to attempt at the present time to present any conclusions that might be generally applicable. Until the regulations are issued, anyone contemplating a change should make a careful analysis of his situation in the light of all of the considerations involved.

PREFERRED-STOCK BAIL-OUTS

The 1954 Code introduced a number of new concepts in the general area of corporate distributions and adjustments and clarified some existing ones. While all of these new rules are important and should be considered in connection with any rearrangement of corporate ownership, there are several that have attracted more than the usual amount of interest.

One of the completely new sections, section 306, was enacted to prevent the use of preferred-stock bail-outs for the indirect removal of accumulated earnings from a corporation at capital-gain rates. Shortly before the development of the Code was started, the decision in the Chamberlin case seemed to open a loophole that was not intended by Congress. In this case the court permitted capital-gain treatment for a sale of preferred stock that had been issued tax-free as a dividend on common stock. This treatment was permitted even though the preferred stock was sold shortly after it was distributed and even though the terms of the stock were designed to appeal to the eventual purchaser. In view of the possibility that there could be a substantial loss of revenue if the use of this device should become widespread, Congress adopted restrictive rules to close the loophole.

In general, the section provides that ordinary-income treatment should be given to amounts received upon the disposition or redemption of section 306 stock except where:

1. The stock is sold and the sale terminates the seller's entire stock interest (including his constructive interest in stock owned by others),
2. The stock is redeemed in a complete termination of the entire interest of the seller in the corporation,
3. The stock is redeemed in a complete or partial liquidation,
4. The disposition is accomplished in a tax-free transaction, or
5. The distribution and subsequent disposition or redemption are not pursuant to a plan of tax avoidance.

While section 306 stock, a term that is specifically defined in the Code, is commonly regarded as being preferred stock, it is actually any stock other than common stock that is received as a tax-free stock dividend, in a tax-free reorganization, or in certain tax-free exchanges for section 306 stock.

As can be seen from this brief description of the basic provisions, they are quite technical. Attempts to apply them and the resulting interpretations of the Internal Revenue Service have developed several problems that may not be readily apparent upon first examination.

One of the key provisions is that the section is not to be applied where the distribution and subsequent disposition or redemption are not pursuant to a plan of tax avoidance. Thus, while section 306 stock might be issued, the penalties of the section need not apply if tax avoidance is not in the picture. For example, if corporation A were to exchange its common and preferred stock for the outstanding common stock of corporation B in a tax-free reorganization, the preferred stock of A would be section 306 stock in the hands of the B stockholders. However, this would not necessarily mean that the penalties of the section would be applied, because the stockholders could attempt to establish that there was no plan of tax avoidance. Because of the difficulty of attempting to establish the absence of such a plan, many corporations contemplating such exchanges attempt to get advance rulings from the Internal Revenue Service.

The Service has indicated a willingness to rule favorably in those instances where both of the corporations involved are large and widely held. The mere fact that there is no predominant group of stockholders that might be in a position to use the plan for tax avoidance is usually accepted by the Service as an indication that tax avoidance is not in the picture, provided that the disposition of the stock is not in anticipation of a redemption shortly after its issuance. This attitude should be of interest to corporations that would like to use preferred stock along with common stock in connection with acquisitions of other companies.

Although the section is ordinarily considered as applying to preferred stock, it is not the name of the stock that governs. Stock that is called common stock might be section 306 stock if it has preferences over another class of common stock. Care should be exercised in any instance in which existing common stock is to be recapitalized into two classes and where one of the two classes is to be given certain privileges to compensate for a restriction of other privileges, such as a restriction of voting rights. The section should not be applicable if the special privileges are granted merely to provide some degree of protection to the stock that does not have normal rights, but that stock can not be given preferences not enjoyed by the other common stock. For example, it should be acceptable to permit the holders of non-voting common stock to require redemption of their stock at book value if dividends are not paid for a certain number of years.

While the section does not apply to preferred stock issued as a tax-free dividend in years to which the 1939 Code applied, present attempts to dispose of such stock may also present problems. There have been a number of instances in which preferred stock was distributed in the past without the provisions, such as a redemption plan, that would make it acceptable to a purchaser. If stockholders should want to sell such stock now, it would be helpful if they could first exchange it for a new issue of preferred stock that would be more acceptable to the prospective buyer. However, the regulations seem to require the classification of the new issue as section 306 stock if its characteristics are substantially different from those of the stock previously held. This would seem to be true even though the terms of the new stock are such that it is not actually any more valuable than the stock exchanged.

The provisions of this section are basically prohibitive and restrictive, but it should not be assumed that there are no longer any uses for preferred stock other than its sale for cash in the investment market. Where a company's stock is widely held in relatively small amounts, preferred stock should still be usable for stock dividend purposes, if the subsequent sales are relatively isolated ones made by minority stockholders, and there is no indication that there may have been a concerted attempt to avoid taxes. Preferred stock might also be used to assist a controlling group in disposing of a business when the purchasers are unable to buy the entire equity. There may be instances also in which a distribution of preferred stock might be a helpful step in permitting a partial change of control of a corporation. Even if the stock is section 306 stock, it loses that taint when it passes into an estate at the time of death.

CORPORATE DIVISIONS

In the last two years there has been a substantial increase in spin-offs and similar divisive transactions. In the past, many corporations that were engaged in more than one business were interested in separating them in order to facilitate their management and development or to protect the investment in one established enterprise from the hazards involved in developing the other. On the other hand the Internal Revenue Service was always alert to possible attempts to use a corporate separation, accompanied by a subsequent sale or liquidation of one of the businesses, as a device for removing earnings from a company without dividend treatment. In the absence of comprehensive statutory rules, the resulting restrictions and uncertainties prevented many corporate divisions that might otherwise have been made. While the provisions of the new Code have eliminated many of these restrictions, there are still a number of problems that should be recognized by a company that is considering a rearrangement of this type.

One of the specific Code requirements is that the separation must involve two or more active businesses. An active business is defined only as a trade or business actively conducted over a period of five years preceding the separation and not acquired during that period in a transaction in which gain or loss was recognized. Neither the Code nor the related committee reports explain what is meant by the active conduct of a trade or business. This portion of the definition has been suppled by regulations and rulings which to some extent seem to be unduly restrictive.

The regulations require that the group of activities constituting a trade or business must include every operation which forms a part of the process of earning income from that group. This requirement, together with the examples that have been provided, tends to prevent the separation of an integrated business into its separate components, even though there might be a good reason for such a separation and even though each of the components might be viewed as a separate business if it were operating independently. Thus a separately owned and incorporated sales agency would be a business but the identical activities would not be if they were performed by a company with other related activities. This approach penalizes the established integrated company and may force artificial and cumbersome separations that would not be necessary from a business viewpoint.

Avoiding this prohibition against a horizontal division of various activities may not be sufficient. Even a vertical division is not acceptable unless it is clear that there are actually two separate businesses. While the regulations deal largely with the necessity for a separation on the basis of area and location or services and products, attention will be given also to the extent to which the segregation of such things as management, employees, and accounting indicate that there are actually two businesses instead of only one.

The holding of assets for investment purposes is excluded from the definition of a trade or business. Therefore, activities of this type cannot be made the subject of a spin-off. The difficulty here lies in the failure of the regulations to distinguish between incidental investment holdings and the business of investing. For example, the functions involved in the continuous use of funds for the purchase of undeveloped real estate for appreciation and eventual resale would seem to constitute a separate business, but they do not come within the provisions of the regulations. This can present a very serious problem to the company that is seeking an orderly segregation of diverse activities which may include an aggressive investment program.

Another essential element in a successful corporate division is that it must not be used principally as a device for the distribution of earnings and profits. The Code clearly indicates that a sale of the stock or securities of one of the separated companies, made after the separation but pursuant to a prior arrangement, would constitute a tax avoidance device, but it does not state what other devices might be prohibited. However, the Treasury Department has interpreted this provision as meaning that the transaction must be for a corporate business purpose and that there must be a continuity of interest after it is completed.

In view of this interpretation, it is to be expected that a sale of stock shortly after a spin-off will cause it to be challenged as a tax-avoidance device, even though there may have been no actual intention to sell at the time of the distribution. This does not necessarily mean that a purchase offer must be refused, but the seller should be careful to retain evidence sufficient to demonstrate that the sale was not contemplated at the time of the spin-off and was made for valid reasons that arose after the spin-off was completed. In this connection, it should be mentioned that the Service will not rule on a proposed corporate division unless the record includes a statement that no sale or liquidation is intended.

In most instances the corporate-business purpose and continuity of interest rules should present no problem except where tax avoidance may be the real motive. However, there could be situations where the purpose of a separation is personal to the stockholders rather than corporate. For example, there may be occasions when a stable business should be separate from a speculative one in order to provide some of the stockholders with a more constant source of income. A strict construction of the regulations would seem to prevent such a division because the business purpose would not be corporate. This requirement seems to be unduly restrictive.