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Analysis of the Tax reform Act of 1969

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analysis of the tax reform act of 1969

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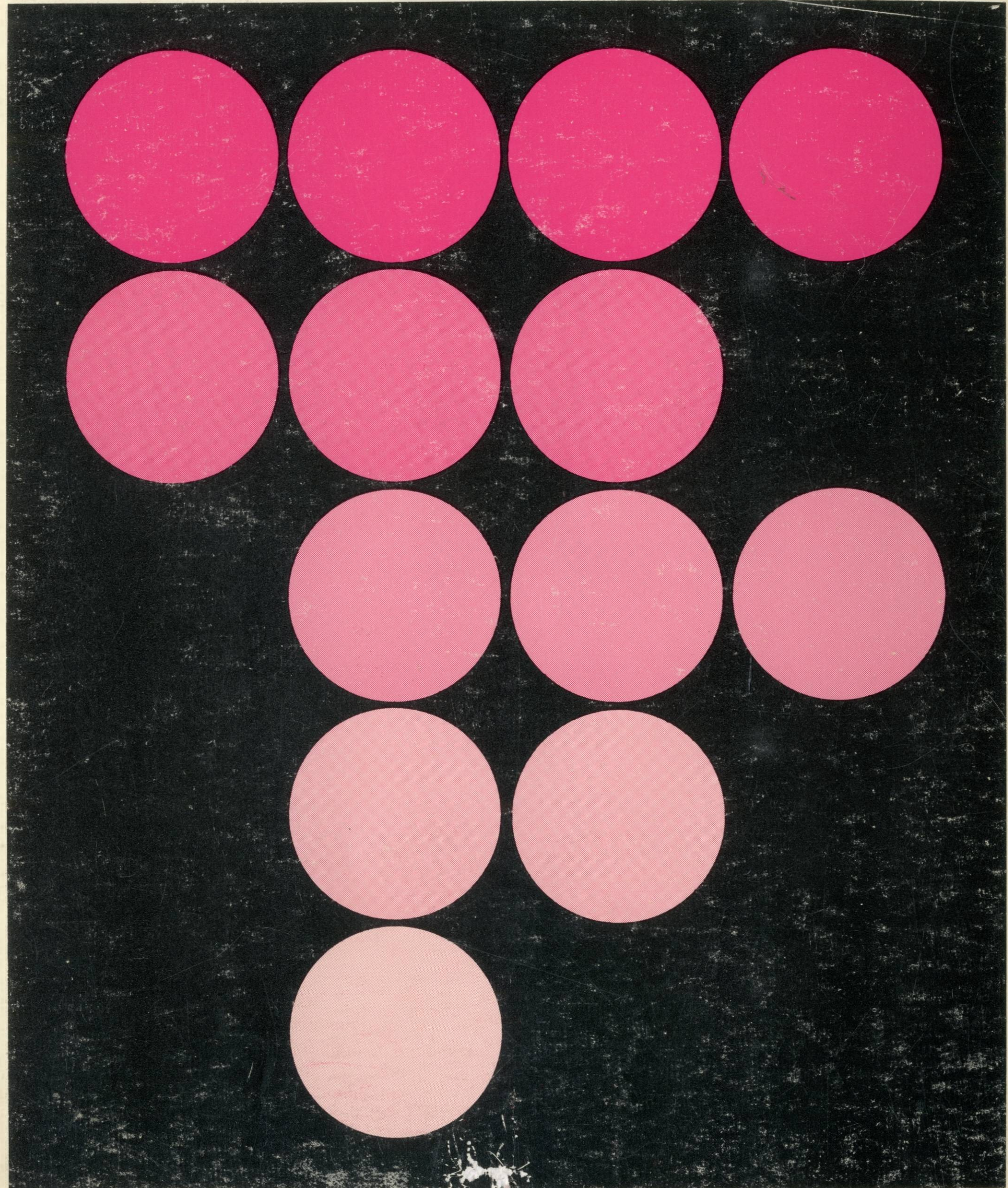

analysis of the tax reform act of 1969

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Foreword

For years to come, the Tax Reform Act of 1969 will not only compound the problems of tax compliance but will also complicate the task of tax planning. It is, therefore, essential that tax advisers have a working knowledge of the TRA.

Analysis of the Tax Reform Act of 1969, a collection of analytical and interpretive articles written by distinguished tax advisers, covers most of the major provisions of the TRA. Each of the 21 articles, which originally appeared in *The Tax Adviser,* deals with a specific aspect of the Act. Detailed discussions and illustrations are designed to give the reader a clear understanding of the provisions and to point out new planning opportunities that have developed, as well as old planning techniques which are no longer effective.

We are deeply indebted to the authors who have devoted their valuable time and extraordinary talents to the preparation of their articles.

GILBERT SIMONETTI, JR., *Executive Editor*
The Tax Adviser

HARRY Z. GARIAN, CPA, *Editor*
The Tax Adviser

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Checklist-summary of Tax Reform Act of 1969

William T. Barnes, *CPA, Lybrand, Ross Bros. & Montgomery, Washington, D.C.*

On December 30, 1969 President Nixon signed into law the Tax Reform Act of 1969. The Act, as signed by the President, combines the provisions of three substantially different bills: the one passed by the House on August 7, 1969, the one reported by the Senate Finance Committee on November 21, 1969, and the floor-amended one passed by the Senate on December 11, 1969.

The Conference Committee not only reconciled the seemingly irreconcilable bills, but did so in incredibly short time—reporting the bill on December 21, 1969. Virtually hours later both houses of Congress had passed the bill. Enough modifications had been made by the Conference Committee to make the bill acceptable to the President, who had earlier indicated that he would veto the bill.

Many provisions are not effective until years beginning in or after 1970; but a few of the new rules will affect tax returns for years beginning in 1969. Therefore, in order to report properly for 1969 and to plan effectively for the 1970s, tax advisers will have to master the new rules. This checklist-summary is designed to alert tax advisers to the new rules (and their effective dates) which affect their clients.

It may be useful to note at this time some of the more publicized proposals which had been included in the bill at one stage or

another but which were *excluded* from the Act as finally passed, namely:

- General reduction of individual tax rates.
- Increase in holding period for capital assets to 12 months.
- Limitation on qualified deferred compensation plan benefits for stockholders of professional corporations.
- General denial of the exempt status of state and local bonds (exemption is denied to arbitrage bonds).
- Allowances of credit for higher education expenses.
- Reduction of exemptions for income earned abroad.

In this checklist each provision of the Act has been classified according to the kind of taxpayer *primarily* affected. The Finding List which appears below provides a bird's-eye view of the checklist.

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Checklist-summary of the Tax Reform Act of 1969

Provisions of the Act	Effective date*
Noncorporate taxpayers	
1. *Maximum tax on earned income.* The tax rate on "net earned income" is limited to 60% in 1971 and 50% thereafter. "Gross earned income" must be reduced by (a) tax preferences in excess of $30,000 and (b) a pro rata portion of deductions. (Act Sec. 804; Code Sec. 1348.)	Years beginning after 1970.
2. *Minimum tax.* A minimum tax of 10% (in addition to the tax otherwise due) is imposed on "net preference items". The gross preference items are reduced by (a) a $30,000 ($15,000 if separate returns are filed) exemption and (b) the income tax otherwise payable. Preference items include: • Excess investment interest expense, but only for years beginning before 1972. (Generally, such interest is determined under the rules discussed in 3.) • Excess of accelerated depreciation and special amortization allowed over straight line depreciation allowable on real property, net-lease personal property, rehabilitation expenditures, pollution control facilities, and railroad rolling stock. • Excess of the value of stock over its cost on exercise of qualified or restricted options. • Excess of depletion over cost basis of property. • One-half of net long-term capital gains.	*Years ending after 1969.*

*NOTES:

1. "Retroactive" dates are shown in italics. A provision is considered retroactive if it could affect a tax return which includes a day in 1969. Thus, a provision which applied to a transaction occurring on or after January 1, 1970 is considered retroactive since it could affect a tax return for a fiscal year beginning in 1969 and ending in 1970.
2. Since the President signed the bill on December 30, 1969, this rather odd date became the effective date for those provisions which are to apply to transactions occurring or years ending "after the date of the enactment of this Act."

Provisions of the Act	Effective date
The minimum tax applies to corporations (under modified rules, see 24) as well as noncorporate taxpayers. Special rules apply in cases of foreign sources items, trusts and estates, controlled groups, subchapter S corporations, and regulated investment companies. The minimum tax is deferrable in a net operating loss year. Note that farm losses are not included as a tax preference item, but are separately treated; see 36. (Act Sec. 301(a); Code Secs. 56-58.)	
3. *Excess investment interest.* "Investment interest" is interest on loans incurred or continued to purchase or carry investments. Only 50% of "excess investment interest" (total investment interest less the sum of (a) $25,000, (b) net investment income and (c) net long-term capital gains) is deductible. Also, since investment interest (to the extent exceeding $25,000 and net investment income) must be deducted against net long-term capital gain, a portion of the gain is converted into ordinary income. The disallowed 50% may be carried forward under prescribed limitations. Excess interest incurred by a subchapter S corporation is attributed to its shareholders. Exceptions are provided for interest on indebtedness incurred or committed to before December 17, 1969. (Act Sec. 221; Code Sec. 163.)	Years beginning after 1971. (Treated as tax preference item in the meantime.)
4. *Income averaging.* Nonaveragable income is reduced to 120% (was 133⅓%) of average base period income. Long-term capital gains, income from gift property and wagering profits are eligible for income averaging, but not accumulation trust distributions. Income averaging cannot be used by a taxpayer who uses the alternative capital gains tax or the maximum tax on earned income. (Act Sec. 311; Code Secs. 1301, 1302.)	Years beginning after 1969.
5. *Taxation of single persons.* Tax rates for a single person cannot be more than 20% above the joint return rates; this limitation does not apply to married persons filing separate returns. Head of household tax rates are fixed halfway between the rates for single persons and joint returns. (Act Sec. 803; Code Sec. 1.)	Years beginning after 1970.

6. *Capital gains and losses.*

Provision	Effective date
6.1 *Alternative tax.* The present effective rate of 25% will continue to apply to the first $50,000 of long-term capital gains. The excess will be at 29½% (plus surcharge) in 1970, 32½% in 1971, and 35% thereafter. (Act Sec. 511; Code Sec. 1201.)	Years beginning after 1969, *with limited exceptions for pre-October 10, 1969 transactions.*
6.2 *Capital losses.* Only 50% of long-term losses may be offset against ordinary income. For married persons filing separate returns, the maximum deduction is reduced from $1,000 to $500 each. (Act Sec. 513; Code Sec. 1211.)	Years beginning after 1969.
6.3 *Life estates, etc.* All of the sale price of a term interest (life estate, income interest in a trust, etc.) acquired by gift or inheritance is considered taxable gain. (In other words, the tax basis of such a term interest is zero.) (Act Sec. 516(a); Code Sec. 1001.)	*Sales after October 9, 1969.*
6.4 *Collections of letters, etc.* Proceeds from sales of collections of letters and like-kind property will be taxed as ordinary income in the usual situation. (Act Sec. 514; Code Secs. 341, 1221.)	*Sales after July 25, 1969.*
6.5 *Sec. 1231 and casualty losses.* See 16.3. (Act Sec. 516(b); Code Sec. 1231(a).)	Years beginning after 1969.
6.6 *Franchises, trademarks, etc.* See 16.4. (Act Sec. 516(c); Code Sec. 1253.)	*Transfers after 1969.*

7. *Deferred compensation.*

Provision	Effective date
7.1 *Lump sum distributions.* A lump sum distribution from a qualified deferred compensation plan will be taxed as ordinary income to the extent it includes post-1969 contributions by an employer. The tax may be computed under a seven-year averaging formula. (Act Sec. 515; Code Secs. 72, 402, 403.)	*Years ending after 1969.*
7.2 *Subchapter S stockholder-employees.* A more-than-5% stockholder of a subchapter S corporation is taxed on the excess of its contribution to a qualified deferred compensation plan on his behalf over the lesser of $2,500 or 10% of his salary. Forfeitures may	Years beginning after 1970.

Provisions of the Act	Effective date
not benefit shareholder-employees. A subchapter S corporation's unused contributions may not be carried over to a nonelecting year. (Act Sec. 531; Code Sec. 1379.)	
7.3 *Restricted Property.* If restricted property (stock, etc.) is received as compensation, the value of the property (determined without regard to the restriction) is taxable when received unless (a) the property is subject to a substantial risk of forfeiture and (b) is not transferable. If taxation is deferred, the value is taxable when either condition (a) *or* restriction (b) lapses. Exclusions are provided for transfers under qualified stock option plans, qualified pension and profit-sharing trusts, etc. Under certain conditions an employee may elect to report the gain when the restricted property is received. (Act Sec. 321(a); Code Sec. 83.)	*Years ending after June 30, 1969, with exceptions for transfers made pursuant to pre-July 1, 1969 and pre-April 22, 1969 plans and contracts.*
8. *Charitable contributions.*	
8.1 *50% limitation.* The limit on deductions for gifts to public charities is increased to 50% of adjusted gross income; contributions to private foundations may also qualify for the 50% limitation under certain conditions. Contributions of appreciated property will not qualify for the 50% limitation unless the taxpayer accounts for the unrealized appreciation on all donations as taxable income. (Act Sec. 201(a); Code Sec. 170.)	Years beginning after 1969.
8.2 *Unlimited deduction.* Will be repealed gradually during the period of 1970-1974. (Act Sec. 201(a); Code Sec. 170.)	Years beginning after 1969.
8.3 *Appreciated property.* A contribution of appreciated property is deductible only to the extent of its tax basis if its sale would result in ordinary income or short-term capital gain. The full value of long-term capital gain property is considered as a charitable contribution except if (a) the donee is a private foundation and there is no pass-through of the contribution to public charities, or (b) the contribution is of	*Generally gifts made after 1969; for letters and memorandums, etc., donations after July 25, 1969.*

tangible personalty whose usefulness is unrelated to the donee's exempt function. In the case of (a) and (b), 50% (62½% for corporations) of the unrealized gain is not deductible.

On bargain sales, the cost basis is allocated between the portion sold and the appreciation donated. The allocation is based on the ratio of the sale proceeds to the total value of the property. (Act Sec. 201(a); Code Sec. 170(e).)

Bargain sales made after December 19, 1969.

8.4 *Use of property.* Gifts of less than the taxpayer's entire interest in property are not deductible; for example, gifts of rental space are not deductible. Exceptions are provided for remainder interests in personal residences or farms, and for undivided interests in properties. (Act Sec. 201(a); Code Sec. 170(f).)

Gifts after July 31, 1969.

8.5 *Two-year charitable trust.* Income of a less-than-10-year charitable trust will be taxable to the grantor; Sec. 673(b) repealed. (Act Sec. 201(c); Code Sec. 673(b).)

Transfers after April 22, 1969.

8.6 *Charitable remainder trusts.* Generally, income and estate and gift tax deductions are denied for transfers of charitable remainders in trust, unless the noncharitable income interest is in the form of a fixed dollar or percentage annuity. (Act Sec. 201(a),(d),(e); Code Secs. 170(f), 664, 2055(a), 2106(a), 2522(c).)

For income and gift taxes, transfers after July 31, 1969; for estate tax, generally, to decedents dying after 1969.

8.7 *Charitable income trusts.* Generally, income, estate and gift tax deductions are denied for charitable gifts of income in trust unless it is an annuity trust or a unitrust. No deduction is allowed for income tax purposes unless the income is taxable to the grantor. (Act Sec. 201(a),(d); Code Secs. 170(f), 2055(e), 2106(a), 2522(c).)

Same as 8.6

9. *Moving expenses.* Deduction is allowed for up to $2,500 of indirect moving expenses such as the costs of house-hunting, meals and lodging in the vicinity of the new job, and selling and buying houses. Deductions for house-hunting and temporary living expenses are limited to

Years beginning after 1969, subject to a retroactive exception in taxpayer's favor.

Provisions of the Act	Effective date
$1,000. For all moving expenses, the distance requirement is increased from 20 miles to 50 miles. The 39-week new employment requirement is waived in cases of death, disability or discharge. The moving expense deduction is extended to self-employed persons subject to 78-week new-location-stay requirement. (Act Sec. 231; Code Sec. 217.)	
10. *Personal use and occupancy insurance.* Insurance reimbursements for loss of use or occupancy of a personal residence are excludable from income to the extent the taxpayer and his family incurred abnormal living expenses during the period involved. (Act Sec. 901; Code Sec. 123.)	*Amounts received after 1968.*
11. *Exemptions.*	
11.1 *Personal exemptions.* Individual exemptions are increased to $625 for 1970 (increased to $650 on July 1, 1970 for withholding purposes), $650 for 1971, $700 for 1972, and $750 thereafter. (Act Sec. 801; Code Secs. 151, 6013(b).)	Years beginning after 1969.
11.2 *Dependency exemptions.* A foster child may qualify as a dependent on the same terms as natural children. (Act Sec. 912(a); Code Sec. 152(b).)	Years beginning after 1969.
12. *Standard deduction and allowances.*	
12.1 *Standard deduction.* The following increased amounts of standard deductions will be allowable for: 1971, the lesser of 13% of adjusted gross income or $1,500; 1972, 14% or $2,000; and 1973 and subsequent years, 15% or $2,000. (Act Sec. 802; Code Sec. 141(a)(c).)	Years beginning after 1969.
12.2 *Low-income allowance.* For 1970, minimum standard deduction will be $1,100, less $1 for every $2 of income above non-taxable level; 1971, $1,050 less $1 of every $15 of excess income; and 1972 and subsequent years, a flat $1,000. (Act Sec. 802; Code Sec. 141(c).)	Years beginning after 1969.

13. *Estates and trusts.*

Provision	Effective date
13.1 *Set-aside contributions.* Deductions are no longer allowed for income permanently set aside for charitable purposes pursuant to a trust agreement, but unlimited deductions may be allowable for amounts actually paid pursuant to the trust terms. Exceptions are provided for irrevocable trusts in existence before October 10, 1969 or created pursuant to a will in existence on such date. Another exception is made for long-term capital gains set aside by a "pooled income fund" trust. (Act Sec. 201(b); Code Sec. 642(c).)	Generally years beginning after 1969, with exceptions for pre-October 10, 1969 situations.
13.2 *Nonexempt charitable trusts.* See 52 for limitation on activities of taxable charitable trusts. (Act Sec. 101(b); Code Sec. 4947.)	*January 1, 1970*
13.3 *Accumulation trusts.* Throwback rule is applied to distributions of accumulated income and capital gains by trusts. A short-cut method of computing the tax is provided. (Act Sec. 331(a); Code Secs. 665-669.)	*Generally years beginning after 1969; exceptions include one for pre-1969 accumulations.*
13.4 *Unit investment trusts.* Participants in periodic payment plan to buy mutual fund shares will be taxed as co-owners, and such unit investment trusts will no longer be taxable as corporations. (Act Sec. 908; Code Sec. 851.)	*Years ending after 1968.*

14. *Procedure and administration.*

Provision	Effective date
14.1 *Withholding taxes.* By certification, withholding may be avoided where no tax liability exists in current or prior year. Flexible schedules are authorized for withholding. IRS is authorized to prescribe rules for voluntary withholding on nonwage payments. Supplemental unemployment benefit payments are made subject to withholding. Prior-year requirement for additional withholding allowances is eliminated in cases substantiated by court order or other evidence. (Act Sec. 805(a)-(g); Code Sec. 3402.)	Specific effective dates, all in 1970, are fixed for each new rule.
14.2 *Filing requirements.* During the period 1970-1972, tax returns need not be filed if taxable income is less than $1,700 in the	Years beginning after 1969.

Provisions of the Act	Effective date
case of a single individual and $2,300 in cases of married couples filing jointly. These amounts are increased for each extra personal exemption (age 65, etc.) the filing taxpayers are entitled to. Present $600 level retained for married couples filing separately. (Act Sec. 941; Code Sec. 6012(a).)	
14.3 *Computation of tax by IRS*. The IRS is authorized to compute income tax liabilities for more types of taxpayers, including those with incomes up to $10,000 (limitation now $5,000). (Act Sec. 942; Code Sec. 6014(b).)	Years beginning after 1969.

Corporations

15. *Multiple corporations*. Surtax and accumulated earnings exemptions for members of a controlled group in excess of one will be phased out over a six-year period; the life insurance company small business deduction will also be phased out. The 85% dividends received deduction will be increased to 100% over a six-year period.	Years beginning after 1969.
The definition of "brother-sister controlled group" is expanded to include corporations 80% owned by five persons with 50% identical ownership. A controlled group will be treated as one corporation for additional first-year depreciation and investment credit purposes. (Act Sec. 401; Code Secs. 1561-1564.)	Years ending on or after December 31, 1970.
16. *Capital gains and losses.*	
16.1 *Alternative tax*. The alternative capital gains tax rate will be increased to 30% in two steps: to 28% (exclusive of the surcharge) in 1970 and to 30% thereafter. However, the 25% rate will continue to apply for a limited period to long-term gains realized under binding contracts or liquidation plans in existence before October 10, 1969. (Act Sec. 511; Code Sec. 1201.)	Years beginning after 1969.
16.2 *Loss carrybacks*. Corporations may carry back capital losses for three years.	Years beginning after 1969.

Quickie refund procedure, subject to certain limitations and exceptions, is established. (Act Sec. 512; Code Secs. 381, 1212, 6411, 6501.)

16.3 *Sec. 1231 and casualty losses.* All casualty gains and losses must be netted. If result is a net gain, it must be consolidated with other Sec. 1231 gains and losses. If result is net loss, it is deductible as an ordinary loss. (Act Sec. 516(b); Code Sec. 1231(a).)	Years beginning after 1969.
16.4 *Franchises, trademarks, etc.* Ordinary income to the transferor and ordinary deductions to the transferee may result from the transfer of a franchise, trademark or trade name if the transferor retains any significant power, right or continuing interest with respect to the subject of the franchises, etc. Professional sports franchises are excluded. (Act Sec. 516(c); Code Sec. 1253.)	*Transfers after 1969, except transferee can deduct certain payments relating to pre-1970 transfers.*
17. *Reasonable accumulations of earnings.* For the accumulated earnings tax, the term "reasonable needs of a business" is expanded to include (a) amounts needed in the year of a shareholder's death and later years to make Sec. 303 redemptions, and (b) amounts needed to redeem excess stockholdings of private foundations. (Act Sec. 906; Code Sec. 537.)	*Years ending after May 26, 1969.*
18. *Stock redemptions—appreciated property.* When a corporation redeems stock with appreciated property, gain will be recognized. Exceptions are provided in cases of complete or partial liquidations, tax-free reorganizations or split-offs, complete termination of interest of a 10% shareholder, distribution of a subsidiary's stock, divestiture distributions, redemptions for death taxes, etc. (Act Sec. 905; Code Sec. 311.)	*Redemptions occurring after November 30, 1969, except for redemptions made pursuant to pre-December 1 agreements and offers.*
19. *Stock dividends.* In general, where there is more than one class of stock outstanding, stock distributions which increase the shareholder's proportionate interest in a corporation will be taxable as an ordinary dividend. Stock dividends on preferred stock (except antidilution distribu-	*Generally, distributions after January 10, 1969, but later effective dates apply in prescribed situations.*

Provisions of the Act	Effective date
tions on convertible preferred) are taxable. (Act Sec. 421, Code Sec. 305.)	
20. *Earnings and profits.* Corporations must use straight line depreciation in computing earnings and profits. (Act Sec. 442; Code Sec. 312.)	Years beginning after June 30, 1972.
21. *Sec. 333 liquidations.* Securities acquired from a stockholder after December 31, 1953 in a Sec. 351 transaction will be regarded as held by the liquidating corporation prior to 1954, if the securities were acquired before 1954 by the transferor-stockholder (or one from whom he acquired his stock in the liquidating corporation by gift or inheritance). (Act Sec. 917; relates to Code Sec. 333(e),(f).)	Only to liquidations occurring during 1970.
22. *Corporate acquisitions.*	
22.1 *Interest deduction.* A $5,000,000 (even less under some circumstances) limit is placed on deductions of interest on "corporate acquisition indebtedness." Such indebtedness is defined, broadly, as subordinated convertible debt (or debt accompanying warrants) which is used to acquire corporate stock or two-thirds of the operating assets of another corporation, if the acquiring corporation's debt-equity ratio exceeds two to one or if its "projected earnings" is less than three times its "annual interest expense." (Act Sec. 411(a); Code Sec. 279.)	*Generally, debt incurred after October 9, 1969 with an exception for debt incurred pursuant to prior dated contract.*
22.2 *Installment method.* Coupon, registered, or other readily tradable bonds are treated as year of sale payments. (Act Sec. 412; Code Sec. 453.)	*Post-May 27, 1969 transactions.*
22.3 *Original issue discount.* Original and subsequent holders of bonds other than government bonds are required to report (accrue) annually a pro rata portion of original issue discount. Life insurance companies using different accrual methods are not subject to this rule. Where the bonds are issued in exchange for property, the original issue discount will be considered	*Bonds issued after May 27, 1969.*

the excess of the face amount of the bonds over the fair market value of the property; in any event, there will be no original issue discount unless the bonds issued or the property acquired in the exchange represents publicly traded securities. In cases of bond-warrant units, the cost is to be allocated between the two components according to their relative fair market values. (Act Sec. 413; Code Secs. 1232, 6049.)

22.4 *Repurchase of convertible debt.* Premium paid on redemption of convertible debt is limited to the normal call premium for a nonconvertible debt, unless the corporation can show a greater amount represents a true borrowing cost. (Act Sec. 414; Code Sec. 249.)

Repurchases after April 22, 1969.

22.5 *Debt vs. equity guidelines.* The IRS is authorized to issue guidelines for distinguishing debt from equity. In addition to the debt-equity ratio, the suggested criteria include whether there are a fixed interest rate, a definite maturity date, any subordination, any convertibility, and proportionality in the interests of stockholders and creditors. (Act Sec. 415; Code Sec. 385.)

No deadline for IRS.

23. *Contributions of appreciated property.* The rules broadly set forth in Sec. 8.3 with respect to contributions of appreciated property by individuals apply to corporations except that in the case of contributions of long-term capital gain property, the percentage is 62½% instead of 50%. (Act Sec. 201(a); Code Sec. 170(e).)

Generally, post-1969 gifts.

24. *Minimum tax for tax preferences.* The rules for noncorporate taxpayers (see 2 above) are generally applicable to corporations, except that less than 50% of a long-term capital gain (5/12 in 1970, 3/8 thereafter) is treated as a tax preference item. Also, among other modifications excess investment interest is not a tax preference item for corporations. For banks, a bad debt deduction in excess of the amount allowable on basis of actual experience is a tax preference item. (Act Sec. 301(a); Code Secs. 56-58).

Years ending after 1969.

Provisions of the Act	Effective date

Taxpayers generally

25. *Extension of surcharge.* The surcharge is extended, at an annual rate of 5%, to June 30, 1970. (Act Sec. 701; Code Sec. 51.)	*Years ending after 1969 and beginning before July 1, 1970.*
26. *Investment credit terminated.* In general no investment credit will be allowed for property acquired or construction of which was begun after April 18, 1969. Exceptions, similar to the 1966 suspension rules, are provided. The principal exception is one for properties acquired or constructed pursuant to pretermination commitments, provided the property is placed in service before 1976. For post-1968 years, only 20% of the total of credit carryovers and carrybacks may be used up annually; but an additional three-year carryforward will be available if carryovers are not consumed in the ordinary seven-year period. (Act Sec. 703; Code Secs. 46, 47, 49.)	*Generally, April 18, 1969 – subject to a few exceptions.*
27. *Installment method.* A dealer in personal property may revoke an election to report on the installment method within three years after the due date of the return for the year the election was made. (Act Sec. 916; Code Sec. 453(c).) As to treatment of readily marketable bonds as payment in year of sale, see 22.2.	Any open taxable year.
28. *Involuntary conversion replacements.* The period for the tax free replacement of involuntarily converted property is extended to two years. (Act Sec. 915; Code Sec. 1033.)	*Post-December 30, 1969 conversions.*
29. *Accrued vacation pay.* Taxpayers who have been accruing deductions for nonvested vacation pay may continue to do so for another two years. (Act Sec. 903; Sec. 97 of Technical Amendments Act of 1958.)	Years ending before 1971.
30. *Antitrust, other public policy violations.*	
30.1 *Treble damage payments, kickbacks, etc.* Deductions are denied for (a) bribes and kickbacks to nonpublic officials provided the taxpayer is convicted for such acts, and for (b) two-thirds of treble	*Generally, nongovernmental bribe-kickback rule applies to payments made after December 30, 1969;*

damages paid on account of antitrust violations. Existing law denies deductions for (a) fines or penalties paid to a government and (b) bribes and kickbacks paid to public officials; these rules are now codified. (Act Sec. 902; Code Sec. 162.)

the anti-trust rule applies to post-1969 payments.

30.2 *Recoveries of damages.* Recoveries of antitrust damages, breach of contract damages, etc., are not taxable to the extent the prior losses did not result in any tax benefit. (Act Sec. 904; Code Sec. 186.)

Years beginning after 1968.

31. *Pollution control facilities.* Air and water pollution control facilities placed in service before 1975 are amortizable over a 60-month period. The investment credit must be waived for pretermination property. (Act Sec. 704; Code Sec. 169.)

Applies to years ending after 1968.

32. *Arbitrage bonds.* The interest on "arbitrage bonds" is no longer tax exempt. The term, very generally, includes indebtedness incurred for the purpose of acquiring other securities which will generate more income than the interest paid on the state or local government bonds. (Act Sec. 601; Code Sec. 103.)

Post-October 9, *1969 issues.*

33. *Excise taxes.*

33.1 *Extension of rates.* Extends schedule for excise taxes on communications services and automobiles for one year. (Act Sec. 702; Code Secs. 4061, 4251, 6412.)

January 1, 1970

33.2 *Concrete mixers.* Exempts concrete mixers mounted on truck chassis from the excise tax on trucks. (Act Sec. 931; Code Sec. 4063(a).)

Sales after 1969.

33.3 *Constructive sales price.* Rules are provided for constructing an excise tax base on sales between affiliated taxpayers. (Act Sec. 932; Code Sec. 4216(b).)

Sales after 1969.

34. *Procedure and administration.*

34.1 *Late payment penalty.* A penalty of ½% per month, up to 25% of the net tax due, is exacted for unreasonable failure to pay income tax when return is filed. In case of unreasonable failure to deposit withholding or

Amounts payable after 1969.

Provisions of the Act	Effective date
other taxes, a flat 5% penalty (rather than 1% per month) is assessed. (Act Sec. 943; Code Sec. 6651.)	
34.2 *Estimated tax penalties and deficiency interest.* Estimated tax payments due after January 29, 1970 must take the effect of the Act into account. Estimated payments due prior thereto (including January 15, 1970) need not include any increase in tax due to this Act. To the extent a deficiency in tax for a taxable year ended before December 30, 1969 is attributable to this Act, no interest will be charged thereon for the 90-day period after such date. (Act Sec. 946(a), (b); Code Sec.—None.)	*No date.*
34.3 *Exemption from levy.* To the extent a taxpayer is required by court decree to contribute to the support of his minor children, his salary or other income is exempt from levy. (Act Sec. 945; Code Sec. 6334.)	Levies made after January 28, 1970.

Particular taxpayers or activities

35. *Co-operatives.*	
35.1 *Housing corporations.* Units owned by governmental entities are disregarded in determining whether a corporation qualifies as a co-operative housing corporation. (Act Sec. 913; Code Sec. 216(b).)	Years beginning after 1969.
35.2 *Per-unit retain allocations.* Co-operatives may deduct (exclude from income) per-unit retain allocations paid in money or property, as well as those paid in qualified certificates. (Act Sec. 911; Code Sec. 1382.)	*Allocations made after October 9, 1969.*
36. *Farming and hobby losses.*	
36.1 *Recapture of prior farm losses.* Noncorporate taxpayers with "nonfarm adjusted gross income" exceeding $50,000 must establish an excess deduction account (EDA) for farm loss exceeding $25,000. There are no dollar exceptions for ordinary corporations; for subchapter S corporations, the dollar exceptions apply only if no shareholder has	Years beginning after 1969.

his own farm loss. The rules do not apply to accrual method farmers. EDA is reduced by future farm income.

Gain on sale of farm property, except land, is recaptured as ordinary income to extent of EDA. Gain on land sale is recaptured at ordinary rates to extent of prior conservation and land clearing deductions. (Act Sec. 211; Code Sec. 1251.)

36.2 *Livestock.* Post-1969 depreciation will be recaptured as ordinary income. Long-term gain holding period for horses and cattle is increased to two years. Exchange of livestock of different sexes will not qualify as a like-kind, tax-free exchange. (Act Secs. 212(a),(b),(c); Code Secs. 1245, 1231, 1031.)

Recapture rule, years beginning after 1969; holding period rule, post-1969 acquisitions; *like-kind exchange rule, all 1954 Code years.*

36.3 *Crop insurance proceeds.* Cash basis farmer has option to report income from crop insurance proceeds in year following receipt, if sale of crop would have occurred in following year. (Act Sec. 215; Code Sec. 451.)

Years ending after December 30, 1969.

36.4 *Citrus groves.* Expenditures for purchasing, planting, cultivating, maintaining or developing a citrus grove must be capitalized if incurred within four years after planting. (Act Sec. 216; Code Sec. 278.)

Years beginning after December 30, 1969; exception for casualty losses.

36.5 *Farmers' estimated tax.* Farmers and fishermen who wish to avoid filing declarations of estimated tax now have until March 1 (was February 15) to file tax returns. (Act Sec. 944; Code Sec. 6334(a).)

Years beginning after 1968.

36.6 *Hobby losses.* In general, net losses incurred by individuals and subchapter S corporations are disallowed if arising from an activity "not engaged in for profit." If profits are realized in any two of five consecutive years (seven years for horse racing, etc., activities), there is a rebuttable presumption that the activity is engaged in for profit. (Act Sec. 213, Code Sec. 183.)

Years beginning after 1969.

37. *Financial institutions.*

37.1 *Commercial banks.* A bank's actual six-year experience will ultimately (in 18 years)

Years beginning after July 11, 1969.

Provisions of the Act	Effective date
replace the 2.4% of eligible loans rule as the limitation to bad debt reserves. Transition rule allows 1.8% as the reserve limitation for six years, 1.2% for the next six-year period, and 0.6% for the last six-year period. (Act Sec. 431; Code Sec. 585.)	
37.2 *Small business investment companies.* SBICs and development corporations must use their six-year bad debt experience to compute additions to their reserve accounts. An industry average may be used for the first ten years of new companies. (Act Sec. 431; Code Sec. 586.)	*Years beginning after July 11, 1969.*
37.3 *Mutual savings banks, etc.* The "3% of real property loans" limitation on reserve for bad debts is repealed. The percentage used under the income method is reduced to 40% over a ten-year period. Savings banks are required to invest 72% (others 82%) in qualifying assets to get the maximum reserve allowances under the income method. Dividends received deduction must be allocated between taxable income and addition to reserves. Reserve for bad debts does not have to be restored to income upon the tax-free reorganization of a savings and loan association. (Act Secs. 432, 434; Code Secs. 593, 596.)	*Years beginning after July 11, 1969.*
37.4 *Bonds—ordinary gain treatment.* Net gain on sale of evidences of indebtedness is taxable as ordinary income, net loss remains deductible as ordinary loss. (Act Sec. 433; Code Sec. 582.)	*Years beginning after July 11, 1969; but prorate for securities acquired before July 12, 1969.*
37.5 *Loss carrybacks.* Financial institutions will be permitted a ten-year carryback of net operating losses incurred in years beginning after 1975. (Act Sec. 431(b); Code Sec. 172(b).)	Years beginning after 1975.
Banks for co-operatives will be allowed a ten-year carryback for net operating losses. (Act Sec. 431; Code Sec. 172.)	*Years beginning after July 11, 1969.*
38. *Foreign taxpayers or income.*	
38.1 *Foreign deposits in U.S. banks.* The limited income and estate tax exemptions	*U.S. branch rule — after 1969.*

with respect to deposits by foreign persons are extended from 1972 to 1975. On the other hand such deposits in U.S. branches of foreign banks will become subject to income and estate taxes if effectively connected with a U.S. business. (Act Sec. 435; Code Sec. 861.)

38.2 *Foreign base company income.* Sales, service and personal holding company income is excluded from foreign base company income if tax avoidance was not a significant reason for the acquisition of the controlled foreign corporation or for the transaction yielding the income. (Act Sec. 909; Code Sec. 954(b).)

Years ending after October 9, 1969.

39. *Insurance companies.* A limited carryover of net operating losses is allowed on a change in organization which subjects a company to a new type of taxation. (Act Sec. 907(c); Code Sec. 844.)

Post-1962 losses may be carried over, but only to post-1966 years.

Distribution of a business subsidiary's stock held since 1957 by an insurance company to its parent is not treated as a taxable event. (Act Sec. 907(b); Code Sec. 815(f).)

Years beginning after 1968.

Interest credited with respect to group term life insurance, etc., on retired persons is deductible. (Act Sec. 907(a); Code Secs. 805, 810.)

Years beginning after 1957.

40. *Natural resources.*

40.1 *Percentage depletion.* Rates are adjusted as follows: domestic and foreign oil reduced to 22%; molybdenum increased to 22%; and 15% minerals (except gold, silver, copper, iron ore, oil shale) reduced to 14%. Percentage depletion extended to mineral extracts from domestic saline lakes. (Act Sec. 501; Code Sec. 613.)

Years beginning after October 9, 1969.

40.2 *Mineral production payments.* Carved-out production payments and retained payments treated as mortgage loans, rather than an economic interest in the property. (Act Sec. 503; Code Sec. 636.)

Generally, payments created after August 6, 1969.

40.3 *Mining exploration expenditures.* Ordinary income recapture rules are provided

Expenditures paid or incurred after 1969.

Provisions of the Act	Effective date
for post-1969 mining exploration expenditures which will be deductible without limitation. Up to $400,000 of post-1969 foreign and oceanographic exploration will be deductible, apparently subject to recapture. (Act Sec. 504; Code Sec. 617.)	
40.4 *Continental shelf.* For income and employment tax purposes, "continental shelf areas" are deemed to be within the boundaries of the U.S. and foreign countries. (Act Sec. 505; Code Sec. 638.)	No date.
40.5 *Foreign tax credit.* Credit is disallowed for foreign taxes on mineral income on a per country basis to extent attributable to U.S. percentage depletion allowance. (Act Sec. 506; Code Sec. 901.)	Years beginning after 1969.
40.6 *Mine safety equipment.* Certified mine safety equipment placed in service before 1975 may be amortized over a 60-month period. (Act Sec. 707; Code Sec. 187.)	*Years ending after 1969.*
40.7 *Oil shale.* The treatment processes which will qualify as "mining" of oil shale, for percentage depletion purposes, are prescribed. (Act Sec. 502; Code Sec. 613(c)(4).)	*Years beginning after December 30, 1969.*
41. *Personal holding company.* For personal holding company tax purposes, a corporation may deduct dividends paid within two and one-half months after the close of the taxable year to the extent of 20% (was 10%) of the dividends actually paid within the year. (Act Sec. 914; Code Sec. 563(b).)	Years beginning after 1969.
42. *Real estate.*	
42.1 *Accelerated depreciation on real estate.* Only straight line or 150% declining balance depreciation is allowed for new nonresidential real estate which was acquired or constructed after July 24, 1969, unless construction was begun or contracted for before then. Depreciation on used nonresidential	*Generally related to July 24, 1969, but recapture rules apply to post-1969 depreciation.*

realty acquired after July 24, 1969, limited to straight line method.

New residential realty still qualifies for all accelerated methods; used residential realty with remaining useful life of at least 20 years may be depreciated under the declining balance method at a 125% rate. Five-year amortization is allowable for certain pre-1975 costs of rehabilitating certain low cost housing.

All post-1969 depreciation claimed over the amount allowable under the straight line method is subject to recapture, subject to limited exceptions for residential property and rehabilitation expenditures. (Act Sec. 521; Code Secs. 167, 1250.)

42.2 *Publicly assisted housing.* Gain on sale of government assisted housing to occupants or nonprofit managing organization is deferred if proceeds are reinvested in similar housing. Tax cost of new project reduced by any gain on sale of old project. (Act Sec. 910; Code Secs. 1039, 1250.)

Dispositions after October 9, 1969.

43. *Regulated industries.*

43.1 *Depreciation.* Generally, public utilities will be limited to prevailing methods of depreciation; overall, the changes limit the use of accelerated methods to companies which account for taxes under the flow-through method for rate making purposes. New rules apply to most utilities other than oil pipelines. (Act Sec. 441; Code Sec. 167.)

Years for which return was not filed before August 1, 1969.

43.2 *Railroad rolling stock.* Five-year amortization allowed for "rolling stock" acquisitions placed in service in 1970-1974 (four-year amortization allowed for 1969 property). Annual repair costs may be deducted where they do not exceed 20% of the unit's unadjusted basis.

Costs of railroad gradings and tunnel bores placed in service after 1968 may be amortized over 50 years beginning in 1970. (Act Secs. 705, 706; Code Secs. 184, 185, 263.)

Years beginning after 1969.

Private foundations*

Provisions of the Act	Effective date
44. *Definitions.* "Private foundations" are Sec. 501(c)(3) organizations other than churches, schools, hospitals, publicly supported charities, etc. "Foundation manager" includes officers, directors and trustees. "Disqualified person" includes foundation managers, substantial contributors, and persons owning more than 20% interest in a substantial contributor. (Act Sec. 101; Code Sec. 507, 509, 4946.)	Years beginning after 1969.
45. *Tax on investment income.* A 4% excise tax is imposed on net investment income, including capital gains attributable to post-1969 appreciation. (Act Sec. 101(b); Code Sec. 4940.)	Generally, years beginning after 1969.
46. *Tax on self-dealing.* Self-dealing with disqualified persons is prohibited. Prohibited acts of self-dealing include sales or leasing of property, loans, furnishing of goods, services or facilities unless without charge. An arrangement may be considered self-dealing even though it is at arm's length. There are exceptions to the self-dealing restrictions; e.g., a foundation may pay reasonable compensation to a manager for services related to its exempt function. A ten-year period is allowed for eliminating arm's-length arrangements existing on October 9, 1969. Taxes totaling 7½% (250% if violation not corrected) may be assessed against the disqualified person and the foundation manager on self-dealing transactions. (Act Sec. 101(b); Code Sec. 4941.)	*Generally, post-1969 transactions.*
47. *Tax on underdistributions.* Subject to a number of exceptions and transitional rules, a private foundation must distribute annually the larger of (a) adjusted net income or (b) 6% of average investment assets. Generally, the 6% requirement does not become effective until 1972, and then it will be phased in over a three-year period. A tax of 15% (100% if not corrected within	Generally, years beginning after 1969.

*This checklist does not reflect administrative provisions relating to applications for exempt status and the filing of information returns.

given period) is levied on the amount which remains underdistributed for one year at the end of the following year. (Act Sec. 101(b); Code Sec. 4942.)

48. *Tax on excess business interests.* Subject to exceptions and transitional rules, the foundation and disqualified persons together may not own more than 20% of the voting stock of a corporation. Comparable limitations are imposed on interests in partnerships or other business entity. A 5% tax is imposed on the excessive amount; an additional tax of 200% may be levied for persistent violation. (Act Sec. 101(b); Code Sec. 4943.)	Years beginning after 1969.
49. *Tax on imprudent investments.* Taxes initially totaling 10% (may be increased by another 30%) are imposed on investments which could jeopardize the carrying out of the foundation's exempt purposes. Apparently, speculative investments will be included as "jeopardy investments." (Act Sec. 101(b); Code Sec. 4944.)	Generally, post-1969 transactions.
50. *Tax on prohibited expenditures.* Taxes totaling 12½% (150% after persistent violations) are levied on expenditures for prohibited activities such as certain lobbying, attempting to influence a specific election, and certain grants to individuals for travel, etc. (Act Sec. 101(b); Code Sec. 4945.)	Generally, post-1969 expenditures.
51. *Tax on termination.* The termination of the exempt status of a private foundation may result in a tax equal to the lesser of (a) all the tax benefits (plus interest) attributable to donations by substantial contributors or (b) the net worth of the foundation. (Act Sec. 101(a); Code Sec. 507.)	*January 1, 1970.*
52. *Nonexempt trusts.* The taxes provided for private foundations are generally made applicable to nonexempt trusts whose unexpired interests are all devoted to charity, etc., and for which charitable deduction was allowed for income, estate or gift tax purposes. If not all the interests are so devoted, the tax is proportionately limited. (Act Sec. 101(b); Code Sec. 4947.)	*Effective January 1, 1970, but not with respect to transfers in trust before May 27, 1969.*

Provisions of the Act	Effective date

Other exempt organizations*

53. *Debt-financed property.* Income from debt-financed property is taxed as unrelated business income but not if "substantially all" of such property is used for exempt purpose (proration is provided if less than "substantially all" is so used). Other exemptions include, for ten years, mortgaged property acquired by devise, bequest or gift. (Act Sec. 121; Code Sec. 514.)	Years beginning after 1969.
54. *Unrelated business income tax extended.* Unrelated business income tax is extended to almost all exempt organizations including churches, social clubs, and voluntary employees' beneficiary associations. Generally, churches are exempt until 1976. (Act Sec. 121; Code Sec. 512.)	Years beginning after 1969.
55. *Investment income of social, etc., organizations.* For social clubs and employee beneficiary associations, investment income will be taxed as unrelated business income. An exclusion is allowed for "exempt function income" such as amounts permanently set aside for charitable purposes. (Act Sec. 121(b); Code Sec. 512(a).)	Years beginning after 1969.
56. *Receipts from controlled corporations.* Interest, annuities, rents, and royalties from controlled corporations are taxed. No tax is imposed on receipts from exempt controlled corporations (unless attributable to unrelated business income) and functionally related controlled corporations. (Sec. 121; Code Sec. 512.)	Years beginning after 1969.
57. *Deductions of nonexempt organizations.* Expenses of taxable social clubs and other membership organizations which are operated primarily to service members may be deducted only against income derived from members. Excess deductions may be carried over. This rule does	Years beginning after 1970.

*This checklist does not include new administrative provisions such as the requirement to file an information return with respect to a transfer of income producing property worth over $50,000 to an organization with unrelated business income.

not apply to organizations receiving prepaid dues (e.g., AAA), securities and commodity exchanges, etc. (Act Sec. 121(b); Code Sec. 277.)

58. *Advertising income.* The Code (generally approving existing regulations) specifies that profit from sale of advertising revenue in publications, etc., is taxed as unrelated business income. (Act Sec. 121(c); Code Sec. 513.)	Years beginning after 1969.

January 1970

Noncorporate taxpayers

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This article will cover most of the provisions of the 1969 Tax Reform Act which affect individuals, namely:

1. Income averaging
2. Moving expenses
3. Insurance reimbursements for certain living expenses
4. Increase in standard deduction
5. Low-income allowance
6. Personal exemptions
7. Tax rates for single persons
8. Extension of surcharge
9. Filing requirements
10. Computation of tax by IRS

Of course, there are other provisions of the Tax Reform Act which also affect the tax liabilities of individual taxpayers. Such provisions include the maximum tax on earned income (60% in 1971, 50% thereafter), the minimum tax on tax preferences, and revised treatment for compensation received in the form of restricted property. These and other provisions of the Tax Reform Act are the subject of separate articles.

1. Income averaging

Income-averaging provisions have been liberalized and simplified to a fairly significant extent, effective for years (i.e., current "computation" years) beginning after December 31, 1969 (and for

related base period years). Code Secs. 1301-1304 were amended by Act Sec. 311 in the following respects.[1]

Eligibilty tests less restrictive. Previously, current year's income was eligible for averaging only to the extent it exceeded 133⅓% of average base period income and no averaging at all was permitted if this excess was $3,000 or less. Amended Sec. 1301 reduces the eligibility percentage to 120%; however, the secondary $3,000 test continues to apply.

Expanded coverage. Averaging will now be available for:

- Long-term capital gains,
- Income from gifts, bequests, etc., and
- Wagering income.

On the other hand, income from accumulation trusts (included under Sec. 668(a)) is ineligible for averaging since it is subject to its own special tax computations.

As a result of these changes, adjustments to taxable income for a given averaging period will be confined to the items listed in Table 1 opposite (assuming as facts the amounts used).

Certain other benefits denied. Sec. 1304(b) previously denied certain other Code benefits to taxpayers electing income averaging, such as the exclusion for income earned without the United States (or within its possessions) and the special averaging computation on certain distributions from qualified self-employed retirement plans. In addition, the election of income averaging will now also preclude the use of the alternative capital gains tax computation as well as the new 50% maximum tax rate on earned income. Moreover, by virtue of Sec. 1304(b)(2), income averaging will also prevent utilization of the new special seven-year "forward" averaging computation which may be otherwise available for portions of lump sum distributions from qualified employee plans no longer

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[1] For brevity and clarity, provisions of the Internal Revenue Code will be simply cited as "Sec."; provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" means pre-Tax Reform Act law. "Amended law," "amended Sec." or "new Sec." refers to post-Tax Reform Act law.

TABLE 1

	Current (Computation) Year	Base Period Year
1. Taxable income	$50,000	$10,000
2. Net income earned without U.S. or within U.S. possessions and excluded under Sec. 911 and 931	xxx	9,000
3. Income from accumulation trusts—under Sec. 668(a)	5,000	4,000
4. Income subject to penalty—under Sec. 72(m)(5), proscribed distribution from self-employed retirement plan	10,000	xxx
5. Adjusted taxable income (lines 1 and 2, less 3 and 4—but not less than zero)	$35,000	$15,000

eligible for long-term capital gain treatment under Act Sec. 515. (Generally, Act Sec. 515 applies to distributions attributable to employer contributions for plan years beginning after 1969.)

On balance, though, the amendments to Secs. 1301-1304 would seem to be quite favorable and should continue the process, begun in 1964, of alleviating progressive tax rate erosion caused by undue peaks and valleys in a taxpayer's income.

2. Moving expenses

Sec. 217, which previously allowed a moving expense deduction only to employees, has been revised as follows:

a. The deduction has been extended to self-employed persons;
b. The time (i.e., 39 weeks, etc.) tests have been changed;
c. The mileage (previously 20 miles) test has been altered;
d. Moving expense reimbursements are now includable in gross income; and
e. Limited deductions will be allowable for three categories of specified indirect moving expenses.

a. Self-employed moving expenses. Self-employed persons can now deduct moving expenses to the same extent as employees. However,

eligibility is conditioned, in part, upon a 78-week test (at new place of employment) as opposed to only a 39-week test (continued from prior law) applicable to employees. This additional requirement was imposed because self-employed relocation was more likely to be voluntary than employee relocation.[2]

b. Time tests. In order for any moving expenses to be deductible under prior law, an employee had to be employed full time in the general location of his new principal place of work during the 12 months immediately following his arrival at such location. Appropriate procedures were provided if this test was not satisfied when the return for the year was due, if it was then still possible for the test to be subsequently satisfied. These provisions have not been changed by the Tax Reform Act except for the aforementioned addition of a comparable 78-week test for self-employed taxpayers.

However, amended Sec. 217(d)(1)(A) waives this time test if it cannot be satisfied because of death or disability. Such test is also waived if an *employee* obtains full-time employment and could reasonably have been expected to meet the test but is either:

- Involuntarily separated from the employer's service, except for willful misconduct, or
- Transferred for the employer's benefit.

c. Mileage test. The 20-mile test previously prescribed by Sec. 217(c)(1) has been replaced by a 50-mile test. In other words, the new place of work must be at least 50 miles further from the old residence than the old place of work. The Conference Committee Report (p. 301)[3] indicates that the distance used between these two points will be the shortest of the more commonly traveled routes between them rather than the actual distance.

Nevertheless, this requirement has been viewed as excessive. Testimony presented by the AICPA's federal taxation division to the

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[2] See page 39 of the Summary of H. R. 13270, dated November 18, 1969, prepared for the Senate Finance Committee.

[3] The committee reports relating to the Tax Reform Act are as follows: "House Report" (No. 91-413, Part 1 or 2, as the case may be, August 2, and 4, respectively), "Senate Finance Committee Report" (No. 91-552, November 21, 1969), and the "Conference Committee Report," House Report No. 91-782, December 21, 1969.

Senate Finance Committee indicated that an employee formerly commuting 20 miles to his old employment may not qualify for the deduction unless the new employment is 70 miles from his former residence. This is not realistic, even in our largest metropolitan areas.

d. Reimbursement. All direct as well as indirect reimbursements for moving expenses must be included in gross income as compensation for services (pursuant to new Sec. 82), with deductions for such expenses allowable in accordance with Sec. 217. Expenses paid by the employer to a mover, lessor of a temporary residence, etc., are considered indirect reimbursements. However, Sec. 3401 (a)(15) provides that such reimbursements are not subject to withholding to the extent it is reasonable to believe that offsetting deductions will be available.

These new rules will provide uniform treatment for all taxpayers who relocate. Under prior law, different treatment was possible, depending upon whether new or present employees were involved. Also eliminated are the dissimilar consequences previously possible for reimbursed as opposed to unreimbursed employees. On the other hand, new Sec. 82 could cause increased tax liability if offsetting expenses cannot qualify for deduction under Sec. 217.

e. Additional Categories of Deductible Expenses. The limited deductions now allowable under Sec. 217(b)(3) for three categories of so-called indirect moving expenses may be explained and illustrated as follows:

	Category of Expense	Maximum Amount Deductible
(i)	Pre-move house-hunting trips	$ 600
(ii)	Temporary living expenses at new job site	700
	Limit on deduction for both (i) and (ii)	$1,000
(iii)	Reasonable expenses of selling, purchasing, or leasing a residence	1,800
	Maximum deduction	$2,500

The maximum deductions are not increased if a husband and wife both obtain new employment in the same general area. How-

ever, the maximum deductions are reduced by 50% for a married taxpayer filing a separate return. To the extent that the amounts incurred with respect to the acquisition or disposition of residences are not deductible as moving expenses, they are treated as capital expenditures which either decrease the net sale price of the old residence or increase the tax basis of the new one.

(i) *Pre-move house-hunting trips.* Under amended Sec. 217(b)(1)(C), such expenses include transportation, meals, and lodging for a taxpayer and members of his household paid for the principal purpose of searching for a new residence, subject to the following conditions:

- The taxpayer has obtained new employment before beginning the trip, and
- The taxpayer makes a round trip between his former residence and the general area of his new principal place of employment.

(ii) *Temporary living expenses at new job site.* Under Sec. 217(b)(1)(D), such expenses consist of meals and lodging incurred by a taxpayer and his household members in the vicinity of a new job location while looking for, or waiting to move into, a permanent residence. However, only those expenses incurred within *any* 30 consecutive days after obtaining employment are deductible. (See House Report, Part 2, p. 50.)

(iii) *Expenses of disposing of and acquiring residences.*[4] The deduction for expenses of selling or exchanging a former residence is confined to those items which would be allowed as offsets against the selling price in determining the gain realized. Selling expenses include sales commissions and related legal fees, title costs, and escrow fees. "Fixing-up" expenses and any realized capital losses cannot be claimed as moving expenses. Double tax benefits are

[4] Sec. 217(b)(1)(E) and 217(b)(2). House Report, Part 1 at p. 76, Part 2 at p. 51. For this purpose, a residence is property owned or leased by the taxpayer, his spouse, or the couple jointly and includes a house, an apartment, a co-operative or condominium dwelling unit, or other similar dwelling.

denied by Sec. 217(e); thus, any selling expenses which are deductible as moving expenses cannot also be used to reduce the gain realized (if any).

In order for expenses of purchasing a new residence to be deductible, the new residence must be located in the general area of the new principal place of employment. Purchasing expenses are confined to those items which would be added to either the adjusted basis of the new residence or the cost of a loan. For example, such expenses include legal, appraisal, and escrow fees, title costs, and loan placement charges (i.e., "points") which do not represent interest or prepaid interest. ("Points" which are essentially interest expenses are deductible as such pursuant to Rev. Rul. 69-582.) The Senate Report (p. 109) states that neither prorated real estate taxes nor the actual purchase price are considered purchasing expenses. Since double benefits are denied under Sec. 217(e), deductible purchasing expenses must be excluded from the residence's tax basis.

The expenses of settling a lease are also deductible as moving expenses. The House Report (Part 2, p. 51) declares that these expenses consist of those items incident to settling an unexpired lease on a former residence, including payments to secure release from the lease as well as legal fees, commissions, and other similar expenses incurred to obtain an assignee or sublessee.

The expenses of acquiring a lease on a new residence may be deducted. These expenses include fees and commissions incident to obtaining a lease, sublease, or assignment of an interest in property used by the taxpayer as his new residence in the general location of his new principal place of employment. According to the Senate Report (p. 109), rent or prepaid rent and security deposits are not includable as lease acquisition expenses.

Effective dates. The new rules regarding moving expenses and their reimbursement (if any) apply to taxable years beginning after December 31, 1969, except:

- *Certain reimbursed expenses.* Reimbursed expenses are not deductible if the reimbursement was received in a taxable year beginning before January 1, 1970 and was not included in gross income (under prior law).
- *Certain moves before July 1, 1970.* At the taxpayer's election, prior law can be applied to moving expenses paid or incurred be-

fore July 1, 1970, pursuant to a notice received from an employer *on or before December 19, 1969.*

Planning implications. Generally, it will be advisable to claim such selling expenses as moving expense deductions, to the extent permitted under the new law, rather than offsetting them against the selling price. (It is not clear whether the selling price could instead be reduced, in those rare instances where it would be more advantageous, for such otherwise deductible expenses. In other words, such a choice may not be possible for such allowable moving expense deductions.)

On the other hand, selling expenses in excess of the deductible limits can, of course, continue to reduce the selling price.

3. Insurance reimbursements for certain living expenses

A homeowner's or tenant's insurance policy may provide for reimbursement of extraordinary living expenses, over and above normal living expenses, which may be incurred because a fire or other casualty damaged or destroyed the insured's residence. Under prior law, insurance reimbursements for such additional living expenses were considered taxable income even though no deduction was allowable for the personal expenses as casualty losses or otherwise.

Thus, the victim of a casualty (which is beyond his control), even though protected by insurance, would suffer a net loss equal to the income tax imposed upon the insurance proceeds.

New rule. New Code Sec. 123 provides that insurance proceeds received, *on or after January 1, 1969,* as reimbursement for living expenses incurred on behalf of a taxpayer and members of his household, resulting from the loss of use or occupancy of the taxpayer's principal residence, are excludable from gross income in either of the following circumstances:

- The principal residence is damaged or destroyed by fire, storm, or other casualty, *or*
- Access to the principal residence is denied by governmental authorities because of the occurrence, or threat of occurrence, of such a casualty.

The exclusion is subject to the following limitation:

"Actual living expenses" incurred by taxpayer and household members while residence cannot be used	$3,000
Less "normal living expenses" which they would have incurred during the same period	2,000
Limitation on amount of exclusion	$1,000

Definitions. There are no statutory definitions of "actual" and "normal" living expenses. However, the Senate Finance Committee Report (pp. 272-3) makes the following comparison between living expenses eligible for insurance reimbursement and living expenses for which reimbursements can be excluded from gross income:

> . . . The additional living expense insurance coverage is intended to reimburse the insured for certain excess living expenses incurred during a period in which his residence may not be used. Generally, these expenses include the additional costs actually incurred for renting suitable housing and extraordinary expenses for transportation, food, utilities, and miscellaneous services.
>
> However, the exclusion is intended to be limited to *reasonable* expenses in excess of normal living expenses, which for purposes of this provision include *only* those required to maintain the insured and his household in the same standard of living that they enjoyed before the loss occurred. . . . (Emphasis supplied.)

It is unfortunate that the operation of this otherwise desirable relief provision may be hampered by a limitation based upon such uncertainties as "reasonable" expenses and expenses required to maintain a pre-loss standard of living. The limitation does not seem necessary to protect the government's revenues since, assuming an insurance policy protects only against abnormal living expenses, the amount of reimbursement would be determined by arm's-length dealing between the insurance company and the taxpayer. Moreover, to the extent relief is limited under the new law, the basic inequity of the old law is still on the books—i.e., the premium is wholly nondeductible but a portion of the recovery may be taxable.

There are also no statutory definitions, nor any congressional committee guidance, for "members of a taxpayer's household" and "principal residence." It would appear desirable for the forthcoming

regulations to correlate these definitions with those used in the insurance policy.

4. Increase in standard deduction

Under amended Sec. 141(b), for years beginning after 1970, the standard deduction will be the larger of the:

- Percentage standard deduction, or
- Low income allowance.

The percentage standard deduction, which previously had been 10% of adjusted gross income with a $1,000 maximum deduction, remains unchanged for 1970 but will increase in stages over the succeeding three years, as follows:

Year Beginning	Percentage	Maximum amount
1970	10%	$1,000
1971	13%	1,500
1972	14%	2,000
After 1972	15%	2,000

Married couples filing separately use the same percentages but are limited to only one-half of the maximum amounts shown above.

The 10% standard deduction was originally introduced in 1944 to simplify preparation and auditing of individual returns. Price levels then prevailing induced more than 82% of the taxpayers to claim this deduction in lieu of itemizing. However, the effect of inflation and other factors upon the size of adjusted gross incomes and increases in itemized deductions (such as state and city income taxes) have reduced the number of taxpayers claiming the standard deduction to an estimated 58% for 1969. The new legislation is designed to reverse this trend.

Tax planning implications. The increased percentage standard deduction accentuates the desirability of various planning techniques previously used with the 10% standard deduction, including:

a. Matching deductions with fluctuating income in such situations as approaching retirement. In this case, doubling up on itemized deductions in a taxpayer's last active year would be advanta-

geous—especially when the next year's income is expected to be considerably reduced and available for offset by the standard deduction.

b. Co-ordinating alternate use of itemized and standard deductions with the availability of deductible medical expenses (i.e., where the 1% and 3% of adjusted gross income limitations are exceeded by medical payments for a given year).

c. Alternating itemized and standard deductions between contiguous years to the extent economically feasible and not in conflict with the basic tax principle of avoiding undue fluctuations in annual taxable incomes.

5. Low-income allowance

In 1964, the minimum standard deduction was introduced in order to remove the burden of the federal income tax from low-income persons. This minimum deduction has been replaced with a low-income allowance which is more attuned to present poverty levels, as follows.[5]

Beginning in:	Allowance
1970	$1,100
1971	1,050
After 1971	1,000

In 1970 and 1971 only, the low-income allowance in excess of the prior minimum standard deduction (which would have been available but for its repeal) is reduced if adjusted gross income exceeds the new nontaxable levels of income ($1,100, or $1,050 for 1971, plus amount of exemptions). These reductions are termed "income phase-outs" and are computed as shown in lines 1-5 of Table 2, p. 40. Accordingly, assuming a joint return, the low-income allowance would be determined as shown in lines 6-9.

It should be noted that such detailed computations of low-income allowances will be obviated by their reflection in the optional tax tables authorized by Sec. 3. Moreover, as previously indicated, the "income phase-out" reduction will be inapplicable after 1971.

[5] Amended Code Sec. 141(c); Conference Report, p. 328.

TABLE 2

		1970		1971
1. Adjusted gross income		$10,000		$10,000
Less:				
2. Tentative low-income allowance	$1,100		$1,050	
3. Deduction for 4 exemptions:				
1970 (at $625 each)	2,500	3,600		
1971 (at $650 each)			2,600	3,650
4. Amount of adjusted gross income in excess of nontaxable level of income		$ 6,400		$ 6,350
5. Reduction in portion of low-income allowance exceeding prior minimum standard deduction:				
1970: 1/2 of line 4		$ 3,200		
1971:1/15 of line 4				$ 423
6. Basic allowance (generally equal to prior minimum standard deduction)		$ 600		$ 600
7. Additional allowance*	$ 500		$ 450	
8. Less: reduction (line 5 above)	3,200	0	423	27
9. Low-income allowance		$ 600		$ 627
*Initial amount	$ 900		$ 850	
Less—$100 multiplied by number of exemptions	400		400	
To line 7 above	$ 500		$ 450	

In the case of married individuals filing separate returns, the following allowances are substituted:

Year	Allowance	Maximum Allowance
Beginning in 1970 and 1971	$100, plus $100 for each exemption	$500
After 1971	$500	$500

If such separate returns are filed, the low-income allowance is not allowed unless the taxpayer's spouse also claims the standard

deduction (i.e., the larger of the percentage standard deduction or the low-income allowance). See existing Sec. 142(a).

Amended Sec. 143(b) provides special relief for a family abandoned by one of the parents; in such case, the other parent can claim either the low-income allowance or the full maximum percentage standard deduction allowable for single individuals rather than for married persons filing separately. In addition, under amended Sec. 2(c), the deserted spouse can use the head-of-household tax rates, if otherwise eligible.

To qualify for these new relief measures, a deserted spouse must:[6]

- File a separate return;
- Maintain as her or his home a household which is the principal place of abode of a dependent;
- The dependent in question must be a son or daughter (or stepson or stepdaughter);
- The individual must be entitled to a dependency deduction for the son or daughter;
- The individual must furnish more than one-half the cost of maintaining the household; and
- During the entire taxable year the individual's spouse must not be a member of the household in question.

6. Personal exemptions

Under Act Sec. 801, personal exemptions will be increased to $750, in four annual $25 increments, as follows:

Year	Exemption
Beginning in:	
1970	$625
1971	650
1972	700
After 1972	750

For 1970 withholding purposes, the increase is $650 and is effective as of July 1, 1970.

Planning for future utilization of these increased exemptions,

[6] See House Report, Part 1, p. 207.

particularly as related to children (within the meaning of Sec. 152(a)(1)), appears to be outside the tax adviser's expertise.

In addition, the prior $600 gross income test for dependents (except for children who are either full-time students or under 19 years of age) has also been liberalized for corresponding years and in corresponding amounts. Therefore, for 1970, such a person can have $624 of gross income, instead of $599, without jeopardizing the taxpayer's exemption (for this dependent). See Sec. 151(e)(1)(A).

Planning Pointers. The increased personal exemption, as well as the low-income allowance (Part 5 above), also makes gifts of income-producing property to such children more attractive. For example, in 1973, $1,850 of ordinary income dividends can be received by them tax free.

Also, the benefit of increased personal exemptions in computing estimated taxes under "Exception 2" (prior year's income—current year's rates and exemptions) is available in 1970. Although Sec. 6654(d)(4) refers to ". . . the basis of the taxpayer's status with respect to personal exemptions . . . for the taxable year, but otherwise on the basis of the . . . law applicable to the preceding taxable year," the IRS has generously announced that an underestimation penalty will not be asserted if $625 (rather than $600) per exemption is used in computing 1970 estimated taxes under Exception 2. (See TIR-1035.)

7. Tax rates for single persons

Beginning in 1971, the tax rates for single persons and heads of households will be reduced, while rates for married individuals (whether filing jointly or separately) and fiduciaries (previously taxed as single persons) remain unchanged. As a result of these changes, the tax imposed upon single persons will not exceed 20% of the tax that would be paid on the same taxable income if a joint return was filed. The new head-of-household rates will be halfway between joint rates and the new single rates.

Table 3, opposite, compares the new and old rates applicable to these various types of taxpayers in selected brackets (exclusive of any surcharges).

It would appear to be beyond the scope of this article to com-

ment on the social implications to be drawn from this expression of national policy which has reduced tax rates only for *unmarried* people.

As indicated in our prior discussion of the new low-income allow-

TABLE 3

Comparison of new and old individual tax rates*

Selected taxable income	Type of taxpayer	Tax on selected taxable income		Marginal rate on additional taxable income	
		1971	1970	1971	1970
$100,000:					
	Married and filing joint returns	$45,180	$45,180	62%	62%
	Head of household	49,120	50,300	66	66
	Unmarried (except surviving spouses and heads of households)	53,090	55,490	70	70
	Married and filing separate returns; estates and trusts	55,490	55,490	70	70
$ 50,000:					
	Married and filing joint returns	$17,060	$17,060	50%	50%
	Head of household	18,640	19,820	56	56
	Unmarried (except surviving spouses and heads of households)	20,190	22,590	62	62
	Married and filing separate returns; estates and trusts	22,590	22,590	62	62
$ 10,000:					
	Married and filing joint returns	$ 1,820	$ 1,820	22%	22%
	Head of household	1,940	2,000	25	27
	Unmarried (except surviving spouses and heads of households)	2,090	2,190	27	32
	Married and filing separate returns; estates and trusts	2,190	2,190	32	32

*Based upon Sec. 1, before and after amendment by the Tax Reform Act of 1969.

ances (Part 5 above), an abandoned spouse may qualify for head-of-household rates for years beginning *after 1969,* if the conditions specified in new Sec. 143(b) are satisfied. Incidentally, the Conference Committee (p. 329 of Report) rejected a House provision which would have extended the use of joint return rates by eligible surviving spouses beyond the present two-year period.

8. Five per cent surcharge for first half of 1970

The prior 10% surcharge has been extended, at a reduced annual rate of 5%, through June 30, 1970. Consequently, under amended Sec. 51(a)(1)(A), the effective surcharge rate for a full calendar year 1970 will be 2½%, with no surcharge in effect thereafter.

It should be noted that in a case of a short taxable year the effective surcharge rate may be 5%. For example, if a calendar-year individual filing a separate return died on June 30, 1970, the surcharge would be effectively 5% of the full tax. See Sec. 51(a)(2).

However, if a joint return is filed, it is treated as if the taxable years of *both* spouses ended with the close of the survivor's year (e.g., December 31, 1970). See Regs. Sec. 1.6013-3. Under this rationale, the effective surcharge rate in the case of an individual dying on June 30, 1970 would be 2½%. Thus, the surcharge would be considered in determining whether a separate or joint return should be filed for an individual dying during 1970.

The extension of the surcharge should be reflected in computing 1970 estimated taxes under Exception 2 (i.e., based upon 1969 taxable income, but using 1970 exemptions and rates). It might also be noted that although the new minimum 10% tax on tax preferences applies to years ending after December 31, 1969, it is not subject to estimated tax requirements.[7]

For 1970 withholding tax purposes, a 5% surcharge rate applies on compensation paid through June 30, with no surcharge applicable thereafter.[8]

Summary. The 1969 Act has scheduled the rate reductions or increases shown in Table 4, opposite.

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[7] See Secs. 56, 6015(c) and 6654(f), as amended.

[8] See p. 88 of the House Summary referred to in note 2.

TABLE 4

Reductions	1970	1971	1972
1. Surcharge rate	2½%	0	0
2. Regular tax rates for unmarried individuals	Same as 1969	Reduced as described in Part 7 of this article	
3. Maximum tax rate on earned income	70%	60%	50%
4. Reduction of regular tax rates through income averaging	Liberalized averaging available, beginning in 1970		
Increases			
5. Maximum tax rate on net long-term capital gains:			
First $50,000 of gains ($25,000 for married individuals filing separately)	25% (same as 1969)		
Additional gains	29.5%	32.5%	35%
6. New minimum tax on prescribed "preferences"	10% rate on preferences exceeding $30,000 and tax otherwise due beginning in 1970*		

* See Secs. 56-58. Under Act Sec. 301(c), this minimum tax will apply to fiscal years beginning in 1969 and ending in 1970.

Planning implications. As a result of these statutory changes, it may be desirable to shift non-capital gains income from 1970 into 1971 or 1972, particularly in the case of substantial earned income subject to the maximum rates shown on line 3 of Table 4. This shifting might be accomplished by accelerating deductions into 1970 and/or postponing receipt of gross taxable income to later years. Of course, the feasibility of such "tax action" must be weighed against such nontax considerations as compensation for the use of the money involved in such arrangements, as well as whether these transactions would be permitted by the other parties thereto. Needless to say, the new 10% minimum tax may have an opposite effect on the above conclusions.

9. Computation of tax by IRS

Optional tax tables were previously authorized for individuals with adjusted gross income of less than $5,000. Effective for taxable

TABLE 5

	1970-1972	1973 and thereafter
Under age 65:		
Single persons	$1,700	$1,750
Married couples:		
Filing jointly	2,300	2,500
Filing separately or living apart	600	750
Age 65 or over:		
Single persons	$2,300	$2,500
Married couples:		
Filing jointly:		
One spouse 65 or over	2,900	3,250
Both spouses 65 or over	3,500	4,000
Filing separately or living apart	600	750

years beginning after 1969, these tables will be available for individuals with adjusted gross income of less than $10,000.

Under prior law, taxpayers could request the IRS to compute their tax in limited circumstances. Effective for taxable years beginning after 1969, these circumstances can be enlarged by regulations which could permit taxpayers to request IRS tax computations without regard to:[9]

- The amount or source of gross income (including situations where gross income is $10,000 or more);
- Whether itemized or standard deductions are claimed; and
- Whether the retirement income credit is claimed.

10. Filing requirements

Under prior law, individual tax returns were required, generally, if gross income was $600 or more (or $1,200 or more, for taxpayers 65 or over). In view of the new low-income allowances (described in Part 5 above), the tax return filing levels have been raised, as shown in Table 5, above.[10]

As under prior law, special rules govern filing requirements for nonresident aliens, individuals entitled to exclude income from U.S. possessions under Sec. 931, and short-period returns resulting from accounting period changes.[11]

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[9] Sec. 6012(a)(1); Act Sec. 914(c) and (d).
[10] Secs. 6012(a)(1)(A) and 142(b).
[11] Amended Sec. 6014(b); Conference Report p. 339.

Maximum tax on earned income[1]

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It has been over twenty-six years since the Congress last recognized that the usual earned income should be given special relief from the graduated tax rates. A provision which had allowed a limited *earned income credit* (not exceeding $1,400) against an individual's tax was eliminated for years beginning after 1943.[2] It is true that an income-averaging method of tax computation introduced in 1964 provides relief from graduated rate tables in a year in which an individual's income is abnormally high. However, this provision does not and was not designed to provide relief for most of the taxpayers whose taxable income consists primarily of earned income since such income tends to be stable from year to year.[3]

New Sec. 1348[4] provides that under certain conditions an indi-

[1] The new Sec. 1348 is entitled "Fifty-Percent Maximum Rate on Earned Income." The caption is imprecise in two respects. Before the 50% rate becomes effective, the maximum rate on earned income will be 60%—and that rate does not become effective until years beginning after 1970. (See "Effective dates" in the text.) Also, the maximum rate applies only to "earned taxable income" which, as will be seen, may be substantially less than "earned income."

[2] Sec. 25(a)(3), 1939 Code, deleted by Sec. 107(a), 1943 Revenue Act.

[3] Under recently amended Sec. 1301, very generally, income averaging applies only to income which is 20% (was 33⅓%) greater than the average income for the four preceding years.

[4] For brevity and clarity, provisions of the 1954 Internal Revenue Code will be simply cited as "Sec.," while provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" means pre-Tax Reform Act law. "Amended law," "amended Sec." or "new Sec." refers to post-Tax Reform Act law.

vidual's earned income after prescribed modifications, is not to be subject to a graduated tax rate in excess of 50%. Sec. 1348 was enacted not so much as a relief measure for tax-underprivileged earners of taxable income but rather to reduce the pressure for their use of tax loopholes.[5] Taxpayers with ordinary income in high tax brackets have been participating in tax-sheltered programs such as oil and gas, leasing, farming, and real estate, although such operations may be unprofitable except for tax considerations. In short, Sec. 1348 is designed as a disincentive rather than as an incentive.

Sec. 1348 will be discussed under the following captions:

1. Effective dates
2. Ineligible taxpayers
3. Earned income defined
   3.1 Included in earned income
   3.2 Excluded from earned income
   3.3 Income attributable to capital
4. Earned net income
5. Earned taxable income
6. Application of Sec. 1348
7. Observations and guidelines
8. Tax planning
9. Summary

1. Effective dates

The maximum graduated tax rate of 50% does not become effective until years beginning after December 31, 1971. For years beginning within 1971 the maximum rate is 60%. Sec. 1348 does not apply to any year beginning in or before 1970. However, it is not too early to plan to maximize the benefits under the section.

2. Ineligible taxpayers

Sec. 1348(a) bars any taxpayer who uses income averaging from utilizing the maximum earned income tax rate. Furthermore, married individuals are prohibited from using Sec. 1348 if they file separate returns.

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[5] House Report, No. 91-413, Part 1, p. 208.

3. Earned income defined

The definition of this basic term consists largely of incorporating by reference definitions provided by other sections of the Code. In essence, Sec. 1348(b) provides that "earned income":

- Includes any income which is considered earned under Secs. 911(b) and 401(c)(2)(C), but
- Excludes most kinds of deferred compensation.

3.1 Included in earned income. By reason of a cross-reference to Sec. 911(b),[6] earned income includes wages, salaries, or professional fees and other amounts received for personal services actually rendered. Specifically excluded are (a) the part of compensation which represents a distribution of corporate earnings and profits rather than reasonable compensation for services actually rendered by the taxpayer and (b) at least 70% of the profits from a trade or business in which capital is a material income-producing factor (see 3.2).

By reason of a cross-reference to Sec. 401(c)(2)(C),[7] earned income also includes gains (other than gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than goodwill) by an individual whose personal efforts created such property.

3.2 *Excluded from earned income.* Specifically excluded from earned income are distributions to owner-employees under self-employed retirement plans which are penalized under Sec. 72(m)(5) as excessive or premature distributions.

Also disqualified are lump sum distributions from qualified deferred compensation plans which are taxed under the income-averaging rules provided in Sec. 72(n) or as capital gain under Sec. 402(a)(2), and distributions under a Sec. 403(b) annuity contract purchased by certain exempt and educational organizations.

Earned income does not include "any deferred compensation within the meaning of Sec. 404." However, the deferred compensation exclusion does not apply to any amount received before the

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[6] Sec. 911(b) exempts limited amounts of income earned abroad under certain circumstances by non-resident U.S. citizens.

[7] Sec. 401(c)(2)(C) considers such income to be earned for the purposes of self-employment retirement plans.

end of the recipient's taxable year following the first taxable year in which his right to receive such amount is not subject to a substantial risk of forfeiture within the meaning of new Sec. 83(c)(1). Thus, compensation received in the form of restricted stock (or other property) should usually qualify as earned income, since such stock will ordinarily be received and be taxable in the year in which the substantial risk of forfeiture lapses.

Finally, if capital is a material income-producing factor in an unincorporated trade or business, at least 70% of a proprietor's or partner's income from such business is excluded from earned income. This exclusion, which is likely to generate considerably more controversy under Sec. 1348 than it has under Sec. 911(b), will be discussed more fully later in this article.

3.3 ***Income attributable to capital.*** Sec. 911(b) states:

> ... In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30% of his share of the net profits of such trade or business, shall be considered as earned income.

Under this rule, a partner's guaranteed payments and distributive share of profits (or a sole proprietor's entire income) will qualify as earned income only to the extent of the lesser of an amount which represents:

- Reasonable compensation for personal services rendered by the partner, or
- Thirty per cent of the sum of his guaranteed payments and share of profits.

In other words, at least 70% of a partner's (or sole proprietor's) income from a business to which capital is material will be excluded from earned income. Furthermore, it appears that a partner is subject to this exclusion even though he himself contributed no capital.[8]

Example 1. From a real estate partnership, *P* derives taxable income totaling $30,000, consisting of a guaranteed salary of $20,000 and a

[8] See *Lawrence L. Tweedy,* 47 BTA 341, involving a prior law provision corresponding to Sec. 911 definitions.

profit-sharing distribution of $10,000. The reasonable compensation for his services is considered to be $15,000. His earned income is limited to $9,000—the lesser of $15,000 or 30% of $30,000.

Example 2. From a manufacturing partnership, *P* receives a guaranteed salary of $10,000, although the reasonable compensation for his services is $20,000. His distributive share of the firm's profits is $40,000. He is entitled to treat $15,000 ($10,000 plus $40,000 × 30%) as earned income since that is less than his reasonable compensation of $20,000. However, the fact that he received a guaranteed salary of only $10,000 may suggest to a revenue agent that only such amount constitutes reasonable compensation for *P*'s services and therefore is the maximum amount allowable. If the $10,000 is really no more than a nominal drawing account, it should not be controlling. But partnerships paying nominal salaries to partners should consider the advisability of fixing realistic "guaranteed salaries." Such amounts, if predetermined on an arm's-length basis for a taxable year, should be useful (but not conclusive) evidence on the question of what constitutes reasonable compensation.

Regs. Sec. 1.911-1(a)(5) indicates that this limitation on earned income applies only where the sole proprietorship or partnership form of doing business is used.[9] Where the corporate form is used, the capital is that of the corporation and the salary received by the individual would be solely for personal services. Thus, the same amount received from the same business by the same individual would be treated differently for "earned income" purposes solely because of the difference in the form of doing business.

Example. A stock brokerage business breaks even under the partnership form of doing business after making "guaranteed payments" of reasonable salaries to the partners. *P*, who received a guaranteed payment of $50,000, could treat no more than $15,000 as earned income. Assuming the same facts except that the business has been incorporated and *P* is a working stockholder, he would be entitled to treat the entire $50,000 as earned income.

As this example suggests, by incorporating a business to which capital is material, the arbitrary limitation on reasonable compensation for a working owner of a business may be avoided.

The question may occur: If a corporation to which capital is

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[9] Also see Rev. Rul. 55-171, Sec. 7.02, 1955-1 CB 80, in which the capital test is limited to sole proprietors and partners.

material has elected subchapter S treatment, will compensation payments to working stockholders be subject to the 30% limitation? We think not. A subchapter S corporation is a true corporation, although it is taxed more like a partnership while the election is in effect. Since compensation paid to an employee-shareholder by an ordinary taxed corporation in which capital is a material income-producing factor is not subject to the 30% limitation, we believe that reasonable compensation paid by a subchapter S corporation should be treated similarly. This is so particularly since subchapter S was intended to be a relief provision.

The IRS has issued several rulings on whether capital is a material income-producing factor to specific trades or businesses:

- Farming, in general, is a business in which a material portion of gross income is attributable to the utilization of capital.[10]
- For an accounting partnership, capital is considered not to be a material income-producing factor.[11]
- For an investment and banking partnership, both personal services and capital are considered material income-producing factors.[12]

4. Earned net income

In effect earned income is a gross amount. To arrive at earned net income, subtract the deductions allowable under Sec. 62 (dealing with adjusted gross income) which are attributable to the trade, business, or employment which produced the earned income. More specifically, such deductions include:

- Deductions attributable to the trade or business.
- For an employee: reimbursed expenses, travel expenses away from home, transportation expenses, outside salesman's expenses, and moving expenses.
- For the self-employed: deductions for contributions on their behalf to pension, profit-sharing, etc., plans; and moving expenses.

5. Earned taxable income

Arithmetically, "earned taxable income" (which is sometimes referred to as ETI) may be defined as follows:

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[10] Rev. Rul. 66-326, 1966-2 CB 281.
[11] Rev. Rul. 67-158, 1967-1 CB 188.
[12] See note 11.

a. Percentage of earned net income to adjusted gross income, but not more than 100%	
b. Taxable income multiplied by line (a)	$
c. Less—reduction for items of tax preference (see (e) to (i) below)	
d. Earned taxable income	$
The reduction for tax preferences[13] is arrived at as follows:	
e. Tax preferences for current year	$
f. Average tax preferences for current and four preceding years[14]	
g. Greater of line (e) or (f)	$
h. Less	$ 30,000
i. Reduction for tax preferences	$

6. Application of Sec. 1348

Once the definitions are understood, Sec. 1348 merely involves the mechanical application of certain predetermined amounts to a three-step formula to determine the total tax due for the year.

Assuming that an individual's earned taxable income is sufficiently high as to be partly subject to a tax rate in excess of 50%, the tax liability under Sec. 1348 will be the sum of:

[13] Tax preference items may exist if the taxpayer (or his partnership) has net long-term capital gains; deducts depreciation on real property or net-lease personal property under other than a straight-line method; acquires stock by exercise of a qualified stock option; deducts depletion in excess of the tax basis of the natural resource property; has substantial interest deductions, or is amortizing a pollution control facility.

[14] Act Sec. 301(c) specifies that the tax preference rules provided in Secs. 56-58 apply to *years ending after December 31, 1969.* Thus, the question arises as to whether, in determining average tax preferences, reference should be made to years ending before 1970—years to which Secs. 56-58 were inapplicable. For example, in the case of a computation for the calendar year 1971, should the taxpayer total up his tax preferences for only 1970 and 1971 and divide it by two? Or should tax preferences the taxpayer *would have had* for 1967, 1968 and 1969 be constructed, the total added to those for 1970-1971, and the result divided by 5? (In this connection, note that fiscal year taxpayers are vulnerable to the tax preference rules on a pro rata basis for years beginning in 1969 and ending in 1970.) Presumably the forthcoming regulations under Sec. 1348 will take a position on these questions.

(i) Tax on the lowest amount of taxable income on which the tax rate exceeds 50%;

(ii) Fifty per cent of the amount by which the earned taxable income exceeds the lowest amount of taxable income on which the tax rate exceeds 50%; and

(iii) The excess of the tax computed on total taxable income over the tax computed on only earned taxable income—both computed without regard to Sec. 1348.

Example. For the calendar year 1972 the pertinent facts concerning John Jones, a single taxpayer with no dependents, are as follows:

• Earned (commissions) income	$ 75,000
• Total of tax preferences (none for prior years)	35,000
• Other taxable income	8,000
• Outside salesman's expenses	5,000
• Itemized deductions and exemption	28,000
• Taxable income	85,000

The *earned income* of John Jones is $75,000, his gross commissions. His *earned net income* is $70,000—gross commissions of $75,000 less the $5,000 of outside salesman's expenses which are deductible in arriving at adjusted gross income.

His *earned taxable income* is $47,655, computed as follows:

First, determine the amount (if any) of adjusted income tax preferences (sometimes referred to as "adjusted ITP") which must be considered in computing ETI.

Items of tax preference	$35,000
Less	30,000
Adjusted ITP	$ 5,000

Then enter the known amounts in the following formula:

$$\frac{\text{Taxable income} \times \text{earned net income}}{\text{Adjusted gross income}} \text{ less adjusted ITP} = \text{ETI}$$

$$\frac{\$85{,}000 \times \$70{,}000}{\$113{,}000} \text{ less } \$5{,}000 = \$47{,}655$$

Under the applicable single-taxpayer rate table,[15] the lowest amount of taxable income on which the rate exceeds 50% is $38,000.

[15] The pertinent portions of the Sec. 1(c) tax table applicable to unmarried individuals for years beginning after December 31, 1970 read as follows:

Income bracket	Tax and Rates
$32,000 to $38,000	$10,290, plus 50%
$38,000 to $44,000	$13,290, plus 55%
$44,000 to $50,000	$16,590, plus 60%
$80,000 to $90,000	$39,390, plus 68%

The 1972 tax, computed under Sec. 1348, would be $42,125, arrived at in the following three steps:

Step 1. Tax on the lowest amount of taxable income on which the tax rate exceeds 50% (i.e., the tax on $38,000)		$13,290
Step 2. Fifty per cent of the amount by which earned taxable income ($47,655) exceeds the amount ($38,000) on which the tax in Step 1 was computed		4,828
Step 3. Excess tax computed on all taxable income over the tax on only ETI, both computed without regard to Sec. 1348.		
Tax on $85,000	$42,790	
Tax on ETI	18,783	24,007
Tax due		$42,125

Under Sec. 1348, John Jones would save $665 ($42,790-$42,125). The proof of the saving is in the difference between the 50% rate and the graduated rates that would otherwise be applicable to the $9,655 of ETI in excess of $38,000, that is:

5% (55% less 50%) of	$6,000	$ 300
10% (60% less 50%) of	$3,655	365
Totals	$9,655	$ 665

7. Observations and guidelines

The following observations and guidelines may help tax practitioners to better understand and more effectively apply Sec. 1348.

• If the earned income of a taxpayer does not exceed the specified amounts for the indicated years, then Sec. 1348 cannot apply to him because such amounts—even without adjustments—could not be taxed at rates in excess of 50% (60% for 1971):

Returns	1971	1972
Single	$ 50,000	$38,000
Head of household	70,000	38,000
Joint	100,000	52,000

• The fact that a person may have $100,000—or even $1,000,000 —of earned income does not, by itself, mean any tax savings will result under Sec. 1348. The maximum tax is computed on earned taxable income which may be substantially less than *gross* earned income. Since there are several variables in computing earned taxable income (i.e., taxable income, earned net income, adjusted gross in-

come, and adjusted ITP), the tax liabilities due under the maximum rate and the regular methods—and possibly under the income-averaging formula—will have to be computed before it can be determined if tax savings would result.

- If income averaging is available for a given year, it may prove more beneficial than the maximum earned income tax. In any event, computation should be made under both methods.
- The 50% maximum rate will serve as a disincentive to incorporating professional organizations and other personal service businesses which, after incorporation, would be required to pay a 48% tax on earnings (exclusive of the surtax exemption).
- The average rate on earned taxable income will be less than 50% (or 60% for 1971) because, under the formula, the lowest levels of such income are *taxed first* at graduated rates until the 50% marginal rate is reached, and only the balance is taxed at 50%. See the example under part 6.

8. Tax planning

Even though Sec. 1348 does not apply until taxable years beginning after 1970, it is not too early to start planning to realize the benefits of this section. Some of the areas that should be explored are suggested by the following questions:

a. Can wages, professional fees, etc., be deferred to 1971? Before arranging such deferments, be sure to consider all factors including:

- Whether this would place the taxpayer in an abnormally high tax bracket in 1971 (even with the 60% ceiling).
- Whether items of tax preference (e.g., long-term capital gains) will reduce the amount of earned net income to a minimal amount of earned taxable income.
- Whether it is wise, considering the interest value of money and the possibilities of the receivables becoming uncollectible, to defer the receipt of the compensation or fees.

b. Where capital is a material income-producing factor, should the business be incorporated so that a greater portion of the net profits will qualify as earned income? (See 3.3.) If the corporation cannot qualify as a subchapter S corporation and cannot justify

paying out substantially all its profits as salaries, incorporation may prove too much to pay for Sec. 1348 benefits.

c. Should investments in tax-sheltered plans in oil and gas, leasing, farming, and real estate be reduced or discontinued by persons with substantial earned income? The risk of the investment, when weighed against the possibly smaller tax benefit, may not make it worthwhile. However, since Sec. 1348 does not apply to 1970 and applies to 1971 only at the 60% rate, tax-sheltered programs for at least those two years may still be worthwhile.

d. Should deferred compensation plans, especially nonqualified ones, be discontinued or modified so that the compensation involved will qualify as earned income?

9. Summary

Sec. 1348 appears at first blush to give substantial benefits to the high tax bracket wage earner and professional person. The actual tax savings, however, may not be as great as they appear at first glance. Accordingly, the tax benefits, if any, can be determined only after the required complex computations have been made.

Although 1971 is the first calendar year for which the tax can be computed under Sec. 1348 (at a 60% rather than 50% rate), tax planning should begin in 1970 to gain the most from this new section. Because of the interrelated variables (itemized and adjusted gross income deductions, as well as tax preferences and earned income), Sec. 1348 planning (like estate planning) has to be re-examined frequently in light of changing facts and circumstances.

April 1970

Deferred compensation

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The TRA has intervened in the well-established compensation plans of (and for) taxpayers in the following areas:

1. Restricted property,
2. Nonqualified deferred compensation plans,
3. Lump sum distributions from qualified plans, and
4. Limitations on qualified plan contributions for "principal" shareholder-employees of subchapter S corporations.

At some point during the TRA's travels through Congress, each of the following proposals was considered but was eliminated from the final version of the Act:

- "Throwback" computation for nonqualified deferred compensation exceeding $10,000 a year[1] and
- Limitation on qualified deferred compensation plan benefits for stockholders of professional corporations.[2]

1. Restricted property

Compensation can consist of cash, other property or other economic benefits. Any type of property can be used as a compensatory device, including stock in the employer corporation, stock of another company—such as an unrelated growth company—or even

[1] H.R. 13270, Sec. 331, as passed by the House.
[2] H.R. 13270, Sec. 901, as reported to the Senate on November 21, 1969.

shares of a mutual fund. For a variety of business and tax reasons, certain restrictions were often placed upon such property, thereby affecting its value.

1.1 ***Treatment under pre-existing regulations.***[3] Where compensation was paid in property subject to a restriction which had a significant effect on its value, income was not recognized until the restriction lapsed (or if earlier, when the property was transferred in an arm's-length transaction).

The amount of such compensation was measured by the *lesser* of:

• Fair market value of property on date of acquisition (determined without regard to restrictions) *or*

• Either:

1. The fair market value of the property at the time the restrictions lapsed; *or*

2. If disposed of prior to the lapsing of the restrictions, the consideration received upon the sale or exchange of the property.

Such compensation was, of course, reduced by any employee payments toward the purchase price of the property.

For purposes of claiming a deduction, the employer was considered to have paid compensation at a corresponding time and in a corresponding amount. (Regs. Sec. 1.421-6(f).)

1.2 ***Scope of new statutory rules.*** The general rule for taxing transfers of restricted property, enunciated by new Sec. 83(a), deals with property transferred, in connection with the performance of services, to any person (except the person for whom such services are performed). This broad language could include the following categories of taxpayers within its ambit:

• Employees;

• Independent contractors such as underwriters of securities, etc., promoters, and real estate developers;

• Third parties who receive property without performing any services;

• Employees receiving property from other parties (e.g., affiliates of the employer); and

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[3] Regs. Secs. 1.61-2(d)(5) and 1.421-6(d)(2).

• "Persons" other than individuals, such as corporations, partnerships, fiduciaries, etc., who receive property in connection with the performance of services.

1.3 ***Effective dates.*** The various effective dates concerning the new restricted property rules provided in Sec. 83 may be summarized as follows.

Under Sec. 83(i), the new rules apply, generally, to property transferred after June 30, 1969. However, there are transitional rules which except the following transactions from the general rule.[4]

1. Property transferred pursuant to a binding written contract entered into before April 22, 1969. Whether a contract is binding is to be determined under state law. The binding nature of a contract is not to be negated by a provision which allows the employee to terminate the contract for any year and receive cash instead of restricted property, if such an election would cause a substantial penalty such as forfeiture of part or all of earlier years' compensation awards.
2. Property transferred upon the exercise of an option granted before April 22, 1969.
3. Property transferred before May 1, 1970 pursuant to a written plan adopted and approved before July 1, 1969. A plan is considered as having been adopted and approved before July 1, 1969, if prior to that date the employer undertook an ascertainable course of conduct which under applicable law does not require further approval by the board of directors or the stockholders. Thus, stockholders' approval is not necessary unless required by state law.
4. Property transferred before January 1, 1973, if before April 22, 1969 an employer had a binding contract with a third party (such as a tax exempt foundation) to pay key employees a determinable amount of stock each year until a fixed number of shares have been transferred.
5. Transfers of restricted property pursuant to certain tax-free exchanges where substantially the same restrictions carry over. See discussions of "Tax-free exchanges and conversions" under 1.10.

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[4] The transitional rules are provided in Sec. 83(i)(1)-(5), and are commented upon in S. Rep. No. 91-552 (11/21/69), p. 124.

1.4 ***When receipt of restricted property will be taxed.*** Under Sec. 83(a), the receipt of a beneficial interest in property for the performance of services will be taxable currently unless the recipient's interest is subject to a "substantial risk of forfeiture." In this latter event, taxation will occur when such risk is extinguished.

Sec. 83(c)(1) states that a "substantial risk of forfeiture" exists if the rights to full enjoyment of property ". . . are conditioned upon the future performance of substantial services by any individual . . ." There is no other apparent statutory definition of "substantial risk of forfeiture." However, both congressional committee reports state that "in other cases, the question of whether there is a substantial risk of forfeiture depends upon the facts and circumstances. . . ."[5]

To mitigate future controversies which may arise in applying this "facts and circumstances" test, it might be advisable for the regulations to provide greater certainty by illustrating other instances of substantial risks of forfeiture. Of course, these regulations should also permit taxpayers to resort to facts and circumstances when appropriate.

Note that the Nixon Administration's Tax Reform Proposal,[6] upon which new Sec. 83 is based, contains the following examples of *insubstantial* risks of forfeiture:

- A requirement that property be returned to the employer if the employee commits a crime against the employer; or
- Acceptance of employment with a competitor of the employer.

Interestingly, these examples were omitted from the reform legislation and its accompanying committee reports.

1.5 Transferable property. Sec. 83(a) also taxes the receipt of restricted property which is transferable without subjecting the transferee to the forfeitability conditions. This can occur, for example,

[5] H. Rep. No. 91-413, Part 1 (8/2/69), p. 88; S. Rep. No. 91-552 (11/21/69), p. 121.

[6] Technical Explanation of Treasury Tax Reform Proposals (4/20/69), p. XII-2.

where an employee receives a forfeitable interest in stock, but the fact of forfeitability is not indicated on the stock certificate, and a transferee would have no notice of it.[7]

On the other hand, an employee does not realize income merely because he can give his forfeitable interest to another person—if the donee would also be subject to the forfeitability condition. Where such gifts are made, the *employee* would first be taxable when the *donee's* rights become nonforfeitable.[8] Similar treatment supposedly might be available where restricted property can be, or actually is, transferred by death;[9] however, the application of these rules appears unclear. For example, how will the employee be taxed if his heir's rights do not become nonforfeitable, under the particular facts and circumstances involved, until ten years after his death? It would seem desirable for the regulations to cover situations involving the employee's death.

In this regard, the AICPA's federal taxation division presented the following specific recommendations to the IRS and the Treasury Department (under date of April 8, 1970):

- The property might be treated as nonforfeitable upon death and compensation income recognized in the deceased employee's final return, unless forfeitability restrictions continue to apply to his estate or other holders of the property.
- In this latter instance, income may not have to be recognized even when property becomes nonforfeitable as the "person who performed such services" (Sec. 83(a)) is no longer a taxpayer. "This may appear to be a windfall arising from the death of the person who performed such services but there is precedent for such treatment. . . ."

In any event, current income will be precipitated if an employee sells property at arm's length even though his interest therein was

[7] S. Rep. No. 91-552 (11/21/69), p. 122.

[8] *Ibid.*

[9] See the Summary of H.R. 13270 prepared for the Senate Finance Committee (11/18/69), p. 45; and the underlying Treasury Department's Technical Memorandum submitted to the Finance Committee (9/30/69), Sec. 321(1). However, S. Rep. No. 91-552 (11/21/69) does not discuss situations involving death in this context.

forfeitable.[10] Presumably, this income will be treated as compensation and will be reduced by any employee payments for such property.[11]

Finally, it should be emphasized that Sec. 83(c)(2) defines transferability as follows: "The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture."

Thus, the statutory determination of when property is transferable and taxable may not always coincide with the actual restrictions placed upon the property's financial transferability. For example, the rights to full enjoyment of property are no longer conditioned upon the future performance of substantial services; therefore, under Sec. 83(c)(1), there would no longer be a substantial risk of forfeiture, and the property would be deemed transferable under Sec. 83(c)(2). However, actual transfer may still be precluded because the property involved is unregistered stock of a public corporation or its sale is barred during a designated time.

Example. Taxpayer renders marketing advice to Excorp, a publicly owned company. He is compensated with 200 shares of Excorp stock selling at $100 a share. Taxpayer's stock is, however, not registered and it is agreed that he may not register it for two years. Taxpayer has immediate taxable income of $20,000 even though the most he can sell the unregistered shares for is $12,000.[12]

This pitfall can cause liquidity problems by creating taxable income in the form of property which cannot be converted to cash

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[10] The summary referred to in note 9 indicates at p. 45 that the Senate Finance Committee's amendments, which were presumably adopted by the Conference Committee, also provide that an interest in property is not forfeitable unless the employer can compel the property's owner to return the identical property on the happening of certain events. However, this provision does not appear to be embodied in the statute; nor is it discussed in S. Rep. No. 91-552 (11/21/69).

[11] The Technical Memorandum referred to in note 9 states in Sec. 321(1) that such income would be equal to the amount received in the sale while the congressional committee pronouncements are silent in this regard. Nevertheless, the regulations should follow the pattern otherwise present in Sec. 83 and allow all income recognized thereunder to be reduced by any employee payments for restricted property.

[12] *New York CPA* (New York, N.Y.: New York State Society of CPAs, April 1970), p. 343.

in order to pay the resulting tax. Further salt is placed on this wound by the requirement that such income must be measured without considering any restrictions which may eventually lapse. (See 1.7 below.)

Even if these financial restrictions permit a sale, their very existence may cause a substantial discount to be realized which might be reflected only as a capital loss. Such losses, of course, have limited tax value and may likely be unable to offset the ordinary income initially precipitated by this financially restricted property.[13]

1.6 ***Special election to be taxed immediately.*** An election is granted by Sec. 83(b) whereby these new restricted property rules can be bypassed even though restricted property is received and is nontransferable or subject to a substantial risk of forfeiture. Such an election will have the following effects:

- Compensation is recognized when the property is received, based upon its current fair market value, and compared in the usual manner described in 1.7.
- Any future appreciation in value will not be treated as compensation, but will permit capital gain treatment—if otherwise available—where such appreciation is subsequently realized upon a sale or other taxable disposition of the property.
- If the property is later forfeited, no deduction or refund is allowable "... in respect of such forfeiture."

The regulations should expressly confine this denial of deduction or refund to amounts previously taxed under the original election and permit tax relief for any forfeited cash or other consideration previously paid to acquire the property. (If instead, the risk lapses and the property becomes transferable, a sale at a normal price could yield a capital loss.)

This election must be made not later than 30 days after the property is transferred, in the manner prescribed by Temp. Regs. Sec. 13.1 (TD 7021). It cannot be revoked without the consent of the IRS.[14]

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[13] See the explanation of new capital loss provisions in an article by G. L. Hinton, Jr., "Capital Gains and Losses," p. 183.

[14] With respect to property transferred on or before December 30, 1970, the date the Tax Reform Act became law, Sec. 83(b)(2) permitted the election to be made no later than January 29, 1970.

Sec. 83(b)(1) specifies that this election may be made by the *person performing the services* on account of which the property is transferred "to any person." In contrast, the Senate Report states that this election is available to *recipients* of restricted property while the Conference Committee Report and the Finance Committee Summary refer to *employees* receiving property.[15]

Not surprisingly, Temp. Regs. Sec. 13.1 makes this election available only to a *person who performs services* related to the transfer of restricted property. In addition, Temp. Regs. Sec. 13.1(a) also states that this election is not necessary in the case of property subject only to a restriction which by its terms will never lapse. (See 1.8.)

1.7 ***Amount and character of income.*** Whether restricted property is taxed upon receipt or when a substantial risk of forfeiture is eliminated, ordinary compensation income is computed as follows:

Fair market value of property, determined without regard to any restriction—except a restriction which by its terms will never lapse	$100,000
Less—any amounts paid for such property	10,000
Compensatory income	$ 90,000

The fair market value of the property, at the time it is to be taxed, is used in the foregoing computation. The AICPA's federal taxation division has suggested to the government that future regulations specify that only contractual restrictions should be ignored in valuing such property; thus permitting recognition of all other pertinent factors such as, in the case of corporate stock, closely held corporations, lack of marketability, blockage, SEC restrictions, etc.

The question of valuation is particularly acute in the case of stock subject to an investment letter, which might sell at a discount of 30% below the selling price of stock not subject to such a letter.

1.8 ***Restriction which will never lapse.*** An example of a restriction which will never lapse is a requirement that an employee sell his stock back to the employer at book value or some other reasonable price if he terminates his employment.[16] In such cases, where the

[15] S. Rep. No. 91-552 (11/21/69), p. 123; H. Rep. (Conf.) No. 91-782 (12/21/69), p. 303; Summary of H.R. 13270, prepared for the Senate Finance Committee (11/18/69), p. 45.

[16] S. Rep. No. 91-552 (11/21/69), p. 121.

selling price must be determined under a formula, Sec. 83(d)(1) requires the formula price to be considered the fair market value of the property, unless the government, bearing the burden of proof, can establish the contrary.

If such a "never-lapse" restriction is canceled, the owner of the property realizes additional compensation in the year of cancellation, calculated as follows:

Fair market value of property at time of cancellation, without regard to the never-lapse restriction		$200,000
Less:		
Fair market value immediately before cancellation, taking such restriction into account, plus	$100,000	
Any amount paid for the cancellation	20,000	120,000
Additional compensation		$ 80,000

However, such additional compensation will not be recognized if the owner of the property establishes that:

- The cancellation was not compensatory; and
- The employer, who would be entitled to a deduction for a compensatory cancellation, will not treat the transaction as compensatory—in a manner to be prescribed by regulations.

Presumably, this additional compensation is recognized only as an adjustment of income previously taxed under these restricted property rules, in view of the following explanation contained in the House Report (No. 91-413, Part 1, 8/2/69, p. 88), "If a restriction on property, which by its terms would never lapse, is canceled, the owner of the property, in effect, is to include in income as compensation, for the taxable year in which the cancellation occurs, *the amount on which he originally was not taxed* because of the decrease in value attributed to the restriction." [Emphasis added.]

1.9 ***Treatment of employer and related parties.*** Under Sec. 83(h), the employer is allowed a deduction at the same time, and in the same amount, as income is taxable to the employee under:

- The general rule of Sec. 83(a);
- The special election authorized by Sec. 83(b); or
- The "cancellation rule" set forth in Sec. 83(d)(2).

It is not clear whether income recognized upon the sale of forfeitable property would be taxable, specifically, under Sec. 83(a). In any event, the regulations should explicity allow corresponding deductions when income is recognized on such transactions.

Property other than employer's stock. When property other than the employer's own stock, (e.g., an unrelated corporation's stock) was given as compensation subject to a substantial restriction and the restrictions lapsed at a later date, the employer was required (under prior law) to recognize income in an amount by which the compensation deduction exceeded the company's basis in the property. Likewise, where the basis of the property exceeded the amount recognized as compensation, the employer could deduct this amount as a loss. The gain or loss would be reported in the employer's accounting period which included the close of the taxable year in which the employee recognized the compensation as income.

These rules continue to apply.[17]

Property not owned by employer. In general, where a parent company's or a shareholder's property is used to compensate employees under a restricted property plan, the transfer of property by the parent company or shareholder is treated as a capital contribution to the company (usually the employer) which is entitled to a deduction in accordance with the new restricted property rules. The parent company or shareholder merely reflects the contribution as an increase in its investment in the company entitled to the deduction.[18]

Conversely, if the employer is the parent company and transfers its subsidiary's property to an employee, a taxable dividend could result in appropriate circumstances.

Furthermore, if property of a related (brother-sister) corporation is used as the compensatory vehicle, the IRS might contend that the related corporation is deemed to have distributed the property to the controlling shareholder who in turn has contributed it to the employer's capital. This is the position taken in Rev. Rul. 69-630[19] regarding bargain sale transactions between such related corpora-

[17] S. Rep. No. 91-552 (11/21/69), p. 124.
[18] *Ibid.*, p. 123.
[19] 1969-2 CB 112.

tions which result in significant shifting of income and are, therefore, subject to reallocation under Sec. 482.

1.10 *Related technical provisions.*

Tax-free exchanges and conversions. Taxable income will not be precipitated if restricted property is exchanged in a tax-free exchange, or an exchange pursuant to the exercise of a conversion privilege, for other property which is subject to substantially the same restrictions. However, the property received will constitute restricted property.[20]

The same principle applies generally where property which is not subject to these new rules—because it was received before the effective date of July 1, 1969—is exchanged in a tax-free exchange or pursuant to a tax-free exercise of a conversion privilege. The property received will not be governed by new Sec. 83 if it is subject to substantially the same restrictions.[21]

Holding period. Sec. 83(f) specifies that the holding period for restricted property begins when the taxpayer's rights therein are transferable or not subject to a substantial risk of forfeiture, whichever is earlier (i.e., when compensation is realized).

Inapplicability of new rules. Subsection (e) makes Sec. 83 inapplicable to:

1. A transaction involving stock options covered by Sec. 421;
2. Transfers to or from qualified employees' trusts, transfers under qualified annuity plans, or premiums excluded from an employee's income in the case of annuities purchased by certain exempt organizations.
3. The transfer of an option without a readily ascertainable fair market value; or
4. The transfer of property pursuant to the exercise of an option with a readily ascertainable value at date of grant.

1.11 *Tax planning implications and comparisons.*

Evaluation of employee versus employer tax burdens.

Should an employer compensate with restricted property subject

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[20] Sec. 83(g); S. Rep. No. 91-552 (11/21/69), p. 123.

[21] Sec. 83(i)(5); S. Rep. No. 91-552 (11/21/69), p. 123.

to a substantial risk of forfeiture? The effect of such a restriction is to treat any appreciation in the property's value—between the date of its acquisition by the employee and the time when the substantial forfeiture risk expires—as ordinary compensation income to the employee and an ordinary deduction for the employer, rather than as capital gain to the employee and, in effect, a nondeductible payment by the employer. The shift in tax burden from employer to employee should be considered by both parties in determining the net after-tax impact of this compensatory device. In some cases, additional before-tax compensation may be justified because of this shift in tax burden.

The net tax expense of both parties may actually decrease, even though the employee is in the maximum tax bracket. This over-all tax decrease could partly result from the new maximum tax rates (60% for 1971, 50% for 1972, and thereafter) to which this particular form of deferred compensation might be subject. This will be further discussed below.

Example. The following computations illustrate the effect of these legislative changes upon the parties involved (ignoring any tax surcharge and the new maximum capital gain rates on gains exceeding $50,000):

Fair market value of property, net of any payment by employee:		
1. At date of transfer	$ 50,000	
2. At date no longer subject to substantial risk of forfeiture	$100,000	
3. Appreciation since transfer (line 2 less line 1)	$ 50,000	
Tax consequences under pre-TRA rules:		
4. Ordinary income (50% of line 1)	$ 25,000	
5. Capital gain (25% of line 3)	12,500	
6. Total tax on employee	37,500	
7. Less tax benefit to employer corporation (48% of line 1)	24,000	
8. Net tax expense		$13,500
Tax consequences under the law:		
9. Tax on individual (50% of line 2)	$ 50,000	
10. Less tax benefit to employer corporation (48% of line 2)	48,000	
11. Net tax expense		2,000
Effect of legislative change:		
12. Decrease in net tax expense (line 8 less 11)		$11,500

This over-all decrease would be accentuated if it were assumed that the employees were in tax brackets lower than 50%. On the other hand, the combined net tax expense would be increased if the employer were in a tax bracket of less than 48%, such as 22%.

In any event, the business reasons for imposing such restrictions, such as the retention of the employee's services, must also be considered.

Should an employer cancel a restriction which by its terms will never lapse? If so, should such cancellation be treated as compensatory? The answers to these questions should be resolved along the lines indicated in the immediately preceding discussion. It is stressed that the business consequences of the cancellation must be carefully examined. For example, where the employer's stock is involved, it may not be desirable to forego control over its subsequent disposition.

Should an employee (or other transferee) exercise the election to be taxed immediately under Sec. 83(b)? The opportunity to convert ordinary income into capital gain may be most enticing. However, the employee will then be compelled to bear the risk of subsequent forfeiture—without any consoling tax relief if the forfeiture materializes. Moreover, if the property is *not financially* (e.g., legally) transferable, it will not be available as a liquid source for payment of the resulting tax. Finally, the employee's current tax bracket should be compared with his projected bracket for the future year in which this income would be recognized (without the election). In addition, it would be necessary, for any such comparison, to value the restricted property, without regard to the restrictions, at time of transfer and at the future date when the restrictions will lapse. The following example may illustrate some of the factors to be considered before making a Sec. 83(b) election.

Example. It is assumed that the restricted property has (or will have) the following fair market values:

Current year (when property received)	$15,000
Future year (when substantial risk of forfeiture expires)	$25,000

	Election	*No election*
Current year:		
Ordinary income	$15,000	None
Future year:		
Ordinary income		$25,000
Capital gain	$10,000	–

Questions:

• Will the ordinary income bracket for the current year be considerably higher than the future year's bracket because the current year is an "active year" and the future year will be a "retirement year"?

• Can the current year's tax bracket be lowered through income averaging?

• Will the retirement year status in the future year also provide a lower effective rate for capital gains?

• Will the capital gain deduction constitute a tax preference item subject to the 10% minimum tax?

• What are the chances of the stock not increasing significantly in value, perhaps even decreasing in value?

• Will the loss of the use of the tax payment now (considering current tax rates) be compensated for by the projected tax benefits?

Limited income shifting by employee. To the extent feasible, an employee can sell restricted property at an arm's-length price while his interest therein is still forfeitable. This will shift post-sale appreciation to the purchaser and might be desirable if the sale is to family members such as children. Such intra-family sales should be permissible if based upon arm's-length consideration. For this purpose, Regs. Sec. 1.482-2(e), regarding tangible property sales between controlled entities, may provide useful guidelines.

Comparing restricted property with other forms of compensation. New comparisons must be made of any revised tax effects as well as business ramifications with respect to such alternative means of compensation as:

- Additional bonuses in cash or employer stock,
- Qualified and nonqualified deferred compensation plans,
- Stock options (both qualified and nonqualified), and
- Phantom stock plans.

Obviously, such comparisons are beyond the scope of this article. However, as will be discussed below, deferred compensation will be ineligible for the new maximum tax rates on earned income—with the notable exception of certain restricted property and, possibly, non-lump sum distributions from qualified plans. In addition, both the bargain element in a qualified stock option and the capital gain deduction for "capital gain compensation" constitute tax preferences for purposes of the new 10% minimum tax. (See Sec. 57(a)(6) and (9).)

Eligibility for 50% maximum tax rate. Sec. 1348 (b)(1) excludes ". . . any deferred compensation within the meaning of Sec. 404 . . ." from eligibility for the prospective 50% maximum tax rate on earned income. However, it also states that ". . . deferred compensation does not include any amount received before the end of the taxable year following the first taxable year of the recipient in which his right to receive such amount is not subject to a substantial risk of forfeiture (within the meaning of Sec. 83(c)(1))."

Since restricted property is ordinarily received before the year in which this risk expires and is taxable within such year, this form of compensation should usually qualify as earned income.[22] Moreover, if the *immediate* taxability election granted by Sec. 83(b) is exercised (see 1.6 above), the resulting income—by its very nature—can hardly be classified as deferred compensation.

In addition, Sec. 83(h) provides that the employer's deductions for restricted property compensation are allowable under Sec. 162 rather than under Sec. 404. Thus, the implication of Sec. 1348 (b)(1) that restricted property could be Sec. 404 deferred compensation is puzzling, especially since Sec. 404(a) specifies that deferred compensation shall not be deductible under Sec. 162.

In any event, all deferred compensation received by independent contractors might be eligible for the 50% tax rate since Sec. 404 appears applicable only to employees.

2. Nonqualified deferred compensation plans

Prior law governing the tax treatment of nonqualified deferred compensation plans has been changed to conform to these new restricted property rules.

For example, if an employer contributes cash to a nonqualified trust or a nonqualified annuity plan and the employee's rights are forfeitable when the contribution is made but subsequently become nonforfeitable, the employee is taxed on the "restricted contribution" the first time his rights are not subject to a substantial risk of forfeiture (instead of the later time when the contribution is distributed to him, as was previously provided—except for nonforfeitable annuities purchased by exempt organizations).[23]

[22] See the discussion by Elder and Kennedy, "Maximum tax on earned income," p. 47.

[23] H. Rep. No. 91-413, Part 1(8/2/69), p. 89.

The amount subject to tax when the employee's interest becomes nonforfeitable is the value at that time of his interest in the trust (or the then value of the annuity contract), as opposed to the fair market value of the accumulated employer contributions or premium payments. However, the value of amounts subsequently contributed by the employer (or premiums subsequently paid) are included in the employee's income when contributed to the trust (or paid to the insurer), if the employee's interest in such amounts is nonforfeitable.[24]

On the other hand, income earned by nonqualified trusts will not be taxed to the beneficiaries prior to its distribution.[25] Of course, such income would be taxable currently to the nonexempt trusts.

Employers will be allowed deductions for contributions to nonexempt trusts at the time the employees recognize income—if separate accounts are maintained for each employee. This amendment to Sec. 404(a)(5) invalidates controversial Regs. Sec. 1.404(a)-12 which permanently denied any deduction for a contribution to a non-exempt trust if the employee's rights were forfeitable at the time.[26]

Employers can obtain ordinary deductions by vesting an employee's interest in a nonqualified trust. Of course, the effect of such vesting on the employee's continued services must be considered as well as the increase in the employee's compensation income precipitated by such action.

3. Lump sum distributions from qualified retirement plans

Before the enactment of the Tax Reform Act, lump sum distributions from qualified "corporate" pension, profit-sharing, stock bonus, and annuity plans were entitled to capital gain treatment under Sec. 402(a)(2) if made on account of the employee's separation from his employer's service or on account of his death (after such separation). In addition, under Sec. 101(b)(2)(B), a limited ($5,000) exclusion from gross income was available if such distributions were paid by reason of the employee's death. Moreover,

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[24] S. Rep. No. 91-552 (11/21/69), p. 122.

[25] Sec. 402(b); H. Rep. No. 91-413, Part 2, (8/4/69), p. 64.

[26] See Russell Mfg. Co., Ct. Cls., 175 F2d 159 (4 AFTR2d 5167, 59-2 USTC ¶9582) which allowed the employer a deduction when benefits were paid to the employee by the trust. In Rev. Rul. 59-383, 1959-2 CB 456, the IRS states that it will not follow the decision.

amounts payable at death to (or for) any beneficiary except the employee's estate were, to the extent attributable to employer contributions, exempt from estate tax under Sec. 2039(c). Comparable gift tax exemptions were provided by Sec. 2517.[27]

The Tax Reform Act has restricted the availability of capital gain treatment for such lump sum distributions. The other tax advantages have not been disturbed.

3.1 ***Partial denial of capital gain treatment.*** Under new Sec. 402 (a)(5), capital gain treatment will apply only to the following segments of lump sum distributions paid after December 31, 1969:

- Benefits accrued by the employee during plan years beginning before January 1, 1970; and
- Benefits accrued during subsequent plan years exclusive of the employee's share of employer contributions—that is, investment income and capital gains.

Thus, the only change with respect to lump sum distributions is the ordinary income treatment given to the portion which represents employer contributions for plan years beginning after December 31, 1969. Employer contributions for prior plan years as well as earnings and appreciation on both employer and employee contributions for all plan years continue to be treated as long-term capital gains. Employee contributions for all plan years can, of course, continue to be recovered tax free. The House Report[28] states that ". . . amounts contributed by the employer with respect to employees which are forfeited and . . . allocated among other employees are to be considered contributions made by the employer. . . ." Presumably, this means that such contributions will be deemed to have been made in the year in which the forfeiture occurs.[29]

The revised tax treatment of lump sum distributions is illustrated in Table 1, page 76.

On the other hand, this newly created ordinary income will be

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[27] None of these income, estate, or gift tax benefits apply to lump sum distributions from "H.R. 10 plans" made on behalf of self-employed individuals. However, Sec. 72(n)(2) provides a special five-year income-averaging formula for computing income tax on lump sum distributions.

[28] H. Rep. No. 91-413, Part 1(8/2/69), p. 155.

[29] To this effect, see a speech by Mr. Isidore Goodman on April 21, 1970 reported in *Pension Plan Guide* (Chicago, Ill.: Commerce Clearing House, Inc., 1970), vol. 3, 2d ed., ¶30,335, ¶30,338.

TABLE 1

New treatment for lump sum distributions from qualified corporate retirement plans*

Facts:	Before 1970	After 1969	Total
	Benefits accrued for plan years beginning		
1. Employee contributions	$1,000	$2,000	$ 3,000
2. Employer contributions	3,000	3,000	6,000
3. Earnings and appreciation on all contributions	1,000	1,000	2,000
4. Total distribution	$5,000	$6,000	$11,000

Tax treatment:	
Total distribution (line 4 last column)	$11,000
Less—employee's total contributions (line 1, last column)	3,000
Total taxable income	8,000
Less—ordinary income (line 2, second column)	3,000**
Long-term capital gain (line 2, first column plus line 3, last column)	$ 5,000

*Based upon example in H. Rep. No. 91-413, Part 2 (8/4/69), pp. 111-112.
**This will be taxed under the seven-year income-averaging formula; see 3.2 of the text.

eligible for a rather favorable seven-year "forward" averaging computation (see 3.2 below) which can be as beneficial as a capital gain tax for many lower bracket employees. In some cases, this special averaging device could even produce a lower tax.

Determination of benefits accrued during pre-1970 plan years. As previously stated, benefits accrued by the employee during plan years beginning before January 1, 1970 continue eligible for capital gain treatment. The House Report[30] states that the limitation on capital gain treatment ". . . will not apply to employer contributions *made* on behalf of the employee during plan years beginning before January 1, 1970. Thus, the bill will have no effect on benefits *previously accrued* by employees. . . ." [Emphasis supplied.] Thus, an ambiguity exists as to the treatment of contributions made during the post-1969 plan years which are required to fund previously accrued benefits. This question of whether "benefits accrued" is to

[30] See note 28.

be based upon actuarial valuations or actual employer contributions will be of particular significance to pension plans with a past service liability.

A similar problem may arise where contributions for 1969 plan years are actually made in 1970 by an accrual basis taxpayer under Sec. 404(a)(6). The Senate Report[31] flatly stated that ordinary income treatment ". . . is not to apply to benefits accrued on behalf of the employee *attributable* to plan years beginning before January 1, 1970. . . ." [Emphasis supplied.] However, the full Senate rejected this provision and the Conference Committee followed the House version.

In any event, post-1969 employer contributions for pre-1970 service appear precluded from capital gain treatment where a plan is established after 1969, since benefits cannot be accrued during plan years beginning before 1970.

Post-1969 losses. A related problem pertains to the allocation of any post-1969 net investment losses to the various lump sum components. In this regard, on April 8, 1970, the AICPA's federal taxation division submitted the following specific recommendations[32] regarding the content of future regulations to the Treasury and the IRS:

1. Fair market value of trust assets should be determined as of the close of the last plan year beginning before January 1, 1970 and allocated to the participants as their "initial year capital gain base."
2. This capital gain base and all employee contributions should be considered frozen amounts.
3. Post-1969 gains or losses (income, sale of securities, valuations, etc.) should be aggregated upon distribution. *Any net loss should first reduce post-1969 employer contributions.*[33]

Substantiating records. New Sec. 402(a)(5) permits capital gain treatment for post-1969 benefits only to the extent the distributee establishes that such benefits do not consist of the employee's allocable share of employer contributions. This poses a monumental

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[31] S. Rep. No. 91-552 (11/21/69), p. 202.

[32] For example, see Table 2, p. 78.

[33] Also see "Lump sum distribution of employer securities under TRA—when market value is less than cost," Dallas E. Stiles, in the Tax Clinic, *The Tax Adviser,* Oct. 70, p. 641.

TABLE 2

Lump sum distribution from qualified plan
Allocation of post-1969 losses*

	Total	Employee Contributions	Ordinary Income	Capital Gain
Initial year				
capital gain base	$12,000	$3,000		$9,000
Post-1969 contributions:				
Employee	2,000	2,000		
Employer	8,000		8,000	
Post-1969 gain or (loss):				
Income	1,000			
Investment appreciation				
or (loss)	(6,000)		(5,000)	$9,000
Total distribution	$17,000	$5,000	$3,000	

*See 3.1 of text, and footnote 32.

accounting problem for such distributees who must invariably rely on either the employer or the trustee of the retirement trust for its resolution. These parties will then be plagued with additional recordkeeping costs which may be particularly severe, for example, in the case of large private and public pension plans where employer contributions are not usually allocated among specific employees.

A related problem will be the practical difficulties in obtaining exact determinations of employer contributions. Perhaps the regulations can provide an approximate approach as an alternative.

A similar determination of employer contributions is required for the estate tax exclusion under Sec. 2039(c) (mentioned earlier). However, Regs. Sec. 20.2039-2(c)(2) acknowledges that, in certain cases, such contributions cannot be readily ascertained and, accordingly, allows the *employee's* contributions to be subtracted from the value of the matured benefits in order to arrive at the employer's contributions. Under this formula, earnings and appreciation are weighted in favor of employer contributions (which is not undesirable in ascertaining the estate tax exclusion attributable to these contributions). Of course, this result would be inappropriate in determining the ordinary income arising from employer contributions. Hence, some modification of this method would be necessary such as imputing a realistic earnings rate to the employee's contributions with a matching or proportionate (as appro-

priate) designation of earnings and appreciation with respect to the employer's contributions. (For precedent, see new Sec. 170(f)(4) which prescribes a 6% discount rate in valuing real property remainder interests for charitable contribution purposes and permits the IRS to assign a different rate if economic circumstances change.)

Nevertheless, the practical difficulties inherent in calculating the capital gains portion of a lump sum distribution may serve as another factor in selecting the alternative periodic pay-out. In any event, these mechanical pitfalls should be recognized in setting up new plans.

3.2 ***New seven-year averaging for ordinary income portion.*** The tax on the portion of a lump sum distribution consisting of post-1969 employer contributions is taxed under a special seven-year "forward" formula provided in new Sec. 72(n)(4). This averaging formula operates similarly to the five-year averaging device available for lump sum distributions to self-employed persons under H.R. 10 plans. In addition to the obvious advantage of spreading only 1/7 of this income across the recipient's tax bracket (as opposed to 1/5 for the self-employed), the new computation is also more beneficial than the H.R. 10 mechanism because current compensation (". . . other than deferred compensation within the meaning of Sec. 404 . . .") and the capital gains portion of the lump sum distribution are not taken into account in calculating the ordinary income tax attributable to such post-1969 employer contributions.

Query: Is restricted property current or deferred compensation, for seven-year averaging purposes, when it is taxed in the same year as the lump sum distribution? (See discussion of restricted property's eligibility for 50% maximum tax rate on earned income under 1.11.)

These computational exclusions were adopted by the Conference Committee to replace the five-year "hindsight" recomputation and refund procedure contained in the House bill (thus "simplifying" the necessary computations and enabling a final tax to be determined when the distribution is received).[34] Further, these features will prevent higher brackets from applying merely because the lump sum is received in the final year of employment instead of

[34] See S. Rep. No. 91-552 (11/21/69), p. 203, upon which this part of the Conference Report appears to be based.

during a lower bracket retirement year. Moreover, the exclusion of the capital gains portion from the averaging base will also preclude a higher bracket even during retirement (which might otherwise result from the nonrecurring distribution). However, current compensation cannot be excluded under this new averaging procedure if the employee has not attained age 59½—unless he has died or become disabled (as defined by Sec. 72(m)(7)). (These conditions do not apply to the exclusion for the capital gains portion of the lump sum distribution.)

Eligibility for special averaging. Employees or their beneficiaries are eligible for this special seven-year averaging only if the distribution is made on account of separation from service or death. In contrast, self-employed individuals can use their five-year averaging computation only for distributions received after age 59½ or because of death or disability.[35]

In addition, Sec. 72(n)(1)(C) denies averaging to an employee of a self-employed person unless he has been a participant in the plan for at least five taxable years prior to the year in which the distribution is made. It is unclear whether this five-year requirement also applies if the distributee, instead, is the employee's beneficiary. Also uncertain are the following terms:

- Taxable year. Whose taxable years must be counted for this purpose—the employee's, employer's, trustee's, or any combination thereof?
- Plan. What status shall be accorded participation in plans of predecessor or successor employers? Will carryover status be recognized only in "Sec. 381 situations"?
- Participant. Does participation coincide with the years of credited service recognized by the plan even though such period includes an eligibility waiting period (prior to actual "participation")?

Hopefully, these questions will be answered by forthcoming regulations.

By reason of Sec. 1304(b)(2), the seven-year averaging provision is inoperative if general income averaging is elected. This option necessitates dual computations to determine which averaging

[35] H. Rep. No. 91-413, Part 1 (8/2/69), p. 156.

formula yields the greatest tax savings. On the other hand, under Sec. 1348(b)(1), the 50% maximum tax rate on earned income is automatically inapplicable to lump sum distributions.

The application of the seven-year averaging rules is illustrated in the following two examples. Note that the facts are such that the 10% minimum tax does not apply.

Example 1. Taxable income consisting solely of lump sum distributions.

In 1975, *T* receives a $148,000 lump sum distribution from his former employer's qualified non-contributory profit-sharing plan. The distribution is taxable as follows:

Ordinary income—under seven-year averaging formula	$ 98,000
Long-term capital gain	50,000
Total distribution	$148,000

T and his spouse have no other income. Their exemptions and deductions aggregate $5,000. The joint tax liability is computed as follows:

Ordinary income tax:		
1. Gross income		$148,000
Less:		
2. Capital gain portion (Sec. 72(n)(4)(C))	$ 50,000	
3. 6/7 of ordinary income portion ($98,000)	84,000	134,000
4. Revised gross income		14,000
Less:		
5. Standard deduction	2,000	
6. Exemptions	3,000	5,000
7. Tentative taxable income		9,000
Minimum taxable income (Sec. 72(n)(2)(B)):		
8. Ordinary income portion	$ 98,000	
9. Less—exemptions (line 6)	3,000	
10. Minimum taxable income (Sec. 72(n)(2)(B))	$ 95,000	
11. 1/7 of line 10 (to nearest $100)		13,600
12. Taxable income for averaging purposes (greater of lines 7 or 11)		$ 13,600
13. Tax on line 12		2,660
14. Ordinary income tax under seven-year averaging method (line 13 multiplied by 7)		18,620

Capital gains tax:

15. Capital gain portion	50,000
16. Less—50% capital gain deduction	25,000
17. Adjusted gross income	25,000[36]
18. Less—standard deduction and exemptions (lines 5 and 6)	5,000
19. Taxable income	20,000
20. Tax on line 19	4,380
21. Alternative tax—25% of line 15 (Sec. 1201(b)(2))	12,500
22. Capital gains tax (lesser of line 20 or 21)	4,380

Total tax:

23. Total tax (lines 14 and 22)	23,000
24. Total tax without seven-year averaging computation	53,480[37]
25. Tax savings (line 24 less line 23)	$ 30,480

Example 2. The facts are the same as in Example 1 except that the lump sum distribution was received in a year in which *T* had the following other income:

Salary	$ 20,000
Deferred compensation	80,000
Total	100,000

Tax attributable to ordinary income portion:

1. Lump sum distribution (Example 1, line 1)		$148,000
2. Additional compensation		100,000
3. Gross income		248,000
Less:		
4. Excludable portions of lump sum distribution (Example 1, lines 2 and 3)	134,000	
5. Current compensation (Sec. 72(n)(4)(B))	20,000	154,000
6. Revised gross income		94,000
7. Less—standard deduction and exemptions (Example 1, lines 5 and 6)		5,000
8. Taxable income		89,000
9. Tax on line 8		38,500

[36] It is submitted that the ordinary income portion of a lump sum distribution should be excluded in computing the tax on the capital gain portion and any other income. Otherwise, inclusion of such ordinary income portion would place the other income in a higher bracket and serve to defeat some of the savings granted by the seven-year averaging device.

[37] The tax liability shown on line 24 (also on line 33 in Example 2) was computed without regard to the general income-averaging rules prescribed in Secs. 1301-1305. See Sec. 1304(b)(2).

10. Taxable income (line 8)	89,000	
11. Less—1/7 of ordinary income portion of lump sum distribution (Example 1, line 4)	14,000	
12. Revised taxable income	75,000	
13. Tax on line 12		30,470
14. Tax attributable to $14,000 (see line 11)		8,110
15. Tax attributable to entire ordinary income portion (line 14 multiplied by 7)		56,770
Tax attributable to all other income:		
16. Gross income (line 3)		248,000
17. Less—ordinary income portion of lump sum distribution (see note 36)		98,000
18. Revised gross income		150,000
19. Less—capital gain deduction (Example 1, line 16)		25,000
20. Adjusted gross income		125,000
21. Less—standard deduction and exemption (line 7)		5,000
22. Taxable income		120,000
23. Tax on line 22		57,580
Alternative tax:		
24. Taxable income (line 22)	120,000	
25. Less—50% of capital gain (line 19)	25,000	
26. Ordinary taxable income	95,000	
27. Tax on line 26 (Sec. 1201(b)(1))	42,180	
28. 25% of $50,000 capital gain (Sec. 1201(b)(2))	12,500	
29. Alternative tax (lines 27 and 28)		54,680
Total tax:		
30. Tax on ordinary income portion of lump sum distribution (line 15)		56,770
31. Tax on all other income (lesser of lines 23 or 29)		54,680
32. Total tax		111,450
33. Total tax without seven-year averaging (see note 37)		118,650
34. Tax savings (line 33 less line 32)		7,200

3.3 ***Unrealized appreciation in employer securities.*** The net unrealized appreciation in employer securities will continue:

- To be nontaxable upon distribution to the employee, and
- To receive capital gain treatment if subsequently sold. If such

TABLE 3

Computation of tax
Lump sum distribution by employer's stock bonus plan

Cash	$ 10,000
Employer securities (at fair market value)	90,000
Total distribution	100,000

The distribution had been accumulated as follows:

	Total	Pre-1970	Post-1969
Employer contributions	$ 50,000	$30,000	$20,000
Unrealized appreciation	40,000	15,000	25,000
Dividends	10,000	3,000	7,000
Totals	$100,000	$48,000	$52,000

The following tax treatment applies:

Total distributions	$100,000
Less—cash (accumulated dividends taxed as capital gain)	10,000
Value of employer securities	90,000
Less—total unrealized appreciation (tax deferred)	40,000
Adjusted cost basis of securities	50,000
Less—capital gain portion (pre-1970 employer contributions)	30,000
Ordinary income (post-1969 contributions)	$ 20,000

sale occurs after the employee's death, no income tax at all would be incurred on such appreciation to the extent his estate obtains a stepped-up basis for these securities.

However, the new ordinary income treatment will apply to that portion of the lump sum distribution representing the adjusted cost basis of employer securities to the extent attributable to employer contributions made in plan years beginning after December 31, 1969.[38] Under prior law, such portion was treated as a capital gain.

On the other hand, accumulated dividends on such securities continue eligible for capital gains treatment.

The tax treatment of a lump sum distribution which includes the employer's securities is illustrated in Table 3, above.

4. Limitations on qualified plan contributions for "principal" shareholder-employees of subchapter S corporations

Subchapter S permits electing small corporations (having, among other requirements, ten or fewer stockholders) to be taxed some-

[38] H. Rep. No. 91-413, Part 1 (8/2/69), p. 155.

what comparably to unincorporated businesses—i.e., no tax on the entity itself. H.R. 10 was adopted in 1962 to provide retirement plan benefits for the self-employed which, however, were less favorable than those available under corporate plans. One of the key distinctions between these two types of plans is the limitation on deductible contributions under a plan for a self-employed individual to the lesser of 10% of earned income or $2,500. (Sec. 404(e).) Continuing the march toward conformed tax treatment for small businessmen, regardless of how they are legally organized, the TRA added Sec. 1379 to the Code in order to place similar restrictions on contributions to retirement plans for "principal" shareholder-employees of subchapter S corporations.

Briefly, Sec. 1379 contains the following measures to achieve this goal:

- Taxation of "principal" shareholder-employees on excess contributions;
- Disqualification of plan unless it provides that forfeitures cannot inure to a "principal" shareholder-employee's benefit; and
- Denial of excess credit carryover from a subchapter S year to a non-subchapter S year.

Each provision will be dealt with in greater detail below. However, it is important to note that they are all *first* effective for corporate taxable years beginning after December 31, 1970. Hence, a short grace period still remains to reap the present subchapter S retirement plan benefits and prepare for compliance with the new law.

4.1 ***"Principal" shareholder-employees.*** These tainted taxpayers are employees or officers of a subchapter S corporation who own more than 5% of the outstanding stock on *any day* during the corporation's taxable year. This 5% test includes indirect stock ownership under the *family* attribution rules of Sec. 318(a)(1). Presumably, no other attribution applies.

4.2 ***Taxation of excess contributions.*** Such a shareholder-employee must include excess contributions in gross income, determined

under Sec. 1379(b)(1) as follows (assuming as facts the indicated amounts):

1. Retirement plan contribution made, and deductible, by subchapter S corporation	$5,000
2. 10% of reportable compensation from corporation during *its* taxable year—$2,000	
3. $2,500	
4. Lesser of lines 2 or 3	2,000
5. Excess contributions (line 1 less line 4)	$3,000

This excess contribution is taxable in the individual's taxable year in which, or with which, the corporation's taxable year ends. As indicated, employees owning 5% or less stock are not subject to this new restriction and would not be immediately subject to tax on such excess contributions made on their behalf.

These excess contributions are treated as *employee* contributions to the retirement plan trust and thus recoverable free of further tax when subsequently withdrawn as a pension, annuity, or lump sum distribution. Moreover, a future deduction from gross income is allowable under Sec. 62(9) for the taxable year (presumably of the employee) in which the employee's (or his beneficiaries') rights under the plan terminate—usually because of death or forfeiture upon termination of employment.[39] In such case the deduction is computed as follows:

Total excess contributions previously taxed under Sec. 1379(b)(1)	$12,000
Less—any benefits received under the plan which were excluded from gross income under Sec. 72	3,000
Deductible amount	$9,000

4.3 ***Multiple subchapter S corporations.*** Neither the statute nor the committee reports mention any application of this new rule to situations involving multiple and/or related subchapter S corporations. Thus, the question arises as to whether each such corporation can make separate contributions for shareholder-employees, within the

[39] S. Rep. No. 91-552 (11/21/69), p. 217.

prescribed limits, and avoid immediate taxation under Sec. 1379 (b)(1). Support for an affirmative response can be drawn from the above-noted official silence and the contrasting specific mandate contained in the Senate Report[40] concerning the ultimately rejected companion rule for professional corporations. The specific policy regarding multiple professional corporations was expressed as follows: "Where an individual is covered by plans of more than one organization, the Treasury Department, by regulations, is to aggregate the contributions paid on his behalf. . . ." It is emphasized that no similar statements can be found in the legislative history of the new subchapter S rules.

4.4 Forfeiture requirements. Profit-sharing and stock bonus plans, to remain qualified, must specify that forfeitures of contributions deductible by subchapter S corporations cannot benefit principal of shareholder-employees. (Sec. 1379(a).) There is no other indication of how such forfeitures should be handled. Perhaps the regulations will permit them to reduce future employer contributions as is required for qualified pension plans; see Regs. Sec. 1.401-7(a).

Forfeitures of contributions made in taxable years beginning before January 1, 1971 are not subject to this new requirement and can benefit principal shareholder-employees. Moreover, the House Report states that forfeitures will inure to a shareholder-employee's benefit only if they are taken into consideration in computing the benefits to which he (or his beneficiary) will be entitled and "The fact that a shareholder-employee may be a beneficiary of another employee or shareholder of the corporation is to be disregarded. . . ."[41]

Affected plans must be amended to reflect this new forfeiture requirement for taxable years beginning after December 31, 1970. This amendment can be made as late as the 15th day of the third month following the close of the first such taxable year (e.g., March 15, 1972 for calendar year corporations), if it is retroactive to the beginning of said year (e.g., January 1, 1971).

The IRS has not yet indicated whether such amendments to previously approved plans should be submitted for advance approval. Perhaps it might suffice for this data to be submitted with

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[40] *Ibid.*

[41] H. Rep. No. 91-413, Part 2 (8/4/69), p. 122.

Form 2950 ("Statement in Support of Deduction . . .") as part of the income tax return (Form 1120-S) for the first taxable year beginning after December 31, 1970.

4.5 *Credit carryover restrictions.* Contributions to profit-sharing or stock bonus plans by subchapter S corporations continue subject to the general corporate limitation of 15% of compensation otherwise paid or accrued to all employees covered under the plan. Sec. 404(a)(3)(A), which sets such limitation, also provides an unusual credit carryover to succeeding taxable years, if the amount contributed is less than this (primary) 15% limitation (subject to a similar secondary 15% limitation in such future year, resulting in a 30% maximum limitation for such carryovers).

To prevent manipulation of the new subchapter S rules, Sec. 1379(c) bars credit carryovers from subchapter S years to non-subchapter S years. On the other hand, carryovers from non-subchapter S years to subchapter S years continue to be permitted.[42]

4.6 ***Evaluation of newly restricted subchapter S qualified plans and H.R. 10 plans.*** Excess contributions made on behalf of owner-employees under H.R. 10 plans, if not repaid as specified in Sec. 401(e)(2), will disqualify the plan. (In the case of non-owner-employee self-employed persons, excess contributions are not deductible but will not cause disqualification.) In contrast, excess contributions on behalf of subchapter S shareholder-employees will not automatically disqualify the plan, although both committee reports state that they are to be regarded as having been made by the corporation for purposes of determining plan qualification.[43]

In the speech cited in note 29, Isidore Goodman observes in this context (see his footnote 56) that deductible contributions must first pass the ordinary and necessary expense tests of Sec. 162 or 212. He points out that contributions to a fully funded pension plan are not deductible and may adversely affect its qualification.

Despite these selected 1969 legislative changes, subchapter S qualified plans continue to be more attractive than H.R. 10 plans in such areas as:

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[42] H. Rep. No. 91-413, Part 1 (8/2/69), p. 171.

[43] S. Rep. No. 91-552 (11/21/69), p. 216; H. Rep. No. 91-413, Part 1 (8/2/69), p. 171.

- Less restrictive coverage and vesting requirements.
- Estate and gift tax exemption.
- More liberal provisions for employee contributions and plan distributions.
- Availability of $5,000 income tax exclusion for lump sum distributions.

However, even these differences may be eliminated in the relatively near future.[44]

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[44] See "Employee Benefits: Equality for Self-employed and Corporate Employees," Washington Report, *The Tax Adviser,* May 70, p. 323.

Minimum tax on tax shelters

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In recent years there has been increasing concern that taxpayers with the necessary financial resources have been able to minimize the effect of our progressive tax rate structure by taking advantage of various tax shelters permitted by the Code. Utilization of these shelters has created substantial variances in the effective rates of tax imposed on economic income and resulted in unfairness in the allocation of the tax burden among taxpayers. The Tax Reform Act of 1969 was enacted to eliminate many abuses and advantages determined to be unacceptable by Congress. Many of its provisions were specifically designed to reduce the availability of certain shelters. In addition to such specific treatment, an overall limitation on certain shelters was enacted in the form of an additional tax. The use of these tax shelters is still permitted, but an additional tax can be incurred for the privilege of their use.

This article will explore the overall limitation on tax shelters contained in new Secs. 56-58[1] providing for a minimum tax on tax preferences.

Legislative background

Inasmuch as the minimum tax is a new concept in our tax structure, a brief review of its legislative history may be helpful in ex-

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[1] For convenience and clarity, provisions of the Internal Revenue Code will be cited as "Sec.," while provisions of the Tax Reform Act of 1969 will be referred to as "Act Sec." "New Sec." and "Amended Sec." will refer to sections of the Code added or amended by the Tax Reform Act.

planation. Also, because the minimum tax as finally enacted differed substantially from the original proposals, the review may give some idea as to modifications that might be expected in the future.

House bill.[2] The bill as originally passed by the House of Representatives provided for a limit on tax preferences (LTP) under which no more than 50% of a noncorporate[3] taxpayer's total income (generally, adjusted gross income plus tax preference items) could be excluded from income tax. LTP income included the following preference items:

- Tax exempt interest (with a ten-year transitional period).
- Excluded one-half of long-term capital gain.
- Excess of market value over basis of property contributed to charity.
- Excess of accelerated depreciation over straight-line depreciation on real property.
- Farm loss in excess of the amount determined under the accrual method.

The limit on tax preferences would not apply if an individual's total tax preferences for the year did not exceed $10,000.

The House bill also required allocation of an individual taxpayer's itemized (personal) deductions between his taxable income and his tax preference items in excess of $10,000. For this purpose, the tax preference list was the same as for LTP, except:

- Tax exempt interest on bonds issued before July 12, 1969 was omitted as a preference.
- Intangible drilling expense deducted in excess of the amount computed under straight-line depreciation was included as a preference.
- Percentage depletion in excess of cost depletion was added to the preference list.

Taxpayers would first apply LTP before allocating deductions. Any tax preferences included in taxable income as a result of applying LTP would be treated as taxable income for the allocation of deductions.

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[2] H. Rep. No. 91-413, Part 1 (8/2/69).

[3] The House curbs on tax shelters did not apply to corporate taxpayers. Thus, neither the LTP rules nor the allocation of deduction rules discussed below would have applied to ordinary corporate taxpayers.

Treasury recommendations. The Treasury recommended the following modifications of the House bill to the Senate Finance Committee.[4]

- The excess of market value over basis of property contributed to charity should not be treated as a tax preference item, either for LTP or the allocation of deductions. (The Treasury had previously recommended its inclusion as a tax preference item.[5])
- Tax exempt interest should not be treated as a tax preference item for LTP but should be treated as such for the allocation of deductions, without a transitional period and without distinction as to date of issue. (An earlier Treasury study had recommended its inclusion as an LTP item.[6])
- Intangible drilling expenses should not be a tax preference—for LTP purposes—for taxpayers who derive 60% or more of their gross income from oil and gas properties. Such taxpayers should, however, be required to recapture such expenses as ordinary income upon the later sale of the property. The percentage depletion preference should be computed by first allowing a full recovery of the basis of the property. To the extent intangible drilling expenses are treated as a tax preference, they should be added to basis for purposes of computing the depletion preference. (Earlier Treasury recommendations had related percentage depletion to cost depletion, and had not contained the income limitation.[7])
- The following items should be included as preference items for both LTP and allocation of deduction purposes:

1. Excess of accelerated depreciation over straight-line depreciation on Sec. 1245 property subject to a net lease.
2. Deductions for interest, taxes, and ground rents with respect to real property during the period of construction of substantial improvements (other than housing construction).
3. Excess of deduction for rapid amortization of rehabilitation expenditures for low-income housing over the amount allowable as straight-line depreciation.

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[4] Technical Memorandum of Treasury Position (9/30/69).

[5] Tax Reform Studies and Proposals, Joint Publication (2/5/69). Tax Reform Proposals (4/22/69).

[6] Tax Reform Studies and Proposals, Joint Publication (2/5/69).

[7] Tax Reform Proposals (4/22/69).

• Expenses allocated to tax preference income and accordingly disallowed should be allowed to reduce ordinary income if the asset is later sold.

Senate bill.[8] The Finance Committee substituted its version of the minimum tax and made it equally applicable to corporations as well as noncorporate taxpayers. Unlike the House bill, the Senate's minimum tax was separate from the regular income tax base and provided for no allocation of deductions. The Committee recommended that tax preference income in excess of $30,000 be subject to a special flat rate of 5%, payable in addition to regular income tax. On the floor, the Senate increased the minimum tax rate to 10%, but also expanded the exemption from $30,000 to include the regular income tax.

The tax preferences contained in the Senate bill, which generally followed the Treasury's recommendations, were as follows:

• Appreciation in value of property donated to charity was omitted as a tax preference item; however, certain limitations on charitable contributions were imposed in another section of the Act.

• Tax exempt interest was eliminated as a preference item; instead, provisions relating to excess investment interest were added.

• Farm losses were removed as a preference item, but a separate provision for recapture of farm losses was provided.[9]

• Rapid amortization of certified pollution control facilities and railroad rolling stock, the excess of the bad debt reserve deductions allowed financial institutions in excess of actual experience, and the bargain element of qualified stock options were added as tax preferences.

The Senate, however, did not follow the Treasury's recommendations with respect to expenses during construction of buildings.

The House-Senate Conference substitute followed the Senate amendment, with these adjustments:[10]

• The excess investment interest and accelerated depreciation on personal property preferences apply only to individuals, subchapter

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[8] S. Rep. No. 91-552 (11/21/69).

[9] New Sec. 1251.

[10] H. Rep. (Conf.) No. 91-782 (12/21/69).

S corporations, and personal holding companies. Also, excess investment interest is considered a preference item only for years beginning before 1972; for years beginning after 1971, the interest limitation deduction provision becomes effective.

- The preference relating to intangible drilling and development costs was deleted, but the basis on which the depletion deduction preference is computed does not include such costs.

The House agreed the Senate version was preferable. The House provisions would have greatly complicated compliance with the tax law due to the inclusion of tax preferences in the same tax base as regular taxable income. Difficulties would also have arisen in allocating deductions; for example, if there were a limitation on a particular deduction based on taxable income, the limit on tax preferences would have affected the amount of taxable income and the amount of taxable income in turn would have affected the deductions and LTP. Simultaneous equations would have been required in many instances. Individuals with the same amount of tax preferences would have been treated differently merely because they had different amounts of taxable income. In addition, the LTP concept did not lend itself well to application to corporate income.

The minimum tax

New Sec. 56 imposes a minimum tax on a tax base composed of certain tax preferences. Effective for years ending after 1969, a 10% tax is imposed on the excess of: the sum of the items of tax preference over the sum of $30,000 and the regular income tax for the year.

This tax, which is in addition to the taxes otherwise imposed, is at a flat rate of 10%—regardless of the amounts of taxable income and income tax otherwise paid. Some deferral relief is granted, however, when the taxpayer sustains a net operating loss.

The tax surcharge is not computed on the 10% minimum tax.[11] Neither the investment credit nor the foreign tax credit can be used to reduce the minimum tax.[12] Yet, rather inconsistently, the retirement income credit can be used to reduce the minimum tax.

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[11] Amended Sec. 51(b)(1).

[12] Amended Secs. 46(a)(3) and 901(a).

Taxpayers subject to minimum tax. Sec. 56(a) specifies that the minimum tax is imposed ". . . with respect to the income of *every person*. . . ." [Emphasis added.] Sec. 7701(a)(1) defines "person" to include an individual, trust, estate, partnership, association, company or corporation. Partnerships, as such, are not subject to the minimum tax. The IRS has announced that the partnership regulations will be amended to make clear that for purposes of the minimum tax, each partner must take into account separately his distributive share of tax preferences.[13] Sec. 58 contains specific rules with respect to other conduit entities such as estates, trusts, and subchapter S corporations.

Not even exempt organizations escape; they are subject to the minimum tax to the extent that items of tax preference enter into the computation of unrelated business taxable income.[14]

The minimum tax base does differ in the case of corporations. As will be pointed out in the item-by-item discussions, certain tax preference items are not applicable to corporations; on the other hand, one item is applicable only to financial institutions.

Tax preferences sheltered by "regular tax." The minimum tax base is reduced, as previously explained, by the "taxes [otherwise] imposed" by Chapter 1 of the Code, subject to certain adjustments. "Taxes imposed," which include the tax surcharge, are reduced by the allowable foreign tax credit (Sec. 33), retirement income credit (Sec. 37), investment credit (Sec. 38); furthermore, "taxes imposed" do not include the personal holding company tax (Sec. 541) and the accumulated earnings tax (Sec. 531).[15] This article will refer to such "adjusted taxes imposed" as the taxpayer's "regular tax."

The inclusion of the regular income tax as a part of the tax-free base in computing the minimum tax, can shelter a substantial amount of tax preference items. For example, a single individual with taxable income of $75,000 would have a tax liability (excluding the surcharge) of $38,490; a married taxpayer filing a joint return would have a tax liability of $30,470. Such taxpayers, therefore, could have tax preferences totaling $68,490 and $60,470, respectively, without incurring liability for the minimum tax. Corre-

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[13] TIR 1032 (3/19/70); also see the instructions to Form 4625, Computation of Minimum Tax, for Fiscal Year 1969-1970.

[14] Amended Sec. 511.

[15] Sec. 56(a) (2).

spondingly, individuals with $150,000 of taxable income could have tax preferences totaling $120,490 and $106,980, respectively, before incurring liability for the minimum tax.

Individual taxpayers can have a substantial amount of net long-term capital gain income without incurring liability for the minimum tax. Assume the individuals in the above examples had no other items of tax preference. In addition to the $75,000 and $150,000 of ordinary income, capital gains of $93,815 and $136,368, respectively, could be realized by the single taxpayer, and $82,581 and $125,134, respectively, by the joint return taxpayer, without incurring any minimum tax liability.

In the case of corporate taxpayers, those with substantial tax liabilities will be able to utilize a substantial amount of tax preferences without incurring the minimum tax. The 10% minimum tax will have the greatest impact on those corporate taxpayers with substantial tax preferences (or for that matter, individuals) who currently pay either nominal taxes or no taxes at all. This apparently was the intent of the Senate floor amendment which provided for the deduction of the regular income tax from the preferences before application of the minimum tax, and at the same time increased the minimum tax rate to 10% from the proposed 5% rate.[16]

Incidentally, substantial tax savings can still be accomplished by high bracket taxpayers through additional deductions even though the deductions constitute tax preference items in excess of the sheltered amount and, therefore, are subject to the 10% minimum tax.

Estimated tax payments. Individuals need not take the minimum tax into consideration in filing estimated tax returns and paying estimated tax.[17] The Code was amended so as to specifically provide that the underpayment penalty will not apply to the minimum tax.[18]

No changes were made by the Act with respect to estimated tax requirements for corporations. However, the existing wording of Sec. 6154 is such that the minimum tax is not included in the taxes subject to the corporate estimated tax requirements.

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[16] Cong. Rec. (12/10/69), S16371-4.

[17] Amended Sec. 6015(c).

[18] Amended Sec. 6654(f).

Extension of time to file. In filing Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, the minimum tax must be considered in arriving at the amount of tentative tax to be paid at that time. The minimum tax must also be taken into consideration in computing the estimated tax to be paid at the time Form 2758, Application for Extension of Time, is filed for an estate or trust. An individual is not required to pay a tentative tax when requesting an extension.

In all instances, however, due regard to the minimum tax should be given. The Tax Reform Act contains a new penalty of .5% per month of the amount shown as tax on an income tax return for failure to pay such amount on or before the date prescribed for payment (determined without regard to any extension of time for payment).[19]

Penalty tax. The minimum tax in operation acts as a penalty tax. No relief is provided at a later date when certain preference items may become subject to income taxes otherwise imposed. For example, in the case of the accelerated depreciation preferences, the depreciation may be later recaptured and taxed at ordinary income rates. The bargain element in stock options (the excess of fair market value of the stock at the time of exercise over the option price of the stock) is subject to tax upon the subsequent disposition of the stock. It may be taxed as capital gain which would itself be a tax preference item subject to tax. No relief by way of addition to tax basis or reduction of later tax preferences is provided. The Senate Finance Committee considered this point, but concluded that ". . . as a practical matter, it would be best not to provide for such basis adjustments . . . since such adjustments would complicate the minimum tax. Moreover, the fact of deferring tax for an extended

[19] Amended Sec. 6651. The question arises in the case of extensions as to whether, for example, a corporate taxpayer is protected from the new penalty only with respect to the amount of tax shown on Form 7004. TIR 1034 (4/6/70) states that taxpayers who receive extensions of time for filing their returns are not subject to the new penalty for failure to pay tax for the period covered by the extension. The release further states, however, that if upon audit the facts contained in the application are not supportable, the taxpayer will have to pay the penalty unless reasonable cause can be established for failure to pay the tax on the original due date. Further, in the case of corporate automatic extensions, the penalty will be asserted when the taxpayer deliberately underestimates the amount of tax.

period of time is itself a tax preference for which the [minimum] tax is a moderate charge."[20]

Effective date. Act Sec. 301(c) makes the minimum tax provisions effective for all years ending after December 31, 1969. In the case of a year straddling December 31, 1969, the tax liability is a fraction of the minimum tax for a full year, based on the number of days in 1970 compared to the number of days in the entire taxable year.

Problems arise in the application of the effective date where a conduit entity and the actual taxpayer have different taxable years. A partnership, for example, could have a fiscal year ended in 1969 which ends within a partner's fiscal year ending in 1970. The problem is more complicated when the partnership has a fiscal year ending in 1970—such as January 31, 1970—and the partner is on a calendar year basis.[21] It is not clear to what extent the tax preferences of the partnership are to be included by the partners in computing the amount of their tax preferences. If the fiscal year of the partnership ended before December 31, 1969, it would not seem fair to consider tax preference items to be passed to a partner whose fiscal year ends in 1970. It seems more equitable to prorate preferences at the partnership level, similar to the proration of tax liability at the individual level, for straddle years.

Regulations are needed for answers.

Items of tax preference

The minimum tax is based on nine items of tax preference: excess investment interest, accelerated depreciation on real property, accelerated depreciation on personal property subject to a net lease, rapid amortization of certain properties (two items), depletion, reserve for bad debt losses of financial institutions, stock options, and capital gains. Seven of these tax preference items may be generally categorized as deductions for tax purposes that do not necessarily represent economic losses and two may be classified as economic income that receives preferential tax treatment. Unless otherwise indicated in the following discussion, the tax preference is applicable to all taxpayers.

[20] S. Rep. No. 91-552 (11/21/69), p. 117.

[21] Similar problems can exist with respect to subchapter S corporations, estates, trusts, common trust funds, regulated investment companies and real estate investment trusts.

Excess investment interest. This item is defined in Sec. 57(b) as the amount by which "investment interest expense" exceeds "net investment income" for the taxable year. Investment interest expense is interest on indebtedness incurred or continued to purchase or carry property held for investment purposes. Net investment income is the excess of investment income over investment expenses.

Investment income consists of gross income from interest, dividends, rents, royalties, net short-term capital gain attributable to investment property and amounts treated as ordinary income under the depreciation recapture rules, but only to the extent that such income and gains are not derived from the conduct of a trade or business.

Investment expenses include property taxes, bad debts, straight-line depreciation, amortizable bond premium, cost depletion, the dividends received deduction allowed corporations, and other expenses directly attributable to the production of investment income.

As will be readily recognized, such definitions lend themselves to a number of practical and technical difficulties in determining the amount to be treated as an item of tax preference.[22]

Excess investment interest constitutes a tax preference item only for years beginning before 1972 and, in any event, does not constitute a tax preference for corporations, except subchapter S corporations (on a pass-through basis) and personal holding companies.[23] For years beginning after December 31, 1971, under new Sec. 163(d) excess investment interest becomes a matter of an unallowable deduction rather than a tax preference item.

Accelerated depreciation on real property.[24] The amount by which the depreciation deduction allowable for a taxable year with respect to real property exceeds the depreciation deduction which would have been allowable under the straight-line method is a tax preference item. This difference, as a tax preference, is limited to real property constituting "Sec. 1250 property."

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[22] For a detailed explanation of this particular preference item, together with problems that will be encountered in its application, see "Excess Investment Interest," Arthur J. Dixon, p. 127.

[23] Sec. 57(a), last two sentences.

[24] Sec. 57(a)(2).

Certain property, even though deemed to be real property under local law, may not constitute Sec. 1250 property as defined in Sec. 1250(c). To the extent that such real property constitutes Sec. 1245 property, accelerated depreciation can be used without creating a tax preference item.

For example, in the case of citrus groves, the trees constitute Sec. 1245 property and accelerated depreciation can be used without giving rise to a tax preference. Elevator and escalator components of a building constitute Sec. 1245 property rather than Sec. 1250 property. Storage tanks and other similar items of tangible property (other than buildings and their structural components) used as an integral part of manufacturing, production, extraction or the furnishing of certain utility services, or constituting research or storage facilities used in connection with such activities, also constitute Sec. 1245 property.

The Tax Reform Act added a provision for 60-month depreciation of certain rehabilitation expenditures on low-income rental housing.[25] This statutory useful life cannot be used in computing the amount of tax preference, however. Thus, the minimum tax may be imposed on the difference between the depreciation computed using the statutory five-year life and the straight-line depreciation computed using the actual life. It is interesting to note that while one provision gives a special tax benefit, another provision takes away the benefit (in fact, penalizes the taxpayer for taking the benefit).

The Tax Reform Act also limited the use of accelerated depreciation for real property.[26] This limitation will over a period of time result in a substantial dilution of the impact of the minimum tax as it relates to this item of tax preference.

Accelerated depreciation on personal property subject to a net lease.[27] Accelerated depreciation on "Sec. 1245 property" *subject to a net lease* is a tax preference item to the extent that the depreciation deduction allowable for the taxable year exceeds the deduction which would otherwise have been allowable under the straight-line method. As noted above, Sec. 1245 property can include property deemed to be real property under local law.

Sec. 57(c) considers property as subject to a net lease if:

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[25] New Sec. 167(k).

[26] New Sec. 167(j).

[27] Sec. 57(a)(3).

- Under the terms of the lease the lessor is either guaranteed a specified return on his investment or is guaranteed in whole or in part against loss of income, or
- For the taxable year, the ordinary and necessary business expense deductions allowed under Sec. 162 with respect to the leased property total less than 15% of the rental income produced by such property.

In the determination of the excess investment interest preference, property subject to a net lease is treated as property held for investment and not as property used in a trade or business, if such property is the subject of a net lease entered into after October 9, 1969. For purposes of this accelerated depreciation tax preference, there is no similar provision as to the date of the lease. Thus, Sec. 1245 property subject to a net lease entered into prior to October 10, 1969 is clearly subject to tax preference treatment.

Net leases had become popular arrangements for tax reduction of high tax bracket taxpayers. Under such an arrangement, for example, taxpayers joined together to finance the purchase of an airplane, leased the airplane to an airline under a net lease, and generated substantial deductions (from interest and depreciation) in the first years of the lease. Insofar as individual taxpayers are concerned, such an arrangement will now come within the scope of the minimum tax, both from the standpoint of excess investment interest and the accelerated depreciation element included as a tax preference item.

This tax preference item is not applicable to corporations generally but does apply to personal holding companies and (the stockholders of) subchapter S corporations.[28] Presumably, this would also be true where a corporation is a partner in a partnership leasing Sec. 1245 property subject to a net lease.

This preference would, however, apparently cover any unincorporated taxpayer in the business of leasing personal property, such as furniture, equipment, etc., to the extent the leases were within the definition of net lease. Computational problems would arise if only some of such leases were net leases. The allocation of expenses in applying the 15% rule could be troublesome, as well as perhaps the determination of the portion of depreciation applicable to the property covered by the net leases. Incorporation of the busi-

[28] Sec. 57(a), last sentence.

ness would be the obvious answer to these problems, if a subchapter S election were not contemplated.

The intent of Congress was apparently to exclude from the tax preference items accelerated depreciation applicable to personal property being used in the taxpayer's trade or business. It is interesting to note that Congress was not willing to exclude accelerated depreciation applicable to real property used in the taxpayer's trade or business except to the extent that such real property might be deemed to be Sec. 1245 property.

Rapid amortization of certain property.[29] Two items of tax preference relate to the 60-month rapid amortization of pollution control facilities and railroad rolling stock allowed under new Secs. 169 and 184, respectively. The amount by which the allowable deduction under such sections for a taxable year exceeds the depreciation deduction which would otherwise be allowable under Sec. 167 is a tax preference item.

Note that the amount of tax preference in connection with accelerated depreciation on real property and personal property subject to a net lease is computed by reference to straight-line depreciation. On the other hand, the amount of tax preference relating to these items of rapid amortization is computed by reference to the "deduction which would otherwise be allowable under Sec. 167." Since no reference is made to the straight-line method of depreciation, the maximum amount allowable under Sec. 167 under an accelerated method can apparently be used in computing the amount of tax preference. The Senate Finance Committee Report describes this excess as ". . . the excess of the deduction over accelerated depreciation."[30]

In the case of rapid write-off of rehabilitation expenditures for low-income rental housing, the tax preference is computed using the straight-line method of depreciation. Thus, expenditures for pollution control facilities and railroad rolling stock appear to have some greater advantage taxwise than housing rehabilitation expenditures. This advantage could reverse itself in later years if accelerated depreciation dropped below straight-line depreciation

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[29] Sec. 57(a)(4) and (5).

[30] S. Rep. No. 91-552 (11/21/69), p. 114; see also Summary of Senate Amendments (12/12/69), p. 58-59 and H. Rep. (Conf.) No. 91-782 (12/21/69), p. 302.

during the five-year rapid amortization period. This raises the question of whether, in computing the amount of this tax preference, taxpayers could switch to straight-line depreciation as would otherwise be permitted if accelerated depreciation were being used.

New Sec. 169(f) places a limit on the portion of a pollution control facility for which rapid amortization can be deducted. Thus, a portion of the depreciation deduction applicable to such a facility could actually be computed under the provisions of Sec. 167 rather than Sec. 169. The question arises: If the straight-line depreciation method is used for the unamortizable portion of the facility, should the tax preference on the amortizable portion nevertheless be computed with reference to an accelerated method of depreciation. Presumably, the portion not qualifying for rapid amortization would create no tax preference item unless such portion came within the scope of Sec. 57(a)(2), dealing with accelerated depreciation of Sec. 1250 real property.

Again, note that acquisition of certain types of properties is encouraged by allowing them to be amortized rapidly, but at the same time a penalty is imposed on the utilization of such rapid amortization by treating it as a tax preference item subject to the minimum tax. Perhaps Congress wanted to avoid abuses of the railroad rolling stock and pollution control facility amortization provisions, and decided that the $30,000 annual exemption plus the amount of regular income tax should be the maximum amount which should be sheltered from the minimum tax.

Depletion. The excess of the deduction for depletion allowable under Sec. 611 for the taxable year over the adjusted basis of the property at the end of the taxable year is listed in Sec. 57(a)(8) as a preference item. The adjusted basis of the property is determined without regard to the depletion deduction for that taxable year. Until the basis of the property has been recovered through depletion, depletion is not considered an item of tax preference; thereafter all depletion may be so considered. The computation is made on a property-by-property basis as defined for depletion purposes in Sec. 614.

As indicated by its legislative history, this tax preference as finally enacted differed substantially from earlier proposals. From a standpoint of tax shelter, it is important to note that intangible drilling and development costs are not items of tax preference. Also, percentage depletion is not considered an item of tax preference until

the total of the depletion deductions has exceeded the adjusted basis of the property.

Reserve for bad debt losses of financial institutions.[31] Another deduction item constituting a tax preference relates to the reserve for bad debts allowed banks, savings and loan associations, mutual savings banks or other financial institutions. Financial institutions have been allowed deductions, computed under certain formulas, for additions to bad debt reserves. New Sec. 585 and amended Sec. 593 now impose certain limitations on determining reasonable additions to reserves for bad debts, but such additions can still exceed actual experience. The difference between the deduction allowable for an addition to a reserve for bad debts and the amount that would have been allowable had the reserve been maintained for all years on the basis of actual loss experience is an item of tax preference.

Regulations are needed to define what is meant by actual experience. The difficulty is that Sec. 57(a)(7) refers to the amount that would have been allowable if the institution had maintained its reserve "for all taxable years on the basis of actual experience." Does this mean, for example, that financial institutions must go back to their first year of existence and compute their actual experience to date? What method will be used in making the computation—a weighted average, a moving average or the experience method set forth in new Sec. 585(b)(3) with respect to commercial banks?

Presumably this provision will not operate to subject to the minimum tax an addition to a bad debt reserve merely because the reserve is maintained at a higher level than justified by prior experience. The annual additions should not be treated as tax preference except to the extent that the actual annual addition exceeds the amount that would have been allowable for the year under the experience method. In other words, an excess accumulation in the reserve should not affect the amount of this preference item.

Regulations also need to make provisions for new financial institutions to use industry experience. This approach is supported by the Senate Committee Report[32] which indicates that in the case of

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[31] Sec. 57(a)(7). This subject is covered in depth in "Impact of 1969 Tax Reform on Financial Institutions," Melvin L. Hamlin, p. 249.

[32] S. Rep. No. 91-552 (11/21/69), p. 114 and Summary of Senate Amendments (12/12/69), p. 59.

new institutions, this tax preference will be measured against an allowance based on industry experience. Relatively new financial institutions should be given the option of measuring the tax preference against their actual experience or by industry average. If industry average is used, the regulations should also provide a definition or source.

The amount of minimum tax generated from this tax preference will decline as the transitional rules of new Sec. 585 and amended Sec. 593 become effective.

Stock options.[33] One of the two economic income items treated as a tax preference is the bargain element with respect to stock issued pursuant to the exercise of a qualified stock option as defined in Sec. 422(b) or a restricted stock option as defined in Sec. 424(b). Ordinarily, there are no tax consequences to the taxpayer-employee when such a stock option is granted, or at the time of exercise. However, for minimum tax purposes, the excess of the fair market value of the stock at the time of exercise of the option over the option price is a tax preference item. Thus, a taxpayer will now be subject to a minimum tax of 10% for the privilege of deferring tax on this bargain element. If the stock is subsequently sold at a gain, the taxpayer realizes gain at that time equal to the difference between the sales price and the option price. Generally the gain will be long-term capital gain, which itself will be a tax preference item again subject to the 10% minimum tax.

The amount of tax preference is measured as of the time of exercise. If the time of transfer differs from the time of exercise, there could be a problem as to which point of time the minimum tax is imposed. The statutory language states "With respect to the transfer of a share of stock pursuant to the exercise. . . ." The Summary of Bill as Reported by Committee states ". . . this is the excess of the fair market value of the stock at the time of the receipt of the stock pursuant to the exercise of the option over the option price of the stock."[34] The subsequent reports,[35] however, refer to ". . . the excess . . . at the time of the exercise. . . ."

[33] Sec. 57(a)(6).

[34] Summary of H.R. 13270 as reported by the Committee on Finance (11/18/69).

[35] S. Rep. No. 91-552 (11/21/69), p. 114 and Summary of Senate Amendments (12/12/69), p. 59.

Undoubtedly, this preference was not intended to apply to corporations. However, there is no express statutory language excluding the employer corporation, such as provided with respect to the excess investment interest and accelerated depreciation on personal property preferences. The stock option preference is defined simply as being "With respect to the transfer. . . ." Perhaps this is just one more drafting oversight of the Act.

Note also that this tax preference does not include the bargain element of an employee stock purchase plan as defined in Sec. 423.[36]

Capital gains.[37] Another economic income item treated as a tax preference is capital gain. The minimum tax is imposed on the portion of the capital gain which receives preferential tax treatment.

In the case of individuals and other noncorporate taxpayers, the tax preference will be an amount equal to one-half of the amount by which the net long-term capital gain exceeds the net short-term capital loss for the taxable year or, in other words, the capital gains deduction.

For corporations, the amount of tax preference is based upon the relationship of the current capital gain tax rate to the current regular corporate tax rate. Corporations have no capital gains deduction as such, only an alternative tax rate. Consequently, the tax preference relates to the excess of the net long-term capital gain over the net short-term capital loss that is taxed at a preferential rate. The theoretically untaxed portion (due to a lesser alternative rate) is the amount of tax preference. This is determined by using a formula to compute the percentage of the net capital gain

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[36] Also, the transfer of property (including stock and options) subject to restrictions that significantly affect its value does not come within the scope of this tax preference item. New Sec. 83 severely limits the tax advantages of such restricted stock compensation plans. Restricted stock transferred after June 30, 1969 will generally provide no tax advantage other than deferral of ordinary income. However, there still remains a tax advantage with respect to restricted stock transferred pursuant to a written contract entered into (or to an option granted) before April 22, 1969, and this bargain element is not a tax preference. Similarly, such stock transferred prior to May 1, 1970, pursuant to a written plan adopted and approved by the employer corporation before July 1, 1969, does not constitute a tax preference item.

[37] Sec. 57(a)(9). For a fuller discussion of the changes in the capital gain rules, see "Capital Gains and the Tax Reform Act of 1969," Gayford L. Hinton, Jr., p. 183.

to be treated as a tax preference. The percentage is a fraction, the numerator of which is the regular corporate tax rate (normal rate plus surtax rate) less the alternative tax rate, and the denominator of which is the sum of the normal tax rate and the surtax rate. The formula produces the following percentages:

Calendar year		
1970	$\frac{(22+26)-28}{22+26} = \frac{5}{12}$	or 41.67%
1971	$\frac{(22+26)-30}{22+26} = \frac{3}{8}$	or 37.5%

There is a problem in the application of this formula. Sec. 1201 retains a 25% alternative tax for certain capital gains of corporations for years beginning before 1975. Thus, for capital gains realized in 1970 or subsequent years, if a corporation's net long-term capital gain is taxed at only a 25% rate (under one of the exceptions, such as an installment sale made prior to 1970), the question arises as to whether, in computing the fraction, the 25% or 28% rate should be used. (The question could be complicated further if the corporation realizes capital gains which are taxed at both rates.) Sec. 57(a)(9)(B) can certainly be interpreted as requiring the use of the higher rates of 28% for 1970 and 30% thereafter, regardless of the rate at which any portion of the capital gain is actually taxed. The committee reports seem to support this interpretation. On the other hand, the amount of capital gain preference could also be computed by separately applying the formula to the different components of capital gain, using the appropriate rate in each computation. Regulations are needed to answer this question.

Another problem exists as to whether capital gain should be a tax preference item to a corporation where such gain receives no preferential tax treatment under Sec. 1201(a). Sec. 57(a)(9)(B) provides that, in the case of a corporation to which the alternative tax rates of Sec. 1201(a) do not apply, the amount of preference will be determined under regulations to be prescribed.

For example, situations in which long-term capital gains would be taxed at ordinary rates include the following:

1. A corporation has regular income and capital gain aggregating $25,000 or less.

2. A corporation has a substantial amount of capital gain but also has an operating loss sufficient to result in taxable income of $25,000 or less.

3. A corporation has capital gain of $250,000 but has operating losses of $150,000.

In all three situations the regular tax would be less than the alternative tax. In the first two, the taxable income level is such that only the normal tax rate (22%) would apply. In the third situation, the surtax rate (26%) as well as the normal rate would apply, but the regular tax of $41,500 would still be cheaper than the alternative tax (at a rate of 28%) of $70,000. Thus there are situations, both at the normal tax and the surtax levels, where the alternative tax under Sec. 1201(a) will not be used because the normal tax and surtax of Sec. 11 is less. Even though such capital gain will be taxed at ordinary income tax rates, will it nevertheless be a tax preference for minimum tax purposes? The committee reports do not clarify the statutory language. However, the statute does suggest that in such instances regulations should be issued which will provide relief from the fixed formula otherwise applicable.

In the case of an individual taxpayer, it seems clear that the minimum tax will be imposed on the portion of the capital gain representing the capital gains deduction without regard to the taxpayer's other income or deductions or tax rate (except perhaps in the case of a net operating loss).

There are situations where capital gain will not produce the "untaxed" benefit at which the minimum tax is aimed. To the extent that capital gains reduce or eliminate a net operating loss, such as where the capital gains deduction of an individual is added back in computing his net operating loss or net operating loss carryover, the taxpayer has no "untaxed" economic benefit. Where the alternative tax computation is used by a corporation for a particular year, the Service position seems to be that any operating loss for that year, or any net operating loss carried back to that year, is used up to the extent of the capital gain. In these instances the capital gain has not really produced a benefit. But the entire capital gain would still seem to be subject to treatment as a tax

preference as defined and subject to the minimum tax.

It seems clear that the capital gain tax preference will be reduced by capital loss carryovers. The preference is defined as the excess of net long-term capital gain over net short-term capital loss for a taxable year; and, under Sec. 1212, a capital loss carryover is treated as a capital loss of the year to which carried. A three-year carryback is permitted for capital losses of corporations (except subchapter S corporations) sustained in taxable years beginning after 1969.[38] Because, under Sec. 1212, a capital loss carryback is treated as a capital loss of the year to which carried back, it appears that a capital loss carryback can be used to reduce the amount of tax preference and thus the amount of minimum tax that might have been imposed in such earlier year.

Additional aspects of the capital gains preference, as related to net operating losses and subchapter S corporations, will be covered later in this article.

The use of the installment sale may become even more popular as a result of the minimum tax provisions. Presumably, the amount of the capital gains preference item will include only the portion of the gain recognized for tax purposes in that particular taxable year. There could be a question where the depreciation recapture provisions result in part of the gain being taxed as ordinary income. For regular tax purposes, the ordinary income portion is recognized in full before any capital gain portion is recognized. The same rule should prevail in determining the amount of capital gain tax preference for a particular year.

It should be noted that for years beginning after 1971, any long-term capital gains used to offset investment interest will be treated as ordinary income and therefore will not be treated as a tax preference item to that extent.[39]

Where the minimum tax is applicable, the *maximum* effective rates on long-term capital gains would be 5% for individuals and 4.167% and 3.75% for corporations. However, such maximum effective rates would be limited to unusual situations, such as where an individual's itemized deductions exceed his adjusted gross income

[38] Amended Sec. 1212. Incidentally, a capital loss carryback may not increase or create a net operating loss in the year to which carried back.

[39] New Sec. 163(d)(5).

[40] For 1970, 10% of 41.67% equals 4.167%; for 1971, 10% of 37.5% equals 3.75%.

(including capital gains) and his other tax preferences exceed $30,000. Ordinarily the effective minimum tax rate on capital gains will vary according to the facts, principally the regular tax imposed on the capital gain and the extent to which the sum of the $30,000 exemption and the regular tax on ordinary income is offset by other tax preferences.

Assuming that the sheltered portion of a capital gain exceeds the sum of $30,000 and the regular tax on ordinary income, and that the capital gain is taxed under the alternative method, the effective minimum tax rates would be as follows:

Individuals:	
On gains taxed at 25%	2.50%
On gains taxed at 29.5% (in 1970)	2.05%
On gains taxed at 32.5% (in 1971)	1.75%
Corporations:	
On gains taxed at 28% (in 1970)	1.367%
On gains taxed at 30% (in 1971)	.750%

The above effective rates represent 10% of the tax sheltered portion of the capital gain less the capital gain itself.

Example. An individual realizes a long-term capital gain of $50,000 that is taxed at the 25% rate.

Tax preference portion (50% of $50,000)	$25,000
Less alternative tax on capital gain	12,000
Taxable tax preference	12,500
10% minimum tax	$ 1,250
Effective minimum tax rate ($1,250 ÷ $50,000)	2.5%

Deferral of minimum tax in NOL year

Because the minimum tax base consists of tax preference items and is determined without regard to taxable income, a taxpayer could have no taxable income or even a loss for a given year and still be liable for the minimum tax. When a taxpayer sustains an NOL, Sec. 56(b) provides some current relief by deferral of the minimum tax liability—provided some portion of the loss is available as a carryover to future years. In such event, the minimum tax liability will be deferred to the extent of the lesser of:

- The amount of the minimum tax, or
- 10% of the amount of the NOL carryover.

The deferred minimum tax will be imposed in a succeeding year in which an NOL carryover attributable to the tax preference items (in excess of $30,000) reduces taxable income. The minimum tax thus imposed will be 10% of the portion of the NOL carryover deduction which is attributable to excess (over $30,000)[41] tax preference items. For this purpose, the non-tax preference items included in the loss carryover will be considered to have been applied first to the reduction of taxable income. To the extent covered by the $30,000 annual exemption, tax preferences are apparently treated as non-preferences in determining whether an NOL carryover deduction is attributable to tax preferences. In other words, a loss carryover is deemed attributable to tax preferences only to the extent they exceed $30,000.

Example. For 1970, *T* has taxable income of $100,000, non-preference deductions of $75,000 and preference deductions of $50,000. The NOL would be $25,000 (all of which can be carried over). Before any NOL deduction, *T*'s 1971 and 1972 taxable incomes are $25,000 and $35,000 respectively. Under the approach stated above, $20,000 of the 1970 loss would be deemed attributable to tax preferences.[42]

For 1970, since the excess (over $30,000) tax preferences total $20,000, the minimum tax would be $2,000; but it would be deferred under the above rules, since it is less than $25,000 NOL carryover. For 1971, since only $25,000 of the loss carryover is used and since it is less than the non-preference items (deemed to equal at least $30,000), no minimum tax would be imposed in 1971. However, in 1972 a $2,000 minimum tax would be imposed; the unused $25,000 of NOL would be deemed to include first $5,000 of non-preference deductions and then $20,000 of preference items.

The deferral of the minimum tax can be indefinite. If the portion of the NOL attributable to tax preference items is never used,

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[41] The tax preference items included in the NOL generate only one $30,000 annual exemption; that is, a taxpayer is not entitled to additional $30,000 annual exemptions for the same tax preferences in subsequent years.

[42] If the loss carryover is divided pro rata between the portion that represents tax preferences and the portion that does not, 40% ($50,000÷$125,000) of the loss carryover would be attributable to tax preferences. Thus $10,000 of the loss carryover would be deemed attributable to tax preferences reducing the income of a subsequent year. This would trigger a minimum tax of only $1,000. Such a result seems contrary to Congressional intent. Regulations are needed to clear up the ambiguities of the new Sec. 56(b)(2) and (3) language with respect to the determination of the ". . . portion of the net operating loss carryover attributable to the excess. . . ."

the minimum tax would never be imposed on such preference items. The Senate Report[43] supports this conclusion.

The taxpayer has an interest-free tax deferral privilege under these provisions. Because an NOL generally has to be sustained in a trade or business and has to be adjusted in the manner provided in Sec. 172, the deferral provision will probably be more beneficial to corporations than to individuals.[44]

Net operating loss carryback. The statute does not specifically refer to NOL carrybacks. However, clearly and logically, there is no deferral of minimum tax liability where an NOL for a taxable year is used entirely through carryback. The minimum tax on tax preferences in excess of $30,000 will be due and payable for the year of the loss.

With respect to a year to which an NOL is carried back, an increase in the minimum tax liability could result. A loss carryback would reduce or eliminate the regular income tax for such earlier year. This would also reduce the amount of tax preferences being sheltered, with a resulting increase in the amount subject to the minimum tax in the carryback year. Of course, this problem will not arise until after 1970.

What if an NOL is carried back to prior years but is not fully utilized in the prior years so that a portion of the loss is available as a carryover? Apparently the priority rules discussed earlier would operate unfavorably; that is, the portion of the NOL attributable to the non-tax preference items (and the first $30,000 of tax preferences) would be deemed applied first in the utilization of the loss carryback in the prior years. Thus, the NOL carryover is more likely to be attributed to tax preferences.

Pass-through of losses. Inasmuch as the losses of a subchapter S corporation and a partnership are passed through the entity to its shareholders and partners, respectively, losses of such entities enter into the computation of an NOL. In such cases, it is necessary to look behind such losses to determine the extent to which the losses resulted from tax preference items. Problems in connection with this will be discussed under "Operational rules."

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[43] S. Rep. No. 91-552 (11/21/69), p. 117.

[44] Also see the discussion under "Operation rules" of the potential deferral computation problems in cases of a husband and wife.

Capital gains. Under Sec. 56(b), it is not clear how capital gain preferences are handled in computing the amount of minimum tax deferred in a year of an NOL. Suppose that the only tax preference of a loss year is the capital gain item. Is the minimum tax still deferred? If so, how is the tax triggered in subsequent years?

Obviously, in such a case, the NOL carryover would not be attributable to excess (over $30,000) preference *deductions* which is presumably what is contemplated by Sec. 56(b)(2). The approach could be taken that, in computing the portion of the loss carryover attributable to the capital gain preference, it is to be offset to the extent possible by non-preference deductions and the $30,000 annual exemption. However, such an approach would not solve every problem. It appears that the relationships of other income to capital gain income, tax preference deductions to non-preference deductions, and the allocation thereof, can produce different results. Regulations must provide guidance in this area.

Operational rules

The application of the minimum tax provisions may well prove to be more difficult than Congress and the Treasury anticipated because of the different factual situations that can exist. Some of the potential problems have already been discussed. Others will be covered under this section describing various operational rules. Hopefully, the forthcoming regulations will minimize, if not eliminate, the uncertainties.

Tax preferences attributable to foreign sources.[45] Items of tax preference, except as noted in the next paragraph, which are attributable to sources within any foreign country or possession of the U.S. are taken into account only to the extent that such items reduce the regular tax otherwise imposed on income derived from sources within the U.S.

Capital gains and stock options which are attributable to sources within any foreign country or U.S. possession are taken into account as tax preferences only if, under the laws of such other country or possession, such items are accorded preferential tax treatment. No definition is given of "preferential" for this purpose. "Preferen-

[45] Sec. 59(g).

tial" may include tax deferral and taxation at rates lower than those imposed on other types of income by the foreign country or possession. What happens, however, when a capital gain or stock option is accorded preferential treatment within the foreign country or possession but is nevertheless taxed at rates equal to or greater than the U.S. tax rates on ordinary income? Regulations should answer questions such as this. If preferential tax treatment is granted such items, they are treated as foreign source tax preference items and are subject to the minimum tax under the general rule set forth in the preceding paragraph.

In applying the reduction-of-tax rule, foreign source items of tax preference are treated as reducing the tax imposed on U.S. income before items which are not items of tax preference. There is no indication as to whether U.S. source tax preference deductions have priority over the foreign source tax preference deductions in the course of applying this rule.

Thus it appears a taxpayer could be subject to the minimum tax because of foreign source tax preferences, even though there were sufficient nontax preference deductions to eliminate taxable income and regular income tax. Apparently, if foreign source tax preference items are included in an NOL, some or all of the minimum tax could be deferred and imposed thereon in subsequent years upon utilization of the loss.

Note that the statutory language requires reduction of U.S. tax liability rather than a reduction of taxable income. The committee reports[46] state that tax preference items which are attributable to sources within any foreign country or U.S. possession are taken into account only to the extent that such items result in foreign losses which reduce *taxable income* from U.S. sources. Further, the amount of tax preferences to be included cannot exceed foreign losses. This indicates that foreign tax preference deductions are to be netted against foreign source income before determining whether tax liability on U.S. source income is reduced.

The Senate Report[47] also states that foreign tax preferences and foreign losses are to be computed on a country-by-country basis or on an overall basis, depending on how the foreign tax credit is

[46] Summary of H.R. 13270 as reported by the Committee on Finance (11/18/69), p. 43; S. Rep. No. 91-552 (11/21/69), p. 115; Summary of Senate Amendments (12/12/69), p. 60.

[47] S. Rep. No. 91-552 (11/21/69), p. 115.

computed. An overall basis must be used if the foreign tax is taken as a deduction.

Husband and wife. A husband and wife are entitled to only one $30,000 annual exemption. Sec. 58(a) specifies that if they file separate returns for the taxable year, each will have an annual exemption of $15,000. Such allocation is mandatory; apportionment is not possible. However, nothing precludes more than one $30,000 annual exemption within a family group; thus, each child, as a separate taxpayer, is entitled to an annual exemption. The exemptions will in most instances not be too useful to children, except perhaps in the case of the capital gain tax preferences. The deductions generated by the other tax preferences, even though subject to the minimum tax, will generally be more valuable to the parents.

It is not clear how the filing of separate returns will affect the operation of Sec. 56(b) concerning deferral of liability for the minimum tax in the case of NOLs. Carrybacks or carryovers from separate return years to joint return years, and vice-versa, could complicate the application of this provision. Generally, the rules relating to NOLs in such situations should serve as guidelines for the regulations to be issued.

Members of controlled groups. Sec. 58(b) allows only one $30,000 annual exemption to a controlled group of corporations. The $30,000 must be divided equally among the component members of the group, unless all component members consent to an apportionment of such amount. The rules as to the time and method of apportionment and manner of consent, which are to be prescribed by regulations, will probably correspond to those for the apportionment of a single surtax exemption. For minimum tax purposes, a controlled group of corporations is a parent-subsidiary group or a brother-sister group as defined in Sec. 1563(a).[48]

Sec. 58(b) does not indicate whether a new election will be per-

[48] The TRA expanded the Sec. 1563 (a) definition of a "brother-sister controlled group" to include two or more corporations which are owned 80% or more by voting power or value by five or fewer persons (individuals, estates or trusts), providing that these persons own more than 50% of each corporation identically. Previously the requirement had been that one individual estate or trust own 80%.

mitted to be made each year. If annual elections are permissible, the members of a controlled group can allocate the exemption annually and thereby minimize their exposure to the minimum tax.

One point with respect to effective dates should be noted. The minimum tax provisions are effective for years ending after 1969. For fiscal years that straddle January 1, 1970, the minimum tax is determined by using a fraction based on the number of days in 1970. The new definition of a brother-sister controlled group is effective for taxable years ending on or after December 31, 1970. Thus, the old definition of a brother-sister controlled group is applicable in computing the minimum tax for years straddling January 1, 1970.

Subchapter S corporations and their shareholders.[49] With one exception relating to capital gains, the tax preference items of a subchapter S corporation are treated as those of the shareholders rather than of the corporation. The tax preferences are apportioned among the shareholders in the same manner that an NOL is apportioned pursuant to Sec. 1374(c)(1). Under such section, each shareholder's share of the tax preference items is allocated on a daily basis based on the number of shares held on each day during the taxable year of the corporation. A change of stock ownership prior to the year end of the corporation will not, therefore, prevent the apportionment of tax preferences.

The one exception relates to capital gain in excess of $25,000 taxed to the subchapter S corporation under Sec. 1378. The minimum tax is imposed on the amount of the capital gain taxed to the corporation. To this extent such capital gain is subject to the minimum tax twice, once at the corporate level and again at the shareholder level.[50] In such a situation, the corporation should be entitled to its own annual exemption of $30,000, separate and apart from its shareholders. It seems clear that the amount of capital gain tax and minimum tax paid by the subchapter S corporation decreases the amount of the capital gain preference item apportioned to the shareholders, just as such taxes reduce the amount of capital gain taxed to the shareholders.[51]

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[49] Sec. 58(d).

[50] S. Rep. No. 91-552 (11/21/69), p. 117. Summary of Senate Amendments (12/12/69), p. 60.

[51] Amended Secs. 1373(c) and 1375(a)(3).

It is not clear how the amount of long-term capital gain preference should be computed. If measured at the corporate level, 5/12 of the capital gain would be a tax preference item for 1970 (3/8 for 1971); if measured at the individual level, 50% of the capital gain would be a tax preference. The language of Secs. 58(d) and 57(a)(9)(B) seems to require that the preference be measured at the corporate level. Certainly this should be true with respect to the capital gain taxed to the corporation under Sec. 1378. As to the capital gain preference of a subchapter S corporation which is passed through to its shareholders, it would seem logical to compute the amount under the individual (50%) rule. This would be consistent with the concept that long-term capital gains of a subchapter S corporation generally retain their character for purposes of taxation at the shareholder level.

A further problem arises, however, where subchapter S items do not retain their same character in the hands of the shareholders. Consider, for example, a year in which a subchapter S corporation realizes $100,000 of net long-term capital gain and sustains a $70,000 NOL. Do the shareholders have a capital gain preference of only $30,000 (the amount of taxable income that would be taxed to them as capital gain) or $100,000? Literally, Sec. 58(d) seems to indicate that $100,000 would be the correct answer. This view would also be in keeping with a basic concept of the minimum tax, that is, the sum of items of tax preferences is determined without regard to the taxable income of the taxpayer. A similar problem arises where the subchapter S corporation has an ordinary loss in excess of its long-term capital gain.

Regulations are needed to define the character and amount of preferences passed through the corporation to its shareholders for purposes of the minimum tax. Sec. 58(d), as well as the committee reports, states that ". . . the sum of the items so treated shall be apportioned. . . ." Such language seems to provide that the items of tax preference are to be lumped together and then apportioned as a single preference item.

This suggests, for example, that short-term gains and losses at the corporate level will lose their identity and not be considered at the individual level in computing the excess of net long-term capital gain over net short-term capital loss for preference purposes. Moreover, this lump sum approach would suggest that, for minimum tax purposes, a capital gain preference would lose its identity, so that

a shareholder would not be able to reduce the amount of such preference by his own capital losses. These results are inconsistent with the conduit concept generally applicable to subchapter S corporations.

Common trust funds. Common trust funds as defined in Sec. 584 are not subject to income taxation. The participants are taxed on the ordinary income or losses and capital gains or losses realized by the fund. Sec. 58(e) provides that items of tax preference for each taxable year of the fund are to be passed through to the participants of such funds. The tax preferences are to be apportioned pro rata among the participants. The statutory language indicates that each item of preference is to be apportioned. Unlike the subchapter S corporation provision, there is no reference to the apportionment of the "sum" of the items.

Regulated investment companies and REIT. In the case of regulated investment companies (mutual funds) and real estate investment trusts (REITs) to which subchapter M applies, Sec. 58(f) provides that the capital gain tax preference should not be treated as a tax preference item of the mutual fund or REIT to the extent that such gain is taken into account as income by shareholders of the mutual fund or holders of beneficial interest of the REIT. The capital gain to the extent distributed is subject to minimum tax at the shareholder level.

All other items of tax preference are allocated between tho mutual fund or REIT for each taxable year in the proportion that dividends (other than capital gains) distributed to the shareholders or beneficial interest holders bear to the taxable income of the corporation. The tax preference items are determined at the mutual fund or REIT level, and the items of tax preference are then allocated.

There is one further exception in the case of REITs. The excess of accelerated depreciation over straight-line depreciation on real property is not treated as a tax preference to the beneficial interest holders. This exception results from the amendment of Sec. 312 providing that only straight-line depreciation (or a comparable method) is considered in determining earnings and profits. Therefore, distribution from REITs, to the extent such distributions are attributable to accelerated depreciation on real property, will be taxed as ordinary income to the beneficial interest holders. Although

not entirely clear, this item appears to remain as a tax preference item to the trust. Such a result may not have been intended.

No reference is made in new Sec. 58(f) as to the availability of the $30,000 annual exemption to the mutual fund or REIT. Apparently the mutual fund or REIT will be entitled to a full annual exemption without proration being required.

Estates and trusts. Sec. 58(c) provides that "the sum" of tax preference items for a taxable year of a trust[52] shall be apportioned between the trust and the beneficiaries on the basis of the income of the estate or trust allocable to each. The Senate Report[53] states that if depreciation and depletion are specifically allocated in the governing instrument, the depreciation and depletion preferences are to be similarly allocated.

The $30,000 annual exemption is allocated to the trust in accordance with the allocation ratio determined pursuant to the preceding paragraph.

It is not clear whether "income" as used in this rule means trust-accounting income or taxable income. Allocations based on accounting income could differ materially from allocations based on taxable income.[54] The committee reports simply refer to "income," without further explanation. (In contrast, in the case of mutual funds and REITs, Sec. 58(f) does specifically refer to "taxable income" for purposes of allocation of preferences.) The use of accounting income in making the allocations would be consistent with the general approach of income taxation of trusts and their beneficiaries, and in keeping with the rules relative to allocation of depreciation (when depreciation is not specifically allocated by governing instrument).

Sec. 58(c) contains no provision as to losses. Presumably, in such case the allocation of preferences would be based on the allocation of the loss.

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[52] For simplicity, the text will refer only to trusts. However, unless otherwise stated or required by context, the rules applicable to trusts are equally applicable to estates.

[53] S. Rep. No. 91-552 (11/21/69), p. 117.

[54] Such differences would result from the accounting distinction between principal and income (as required by local law or the governing instrument), the tier system concept used in the taxation of beneficiaries, and the limitations of distributable net income in the determination of taxable income.

As in other conduit situations, problems in application will arise due to the various fact situations possible. Assume, for example, that a trust has accounting income, but for tax purposes:

1. Has an NOL.
2. Has an excess of deductions over income other than in year of termination (but not an NOL).
3. Has an excess of deductions over income in year of termination.
4. Has a deduction for an NOL carryback.
5. Has a deduction for an NOL carryforward.

In situation 1, regardless of the deferral rules of Sec. 56(b), a portion or all of the tax preferences might be deemed allocable and currently taxable to the beneficiaries (unless they are entitled to deferral in their own right). If a portion or all of the preferences are allocated to the trust, the deferral rules of Sec. 56(b) would appear to apply to it. In such case adjustment would be necessary, with respect to any preferences allocated to the beneficiaries, in applying the rules of Sec. 56(b) in computing the minimum tax of the trust deferred for the loss year and the minimum tax imposed in subsequent years. To the extent the preferences of the loss year were allocated to beneficiaries, such preferences should be treated as nonpreferences to the trust in applying the priority rule of Sec. 56(b)(3).

In situation 2, the preferences would be allocated between the trust and the beneficiaries based on income allocable to each. There would be no deferral of minimum tax by the trust under Sec. 56(b).

Situation 3 would result in all preferences being allocated to the beneficiaries.

In situations 4 and 5, to the extent that references were allocated to the trust, the problems and results at the trust level would seem to be the same as those discussed for taxpayers generally at the beginning of this section. To the extent the preferences are allocated to the beneficiaries, the tax situation of the trust is immaterial; taxation of the preferences of the beneficiaries would be based on their individual situations. If a minimum tax at the trust level has been deferred in the prior year, it would seem fair to impose the tax on the trust in a subsequent year in which an NOL is used even though the loss carryover benefits only the beneficiaries because all the trust income is distributed. An alternative would be

to consider the triggered tax passed on down to the beneficiaries who enjoy the benefits of the loss carryover.

Allocation based on taxable income might well be simpler than allocation based on accounting income. In such case, however, the impact of the minimum tax might not reach those intended to be taxed by Congress. In the first three situations above, the preferences would apparently be allocated to the trust. In these situations the minimum tax would be imposed on the trust in the year of loss or of excess deductions (unless in the first situation the deferral provisions of new Sec. 56(b) were applicable). This would be true even though accounting income (including cash flow generated by tax preferences) was distributed to the beneficiaries. If the allocations are based on losses, the third situation would result in the preferences of the trust being attributed to the beneficiaries. The fourth situation would result in a reallocation of preferences for the prior year. The loss carryover would affect the allocation in the fifth situation.

Where long-term capital gains are retained by the trust, the capital gain preference should not be allocated to the beneficiaries. Allocation based on taxable income would accomplish this result; regulations would probably be needed if allocation is based on accounting income. A similar problem exists with respect to the preference resulting from an estate's exercise of a stock option held by a decedent at his death.

From the above, it is apparent that tax preferences may be allocated to, and minimum taxes paid thereon, by taxpayers who may not have received corresponding benefit from the tax preferences. The provisions taxing trusts are already quite complex. The addition of the minimum tax rules certainly does not improve the situation.

The expanded throwback rules[55] further complicate the application of the minimum tax provisions. Whether the preferences are deemed allocated according to accounting income or taxable income, a throwback of an accumulation distribution seems to carry with it a throwback of tax preferences to be considered in recomputing the beneficiary's tax liability, even if the short-cut method is used in the recomputation. An argument could be made that if accounting income is used for allocation of preferences, the tax

[55] Amended Secs. 665-669.

preferences should not be considered as thrown back to earlier years in the computation of the beneficiary's tax. But, although not clear, the computation of tax under amended Secs. 668 and 669, and the credit for taxes paid by the trust allowed under amended Sec. 666, seem to require that the minimum tax be included in the throwback tax computations. In any event the minimum tax liability for the year of actual distribution will be affected because of the additional regular tax imposed in that year and the credit granted for taxes paid by the trust.

Consolidated returns. TIR 1032 (Mar. 19, 1970) announced that the Treasury will issue regulations covering the minimum tax on tax preferences where an election to file a consolidated tax return is in effect. This release stated that an election to file a consolidated income tax return will constitute an election to compute the minimum tax on a consolidated basis, as well as the regular tax. This means the entire group will be treated as one corporation for purposes of computing the minimum tax. In such event, the regulations should provide for the allocation of the minimum tax as so computed among the constituent corporations.

The corporations included in a consolidated return would be within the scope of the controlled group definition of Sec. 1563. Thus it seems clear that only one $30,000 annual exemption would be applicable. Provision will have to be made for corporations that are not part of the consolidated group for the entire year.

Partnerships. Secs. 56-58 contain no specific provisions relating to partnerships as such. As stated earlier, under "Taxpayers subject to minimum tax," the IRS has made its position clear—that is, for purposes of the minimum tax, each partner must take into account separately his distributive share of items of income and deductions which enter into the computation of items of tax preferences.

The treatment of partnership tax preferences as preferences at the partner level and not at the partnership level will require additional detailed information on partnership tax returns. Perhaps the regulations will allow, to the extent possible, the grouping of preferences. For purposes of the application of the minimum tax provisions at the partner level, the character of each preference should be the same in the hands of the partners as in the partnership.

The regulations should also permit items of tax preference to be specifically allocated among the partners pursuant to agreement,

as is presently permitted for other items such as depreciation and depreciation recapture. The allocations should of course be subject to limitations such as exist presently.

Miscellaneous

Short-period "years." In the case of any short-period return (whether the taxpayer has not been in existence for a full year or there has been a change in taxable year), the $30,000 exemption is prorated based on the number of days in the short year divided by 365.[56] Presumably, since the exemption is de-annualized, the preference items of the short period need not be annualized for purpose of the minimum tax—even though taxable income is required to be annualized by Sec. 443(b)(1).

Where the short-period return straddles January 1, 1970, the tax imposed is a fraction of the 10% tax, based on the number of days in 1970 compared to the number of days in the short period.

Each item of property. The computations with respect to the accelerated depreciation and the rapid amortization preferences are made for each item of property. Thus, in the case of accelerated depreciation, it appears that the preference computations cannot be netted to take advantage of those situations where the accelerated depreciation for an item is less than the straight-line depreciation would have been. The computations where a multiple asset account is used is uncertain. It would not appear reasonable to require an item-by-item computation in such case.

Change to installment method. Sec. 453(c)(3) was amended to make it clear that the minimum tax is disregarded in computing the adjustment in tax for amounts previously taxed when a dealer in personal property changes from the accrual method to the installment method of reporting sales of personal property.

Nonresident aliens and foreign corporations. The House bill provided that in the case of nonresident aliens, the tax preferences included only those items of income and deductions which were effectively connected with the conduct of a trade or business within

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[56] See instructions to Form 4625, Computation of Minimum Tax, for fiscal year 1969-1970.

the U.S.[57] As finally passed, the minimum tax provisions contain no specific reference to nonresident aliens or foreign corporations. Presumably they are within the scope of "persons" upon whom the minimum tax is imposed.

Relationship of minimum tax provisions to other TRA provisions

The minimum tax provisions were only one phase of Congress's consideration of tax shelters. In addition to the overall approach of the minimum tax, there were numerous specific changes which have a direct bearing on the use of various types of tax shelters, including provisions relating to farm losses, accelerated depreciation, depreciation recapture, investment interest, tax rate changes and limits, multiple entities, and various others. The impact on the use of various types of tax shelters—considering all the changes of the Tax Reform Act—is beyond the scope of this article. Certainly, tax practitioners must now recompute the tax advantages to be gained (or detriment to be sustained) with respect to each tax shelter before recommending its use to a client.

Observations

The minimum tax on tax preferences is an entirely new concept in our tax structure. As finally enacted, the minimum tax concept is an improvement over the prior proposals (limitation on tax preferences and allocation of deductions) to demolish tax shelters—at least from the standpoint of application, compliance and administration. A word of caution, however—the concept is much more complex than it may seem. There are numerous uncertainties in its operation, due to the difficulty of adequately covering in statutory language the myriad factual situations (especially those involving conduit entities) that exist.

This article has attempted to point out some of the problems that will be encountered. Regulations, as well as technical amendments, will be needed before these uncertainties can be resolved.

From a conceptual standpoint, the minimum tax provisions should accomplish their intended purpose. Those taxpayers with substantial economic income paying no tax or only nominal tax will pay a

[57] H. Rep. No. 91-413, Part 2 (8/4/69), p. 56.

minimum tax for the privilege of utilizing certain tax shelters. However, such shelters still offer substantial tax savings—subject to the dangers of an increase in the rate of minimum tax and an expansion of the list of preference items. The use of tax shelters often involves a long-term commitment of financial resources. When weighing the current tax savings against the economic realities of the "shelter," consideration should also be given to the possibilities of the impact of adverse changes in the minimum tax concept.

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Excess investment interest

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The Tax Reform Act of 1969 has added many new words to our tax vocabulary. Among these are "investment interest," "investment income," "investment expenses," "excess investment interest" and "disallowed investment interest."[1] This article will deal with the tax consequences resulting from the application of these new concepts to interest expense related to investment assets.

Legislative history

The genesis of the problem to be dealt with can be found in the summary of the House of Representatives' version of the bill,[2] which states:

> The principal reason why the 154 high-income non-taxable tax returns for 1966 paid no tax was the deduction allowed for "other interest" (that is, interest other than that on a home mortgage and other than interest incurred in connection with a business). In many of these cases, the interest deduction was substantially greater than the investment income and, thus, was used to shelter other income from taxation.

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[1] These new words are included in new Sec. 57(b) which was added by Sec. 301 of the Act, and in new Sec. 163(d) which was added by Act Sec. 221. (All "Sec." references are to sections of the Code as amended by the Tax Reform Act unless otherwise indicated.)

[2] Prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Senate Finance Committee (8/18/69), p. 44.

The House bill limited the deduction allowed individuals for interest on funds borrowed for non-business investment purposes to net investment income, plus long-term capital gains (which, to the extent so absorbed were, in effect, converted to ordinary income) plus $25,000. Disallowed investment interest would be carried forward for possible deduction, within certain limits, in later years.

In its comments to the Senate Finance Committee on the House bill, the Treasury Department recommended that the investment interest limitation be deleted pending further study. The Finance Committee reported on its version of the bill:[3]

> [The Treasury] noted that there is an abuse in this area which results from the possibility of acquiring growth property with borrowed funds, deducting the interest expense against ordinary income, and then treating the ultimate gain on the property as a capital gain. It believes, however, that the House provision did not correct many of the problems in this area. Particularly it expressed concern that the provision would affect the taxpayer who has only earned income more severely than an individual who also has investment income.
>
> In view of this, the [Finance] committee believes this provision of the House bill should be deleted pending further study of this problem. However, investment interest expense in excess of investment income is an item included in the base for the minimum tax on preference income. . . .

As finally passed by the Senate, excess investment interest, defined pretty much the same as in the House bill, was treated as a tax preference item for the purpose of the 10% minimum tax.

Summary of new rules

The compromise version worked out by the House and Senate conferees, which will be discussed later in detail, treats excess investment interest as a tax preference item subject to the 10% minimum tax for taxable years ending after December 31, 1969 and beginning before January 1, 1972.[4] This does not apply, however, to

[3] S. Rep. No. 91-552 (11/21/69), p. 306.

[4] Sec. 57(a): "Paragraph (1) [excess investment interest] shall apply only to taxable years beginning before January 1, 1972." Such years will occasionally be referred to herein as "tax preference years"; subsequent years may be referred to as "limitation years."

corporations other than personal holding companies or subchapter S corporations.[5]

For taxable years beginning after December 31, 1971,[6] new Sec. 163(d) disallows one-half of the amount by which investment interest expense of *noncorporate taxpayers* (which would otherwise be properly deductible) exceeds the sum of:

- $25,000 ($12,500 in the case of a separate return by a married individual and zero in the case of a trust),
- Net investment income, plus
- Excess of net long-term capital gain over net short-term capital loss on investment property.

A net long-term capital gain which absorbs investment interest in this formula is treated for all other tax purposes as ordinary income. Disallowed investment interest is carried forward indefinitely. In a subsequent year, that year's investment interest is first offset against the flat dollar allowance, and then against current investment income. The carryover amount is then deductible to the extent of only one-half of the amount of the current investment income not used to absorb current investment interest; the carryover is not allowable on the basis of the dollar allowance or long-term gains in subsequent years. Although a carryover is not fully deductible in a subsequent (intervening) year under the formula set forth in the preceding sentence, the portion which can be carried forward further must be reduced by the Sec. 1202 deduction (one-half of the excess of net long-term capital gain over short-term capital loss) in the intervening year.

The definitions of investment interest, investment income and investment expenses are practically identical in both the tax preference item years and thereafter when the limitation applies.[7] The following discussion, therefore, will apply to both unless otherwise indicated.

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[5] Somewhat inconsistently, personal holding companies are subject to the minimum tax on excess investment interest for the tax preference years but are not subject to the disallowance of such interest for the limitation years. While a subchapter S corporation itself is not subject to the excess investment interest rules at any time, the components used in the computation are passed through to the shareholders of subchapter S corporations.

[6] Act Sec. 221(b)

[7] Compare Secs. 57(b) and 163(d)(3).

Investment interest

This term means "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment."[8] It should be noted that this language, up to the word "investment," is the same as that which is used in Sec. 265(2) in connection with the disallowance of interest attributable to tax exempt interest income, and it can be anticipated, as discussed below, that some of the problems of the latter provision will apply to the new investment interest concept.

Business interest distinguished. Investment interest does not include interest incurred in a trade or business. It is obvious that many problems will arise in determining whether particular items of interest are attributable to loans incurred to acquire an investment or business asset. The Joint and Senate Committee staffs' report, recognizing this problem in its summary of arguments for and against the provision, states:[9]

> . . . there are difficulties in distinguishing between investment interest and business interest which this provision may not adequately deal with. An example of this is the case where the taxpayer purchases 100 percent of the stock of a corporation. Although the limitation would appear to apply to this situation, it is questionable whether the purchase of the stock is made for investment purposes rather than for business purposes.

The Finance Committee report gives further evidence of this difficulty in the following statement replete with words which the provision, states:[9]

> Generally, investments carried by a *financial institution* would be *directly related* to the trade or business carried on by the institution, and interest paid to purchase or carry such assets would not be considered investment interest. However, interest incurred to purchase or carry *unrelated investments*, such as *equity securities* or undeveloped land, would be classified as investment interest. . . . [Emphasis added]

What is a financial institution? What investments are directly related to its business? How does one distinguish between related

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[8] Sec. 57(b)(2)(D) defines "investment interest expense"; Sec. 163(d)(3)(D) defines "investment interest." Both terms are defined in precisely the same way. They are used in the text interchangeably.

[9] Note 2, p. 45.

and unrelated investments? Equity securities may not be unrelated to the business if, for example, the financial institution is a dealer in such securities.

Net lease interest. In general, property subject to a lease is treated as "net leased" and, therefore, as investment property of the lessor if the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income,[11] or if the total of the deductions for the taxable year with respect to the property allowable solely by reason of Sec. 162 (usual operating expenses other than interest, taxes and depreciation) is less than 15% of the rental income from the property.[12] In the tax preference years, however, Sec. 57(b)(3) says that "property which is subject to a net lease entered into after October 9, 1969, shall be treated as property held for investment, and not as property used in a trade or business."

Conversely, it is inferable, property subject to a net lease entered into on or before October 9, 1969, is to be considered business property for this purpose, so that the interest, income, etc., attributable thereto would be excluded from the operation of the section. The Finance Committee report specifically states, "Investment income for this purpose does not include income from property subject to a net lease entered into before October 10, 1969."[13] Nevertheless, all that the statute does is to specifically cover inclusion of post-October 9 net leases as property held for investment and to exclude such leases from trade or business treatment. The trade or business status of earlier leases would seem to depend upon the general tax law, which in most, but not all, cases considers the leasing of property as a trade or business.

In the limitation years, beginning after 1971, the net lease

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[10] Note 3, p. 114.

[11] The concept of a net lease as including a lease in which there is a guarantee in whole or in part against loss of income may present problems. Does it include, for example, a guarantee of payment by someone other than the lessee? This should be all right if the test to be applied is whether risks of ownership are shifted from the lessor to the lessee. Real estate tax and operating expense escalation clauses may, however, be covered by the statute's literal language. Hopefully, these and similar problems will be treated realistically in the regulations.

[12] Secs. 57(c) and 163(d)(4)(A).

[13] See note 10.

"grandfather clause" discussed above does not apply.[14] Instead, Sec. 163(d)(6) specifies that the limitation provisions do not apply "to investment interest, investment income, and investment expenses attributable to a specific item of property, if the indebtedness with respect to such property

- Is for a specified term, and
- Was incurred before December 17, 1969, or is incurred after December 16, 1969, pursuant to a written contract or commitment which, on such date and at all times thereafter prior to the incurring of such indebtedness, is binding on the taxpayer."

The prospective application of both the tax preference and limitation treatments of "net lease interest" responds to loud howls of distress with respect to the original House bill. The latter would have applied to most of the many real and personal property leasing partnerships which have been set up in the past. It appears that these pre-existing transactions will be exempt from investment interest treatment; indeed, the limitation provisions will be inapplicable to most pre-December 17, 1969 indebtedness which can be identified with a specific item of property.

Measuring investment interest. This leads to the question of how "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment" is going to be measured. Is it to be on a specific, item-by-item of investment property basis, or will some sort of apportionment formula be applied? The House Report may be taken as supporting the specific item approach in saying that "interest incurred on funds borrowed for other [than investment] purposes such as a home mortgage, installment purchases, consumer goods, and personal or student loans would not be affected by the limitation."[15] Yet this does not really answer the questions which are likely to come up in the real world in which it may not be possible to trace all loans to a specific use, and the proceeds of various loans may be intermixed and used for various purposes.

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[14] Sec. 163(d)(4)(A) does not include the phrase "entered into after October 9, 1969."

[15] H. Rep. No. 91-413, Part 1 (8/2/69), p. 73. Will interest paid on loans incurred to pay life insurance premiums be treated as being for noninvestment purposes? It is hoped that the regulations will so indicate.

It seems likely that the rules which have been developed, both administratively and through litigation, in connection with the disallowance under Sec. 265(2) of interest paid on loans incurred or continued to purchase or carry tax exempt bonds, will be applied. Without analyzing such rules completely in this article (although such analysis will now take on additional significance), the following is probably a fair summary as they may apply to investment interest:

1. A loan easily traceable to a particular personal use, such as a mortgage to purchase a house, would be excluded from investment interest consideration. On the other hand, the nature of the collateral per se would not be determinative.[16] Thus, if the proceeds of an increase in an existing mortgage on a residence cannot be easily traced to a personal use (such as improvements on the house), the related interest cost may be included as investment interest.

2. When a pool of assets exists, some financed out of the taxpayer's own capital and some out of borrowed funds, and where any tracing of the proceeds of particular loans to specific assets or to specific collateral is not based upon a good nontax purpose, it is likely that some sort of overall apportionment of the interest paid will be required.[17] A good nontax purpose would exist, for example, if the taxpayer owned investment assets and, in order to build a piece of business property, negotiated a long-term mortgage instead of selling the investment assets. In that case, it would be unreasonable to expect the taxpayer to dispose of liquid assets to finance the building of the property which is normally done through long-term borrowing. The mortgage should not, therefore, be deemed to have been "incurred . . . to carry property held for investment."[18]

3. The asset pool concept which results in the allocation described in the preceding paragraph may not necessarily apply to all loans, nor even to all loans which cannot be traced to nonprohib-

[16] Constance M. Bishop, 41 TC 154, aff'd CA-6, 342 F2d 757 (15 AFTR2d 620, 65-1 USTC ¶9304), citing R. B. George Machinery Co., 26 BTA 594, and Sioux Falls Metal Culvert Co., 26 BTA 1324.

[17] John E. Leslie, 50 TC 11, rev'd CA-2, 413 F2d 636 (24 AFTR2d 69-5219, 69-2 USTC ¶9540).

[18] The Wisconsin Cheeseman, Inc., CA-7, 388 F2d 420 (21 AFTR2d 383, 68-1 USTC ¶9145); also see Edmund F. Ball, 54 TC 114.

ited uses. In the tax exempt area, the IRS has conceded that "Congress intended to disallow interest under such section only upon a showing of a purpose by the taxpayer to use borrowed funds to purchase or carry tax exempt securities."[19] The cases require a sufficiently direct relationship between the incurrence or continuation of indebtedness and the carrying of tax exempt securities.[20] A very recent case states the proposition thusly:

> We are of the opinion that the requisite sufficiently direct relationship between the incurring of various indebtedness by petitioner and his holding of tax exempt securities, is absent here, except for the general one that the incurring of indebtedness allowed petitioner to retain his tax exempt holdings. However, if this were a sufficient ground for disallowing the interest deduction, then Sec. 265(2) would in fact be a mechanical test; i.e., the deduction would be disallowed whenever indebtedness was incurred while tax-exempts were held. . . . [T]his is not the result that the statute was intended to achieve. When we examine each of the debts for which the Commissioner has disallowed the interest deduction, we find that there is no relationship at all between them and petitioner's holding of tax-exempts. . . .[21]

As applied to the investment interest problem, one can only conclude that the issue is factual, to be decided on a case-by-case basis, and that adverse consequences will require something less than direct tracing into investment assets but something more than the mere coexistence of a loan and investment assets. It is to be hoped that the Treasury Department will promulgate regulations

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[19] Rev. Proc. 70-20, IRB 1970-33.

[20] See, for example, the decision in Illinois Terminal Railroad Co., Ct. Cls., 375 F2d 1016 (19 AFTR2d 1219, 67-1 USTC ¶9374) which was decided against the taxpayer, but with an opinion containing the following language: "A relationship must be shown, and, in the relatively few cases which could not be settled administratively, it has been the task of the courts to define the relationship and apply it to the facts. This is an area of tax law in which it is more difficult to define the legal standard than it is to pass on a particular fact setting. Here, the total impression given by the evidence leads to the conclusion that the taxpayer had the forbidden purpose. In another case, the impression will be different." In Marsh Monument Co., Inc., 301 F. Supp. 1316 (23 AFTR2d 69-1062, 69-1 USTC ¶9286) the impression was different, and the court held "that the loan does not have a sufficiently direct relationship to tax exempt interest received. . . ."

[21] Edmund F. Ball, 54 TC 114.

on this point which are more specific than those in the tax exempt area and which are reasonable in scope and practical in use.

Relationship of exempt and taxable investments. What is the relationship between the new investment interest provisions and long-standing Sec. 265(2) which disallows interest expense allocable to tax exempt interest income? Strangely enough, the new statute does not deal specifically with this matter, and the committee reports are silent. Presumably, Sec. 265 computations would take priority, and the tax preference item and limitation treatments would deal only with investment interest not disallowed under Sec. 265.

In the investment interest expense limitation years, the Sec. 265(2) disallowance appears to be taken care of by the following language in Sec. 163(d)(1): "The amount of investment interest . . . otherwise allowable as a deduction under this chapter shall be limited. . . ." There may even be an implication in this wording that interest on indebtedness to purchase or carry tax exempt securities for investment is investment interest expense, although not otherwise allowable as a deduction. If so, it is unfortunate that the definition of excess investment expense as a tax preference item does not contain any language which would clearly exclude from the minimum tax base interest expense from which no tax benefit could have been derived, such as either interest disallowed under Sec. 265(2) or interest capitalized as a carrying charge under Sec. 266. The complete lack of guidance as to the interrelationship seems to be a legislative omission which should be cured by amendment or covered by regulations.

Construction interest. For both the preference and limitation years, "interest paid or accrued on indebtedness incurred or continued in the construction of property to be used in a trade or business shall not be treated as investment interest."[22] Thus, if property is being constructed which, when completed, will be business property, the interest during construction will not be subject to the investment interest rules, and, of course, the opposite will also be true.

Suppose a net lease (as previously defined for the purpose of these sections) with respect to property not yet built is entered into after October 9, 1969. The property when completed will not be

[22] Secs. 57(b)(2)(D) and 163(d)(4)(D).

treated as business property during the tax preference years, so that the interest during construction will apparently be treated as investment interest. The same result would seem to follow during the limitation years, regardless of when the net lease was entered into, unless the building loan on which the construction interest is paid is for a specified term and the loan is being advanced under a written contract or commitment which was binding on the taxpayer on and after December 16, 1969.

Investment income

Investment income[23] includes the following three categories:

- Gross income from interest, dividends, rents and royalties. Tax exempt interest, of course, is not gross income.
- Net short-term capital gain attributable to the disposition of investment property. The investment property net short-term gain is included here even though in the computation of overall taxable income, it may be offset in whole or in part by a net long-term capital loss.
- Gain treated as ordinary income as a result of the depreciation recapture requirements of Secs. 1245 and 1250.

An item in any of the three categories is considered investment income, however, only if it is "not derived from the conduct of a trade or business." This requirement seems to recognize that a dividend, or short-term gain attributable to the disposition of property held for investment, can, nevertheless, be derived from the conduct of a trade or business. This recognition has significance in determining whether the interest paid on a loan attributable to such an asset is investment interest.

Investment expenses

Taken into account for this purpose are real and personal property taxes, bad debts, depreciation, amortizable bond premiums, Sec. 212 expenses and depletion to the extent "directly connected with the production of investment income."[24]

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[23] Secs. 57(b)(2)(B) and 163(d)(3)(B).
[24] Secs. 57(b)(2)(C) and 163(d)(3)(C).

Depreciation and depletion elections. Depreciation considered as an investment expense need not exceed the amount which would be the straight-line depreciation for the year computed as if the taxpayer had always used that method for the property. Similarly, depletion can be computed on a cost basis, as if the taxpayer had always used that method for the property. The use of straight-line depreciation and cost depletion in determining investment expenses is optional with the taxpayer. If he is using a rapid depreciation method or percentage depletion in determining his regular taxable income, the advantage of exercising these options for investment expense purposes is that he frees more investment income to offset investment interest. On the other hand, there is undoubtedly extra work in making two different sets of computations. A determination based on some sort of estimate has to be made in each case as to whether the advantage warrants the burden of making detailed computations. These options are presumably granted because the excess depreciation and depletion are treated as tax preference items and therefore should not doubly penalize the taxpayer.

"Directly connected" test. The statute is specific that only those items of deduction must be counted which are "directly connected" with the investment income. It would seem to rule out the necessity of allocating to investment income any portion of the Sec. 212 expenses (for example, an accounting fee for the preparation of the tax return) which do not appear to be so directly connected. This is to be contrasted with Sec. 265(1) which uses an "allocable" concept with respect to Sec. 212 deductions. On the other hand, the Treasury Department has certainly taken a very narrow view of the meaning of the words "directly related" when used in the context of the deductibility of entertainment expenses,[25] and it is hoped that a similar view will be taken with respect to investment expenses.

Net investment income

This is simply the excess, if any, of investment income over investment expenses.[26]

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[25] Regs. Sec. 1.274-2(c), etc.

[26] Secs. 57(b)(2)(A) and 163(d)(3)(A).

Partnership items

Limitation years. In the limitation years, Sec. 163(d)(4) specifies that the partnership will pass through to each partner his distributive share of the partnership's investment interest, income and expenses. The limitation is not applied separately at the partnership level, which removes one of the major objections to the House version.[27] Under the statute as enacted, the limitation is applied only to the partner, and he takes into consideration his own investment items and his share of such items of partnerships of which he is a member.

Preference years. The tax preference section makes no specific provision for partnerships. It seems clear that, under Sec. 702, each partner will pick up his distributive share of partnership preference items. However, in the case of the investment interest factor, it is not clear whether:

1. The partnership must compute its excess investment interest and distribute it among the partners, or
2. The various components should be distributed separately as in the limitation years.

The first approach is used by subchapter S corporations with respect to tax preference items (see below) but the second approach seems more consistent with the partnership regulations. They state that "each partner must also take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately."[28] The IRS has publicly indicated that the forthcoming regulations will follow the second approach.[29]

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[27] The House version applied its limitations at the partnership level and then again at the partner's level.

[28] Regs. Sec. 1.702-1(a)(8)(ii).

[29] Ann. 70-34, IRB 1970-18, 19 states: "The Amendment [to the regulations] relating to partnerships will make clear that for purposes of the minimum tax, each partner must take into account separately his distributive share of items of income and deductions which enter into the computation of items of tax preference under Sec. 57(a)." In fact, the second approach has already been taken in the instructions to Form 4625, Computation of Minimum Tax, for fiscal year 1969-1970.

Shareholders of subchapter S corporations

Limitation years. The treatment in the limitation years is like that for partners. The components for computing investment interest, income and expenses of the corporation will be allocated among the shareholders "in a manner consistent with" the net operating loss allocation rules of Sec. 1374(c)(1), which give effect to the days stock is held during the loss year. Furthermore, again similar to partnerships, the investment interest limitation will not be applicable to the subchapter S corporation itself.[30]

Preference years. For years in which interest is a tax preference item, a subchapter S corporation will compute excess investment interest and include it in a total of tax preference items other than capital gains taxed to the corporation. Sec. 58(d)(1) specifies that the total is then to be apportioned pro rata among the shareholders in a manner consistent with Sec. 1374(c)(1). The individual components of the excess investment interest computation will not be allocated. As was previously indicated, excess investment interest is not a tax preference item for corporations except subchapter S corporations and personal holding companies.[31]

Estates and trusts

Limitation years. The deduction limitations in years beginning after 1971 will apply to estates and trusts as well as individuals. In the case of trusts, however, the $25,000 of investment interest usually allowable (see below) is not applicable.[32] The statute does not contain any provision for passing through to beneficiaries who receive distributions an appropriate share of the estate's or trust's investment items, to be taken into consideration by the latter in their own limitation computations. Nevertheless, Secs. 652(b) and 662(b) require distributees to characterize their shares of income, pursuant to prescribed rules, according to the classes of the items of income received by the estate or trust. Those sections, however, contain no provisions generally requiring a similar characterization of deductions; thus only net investment income seems allocable to distributees. Because of the delay in the applicability of the limi-

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[30] Sec. 163(d)(4)(C).

[31] See notes 5 and 6.

[32] Sec. 163(d)(1), next to last sentence.

tation section, this is not a matter of immediate urgency. Hopefully it will be clarified by regulations or legislation in due course.

Preference years. In the tax preference years, the sum of the items of tax preference, including excess investment interest, is computed by the estate or trust, and apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.[33]

Operating rules in limitation years

Assuming that the amount of investment interest and net investment income has been determined, the substantive treatment is completely different in the tax preference years (as previously explained, years beginning before 1972) and the subsequent limitation years. In the pre-1972 years, the excess of investment interest over net investment income is labeled "excess investment interest" and is considered a tax preference item which may be subject to the 10% minimum tax imposed by Sec. 56.[34]

Tier approach. After 1971, the otherwise deductible investment interest of taxpayers other than corporations will be limited to the following, and will be applied in the following order:

Tier 1. $25,000 ($12,500 in the case of a separate return by a married individual and zero in the case of a trust).

Tier 2. The amount of net investment income.

Tier 3. The excess of net long-term capital gain over net short-term capital loss attributable to investment property.

Tier 4. One-half of the balance of the investment interest. The other half of the amount of investment interest in excess of the total of tiers 1, 2 and 3 is not deductible in the current year.[35] Such "disallowed investment interest" can be carried forward and deducted under the rules explained below.

The tier system is important. In tier 1, up to the first $25,000 (or less, as indicated above) of investment interest is deductible as a flat amount. Then, in tier 2, the investment interest in excess of

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[33] Sec. 58(c)(1).

[34] See "A Minimum Tax on Tax Shelters," Solon F. O'Neal, Jr., p. 91, for a comprehensive coverage of this additional tax.

[35] Sec. 163(d)(1).

the applicable flat allowance is deductible to the extent of the net investment income. In tier 3, any investment interest in excess of the amounts allowable in tiers 1 and 2, is deductible up to the amount of the net long-term capital gain as described above. Any balance above the total of the three tiers is one-half deductible and one-half non-deductible.

Spill-over effect on capital gain. To the extent that the investment interest is allowed under tier 3, there is a spill-over effect on capital gain income and tax computations. Of the excess of net long-term capital gain over short-term capital loss attributable to investment assets, an amount equal to the investment interest expense deductible in tier 3 is considered ordinary income for the purpose of the alternative tax, the 50% long-term capital gains deduction and the tax preference item inclusion.[36] Thus, the portion (or all, as the case may be) of tier 3 needed to permit the deduction of investment interest is not eligible for the alternative tax and is, in effect, fully includable in regular income—but is not treated as a tax preference item and does not, as noted below, affect investment interest carryovers. In the light of this result, the importance of the tier system itself, and of maximizing the net investment income which precedes long-term gains in that system, is obvious.

Carryover rules. The disallowed investment interest in any year is carried forward to all succeeding years. (There are no carryback provisions yet.) The carryover rules allow a deduction in each succeeding year of previously disallowed investment interest expense to the extent of one-half of the amount of the second (net investment income) tier in that succeeding year which is not absorbed by that year's investment interest expense. As written, probably inadvertently, the law would be more generous to a married individual filing a separate return in a carryover year (entitled to a first tier of only $12,500) since the rules call for a computation of the unused portion of the second tier for purposes of the carryover deduction allowance as if the first tier were $25,000.[38] On the other hand, the intent of the statute is carried

[36] Sec. 163(d)(5).
[37] Sec. 163(d)(2)(A).
[38] Sec. 163(d)(2)(A)(i) and (ii).

out in the case of trusts because the $25,000 first tier is eliminated for both the deduction and the carryover computations.[39]

The carryover cannot be deducted against tier 3 (excess long-term gain) investment income in the carryover years. Nevertheless, in determining the amount of a carryover from a second (or earlier) preceding year, available for future years, the carryover amount must be reduced by the Sec. 1202 deduction in each intervening year.[40] As previously pointed out, however, the Sec. 1202 deduction in any year reflects reclassification of gain to "noncapital" status for any part of tier 3 utilized in such year to permit deduction of that year's investment interest.[41] Therefore, the Sec. 1202 deduction attrition to which disallowed investment interest is subjected when it is carried through any year will reflect only unused tier 3 net investment property long-term capital gains of that year plus such gains on noninvestment property in that year. The noninvestment property adjustment may not have been intended, but (unlike the tier 3 rules for the deduction years) Sec. 163(d)(2)(B)(ii) does not limit its applicability to the "Sec. 1202 deduction attributable to investment property."

Example. In 1972 *T* has investment interest of $100,000 in excess of tiers 1, 2 and 3. In 1972 he deducts $50,000 of the excess, and carries over the other $50,000 to 1973. In 1973 *T* has net investment income of $60,000, investment interest of $40,000 and a $20,000 excess of net long-term capital gain over net short-term capital loss. The $40,000 of investment interest incurred in 1973 is first absorbed by the $25,000 tier 1 allowance (assuming *T* is either a single man or, if married, is filing a joint return). The balance of $15,000 is offset against an equal amount of net investment income, leaving $45,000 of the latter unabsorbed. *T* may deduct his $50,000 carryover to the extent of one-half of the unabsorbed net investment income in 1973, or $22,500. This leaves $27,500 of the carryover still unused. However, in determining the amount which can be carried over to 1974, the carryover must be further reduced by the intervening year (1973) Sec. 1202 deduction of $10,000 (one-half of $20,000). This leaves $17,500 to be carried over, subject to the same rules, in 1974.

Why should the portion of the 1972 carryover which is not useable in 1973 be reduced by the 1973 Sec. 1202 deduction before it can be carried over further? To understand the reasoning behind

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[39] Sec. 163(d)(1), next to last sentence.

[40] Sec. 163(d)(2)(B).

[41] Sec. 163(d)(5).

this provision, one must bear in mind that the theory is to offset every dollar of excess investment interest against a dollar of long-term gain. In the above example, the $10,000 of carryover which is eliminated in 1973 is matched by $10,000 of investment interest which was deductible in 1972, because only 50% of the 1972 excess investment interest is disallowed and carried over. Similarly, only $10,000 of the $20,000 of 1973 net long-term gain is included in income because of the Sec. 1202 deduction. Therefore, the 1972 deduction of $10,000 matches the 1973 income of $10,000. Netting out the results of the two years, there is zero income from these items. To maintain this result, the $10,000 of carryover, which is the other side of the coin of the $10,000 of 1972 deduction, must be erased.

However, what is not understandable is why the amount of carry-over must be reduced by one-half of the Sec. 1202 deduction attributable to the net long-term capital gain from *noninvestment assets.*

Basic and technical objections

As part of a tax reform package, the relationship between interest deductions and long-term capital gains was certainly a matter of legislative concern. The original proposal in the House bill was, however, a great overreaction fraught with inequities. A strong case can be made that the Senate treatment of excess investment interest as a tax preference item is the correct solution. Certainly, however, the limitation statute as finally enacted is a great improvement over the House version. Nevertheless, some basic and some technical objections still exist, for example:

- The Tax Reform Act only limits deductions for interest on loans which are used to acquire assets which produce taxable income. Interest used for non-income producing purposes continues to be fully deductible. It is true that long-term gains are tax favored, but the favored portion is itself treated as a tax preference item and subjected to the tax which Congress has decided should be applied to *all* such items. Is the additional investment interest penalty necessary or fair?
- The *raison d'etre* for the investment interest provisions, as clearly set forth in the literature, is the concern about the deduction against ordinary income of interest on loans invested to produce

long-term gains. As investors are from time to time reminded, they sometimes have capital losses. Broadly speaking, the tax law may now have the effect of disallowing some of the interest paid with respect to such a loss as well as most of the loss itself. Again, is this necessary or fair?

- As was indicated previously, one of the reasons the Senate dropped the investment interest limitation was that it favored taxpayers who have investment income over those who have only earned income. The final version of this provision still does. Perhaps it was felt that the maximum tax on earned income justified the discrimination.
- At least one technical inequity is apparent at the moment, although others will probably crop up as tax advisers start to anticipate the impact of the new rules on their clients. To the extent that investment interest is deductible because of long-term gains realized in the year in which the interest is paid, and the gains are converted into ordinary income, they are not subject to the minimum tax. In a subsequent year, however, a long-term gain which reduces an investment interest carryover is still treated as a tax preference item. Yet, the portion of the capital gain which has been excluded from income has eliminated an equal amount of deduction, and has not really been given any tax preference.

The primary purpose of this article is to explain the investment interest provisions, not to criticize them. Nevertheless, it is hoped that reconsideration will be given to the limitation features before they become effective in 1972.

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Charitable contributions

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No area of the Code was devastated more by the Tax Reform Act of 1969 than the provisions dealing with charity—from the viewpoint of the donee-charitable organizations (especially private foundations) and the donors. This article will be confined to those provisions concerning charitable contributions not involving trusts.[1]

The provisions discussed here apply to taxable years beginning after December 31, 1969 unless another effective date is specifically indicated.

Appreciated property

No longer will it be possible to avoid the tax on the unrealized appreciation in the value of property—if such increment would have been taxed as ordinary income rather than as a long-term capital gain—by donating the property to a charity. Under prior law,[2] ordinary income accumulated with respect to property, other than Secs. 617, 1245 and 1250 properties, was not taxed when the prop-

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[1] Accordingly, this article does not cover the provisions repealing the two-year charitable trust rule, restricting charitable deductions for gifts of income or remainders to or through trusts, and deductions for amounts permanently set aside for charitable purposes by trusts.

[2] For brevity and clarity, provisions of the Internal Revenue Code will be simply cited as "Sec.," while provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" means pre-Tax Reform Act law. "Amended law," "amended Sec." or "new Sec." refers to post-Tax Reform Act law.

erty was given to charity. It was possible for an individual to realize more dollars by donating certain ordinary income (such as inventory) or short-term capital gain property to charity than by selling the property and paying the tax. (Herein, any such property frequently is referred to as "ordinary income property.")

> *Example.* S, a single taxpayer with $60,000 of taxable income, sells inventory items worth $15,000 with a tax basis of only $3,000. The 1969 ordinary income tax on $12,000 would be $8,492, leaving S with $6,508 after taxes. On the other hand, if S donated the $15,000 of ordinary income property to a qualified charity, he would reduce his taxable income to $45,000 and his tax liability by $10,120. Thus, by donating rather than selling the property, S would improve his after-tax position by $3,612—that is, $10,120 less $6,508.

Amended Sec. 170(e)(1) provides that the amount of any charitable contribution otherwise taken into account shall be reduced by the amount of gain which would not have qualified as a long-term capital gain if (instead of being contributed) the property had been sold at its fair market value at the time of the contribution. In other words, the charitable contribution deduction is limited to the tax basis of ordinary income property. This rule applies in all cases, to all gifts, to all charities.

If the contributed property would have produced a long-term capital gain if sold, *under limited circumstances* the charitable contribution deduction is reduced by 50% (62½% in the case of a corporation) of the amount of gain which would have been long-term capital gain if sold at its fair market value at the time of the contribution. The 50% (or 62½%) adjustment is made with respect to the following gifts of "capital gain" property:

1. In the case of a gift to a private foundation, other than:
   a. a private foundation (generally one which is actively engaged in furthering its charitable purposes), or
   b. a private foundation which distributes all of the gifts received by it within two and one-half months after the year of receipt.
2. In the case of a gift of tangible personal property (such as a painting), unless the use by the charitable donee is related to its purpose or function.
3. In the case of a gift which the taxpayer elects to qualify for the 50% rather than 30% limitation. (See "50% limitation on deduction," page 150.)

The appreciated property gift rules apply to contributions made after December 31, 1969, except that they also apply to gifts of letters, memorandums, and similar property (see amended Sec. 1221(3)) made after July 25, 1969. Note that since these rules apply to contributions made after 1969 *(not for years beginning after 1969)*, the rules would apply to a fiscal year beginning in 1969 and ending in 1970 if the contribution is paid in 1970 (or after July 25, 1969 for letters, etc.).

It appears that Sec. 170(e) deliberately discriminates against most private foundations. With respect to gifts of capital gain property to passive foundations and those not distributing "gift receipts" currently, a donor's contribution deduction is reduced by 50% of the appreciation in value, whereas no such reduction is made for a gift to a public charity (and certain private foundations). This provision seems to have been designed to discourage the growth of existing foundations, as well as the creation of new foundations. Since Act Sec. 101 is specifically designed to restrict the growth of private foundations, there seems to be little need to use the backdoor approach of limiting the donor's deduction.

Bargain sales to charity

Under prior law, it may have been advantageous for a donor to sell, rather than simply give, appreciated property to a charity for less than its fair market value (e.g., at the donor's cost). Regardless of tax considerations, the result is the same, since the taxpayer intends to benefit the charity only by the net amount of the gift.

Example. G, in the 50% tax bracket, owns $25,000 worth of stock which cost him $5,000. He wishes to make a $20,000 gift to charity. If he donates $20,000 of the stock to charity, the net cost of his gift is $10,000 (50% of $20,000). If he were to sell the remaining stock to a taxable entity, he would have to pay a $1,000 tax ($5,000 less $1,000 basis × 25%). Thus, after disposing of the stock he would have $14,000 in cash ($10,000 in tax benefit on the gift and $4,000 after taxes on the sale).

On the other hand, he could sell all $25,000 of stock to the charity for his cost basis of $5,000. Under prior law, the $5,000 sales proceeds were first allocated to a return of his cost basis; and, since that basis is $5,000, there would be no tax. His deductible gift to charity would still be $20,000, with the same tax benefit of $10,000. Under the bargain sale procedure, instead of having $14,000 cash after

disposing of all the stock, he would have $15,000 ($10,000 due to tax benefit and all $5,000 of sale price); thus, he is $1,000 better off.[3]

Amended Sec. 170(e)(2) provides for an allocation of the tax basis of bargain sale property between the portion "sold" and the portion "contributed" to the charity in accordance with regulations to be issued. The House Committee report indicates that the allocation should be based on the fair market value of each portion.

Example. Assuming the facts in the preceding example, if the sale occurred after December 19, 1969, the basis of the stock sold by *G* to charity would be $1,000 determined as follows:

1. Tax basis	$ 5,000
2. Value of portion sold	$ 5,000
3. Values of portions sold and contributed	$25,000
4. Ratio of 2 to 3	20%
5. Adjusted tax basis. (1 × 4)	$ 1,000

Thus, *G* would realize a $4,000 gain and pay a $1,000 tax, exactly the same as if he had sold the property to a taxable entity, as S did in the second preceding example.

The bargain sale rules apply to sales made after December 19, 1969.

Gifts of the use of property

The Tax Reform Act attacked still another means by which taxpayers obtained special charitable deductions, namely, through gifts of the use of property. Under prior law, a taxpayer, by granting a charity the right to use property rent free (or perhaps below fair rental value) for a specified period, could claim (according to some courts)[4] a charitable deduction for the fair rental value of the property—without reporting the rental income he would have received as taxable income. However, the IRS has insisted, and still does, that no deduction is allowable.[5]

Example. O, the owner of a five-story office building which is currently grossing $100,000 annually, donates the use of one floor for a

[3] See Waller, 39 TC 665, acq.

[4] For example, see Passailaigue, 224 F. Supp. 682 (13 AFTR2d 408, 64-1 USTC ¶9154).

[5] IT 3918, 1948-2 CB 33; *Your Federal Income Tax Guide,* 1970 Edition, page 120, published by IRS.

year to a charity. His gift, economically speaking, is $20,000, the fair rental value of the space. For tax purposes, however, the courts have held that, although reporting only $80,000 as income for the year, *O* could deduct the $20,000 rental value from income.

Amended Sec. 170(f)(3) denies a deduction for a contribution to charity of less than the taxpayer's entire interest in property, except that deductions are still allowable for:

1. A contribution of a remainder interest in a personal residence or farm, and
2. A transfer of an undivided portion of his entire interest in property (such as a fractional interest in the property). This limitation is effective as to contributions made after July 31, 1969.

Unlimited deduction

Under prior law, an unlimited charitable deduction was allowed to an individual taxpayer if, in the deduction year and eight out of ten preceding years, the total of his charitable contributions plus income taxes exceeded 90% of his taxable income computed without regard to charitable contributions, net operating loss carrybacks and personal exemptions. The unlimited charitable deduction has been utilized by a relatively few persons with high economic income but relatively low taxable income, principally because of percentage depletion, etc.; frequently, their contributions consisted of appreciated properties.

Amended Sec. 170(b)(1)(C) eliminates the unlimited charitable contribution deduction for years beginning in 1975; in the interim, during 1970-1974, an increasing limitation is placed on the amount by which the "unlimited deduction" may reduce taxable income. For years beginning in 1970, for those individuals otherwise entitled to the unlimited charitable deduction, the total deduction cannot reduce taxable income below 20% of adjusted gross income; for years beginning in 1971, the percentage will be 26%; for 1972, 32%; for 1973, 38%; and for 1974, 44%.

To offset the "increasing limitation on the unlimited deduction," corresponding downward adjustments are made in the percentage of a taxpayer's income which must be given to charity (or paid in income taxes) in the taxable year and eight out of ten years preceding the taxable year, to qualify for the unlimited charitable

deduction; for 1970, in lieu of 90%, the percentage will be 80%; for 1971, 74%; for 1972, 68%; for 1973, 62%; and for 1974, 56%.

It should be noted that during the interim period, (1970 through 1974), the 30% limit on gifts of appreciated property and the rule taking appreciation into account in the case of capital gain property do not apply to an individual entitled to deduct more than 50%.

50% limitation on deduction

Not all of the Tax Reform Act provisions spread gloom and doom in the charitable contribution area. In at least one area there has been some shedding of sweetness and light, namely, the increase in the maximum limitation from 30% to 50%.

Committee reports indicate that one of the reasons for the increase was to benefit taxpayers who devote substantial portions of their income to charity, primarily those in the middle and upper income brackets. The increase in limitations to 50% and the repeal of the unlimited charitable deduction mean that, in effect, a charity can be an equal but not a majority partner with respect to an individual's income.

Amended Sec. 170(b) increases the ceiling on deductions to certain charities from 30% to 50% of adjusted gross income, except that the 30% limitation will apply to contributions of capital gain property. Contributions to the following charities qualify for the 50% ceiling:

1. "Public charities" (including churches, schools, and other publicly supported organizations) as listed and defined in Sec. 170(b)(1)(A);
2. Private operating foundations, as defined in Sec. 4942(j)(3); and
3. Private foundations, as described in Sec. 170 (b)(1)(E), which distribute the contributions they receive within two and one-half months following the year of receipt.

A taxpayer may elect, under regulations to be prescribed, to include appreciated capital gain property given to 50%-limitation charities as qualifying for the 50% limitation, provided the values of all such gifts are reduced by 50% of the appreciation in their values.

Ordinarily, it will be inadvisable to elect to reduce a contribution

by 50% of the gain just to increase the limitation from 30% to 50%, since the unused portion may be carried over and deducted under the 30% rule in the following year. However, it is conceivable that a set of circumstances may justify such an election. For example, if it is expected that a taxpayer's income in the following year will be substantially lower than in the year of gift such an election seems advisable.

Example. In 1970 taxpayer donates to a public charity capital gain property worth \$20,000, having a tax basis of zero. Because he has already used up his 30% limitation, he cannot deduct any portion of the gift. He is in a 70% tax bracket in 1970, but since he will retire at the year end, he will be in only a 25% tax bracket in 1971. It is obvious he would benefit more from deducting 50% of the appreciation in 1970, than from carrying over the contribution to 1971. For one thing, insofar as the appreciation is concerned, he will get a \$7,000 (70% of 50% of \$20,000) tax benefit in 1970 whereas he would realize a \$5,000 (25% of \$20,000) benefit in 1971. Moreover, he actually will not be able to claim the \$20,000 in 1971 since, as the 25% tax bracket indicates, under the 30% limitation his charitable contribution deduction may be limited to a substantially smaller amount. Thus, he would have to carry over the deduction for another year or two.

It is emphasized, however, that this election not only applies to all gifts of capital gain properties within the year but also has the retroactive effect of reducing carryovers from prior years to the extent consisting of appreciation on capital gain properties.

Carryovers

Contributions by corporations are still subject to the 5% ceiling with a five-year carryover. For an individual, the contribution carryover to 1970 is determined on the basis of 30% of adjusted gross income. The amount which may be carried over from 1970 is the excess of contributions over 50% of adjusted gross income or 30% in the case of capital gain property.

Charitable contribution caveats

The following notes of caution are offered:

1. Whenever gifts are to be made to 20% and 50% charities, it is important to check the various limitations in order to avoid any loss of deduction.

Example. Assume that in 1970 a taxpayer with adjusted gross income of $50,000 makes the following contributions: to his college, securities which originally cost him $5,000 but are worth $25,000 on the date of gift; to his church, a $5,000 cash contribution; and to a 20% charity (a private nonoperating foundation), $5,000 in cash. Under those circumstances, the taxpayer's charitable deduction for 1970 is $20,000 (30% of $50,000 for the gift of appreciated property, plus $5,000 in cash). He has a $10,000 carryforward (the unused portion, under the 30% rule, of the property gift) to the following year, but has lost forever a deduction for the $5,000 gift to the private nonoperating foundation.

2. Do not give ordinary income property which has appreciated in value to charity since the deduction will be limited to the cost of the property. It would be better to retain such property until death and provide for disposition of such property to charity by will. In this manner, a deduction for the appreciated value will be permitted for estate tax purposes.

3. Avoid gifts of appreciated capital gain property to private nonoperating foundations, since the deduction will be reduced by 50% of the appreciation if the donee does not distribute an amount equal to its gifts within two and one-half months following the year of receipt.

4. Avoid gifts of tangible personal property which have appreciated in value unless the charitable donee will use the property in connection with the purpose or function constituting the basis for its exemptions. If the gift fails to meet the above test, the deduction will be reduced by 50% of the appreciation even though a sale of the tangible personalty would have yielded a long-term capital gain and the donee is a public charity.

5. Don't make "basket" bargain sales of long-term capital gain properties with different tax basis; instead, separately sell items with the highest tax basis, and separately contribute those with the lowest tax basis. This will reduce the amount of taxable gain.

Example. D owns two lots of IBM stock, each worth $25,000. Lot #1's tax basis is $5,000 and Lot #2's is $25,000. *D* wants to make a bargain sale of the two IBM lots to a 50% charity at his tax cost of $30,000. Unless the to-be-issued regulations permit identification of each lot sold for tax basis purposes, *D* will have a gain of $12,000; since proceeds are 60% of value, only 60% of basis or $18,000 offsets the $30,000 proceeds. However, if *D* were to sell each lot separately at its tax basis, Lot #1 would yield a gain of only $4,000 (80% of

the proceeds of the $5,000 received), while no gain would be realized on Lot #2, since it was sold for its tax basis of $25,000.

Undoubtedly, prior to the Tax Reform Act, unintended benefits to many taxpayers resulted from charitable contributions deductions under certain circumstances. The elimination of these benefits may change the philanthropic patterns of many taxpayers who, in the past, gave generously to charity knowing that their own pocketbook was helped through reduced taxes.

Time alone will tell whether the additional tax revenues obtained from the tax reform measures will compensate for the reduced charitable giving in creating a better-adjusted society.

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Accumulation trusts

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For more than thirty years the Executive Branch has been extremely unhappy about the "abuses" of accumulation trusts, but they had not been able to effectively do anything about it until recently.[1] As one of the "reforms" in the Tax Reform Act of 1969, a complete new set of rules has been fashioned which will eliminate most—but not all—of the tax benefits previously available from the use of trusts which accumulate income.[2]

1. Prior law[3]

A trust which accumulates income as a separate taxable entity is taxed on the income it earns at its own low tax brackets and not

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[1] In 1937 President Roosevelt called for reform in a message to Congress. More recently, President Kennedy made a similar appeal. While the 1954 Revenue Code did attempt to place some restrictions on these "abuses", they were largely ineffective because of the many exceptions allowed. See 1.2 of the text.

[2] The provisions of the new law had their genesis in the Johnson Administration's Treasury Department tax reform studies and proposals. (See Tax Reform Studies and Proposals of U.S. Treasury Department; Joint Publication, House Committee on Ways and Means and Senate Finance Committee, Feb. 5, 1969, p. 164.) It is this accumulation trust proposal, reiterated by President Nixon's Treasury Department, which forms the basis for the new rules applicable to domestic trusts. (See Tax Reform Proposals Presented by the Treasury Department to the Committee on Ways and Means at Public Hearings, April 22, 1969, p. 239.)

[3] For brevity and clarity, provisions of the Internal Revenue Code will be simply cited as "Sec.", while provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" means pre-Tax Reform Act law. "Amended law," "amended Sec." or "new Sec." refers to post-Tax Reform Act law.

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that of its creator or beneficiary. Secs. 665-669, before their amendment by the Act, provided a relatively weak solution to this problem—a special rule known as the "five-year throwback rule."

1.1 Five-year throwback rule. In substance, the five-year throwback rule provided that when a "complex" trust eventually distributed its accumulated income to the beneficiary, the amount of such accumulation distribution[4] (in excess of the current year's distributable net income) was thrown back through the trust's five preceding years and treated as though the trust had made distributions in each of the preceding years to the extent of each year's undistributed net income. Following a Lifo (last-in, first-out) order, the distributions were deemed to come from the immediately preceding year; then, any excess from the second preceding year; and so on, back to the fifth preceding year.

Thus, to the extent that an accumulation distribution would have been included in the beneficiary's income for each of the five preceding years (had it been distributed over those years), it would be included in the beneficiary's income of the *current* (receipt) year. In addition, the beneficiary was regarded as having received and paid the amounts of tax paid by the trust with respect to the accumulation distribution. (In other words, the beneficiary's income was "grossed up" for the amount of tax paid by the trust, and he received a credit for such amount against his tax.) Under prior Sec. 668 the beneficiary's tax attributable to the accumulation distribution in the year of receipt, however, could not exceed what he would have paid had the amounts been distributed each year as earned by the trust. Any part of the distribution attributed to years earlier than the fifth preceding year was received by the beneficiary tax free (except, of course, for the tax already paid by the trust).

The foregoing indicates the following weaknesses to the old throwback rule:

- The period was limited to five years.
- Since the beneficiary's tax liability on the accumulation distribution could not be greater in the year of receipt than it would have been over the throwback period, a proper timing of distribu-

[4] "Ordinary income distribution" and "accumulation distribution" are used interchangeably in this article. Both terms refer to distributions of amounts (to the extent the trust has accumulated ordinary income) in excess of the distributable income for the year in which the distribution is made.

tion (e.g., in a year in which the beneficiary otherwise had a loss) could virtually vitiate the throwback rule. In fact, the beneficiary could have received a refund of the taxes previously paid by the trust. (In no event, however, would tax be refunded to the trust.)

1.2 Exceptions under prior law. In addition to the mathematical limitations on the tax computations, there were numerous exceptions provided by former Sec. 665(b) which virtually destroyed the effectiveness of the prior law during its 15-year existence. The exceptions were:

- A distribution of income which was accumulated prior to the beneficiary's attaining the age of 21;
- A distribution of accumulated income to a beneficiary to meet his "emergency needs;"
- A distribution of accumulated income which was a final distribution and which was made more than nine years after the last transfer to the trust;
- A distribution of accumulated income not in excess of $2,000 *(de minimis);* and
- Certain periodic mandatory distributions of trusts created prior to 1954.

The existence of these exceptions to the throwback rule, said the Treasury, "seriously erodes the basic principle that a beneficiary who receives income from property should pay tax on that income at the same rate as he pays on his other income."[5] All of these exceptions have been eliminated under the Tax Reform Act for accumulations during taxable years beginning after December 31, 1968.

1.3 Multiple trusts. The often significant tax savings which formerly could have been obtained from accumulation trusts were multiplied when many trusts, rather than one, were set up for the same beneficiary (or beneficiaries). The enormous benefits which, until recently, could have been obtained by the establishment of multiple accumulation trusts are probably best highlighted in the decision in *Estelle Morris Trusts*[6]. In this case the Tax Court determined that

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[5] See "Tax Reform Studies and Proposals," cited in Note 2, at p. 164.

[6] Estelle Morris Trusts, 51 TC 20. For a full discussion of the advantages of multiple accumulation trusts, attempts to curtail abuses and significant court decisions in that area, see Barnett, "The Use of Multiple Trusts," *The Journal of Accountancy,* Jan. 1969, p. 78.

even though the trusts had been set up "principally for tax avoidance reasons," under the Code as it then existed, this fact was not enough to prevent 20 separate accumulation trusts for the same beneficiaries being taxed as 20 separate low-tax-bracket entities.

2. New unlimited, tougher throwback rules

Act Sec. 331 amended Secs. 665-669 so as to completely change the basic rules governing taxation of accumulation distributions made by trusts. The five-year throwback rule has been replaced by an *unlimited* period throwback rule. Moreover, the tax liability must be computed under a prescribed throwback method, and all of the exceptions to the five-year rule have been eliminated. Beneficiaries will be taxed on distributions received from accumulation trusts in substantially the same manner as if the income had been distributed to them currently, as earned, instead of being accumulated in the trust. And it does not matter if the accumulation distributions are from one trust or from many trusts.[7] The new rules for computing the amount of the undistributed net income and accumulation distribution for the unlimited period are basically the same as those applicable to the five-year throwback under the former law—but there are two important differences; i.e., capital gains may be thrown back and the order of throwback has been reversed.

2.1 New capital gain throwback rules. Now, for the first time—except as to trusts which are required to or do distribute all income currently[8]—the accumulation distribution on which the beneficiary

[7] Sec. 668(b)(4) and Sec. 669(c)(2), as amended. The distributions from two or more trusts in one year are deemed to have been made consecutively in whichever order the beneficiary elects.

[8] Amended Sec. 668(a) provides that even a trust which is not required to distribute ordinary income currently is excepted from the new capital gains throwback rule if, in fact, it does distribute all of its income currently. Thus, where the trustee has discretion to distribute or accumulate income, but actually distributes all income currently, the capital gains throwback rule will not apply until the first year in which ordinary income is accumulated. Then and thereafter, any excess distribution will be subject to the new capital gains throwback rule. The fiduciary of such a trust must, therefore, be extremely careful *not* to exercise his discretion to accumulate income if he does not want the beneficiary to ultimately pay tax on capital gains realized by the trust.

Sec. 13.6(b) of the Temporary Income Tax Regulations, TD 7025, states

will be taxed is expanded under amended Sec. 669(a) to include capital gains allocated to principal. Capital gain distributions are deemed made only when the amount of the trust's excess distribu-

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that for the purposes of Sec. 668(a) the accumulation of income in years beginning before 1969 would be disregarded. Thus, the capital gains throwback rule will not apply so long as all ordinary income is distributed in years beginning after 1968, even though income had previously been accumulated.

In this regard, note that amended Sec. 663(b)(2) enables the fiduciary of a complex trust to elect to treat a trust distribution actually made in the first 65 days of the trust's year as having been made to the beneficiary as of the last day of the trust's preceding year, effective for years beginning after 1968. Trustees of calendar year trusts could have utilized this provision for 1969 by making distributions by March 6, 1970 and the related election. Trustees of fiscal year trusts, by distributing all ordinary income within 65 days after the close of the year ending in 1970 and making the election, can avoid the capital gains throwback rule on all future distributions so long as all income is distributed currently. This 65-day rule gives trustees time to determine more exactly how much income must be distributed for a given year. The method of making the election is set forth in Sec. 13.6(a) of the Temporary Income Tax Regulations, TD 7025 as amended by TD 7029.

It is extremely important to realize that the distribution each year by the trustee of a complex trust of all of the trust's *distributable net income*[6] will *not* comply, except fortuitously, with the requirement that all *income* be distributed currently. Sec. 643(b) defines the term "income" ". . . when not preceded by the words 'taxable,' 'distributable net,' 'undistributed net' or 'gross' [as] the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law."

Example. The following items of income and deductions are reportable by a trust if its income is distributable solely at the discretion of the trustee:

Interest income		$5,000
Deductions:		
Principal commissions	$100	
Income commissions	150	
		250
Distributable net income		$4,750

If the trustee distributes to the beneficiary $4,750 (either during the year, or subsequently by taking advantage of the new 65-day rule provided for in Sec. 663(b)(2)), he will *not* have distributed all of the *income* currently and will subject future excess distributions of the trust to the capital gain throwback rule. He should have, of course, distributed $4,850, the income under local law ($5,000 income less the amount of commissions chargeable to income, $150).

tions in any year is greater than all of the accumulated undistributed ordinary income. Amended Sec. 669(f) specifies that a capital gain distribution will be taxed to the beneficiary as long-term and/or short-term gains, depending on their classification to the trust. Of course, if the distributions are greater than the ordinary income and capital gains accumulated in prior years, the difference will be treated as a nontaxable distribution of trust principal.

2.2—Capital gain throwback ambiguity. The Tax Reform Act is replete with examples of faulty draftsmanship, no doubt the result of the tremendous haste in passing the new law. One particularly "good" example of bad draftsmanship is contained in new Sec. 665(g) which states that "the term 'capital gain distribution' for any taxable year of the trust means, to the extent of undistributed capital gain *for such taxable year* . . ." the excess of other amounts paid or credited to beneficiaries over the undistributed net income of the trust for all preceding taxable years. Interestingly enough, the four italicized words were not contained in the original version of this section approved by the originating Senate Finance Committee.

Taking Sec. 665(g) at its wording, one tax service literally jumped to the observation that there can be no capital gains distribution in the current year (to be "thrown back" to preceding years) unless there are undistributed capital gains for the current year. Such a construction of Sec. 665(g) would, of course, completely negate the expressed intent of Congress. The Senate Finance Committee Report (No. 91-552, p. 127) states that capital gains of accumulation trusts should be taxed in a manner similar to ordinary income accumulations "to prevent the use of trusts to accumulate capital gains at low rates for future distribution to high-bracket beneficiaries without any additional tax. It also will reduce the extent to which trust income is taxed to the trust instead of to a beneficiary."

The Treasury Department reacted quickly to this apparent "loophole" by promptly issuing proposed Regs. Sec. 1.665(g) which states, "For [the year of distribution] the undistributed capital gain includes *the total undistributed capital gain for all years of the trust* beginning after December 31, 1968, and ending before such year." Conceivably, the Code's definition may be con-

formed in a "Technical Amendment Act of 1970." If not, it will be interesting to see whether the courts will uphold the regulation as being in accord with the intent of Congress, or nullify it as being contrary to the plain wording of the statute.

2.3 New Fifo order. Amended Sec. 666(a) provides that, effective for years beginning after 1969, a Fifo (first-in, first out) rule is to be applied to determine in which trust years the ordinary income and capital gains distributions were accumulated by the trust for the purpose of the throwback. Formerly, as explained in 1.1, a Lifo (last-in, first-out) rule governed the five-year throwback computations; that is, the accumulation distribution was first thrown back to the most recent preceding year. Now, however, accumulated income is attributed to the earliest year of the throwback period; then the second earliest year, and so on. For example, if income has been accumulated under the new law for 11 years before an excess distribution is made in 1982, the distribution is first deemed to be from the undistributed income of the earliest year of the 11-year period (1971), then the tenth preceding year (1972), and so on.

2.4 Effective dates. Act Sec. 331(d)(2) provides, generally, that the new rules apply to all excess distributions in years beginning after 1968. Distributions made in the years beginning in 1969 through 1973 will not be deemed to be accumulation distributions under the new rules to the extent that they were accumulated in years beginning before 1969. Generally, distributions of income accumulated in pre-1969 years are subject to the former five-year throwback rule including all but one of the exceptions to the application of the rule. However, for years beginning in 1970, the $2,000 *de minimis* exception is no longer available and the Fifo order replaces the Lifo throwback scheme. For trusts in existence on December 31, 1969, the throwback provisions of the new law generally do not apply to capital gain distributions made to beneficiaries before 1972. See Exhibit I, page 174, Table of Effective Dates, for more information and illustrations of the taxability of distributions of accumulated ordinary income and capital gains made in various years, as well as the determination of the preceding years from which the income is deemed to come.

3. Computing the beneficiary's tax liability

Substantively, both ordinary income and capital gain distributions will be taxed as though they had been distributed in preceding years; but procedurally they are includable in the income of the beneficiary only for the current year in which he received the distribution. That is, the amount of tax liability will be computed with reference to preceding years' income; but such procedural tax aspects as payment of tax and the statute of limitations will be governed by the return covering the year in which the excess distribution is taxable without regard to the throwback rules.

For years beginning after 1969, under amended Sec. 668(b) the tax on such amounts is to be computed in either of two ways—the "exact method" or the "short-cut method," whichever is less. Under both methods, the tax payable by the beneficiary in the year the accumulation distribution is received is fixed by amended Sec. 668(a) to be the aggregate of:

1. The regular tax on his income, excluding the distribution;
2. A partial tax on the ordinary income accumulation distribution; and
3. A partial tax on the capital gain distribution.

The tax cannot be simply computed under the regular method—that is, by adding the accumulated income to the beneficiary's other income and taking a credit for the taxes paid by the trust with respect to the excess distribution—regardless of its amount.

3.1 Exact method. The so-called "exact method" of computing the partial taxes is substantially the same as that provided under the former five-year throwback rule.[9] Under this method the beneficiary's tax liability is recomputed for each and every year to which the distributions are "thrown" as follows: The amounts of the ordinary income and capital gain distributions ("grossed up" by adding the allocable share of tax paid by the trust to the distributions) are added to his other income in the deemed-distributed year. Next the tax on the recomputed income is determined. Then, under Sec. 667(b), a credit is allowed against the recomputed tax liabilities for the taxes previously paid by the trust allocable to the distribution (same as the amounts used in the gross-up computa-

[9] Amended Secs. 668(b)(1)(A) and 669(b)(1).

tion). The balance of the tax is payable as part of the tax liability for the year in which the distribution is received. If the credit for the taxes paid by the trust exceeds the beneficiary's tax liability, a refund will be due. The complex rules and exceptions applicable to the exact method computation are reflected in the detailed case study, Exhibit II, Table 3, page 179. The reader will, hopefully, gain a better insight into the labyrinthian calculations required than could be obtained from a mere recital of the applicable rules.

The exact method requires that complete trust and beneficiary records be retained so that the trust's distributable net income can be determined and the beneficiary's income tax can be recomputed for each year in the throwback period. If adequate trust information is not available, Sec. 666(d) presumes that an accumulation distribution is attributable to the earliest year of the trust's existence.

3.2 Short-cut method. Alternatively, the beneficiary's throwback tax liability may be computed under the so-called "short-cut" method.[10] Although requiring computations for fewer years than the exact method, the short-cut calculations are nevertheless extremely lengthy—see Exhibit II, Table 4, page 180.

The short-cut method, in effect, averages the tax on an accumulation distribution under a five-step formula, namely:

1. The accumulation distribution is divided by the number of years in which the income was accumulated by the trust to arrive at an average annual accumulation distribution.
2. The average distribution is added to the beneficiary's income for each of the three years immediately preceding the distribution year.
3. The tax for each year is recomputed to arrive at the additional tax attributable to the average annual accumulation distribution.
4. The average additional tax is then computed by totaling the additional taxes for the three years and then dividing by three.
5. The total tax on the excess distribution is computed by multiplying the average tax by the number of years involved in the throwback period.

The same five-step formula is applicable to capital gain distributions.

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[10] Amended Secs. 668(b)(1)(B) and 669(b)(2).

Example. In 1980, *B* receives $7,000 from a trust representing an accumulation distribution of ordinary income which had been accumulated over the seven-year period 1973-1979 inclusive. The average amount of $1,000 is added to *B*'s taxable income for 1977, 1978 and 1979; his tax liability for each year is recomputed with the result that such tax liabilities are increased $400, $500, and $600 respectively. The aggregate increase of $1,500 is divided by three, so that the average increase is $500. The total tax would be $3,500, i.e., $500 × 7=$3,500.

Under the short-cut method averages are used, regardless of whether the accumulations by the trust or the beneficiary's tax brackets may have fluctuated substantially from year to year. However, a "minimum-amount" rule, provided in amended Sec. 668(b)(2)(C), is designed to prevent tax minimization which could be achieved by maximizing the throwback period and thereby decreasing the average amount of income to the three-year base period. The minimum-amount rule provides that if the undistributed income of the trust for any year is less than 25% of the accumulation distribution divided by the number of years during which income was accumulated, such year is eliminated from the denominator in determining the average annual accumulation distribution (in Step 1 above). Thus if, in the preceding example, the undistributed income was only $100 in 1979 (less than 25% of $1,000) the throwback would be considered to include only six years; and the average income would be increased to $1,667 ($7,000 divided by six). The mechanics of the short-cut method computation are specifically illustrated in Exhibit II, Table 4.

3.3 Limitations and exceptions. Regardless of the amount of the excess distribution, the beneficiary's additional income tax cannot be computed under the "regular method" used for other income; that is, the beneficiary cannot now (as he could have under the prior five-year throwback rule) simply add the distribution to the rest of his current year's income and compute the tax on the total income. Also, since there is no longer a *de minimis* rule, even a $100 excess distribution will necessitate a tax computation under either the exact method or the short-cut method.

Further, although long-term capital gains and income from gifts and inheritances are now eligible for income-averaging relief, amended Sec. 1302(a)(2)(B) specifically excludes trust excess distributions from averageable income. In other words, income

averaging can be utilized by the beneficiary to compute the tax on his other income for the year in which he receives the excess distribution, but the tax on the excess distribution must be computed under either of the two methods described above.

Amended Sec. 668(b)(2)(B) bars the use of the short-cut method where prior accumulation distributions from more than one other trust are thrown back to the same preceding taxable year to which any part of the current accumulation distribution is thrown. The Senate Finance Committee Report (No. 91-552, p. 29) states that this prohibition was designed to prevent the creation of multiple trusts with staggered accumulation distributions in order to take advantage of the short-cut rule with its three-year averaging computations.

The new law also provides for something novel in tax law, the "constructive existence" or "imputed existence" of beneficiaries. For a beneficiary who was not alive during the year in which a trust had accumulated income, amended Sec. 668(b)(2)(A) permits the tax to be computed under either of the two alternative methods described above as though he *were* alive during that year and:

- Had no gross income (other than the trust income thrown back);
- Had no deductions other than a personal exemption and standard deduction; and
- Was single (while there may be married non-entities, who has ever heard of a married non-person).

Another special rule requires a beneficiary to include in his income for the years involved in the exact and short-cut methods computations any income which was previously deemed distributed in such years from prior accumulation distributions.[11] This exception, which cumulates taxable income and increases the top tax rates, governs whether the prior deemed distributions were from the same trust or another trust.

Other special rules applicable to the computation of the beneficiary's tax under either the exact or short-cut methods are reflected in the computations in Exhibit II and in the notes thereto.

3.4 Choosing the proper method. In order to determine which method to use in computing the beneficiary's tax, ordinarily both

[11] Amended Secs. 668(b)(3) and 669(c).

calculations should be made. Where there are both capital gain and ordinary income distributions in the same year, the Code appears to permit capital gain throwback computations to be made under one method and the ordinary income throwback computation to be made under the other method.

Where the beneficiary's income is lower in the early years, the exact method will tend to produce the smaller tax (See Exhibit II). Where the beneficiary's income is lower in the three years immediately preceding the year of distribution, the short-cut method will tend to yield the smaller tax.

4. Funding testamentary trusts early—still useful?

Will the early funding of testamentary trusts backfire as a result of the passage of the TRA?

A favorite planning device to reduce overall income taxes (to the estate and its beneficiaries) has been to plan distributions from principal to a marital deduction or other testamentary trust. Each testamentary trust is a separate taxable entity. The impact of the income tax can be greatly minimized by spreading the estate's income among a maximum number of taxable entities.

Normally, any distribution from an estate to a residuary beneficiary, whether of income or principal, is considered to be a distribution of income for tax purposes.[12] Before TRA, it was generally accepted that early funding of testamentary trusts would effectively spread the estate's income among taxpayers—with resultant overall savings of income tax.

> *Example.* The widow of a decedent has substantial income of her own. His estate receives $20,000 of income in its first taxable period ended December 31, 1970. No income was required to be distributed under the will nor was any actually distributed during such period. On December 31, 1970, the executor makes a $10,000 distribution of principal to a power-of-appointment marital deduction trust. Since such distribution will be deemed to have been made from 1970 taxable income, the estate will be entitled to a $10,000 distribution deduction and the trust must report $10,000 as taxable income. The trust's first taxable period is also ended on December 31, 1970 (before any income can be received on its $10,000

[12] For a technical discussion of this technique, see "After-Death Estate Planning" by Bernard Barnett, *The Tax Adviser*, March 1970, p. 778.

principal); consequently, the entire $10,000 "income" reflected on no *income* (as defined under local law) earned which was required to be distributed to the widow. (Of course, the trust would not be entitled to a deduction for distributions to beneficiaries.)

Thus, by distributing the $10,000 of principal to the marital deduction trust on December 31, 1970, the executor will have split the $20,000 income received by the estate during 1970 between two separate taxable entities—and none would be taxed at the widow's top tax brackets. The lower effective tax brackets will have been "doubled."

This plan was generally recommended before TRA. But have any of the new rules thrown a monkey wrench into the works? Specifically, will not the $10,000 principal distribution received by the trust in 1970 be subject to the new accumulation distribution throwback rules in the year of the trust's termination when the trustee eventually distributes an amount greater than the current year's distributable net income? A painstaking journey through the intricate verbiage of the amended Code may enable us to arrive at the answer.

4.1 ***Sec. 665 implications.*** New Sec. 665(b) defines an accumulation distribution as any amount actually paid or credited to a beneficiary in one year in excess of the distributable net income for such year reduced by all income required to be distributed for that year. This accumulation distribution is then carried back to the trust's preceding year(s) and taxed in such preceding year(s) to the extent of the "undistributed net income" of such preceding year(s). The term "undistributed net income" is defined in new Sec. 665(a) as equaling the difference between the trust's distributable net income (DNI) for such taxable year reduced by the sum of the income required to be distributed currently for that year as well as other amounts properly paid, credited, etc., during that year. Therefore, the extent to which the beneficiary will be taxed on the accumulation distribution thrown back to any year depends upon the amount of the undistributed net income for the preceding year(s).

In the example, since the distribution from the estate to the marital deduction trust becomes part of the trust's DNI for 1970, the $10,000 will be included in the trust's undistributed net income for 1970. Any subsequent accumulation distribution by the trust

which would be thrown back to its initial year could, considering the literal wording of Sec. 665 by itself, be taxed to the beneficiary to the extent of the $10,000 distribution—even though it constituted principal to the trust rather than income for trust accounting purposes.

4.2 *Simple vs. complex trust.* This result will be true, however, only where the trust is not a "simple" trust (which is required to distribute all its income currently). A power-of-appointment marital deduction trust (which by definition must distribute all income currently) as well as any other residuary trust which is governed by similar dispositive provisions, would apparently not be subject to the new unlimited throwback rules. Sec. 666 restricts the new accumulation distribution provisions to trusts which are subject to *subpart C* of subchapter J of the Code. Subpart C deals only with complex trusts. Simple trusts, which are governed by *subpart B* of subchapter J, would therefore appear to still enjoy the substantial tax advantages which could flow from the early funding of testamentary trusts.

Unfortunately, however, the answer is not that simply reached. One question remains: Can a trust which is required to distribute all income currently still retain its status as a simple trust in the year of termination or is it taxed as a complex trust? Regs. Sec. 1.651(a)-1 defines a "simple trust" as a trust which ". . . does not make any distribution other than of current income" and whose governing instrument requires that all of its income be distributed currently and does not provide for any charitable contributions. This regulation goes on to state that a trust may be a simple trust for one year and a complex trust for another year. To this extent, all trusts appear to be "complex" in the final year of administration since principal is necessarily distributed on termination. Thus, it appears that a well-camouflaged tax trap has been laid which will be sprung when all of the principal (including the $10,000 undistributed income in the example) is distributed in the year the trust is terminated.

4.3 *Sec. 668(a) to the rescue.* However, a literal reading of new Sec. 668 may provide the key to unlock the trap door. The last sentence of Sec. 668(a) reads as follows:

> "For purposes of this subpart [presumably subpart D of subchapter J, Secs. 665 to 669, the new accumulation trust provisions] a trust shall not be considered to be a trust which is not required to distribute all of its income currently for any taxable year prior to the first taxable year in which income is accumulated."

While this sentence appears as part of Sec. 668 which specifically deals with the treatment of amounts deemed distributed in preceding years under the new unlimited throwback rule, it clearly states that for the purposes of the entire *subpart D* (significantly not for only Sec. 668 purposes), a trust shall not be considered a complex trust unless *income* is accumulated. When used in the Code without any modification (such as "gross," "adjusted gross," "taxable," etc.), the word "income" signifies income as defined under local law, that is, as contrasted with principal. Since, in the example, all income (as defined under local law) is required to be distributed currently to the surviving spouse, and none could be accumulated, it would appear, at least from a literal reading of subchapter J in its entirety, that the power-of-appointment marital deduction trust is not within the concept of a complex trust, even in its final year, for the purposes of the new accumulation trust throwback rules; and therefore they would not apply. Furthermore, there is no indication in the committee reports that Congress intended to have a distribution of principal on termination of a true simple trust become subject to the new unlimited throwback rules.

4.4 ***Disadvantage of estate trust.*** On the other hand, if the testamentary trust which is funded early by a distribution of principal is a trust which is required or has the discretion to accumulate income, or is any other type of complex trust, the final year's distribution of principal will certainly be treated as an accumulation distribution subject to the new unlimited throwback rules. For example, a so-called "estate trust" can be created which will qualify for the estate tax marital deduction. The will can provide that income is to be accumulated during the life of the surviving spouse and upon her death the accumulated income (and principal) is to be paid to her estate. Although such an estate trust would qualify for the marital deduction, any distribution of principal (which carried with it the attributes of taxable income) received from the decedent's estate would appear to be a distribution

which will eventually (on termination) bring into play the new throwback rules.

Whether an additional tax will result under the throwback computations will depend on all the facts. It is interesting to note that the estate of the surviving spouse will never be entitled to a refund —even though its taxes for the throwback years are less than the taxes actually paid on the accumulations of income by the estate trust. This will often be the case since, under the exact method of computation, the estate of the surviving spouse will generally owe less tax for the throwback years (during which it was nonexistent) than the estate trust paid—because an estate is entitled to a $600 exemption while the complex estate trust is limited to a $100 exemption. However, almost undecipherably, Sec. 667(b) denies a refund of tax to a beneficiary of an accumulation trust except for those "preceding taxable years of the trust on the last day of which the beneficiary *was in being*. . . ." (Emphasis supplied.)

The tax adviser must evaluate many new considerations before recommending that testamentary trusts be funded early in order to minimize the tax on income earned by the estate.

5. Accumulation trusts still useful

While removing most of the tax incentives for the creation of multiple accumulation trusts, the Tax Reform Act does not necessarily discourage the setting up of an accumulation trust which has valid nontax reasons for its existence. In fact, the interplay of the Act's provisions for lower tax rates for single individuals and "tax free" low-income allowance—available to trust beneficiaries but not to the trust itself—may often make the beneficiaries' tax liabilities on the excess distributions substantially less than the aggregate taxes paid by the trust on the same income. In other words, refunds to trust beneficiaries may often result from excess distributions, especially to beneficiaries who had little or no other income, or were not in existence, during the accumulation period.

There are several additional tax advantages which can still be gained from their use, namely:

1. The trust will normally have more "aftertax" money to invest, because during the period of accumulation, the income tax levied will be at the low rates applicable to the trust (a separate taxable entity) rather than at the creator's or beneficiary's tax rates.

2. Even when the accumulated income is distributed and is taxed to the beneficiary under either the exact or short-cut methods described above, the tax will be computed at the beneficiary's effective tax brackets, not at the creator's (see Exhibit II, Table 5, page 182.) Generally, accumulation trusts are established by relatively high-bracket taxpayers. While the same benefits can be obtained from the creation of trusts which distribute income currently, there are often reasons why such trusts may not be desired, for example, where the beneficiary is a minor.

3. When computing the tax at the beneficiary level, it must be remembered that the Tax Reform Act increased the amount of income that the beneficiary can receive each year "tax free" by providing the new Sec. 141 low-income allowance. Thus, for example, a beneficiary of a trust (or any other person) can receive $1,725 ($1,825 if the income includes $100 in dividends) in 1970 without owing one cent of federal income tax liability.

The advantages of creating accumulation trusts for other than strictly tax reasons still remain valid. Creators of trusts often wisely insist that income be accumulated while the beneficiaries are minors or are adjudged to be immature or emotionally unstable. Personal, business or other nontax reasons may be behind the creation of trusts under which the trustee can distribute or accumulate income, in his discretion. And, of course, sprinkling trusts remain an extremely flexible planning tool for meeting changes in the financial needs of beneficiaries—without regard to taxes. While a tax premium has now been placed on trusts which distribute income currently, accumulation and discretionary trusts will continue to be created for valid tax and nontax reasons.

6. Trust for spouse's benefit

Under prior law it was possible to create a short-term ("Clifford") trust under which income could be accumulated for the benefit of the creator's spouse and distributed to her after ten years. In such a short-term trust, the distribution made of the accumulated income in, let us assume, the trust's eleventh year, would be tax free to the wife except to the extent of the eleventh year's income. The first ten years of income realized by the trust were taxed to it—usually at much lower rates than if the income had been taxed to the wife on a separate or joint return.

The Tax Reform Act closed this "loophole." Henceforth, in the

case of a trust created by one taxpayer for the benefit of his spouse (a trust whose income may be distributed to, held for, or used for the benefit of the spouse) is to be taxed to the *creator* of the trust as it is earned.[13] In other words, in the foregoing illustration, even though the trust income is accumulated (and cannot be distributed) during the first ten years of the trust's existence, each year's income will be taxed annually to the husband-creator. The new law is applicable not only to short-term trusts but also to any trusts created for the benefit of a spouse. However, it does not apply where another provision of the Code requires the wife to include in her income the income of the trust. Under Act Sec. 332(b), the new rule is effective only with respect to property transferred in trust after October 9, 1969.

6.1 ***Pre-10/10/69 transfers and accumulation trust rules.*** In view of the October 9, 1969 cutoff date, will the TRA have any effect on the taxation of the distribution of the accumulated income where the principal was transferred to a spouse's trust before October 10, 1969? The answer, depending upon the facts and the years involved, is that the income will be taxed to the trust, or to the spouse or to both—but not to the creator.

Although the TRA provisions specifically relating to trusts for the benefit of a spouse do not apply to pre-existing transfers, the accumulation trust provisions of the new law are applicable. Income accumulated in the trust's year beginning in 1969 and in later years will be considered to be undistributed net income subject to the new throwback rules. For excess distributions made in years beginning before 1975, the throwback period is limited to five years; as to distributions in later years, the throwback period is unlimited except, of course, that income may not be thrown back to a trust year beginning before 1969 in any case. The TRA, furthermore, provides that there will be no throwback of any accumulation distribution to years beginning before 1974 if any of the exceptions (other than the $2,000 *de minimis* exception) to the prior year five-year throwback rule apply.

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[13] Amended Sec. 677 now taxes the grantor on the income of any trust which can be distributed, accumulated or applied for the benefit of the grantor ***or the grantor's spouse***. Italicized words added by Tax Reform Act.

Example. Ulysses S. Grantor established an accumulation trust for the benefit of Mrs. Grantor on January 1, 1962. The trust adopted a calendar tax year. The trust is to terminate on February 1, 1972. The distribution to Mrs. Grantor of the accumulated income on that date will be taxed as follows:

- Mrs. Grantor must report on her 1972 income tax return the taxable income of the trust for its short year of termination January 1 to February 1, 1972. This rule, contained in Sec. 662, has not been affected by the TRA.
- Under the throwback provisions of the new accumulation trust rules, Mrs. Grantor will be deemed to have received an excess dis-
tion distribution). Of course, if a joint return was filed, the recompu-
1971. Her tax on this income must be computed under either the exact method or the shortcut method, and she will receive a tax credit for the amount of the income taxes paid by the trust during 1969-1971 (even if the credit exceeds the tax she incurs on the accumulation distribution). Of course, if a joint return was filed, the recomputation of Mrs. Grantor's tax would also involve Mr. Grantor. Although the throwback period will normally include five years (see above), under these facts no throwback would be made to 1967 and 1968 because the 1972 distribution, a final distribution made more than nine years after the last transfer to the trust, was an exception to the prior five-year throwback rule.
- The income earned by the trust during the years 1962-1968 is not subject to the throwback provisions. The trust was required to pay the taxes for each of the years, and that's it.

7. Tax practitioners—become aware!

While the throwback concept has been in the Code for over fifteen years, relatively few tax practitioners have had need to become acquainted with it because the numerous exceptions rendered the throwback computations relatively academic. However, tax advisers to trusts and their beneficiaries will now have to become familiar with the rules since all the exceptions have been deleted—even the $2,000 *de minimis* exception.

Furthermore, it is not permissible (for expediency or other reasons) to waive the alternative exact or short-cut methods of computation and simply include the accumulation distribution (like a dividend) in income and compute a tax in the regular manner. At the least, the beneficiary's tax would have to be computed under the shortcut method. However, waiving the exact method of computation means risking the payment of excess taxes. Thus, tax advisers to complex trusts and their beneficiaries must master exact and short-cut methods of computing tax on excess distributions.

EXHIBIT I

ACCUMULATION TRUSTS
Table of effective dates
for throwback provisions of the Tax Reform Act

Excess distribution in years beginning in (A)	Is deemed to be from trust's income for years beginning in (B)	And is taxed as: Accumulation distribution (ordinary income)	Capital gain distribution: Trust in existence on 12/31/69	Capital gain distribution: Trust created after 12/31/69
1969	1968, 1967, 1966, 1965, 1964	Yes (C)	No	—
1970	1965, 1966, 1967, 1968	Yes (C)	No	—
	1969	Yes	No (D)	—
1971	1966, 1967, 1968	Yes (C)	No	—
	1969, 1970	Yes	No (D)	Yes
1972	1967, 1968	Yes (C)	No	—
	1969, 1970, 1971	Yes	Yes	Yes
1973	1968	Yes (C)	No	—
	1969, 1970, 1971, 1972	Yes	Yes	Yes
1974	1969, 1970, 1971, 1972, 1973	Yes	Yes	Yes
1975	1969, 1970, 1971, 1972, 1973, 1974	Yes	Yes	Yes
1976 and thereafter	1969 through the year preceding year of distribution	Yes	Yes	Yes

A. "Excess distribution" refers to distributions in excess of distributable net income, and may represent ordinary income accumulations and capital gains.

B. As explained in the text, an excess distribution will be thrown back to preceding taxable years under a Lifo order for years beginning in 1969 and under a Fifo order for years beginning after 1969. (See 1.1 and 2.3, respectively, in the text.) For excess distributions in years beginning before 1975, the throwback period is limited to five years; for excess distributions in years beginning after 1974 the throwback period is unlimited—except, of course, income may not be thrown back to a trust year beginning before 1969 under any circumstances.

C. However, for ordinary income distributions made in years beginning before 1974, there would be no throwback if any of the exceptions (other than the $2,000 *de minimis* exception) to the prior throwback rule apply. See Act Sec. 331(d)(2)(A) and 1.2 of the text.

D. The answer changes to "yes" when a beneficiary receives an excess distribution from two or more trusts, but only as to trusts in excess of one. However, distributions from one marital deduction trust shall be disregarded for this purpose. Act Sec. 331(d)(2)(B).

EXHIBIT II

ACCUMULATION TRUSTS
Taxation of excess distribution
case study

On January 1, 1970 *F* (in the 60% tax bracket) creates an irrevocable accumulation trust for the benefit of *S*, his unmarried son. On January 1, 1976, when *S* becomes 21, he will receive the accumulated income and trust principal and the trust will terminate.

Table 1, page 177, summarizes the facts shown on the income tax returns of *S* and the trust for the calendar years 1970 through 1975. In 1976 *S*'s taxable income (exclusive of the termination distribution received on January 1, 1976) is $6,000, and the income tax thereon is $1,110.

The trust realized no income on January 1, 1976, the first and only day of its 1976 year. Therefore, the termination distribution is deemed to include an excess distribution of the ordinary income and capital gain accumulated during the six years of its existence. (If the trust had received any income on January 1, 1976, the termination distribution would have been treated first as a distribution of current income to the extent of such amount, and taxed to the beneficiary in accordance with Secs. 661-663.)

The excess distribution is deemed to consist first of a "gross" accumulation (ordinary income) distribution of $45,600 and then of a "gross" captial gain distribution of $10,000. See Secs. 666 and 669. The computation of these amounts is shown in Table 2, page 178.

Table 3, page 179, shows the exact method of computing *S*'s tax on the excess distribution. In essence, such computations show that *S*'s net liability (after credit for taxes paid by the trust with respect to the excess distribution) for 1976 would be $2,399. Of such amount, $1,110 represents the tax he would have paid if he had not received the excess distribution. Thus, the portion of *S*'s 1976 tax liability attributable to the excess distribution of both ordinary income and capital gains is $1,289 ($2,399 less $1,110).

Table 4, page 180, shows the short-cut method (which is longer than the exact method) of computing *S*'s tax liability for 1976. These computations show that *S*'s net liability (after credit for tax paid by the trust with respect to the excess distribution) would be $2,973. Of such sum, $1,110 represents the tax payable on *S*'s taxable income without the excess distribution. Thus, the tax imposed on the excess distributions under the short-cut method is $1,863 ($2,973 less $1,110)—which is slightly higher than the tax payable under the exact method. *S* should use the exact method.

It should not be concluded from Tables 3 and 4 that *either* the short-cut method *or* the exact tax method has to be used with respect to both ordinary income and capital gain distributions. It appears from a literal reading of the law that a combination of methods can be used. For example, the throwback tax on the ordinary income distribution could be computed under the exact method while the throwback tax on the capital gain distribution could be calculated under the short-cut method, or vice

versa. Under these facts, Tables 3 and 4 show that the exact method would result in less tax than the short-cut method for both the ordinary income distribution ($10,536 vs. $10,974) and the capital gain distribution ($1,376 vs. $1,512).

Table 5, page 182, summarizes and compares the taxes payable with respect to the trust's income on the following bases:

1. If the trust had not been established (the tax payable by *F*);
2. If the trust income were taxed to *S* under the "regular method;"
3. Under the exact method of computation; and
4. Under the short-cut method.

This comparative summary shows that income realized by the trust would have been taxed substantially higher under assumptions 1 and 2.

In this case study, the beneficiary's tax liability attributable to the excess distribution exceeded the credit allowable for trust tax payments. However, it should be noted that there is no statutory limitation (like the foreign tax credit limitations) on the credit allowable to a beneficiary for taxes paid by a trust. In fact, if *S*'s total liability was less than the allowable credit, he would be entitled to a refund.

TABLE 1

Facts shown on 1970-1975 income tax returns of Trust and *S**

	Total	1970	1971	1972	1973	1974	1975
Trust							
Income:							
Interest (net of ordinary deductions)	$45,600	5,100	6,100	7,100	8,100	9,100	10,100
Long-term capital gain (100%)	10,000			10,000			
	55,600	5,100	6,100	17,100	8,100	9,100	10,100
Less:							
50% of long-term capital gain	5,000			5,000			
Exemption	600	100	100	100	100	100	100
	5,600	100	100	5,100	100	100	100
Taxable Income	50,000	5,000	6,000	12,000	8,000	9,000	10,000
Tax	$10,623	933	1,130	2,830	1,630	1,910	2,190
S							
Taxable income	$15,000	0	1,000	2,000	3,000	4,000	5,000
Tax	2,545	0	145	310	500	690	900

*The tax computations reflect all changes made by the Tax Reform Act, thus: The surcharge is added for 1970; for *S* (who is unmarried), the single-taxpayer rate tables have been used; and, for the trust, the rates applicable to married individuals filing separate returns have been applied.

While the trust, as well as *S*, is subject to the Sec. 56 minimum tax, no such tax would be due since the amount of the only tax preference item ($5,000 representing 50% of the long-term gain) is less than the exemption ($30,000 plus the income tax liability computed without regard to the minimum tax).

TABLE 2

"Gross" accumulation and capital gain distributions

A. Accumulation distribution (ordinary income) throwback:	
1. Aggregate "distributable net income" (DNI)	$45,600
2. Less taxes of trust attributable to DNI*	9,735
3. Aggregate "undistributed net income"	$35,865
4. Plus aggregate taxes deemed distributed (same as line 2)	9,735
5. "Gross" accumulation distribution	$45,600

B. Capital gain (long-term) distribution throwback:	
1. Aggregate capital gain	$10,000
2. Less taxes of trust attributable to capital gain*	888
3. Aggregate "undistributed capital gain"	$ 9,112
4. Plus aggregate taxes deemed distributed (same as line 2)	888
5. "Gross" capital gain distribution†	$10,000

*Pending the issuance of regulations under the new law, it is assumed on the basis of present Regs. Sec. 1.665(d)-1 (applicable to former law) that the amount of 1972 tax attributable to ordinary income should be computed as though the capital gain had not been distributed (thus, at top tax rates), and the tax attributable to the capital gain should be computed as though all distributable ordinary income had been distributed first (thus, at lowest tax rates).

†In this case study, the definition of "capital gain distribution" contained in proposed Regs. Sec. 1.665(g) has been adopted. This regulation is designed to correct the faulty statutory definition which, under these facts, would allow the capital gain portion of the distribution to escape the throwback rule. See discussion in 2.2 of the text.

TABLE 3

Exact method of computing S's 1976 tax

A. Partial tax on 1976 taxable income (excluding trust distribution) of $6,000							$ 1,110
B. Partial tax on ordinary income accumulation distribution of $45,600 allocated to prior years:							
	1970	1971	1972	1973	1974	1975	
Taxable income without distribution	0	1,000	2,000	3,000	4,000	5,000	
Accumulation distribution	5,100	6,100	7,100	8,100	9,100	10,100	
Recomputed taxable income	5,100	7,100	9,100	11,100	13,100	15,100	
Tax on recomputed income	955	1,374	1,865	2,387	2,949	3,551	
Less tax on income without distribution	0	145	310	500	690	900	
Ordinary income throwback tax liability	955	1,229	1,555	1,887	2,259	2,651	10,536

C. Partial tax on capital gain distribution of $10,000 allocated to 1972:		
Recomputed taxable income for 1972 (see B above)	$9,100	
Capital gain distribution (long term—50%)	5,000	
Recomputed taxable income—1972	14,100	
Tax on $14,100 (alternative tax inapplicable)	3,241	
Tax on recomputed income (without capital gain) for 1972	1,865	
Capital gain throwback tax liability		1,376
D. Total tax under exact method		13,022
Less credit for taxes paid by trust		10,623
Tax due under exact method		$ 2,399

TABLE 4

Short-cut method of computing S's 1976 tax

A. Partial tax on 1976 taxable income (excluding trust distribution)—same as under exact method (Table 3) $ 1,110

B. Partial tax on ordinary income (accumulation) distribution of $45,600 allocated to prior years (computed in five steps; see 3.2 of text):

Step 1: Determine the average annual accumulation distribution:

$$\frac{\$45{,}600}{6 \text{ years}^*} = \$7{,}600$$

Steps 2 and 3: Add the $7,600 to each of the three years immediately preceding the distribution year and recompute such tax liabilities.

	1973	1974	1975
Taxable income without distribution (Table 1)	$3,000	$4,000	$5,000
Add average annual accumulation distribution (above)	7,600	7,600	7,600
Recomputed taxable income	10,600	11,600	12,600
Tax on recomputed income	2,252	2,522	2,804
Less tax on income without distribution (Table 1)	500	690	900
Tax on amounts deemed distributed	$1,752	$1,832	$1,904

Step 4: Compute the average increase in tax attributable to the distribution:

$1,752 + 1,832 + 1,904 = $5,488 aggregate taxes

$$\frac{\$5{,}488}{3} = \$1{,}829 \text{ average increase in tax}$$

Step 5: Arrive at the total tax on the accumulation distribution:

$1,829 × 6 years = 10,974

*As explained in 3.2 of the text, the number of preceding taxable years to be used in averaging the ordinary income accumulation distribution must exclude any year in which a "minimum amount" of income was accumulated. This minimum amount is defined as 25% of the average income deemed distributed. Thus, using the figures in this case study, any preceding year in which the undistributed ordinary income was less than $1,900 (25% of $7,600) may not be

C. Partial tax on long-term capital gain distribution allocated to 1972 (see B above for explanation of the five steps):

Step 1:

$\frac{\$10,000}{1 \text{ year}^*}$ = average annual capital gain distribution of $10,000

Steps 2 and 3:

	1973	1974	1975
Taxable income—as recomputed under B	$10,600	$11,600	$12,600
Add average long-term capital gain (50%)	5,000	5,000	5,000
Recomputed taxable income	15,600	16,600	17,600
Tax on recomputed income (alternative tax inapplicable)	3,706	4,034	4,374
Less tax on recomputed income without capital gain (see B)	2,252	2,522	2,804
Tax on capital gain deemed distributed	$ 1,454	$ 1,512	$ 1,570

Step 4:

$1,454 + 1,512 + 1,570 = $4,536

$\frac{\$4,536}{3}$ = $1,512 average increase in tax

Step 5:

$1,512 × 1 year* = 1,512

D. Total tax under short-cut method	13,596
Less credit or taxes paid by trust	10,623
Tax due under short-cut method	$ 2,973

used as a year in the denominator of the fraction. Since the undistributed income of each of the years 1970-1975 in the assumed facts exceeded this $1,900 minimum, the number of preceding taxable years usable in the denominator is six. The same rule causes the number of years to be used to determine the average annual capital gain distribution to be one year, 1972, in which all of the capital gain was realized. Amended Secs. 668(b)(2)(C) and 669(c).

TABLE 5

Comparative summary of tax liabilities on trust income

A. If trust not established:		
F's (creator) tax would be (assuming 60% ordinary income and 25% capital gain tax brackets):		
Ordinary income—$45,600 @ 60%	$27,360	
Add long-term capital gain—10,000 @ 25%	2,500	
Aggregate tax liability		$29,860
B. If trust income were taxed under regular method:*		
S's total tax	$13,059	
Less tax attributable to *S*'s 1976 other income	1,110	
S's tax on trust distribution	11,949	
Add taxes paid by trust	10,623	
Aggregate tax liability		$22,572
C. Exact method:		
S's total tax	$ 2,399	
Less tax attributable to *S*'s 1976 other income	1,110	
S's tax on trust distribution	1,289	
Add taxes paid by trust	10,623	
Aggregate tax liability		$11,912
D. Short-cut method:		
S's total tax	$ 2,973	
Less tax attributable to *S*'s 1976 other income	1,110	
S's tax on trust distribution	1,863	
Add taxes paid by trust	10,623	
Aggregate tax liability		$12,486

*"Regular method" means adding the gross amounts of the ordinary income and capital gain distributions to *S*'s other 1976 income, computing the tax on the aggregate, and taking a credit for the aggregate taxes paid by the trust. Although this simple method can no longer be used for years beginning after December 31, 1969 (see 3.3 of the text), the tax that would result under such method is included here for comparative purposes. The computation details are not reproduced in this study.

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Capital gains and losses

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One of the major objectives of the Tax Reform Act[1] was to narrow the gap between the taxation of capital gains as compared with other income and to correct purported abuses in the capital gains area by certain taxpayers and industries. The table of contents to the Act indicates that only six sections (511-516) are specifically related to "Capital Gains and Losses," namely:

- Increase in alternative capital gains tax;
- Capital losses of corporations;
- Capital losses of individuals;
- Letters, memorandums, etc.;
- Lump sum distributions from qualified pension, etc., plans; and
- Other changes in capital gains (sale of life estates, casualty losses and franchises).

This article is devoted primarily to an examination of the foregoing changes, except for the provision relating to lump sum distributions from qualified pension, etc., plans.

Although it may appear at first glance that capital gains have been lightly touched by reform, a closer analysis shows that about one-fourth of the new sections affect capital gains in some manner.

[1] For brevity and clarity, provisions of the Internal Revenue Code will be simply cited as "Sec.," while provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" means pre-Tax Reform Act law. "Amended law," "amended Sec." or "new Sec." refers to post-Tax Reform Act law.

Although a detailed study of all the provisions affecting capital gains is outside the scope of this article, the other changes, including some of the obscure ones, will be briefly reviewed at the end of this article in order to give a complete picture of the reforms in this area.[2]

1. Capital loss carryback—corporations[3]

One beneficial reform for corporations is the introduction of a carryback provision for most capital losses sustained in years beginning after 1969. Capital losses attributable to foreign expropriations, for which a ten-year carryforward is permitted under present law, are not subject to this treatment.

Qualifying capital losses (long term or short term) can be carried back to the earliest of the three taxable years preceding the year of loss and are treated as short-term capital losses for such years. A corporation cannot carry back a loss to a taxable year for which it was a foreign personal holding company, a regulated investment company, or a real estate investment trust, or for which an election by a foreign investment company to currently distribute income was in effect. The provision also does not apply to a corporation which was treated as a subchapter S corporation for the loss year or for the year to which the loss could otherwise be carried. Tentative carryback adjustments, or *quick refunds,* can be obtained for those losses. Any loss not utilized as a carryback will continue to be available as a short-term capital loss carryover for five years following the year of loss.

The carryback can offset only capital gains of the prior year, and is further limited to an amount which does not *increase or produce a net operating loss* for the year to which it is carried. A capital loss carryback generally will be considered "absorbed" in determining the amount of carryover to other years to the extent of the net capital gains of the years to which it is (or should have been) carried. Where the carryback is limited by its effect on a net operating loss for the prior year, only the amount actually used as an offset against the prior year capital gain will be considered absorbed in that year.

[2] These provisions, as well as the one relating to lump sum distributions from qualified deferred compensation plans, have been or will be covered in depth by *The Tax Adviser* in other articles.

[3] Amended Secs. 381, 1212, 6411, etc.

Example. In 1970 a corporation incurs a net capital loss of $100,000 which is not attributable to a foreign expropriation. Taxable income of the corporation for prior years is comprised of the following:

	1967	1968	1969
Ordinary income (loss)	$400,000	$(30,000)	$250,000
Capital gain (long term or short term)	20,000	80,000	10,000
Taxable income	$420,000	$ 50,000	$260,000
Capital loss carryback deduction	$ 20,000	$ 50,000	$ 10,000

The utilization of the capital loss carryback in 1968 is limited to $50,000 because a net operating loss would be produced if a greater offset were allowed. The unabsorbed 1970 capital loss of $20,000 can be carried forward to 1971 and the four succeeding taxable years.

The increased flexibility afforded by the capital loss carryback should be welcomed by most corporations, especially those forced to *arrange* capital gain transactions to ensure utilization of those losses. If capital gains were recognized during 1967-1969, it may be beneficial to realize a potential capital loss during 1970 to use as a carryback against those gains. Because the carryback is treated as a short-term loss, the tax benefit can be increased if the loss is incurred in a year permitting a carryback to a year including a short-term gain. Of course, this provision is a two-edged sword and the effect of any carryback on net operating loss carryovers, foreign tax credits or investment credits in the prior years must be considered. For instance, a previously utilized investment credit which becomes a carryover into 1969 may be adversely affected by the 20% transitional rule (new Sec. 49) accompanying the investment credit repeal. Improperly timed losses may eliminate the benefits of a capital gain in a prior year to utilize an otherwise expiring net operating loss carryover to that year.

2. Alternative tax rate increase—corporations

The maximum tax on long-term capital gains provided by the alternative tax computation in the case of corporations is increased (amended Sec. 1201) from 25% to 30% on *all* gains for years beginning after 1974. For years beginning after 1969 and before 1975, the increase in tax will be phased in under several transitional rules.

Transitional rules. All gains (but not losses) from sales or other dispositions pursuant to binding contracts entered into on or before

October 9, 1969 which are recognized before January 1, 1975 remain subject to the prior law rate of 25%. This includes sales being reported on the installment basis. The binding contract rule does not apply in the case of dispositions of timber, coal or domestic iron ore interests or to the sale or exchange of patents. The Senate Report (No. 91-552, p. 194) does not elaborate on the definition of a binding contract for this purpose, other than a reference to stock market orders to sell at market; but its meaning obviously becomes important in view of the continuation of the 25% rate for these items during the transitional period. Ordinarily, it will be advisable to recognize all such gains prior to 1975. Another limited transitional rule retains the 25% rate for gains attributable to distributions from a corporation made prior to October 10, 1970 pursuant to a plan of complete liquidation adopted on or before October 9, 1969. Losses from transactions under the binding contract or liquidating distribution rules are grouped with gains not subject to the 25% rate. To the extent all such transactions result in a net loss, this loss reduces the gain subject to the 25% rate.

A final transitional rule—restricted to years beginning during 1970—will substitute a 28% alternative tax rate for the 30% rate on all gains *not subject* to the 25% rate under the binding contract or liquidating distribution rules. The 30% rate will apply to "nontransitional" gains for years beginning after 1970 and to all gains recognized after 1974.

Fiscal year corporations. The increases in the corporate alternative tax (to 28%, then to 30%) constitute changes in tax rates with effective dates of January 1 in 1970 and 1971. Corporations with fiscal years or short taxable periods straddling such dates will be required to make the prorated tentative tax calculations required by Sec. 21, if the alternative tax affects the computation of income tax for the year.

Examples. The following examples illustrate the new alternative tax rules for corporations:

Example 1. In 1970 a calendar year corporation recognizes a $10,000 long-term capital gain from the disposition of a capital asset, a long-term capital gain of $90,000 attributable to collections on a 1968 installment sale, and ordinary income of $500,000. The corporation's 1970 tax is computed as follows:

1. Ordinary income—$500,000 at 48%, less $6,500	$233,500
2. "Transitional" capital gain—$90,000 at 25%	22,500
3. Other capital gain at 1970 rate—$10,000 at 28%	2,800
Total tax before surcharge	$258,800

Example 2. If, in Example 1, the corporation had also sustained a $15,000 capital loss under a 25% rule situation, the loss would be applied first against the "nontransitional" 1970 capital gain of $10,000 and then against the transitional gain. Thus, the 25% alternative tax rate would apply to the net gain of $85,000.

Example 3. If the $10,000 capital gain in Example 1 had occurred in 1971 rather than 1970, the alternative tax rate applicable at step 3 would be 30%. The 28% rate is applicable only to years beginning in 1970. For taxable years beginning after 1974, the transitional rules will cease to apply and all gains will be subject to a 30% alternative capital gain rate.

Computation of tax preferences. The minimum tax preference item for corporate capital gains listed in new Sec. 57(a)(9) is determined by applying the following fraction to the excess of net long-term capital gain over net short-term capital loss:

$$\frac{\text{Normal tax rate} + \text{surtax rate} - \text{alternative tax rate}}{\text{Normal tax rate} + \text{surtax rate}}$$

When the alternative tax rate increase becomes fully effective in 1975, this fraction will be 18/48. Several computations may be required during the transition period because of the different applicable alternative tax rates; for example, a fraction of 23/48 will apply to those gains taxed at the 25% rate, while a fraction of 20/48 will apply to those gains taxed at 28% in 1970. This provision can apply to a portion of all capital gains recognized by a fiscal year corporation whose taxable year *ends after* December 31, 1969, regardless of the date of the transaction.

3. Alternative tax rate increase—noncorporate taxpayers

The prior law 25% (or 50% on half of the gain) maximum rate on long-term capital gains provided for by the alternative tax computation for noncorporate taxpayers remains in effect under amended Sec. 1201—but for taxable years beginning after December 31, 1969, it applies only to $50,000 of such gains ($25,000 for married individuals filing separate returns). The income-averaging

provisions have been liberalized to include capital gains in averageable income, but amended Sec. 1304(b) prohibits the use of the alternative tax computation when the income-averaging computation is used.

A special alternative tax computation is provided for the portion of any net long-term capital gain in excess of $50,000. This is equal to the excess of:

1. A tax computed at graduated rates on an amount equal to regular taxable income *(but not less than 50% of the entire net long-term capital gain),* over
2. A tax computed at graduated rates on an amount equal to taxable income, excluding any net long-term capital gain, plus 50% of any gain subject to tax at the 25% rate. (Under the rationale of (1), an ordinary loss is apparently disregarded in this computation.)

Transitional rules. As in the case of changes in the alternative tax for corporations, the 25% rate continues in effect for any long-term capital gains arising from amounts *received before 1975* pursuant to binding contracts entered into on or before October 9, 1969 (including installment sales before that date) and for certain liquidating distributions received prior to October 10, 1970—even if these gains exceed the $50,000 limitation. All gains subject to the transitional 25% limit reduce the $50,000 amount for other gains which might otherwise be eligible for the 25% rate. The exceptions to the binding contract rules applicable to corporations (namely, gains from timber, coal or iron ore interests and transfers of patents) also apply to noncorporate taxpayers.

Limitations. For years beginning in 1970 and 1971, there are maximum limitations on that portion of the alternative tax on any net long-term capital gain in excess of the $50,000 or other amount subject to the 25% tax rate. For a 1970 year, the maximum alternative tax (before surcharge) on this portion of the capital gain cannot exceed 29½% of the total excess gain; for a 1971 year this limitation is 32½% of the excess. For years beginning after 1971, the maximum effective tax on any excess long-term capital gain generally will be limited to 35%—i.e., the top marginal tax rate of 70% applied to half of the excess gain included in taxable income. This maximum effective tax does not reflect the minimum tax on tax preferences.

Fiscal year—noncorporate taxpayers. The prorated tentative tax calculations required in the case of a tax rate change occurring during a tax year also apply to the fiscal years of individuals, estates and trusts beginning before January 1, 1970 and ending after that date. The special alternative tax computation on gains in excess of $50,000 is considered a tax rate change under Sec. 21. It is not clear, however, whether the transitional maximum limitations on the amount of tax of 29½% and 32½% will be treated as tax *rate* changes requiring Sec. 21 computations for 1970-71 and 1971-72 fiscal years.

Examples. The following examples illustrate the new alternative tax computation under the various transitional rules.

Example 1. A has taxable income of $164,000 for calendar year 1975 comprised of the following:

Ordinary income	$ 64,000
Long-term capital gain (current year transaction)	200,000
Capital gain deduction	(100,000)
Taxable income	$164,000

A's tax, on the basis of a joint return, is computed as follows:

1. On $64,000, at graduated rates		$ 24,420
2. On $50,000 of long-term gain, at 25%		12,500
3. On $164,000, at graduated rates	$86,300	
Less tax on $89,000 (ordinary income plus ½ of amount taxed at 25%) at graduated rates	38,580	47,720
		$ 84,640

Example 2. If the long-term capital gain in Example 1 had arisen from a binding contract entered into before October 9, 1969 (e.g., collections on an installment sale prior to that date) and were received in the calendar year 1974, the tax for the year would be computed as follows:

On $64,000 at ordinary rates	$24,420
On $200,000 at 25%	50,000
	$74,420

The tax computed in this example is the same as the tax computed under prior law, without regard to any surcharge. A comparison of tax liabilities resulting solely from the revision of the alternative tax computation for individuals when this provision becomes fully effective in 1975 (Example 1) with the tax computed on the same facts under prior law (this example) shows an increase of $10,220 ($84,640 less $74,420).

Example 3. Assume the same facts as in Example 1, except that 1970 is involved. The tax of $47,720 computed at step 3 in that example

would be limited to $44,250 ($150,000 at 29½%) under the transitional tax limitation of 29½%.

Example 4. B's taxable income for 1973 is $130,000, comprised of the following:

Ordinary loss	$(20,000)
Long-term capital gain	300,000
Capital gain deduction	(150,000)
Taxable income	$130,000

The alternative tax on the basis of a joint return is computed as follows:

1. On ordinary income (loss)		none
2. On $50,000, at 25%		$ 12,500
3. On $150,000 (taxable income but not less than 50% of long-term capital gain), at graduated rates	$76,980	
Less tax on $25,000 (½ of amount taxed at 25% rate) at graduated rates. (The ordinary loss is apparently disregarded.)	6,020	70,960
		$ 83,460

The tax at ordinary rates on regular taxable income of $130,000 is only $63,980; and accordingly, the alternative tax would not apply.

Realize transitional gains. To qualify for the 25% rate, it is essential that all amounts attributable to the transitional rules be received before 1975. Moreover, because of the annual $50,000 qualification of any long-term capital gain for the 25% rate, whether or not resulting from a pre-October 10, 1969 transaction, it may be beneficial to realize all of these transitional gains as early as possible—to the extent it is otherwise economical to do so and considering the potential application of the minimum tax on preference items.

Transitional gains will be taxed at a maximum 25% regardless of amount, but these gains reduce the amount of other gains which could qualify under the $50,000 limit. Early recognition of the transitional gains will permit the maximum amount of nontransitional gains (if any) to qualify for the 25% rate. It may be desirable to arrange for large capital gains to be reported on the installment method in order to keep within the annual $50,000 limitation; but the amendments made to Sec. 453(b), regarding the treatment of certain evidences of indebtedness as year-of-sale payments, should not be overlooked.

Computation of tax preferences. New Sec. 57(a)(9) provides that the capital gain tax preference item in the case of noncorporate taxpayers is equal to 50% of the excess of net long-term capital gain over the net short-term capital loss for the year. This will be the most common tax preference item for individuals. It will equal the capital gain deduction whether or not tax is computed under the alternative method.

4. Capital losses—noncorporate taxpayers

Under prior law, individuals (and other noncorporate taxpayers) were permitted to deduct net short-term or long-term capital losses against ordinary income for any year to the extent these losses did not exceed the lesser of *taxable income* or $1,000. Any unused loss could be carried forward for an unlimited period of time as a short-term capital loss and/or long-term capital loss (depending on the original status), and applied against a subsequent year's capital gains and/or ordinary income to the extent of not more than $1,000.

Limitations on deductions and carryovers. An attempt was made to provide parallel treatment for net long-term capital losses and net long-term capital gains for years after 1969. Sec. 1211 was amended to limit the deduction against ordinary income to only 50% of the excess of net long-term capital losses over net short-term capital gains. Net short-term capital losses remain fully deductible within the ceiling of taxable income or $1,000.

The amended carryover provisions reduce a long-term capital loss carryover by *double* the amount of any net long-term capital loss deductible against ordinary income. It is presumed that ordinary income first absorbs any net short-term losses (including carryovers). Thus, a current year net long-term loss will become a long-term capital loss carryover to a subsequent year only to the extent it is twice the amount of net long-term loss deducted from ordinary income, considering any net short-term capital losses deducted first in the case of the $1,000 or taxable income limitations.

Transitional rules. The full amount of any net long-term capital loss arising in a year beginning prior to 1970, which is carried over to the first taxable year beginning after 1969, is reduced only dollar for dollar when and if deducted against ordinary income (as under prior law). Although it is now too late for calendar year taxpayers

to increase amounts subject to this transitional rule, fiscal year taxpayers have until the end of their 1969-70 fiscal year to realize long-term losses which can be fully deducted against ordinary income. (Of course, to the extent the carryover is utilized to offset a subsequent year's net long-term or short-term capital gain, the carryover is absorbed by the full amount of that net gain.) The dollar-for-dollar deduction against ordinary income for pre-1970 losses applies only to the extent the amount of pre-1970 carryover exceeds the total of any net capital gains of taxable years beginning after 1969. It is not clear whether the determination of total net capital gains after 1969 is to be made on an annual basis or a cumulative basis.

Married taxpayers filing separate returns. Married taxpayers filing separate returns could deduct up to $1,000 of net capital losses against ordinary income in each return. This opportunity to deduct $2,000 of capital losses was of rather limited appeal (except in community property states). The aggregate tax liabilities on unequal separate incomes were often sufficiently greater than a joint return liability making it inadvisable to file separate tax returns to accelerate a capital loss deduction. In any event, for taxable years beginning after 1969, the $1,000 maximum limitation on the deduction of net capital losses from ordinary income is lowered to $500 for each married person filing a separate return.

Examples. The following examples illustrate the new capital loss deduction and carryover rules.

Example 1. C's 1970 taxable income is $9,000, before considering a net short-term capital loss of $300 and a net long-term capital loss of $800. The capital loss deductible in 1970 is limited to $700, determined as follows:

Net short-term capital loss (100% deductible)	$300
Net long-term capital loss (50% deductible)	400
	$700

None of the nondeductible $400 net long-term capital loss is available as a carryover, because the total loss is reduced by double the amount deducted from ordinary income.

Example 2. If the $800 net long-term capital loss in Example 1 had been a carryover from 1969, $700 of that loss would be deductible in 1970 (the $1,000 maximum limitation less $300 net short-term

loss which is applied first). The remaining $100 would be carried over and would offset any net long-term or net short-term capital gain realized in 1971, or would be fully deductible against ordinary income subject to the taxable income limitation.

Example 3. D's 1971 taxable income is $35,000, before considering a net short-term capital loss carryover of $800 carried from 1970 and a current year net long-term capital loss of $2,000. The deductible capital loss for 1971 is $1,000, computed as follows:

Net short-term capital loss (100% deductible)	$ 800
Net long-term capital loss (50% deductible)	$1,000
	$1,800
Limited to	$1,000

The carryover to 1972 consists of a net long-term capital loss of $1,600; i.e., the $2,000 loss less double the $200 considered deducted from ordinary income ($1,000 minus the $800 short-term capital loss). Assuming no capital gain or loss transactions in 1972, $800 (50% of the $1,600 carryover) would be available as an ordinary deduction.

Example 4. E has a net long-term capital loss carryover of $5,000 from calendar year 1969. In 1970 he sustains a short-term capital loss of $3,000, of which $1,000 is deducted against ordinary income. In 1971 *E* recognizes a short-term capital gain of $5,000; but, because of the 1969-1970 carryovers, no net gain results and $1,000 is deducted from ordinary income. *E* still has a net long-term capital loss carryover to 1972 of $1,000, calculated as follows:

	Long-term	Short-term
1970		
Carryover from 1969	$(5,000)	
Current year (loss)		$(3,000)
	$(5,000)	$(3,000)
Deduction from ordinary income		1,000
Carryover to 1971	$(5,000)	$(2,000)
1971		
Current year gain		5,000
	$(5,000)	$ 3,000
Offset against short-term gain	3,000	(3,000)
	$(2,000)	-0-
Deduction from ordinary income	1,000	
Carryover to 1972	$(1,000)	

If the transitional rule is construed to require that total post-1969 net capital gains be determined on an annual basis ($5,000), the remaining long-term capital loss carryover from 1969 could be deducted from 1972 ordinary income only to the extent of $500. On the other hand, if total post-1969 net capital gains are to be determined on a cumulative basis ($2,000), the entire remaining loss carryover of $1,000 from 1969 would be available as a deduction from 1972 ordinary income.

Using up long-term losses. Since a net long-term capital loss carryover is reduced by double the amount of long-term loss applied against ordinary income in each year, it may be advisable to realize short-term capital gains during any year which would otherwise result in a net long-term capital loss. Then the long-term loss would absorb income otherwise taxable at ordinary rates.

5. Life estates and term interests

Sales of a life estate or other term interest in property have been held to result in capital gain even though the interest may have represented a right to receive future ordinary income.[4] Where such an interest is acquired by gift, bequest, or inheritance, a "uniform basis" applies to the entire property which is divided between the life estate and the remainder interest. With the passage of time, the portion of this uniform basis applicable to the life estate diminishes while the portion applicable to the remainder interest increases by a corresponding amount. Except to the extent of any depreciable property represented by these interests, Sec. 273 denies deductions for depreciation of this uniform basis.[5]

As a result of Sec. 273, a life tenant who acquired his interest by gift, etc., could utilize his portion of the uniform basis only if he sold the life estate. To the extent of the basis allocated, the life tenant received a tax-free recovery of capital and frequently was able to treat the remaining proceeds as capital gain. Such a sale would not affect the basis of the remainderman; see Regs. Sec. 1.1014-4(a)(1).

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[4] For example see Est. of F. S. Bell, CA-8, 137 F2d 454 (31 AFTR 411, 43-2 USTC ¶9565); and McAllister, CA-2, 157 F2d 325 (35 AFTR 91, 46-2 USTC ¶9337).

[5] A life estate acquired by purchase is amortizable over the period of the life interest. See Wm. N. Fry, Jr., CA-6, 283 F2d 869 (6 AFTR2d 5691, 60-2 USTC ¶9738); and Rev. Rul. 62-132, 1962-2 CB 73.

The Tax Reform Act eliminated the possible double utilization of basis by the life tenant and remainderman in the case of a life estate, an interest in property for a term of years, or an income interest in trust, acquired by gift or inheritance or by transfer in trust. Amended Sec. 1001 provides that no portion of the basis of such an interest can be used in determining gain or loss on a sale or disposition after October 9, 1969. An exception is made if the sale or disposition is part of a transaction in which the entire property interest is transferred to any person or persons.

Future dispositions of these interests will undoubtedly be restricted since it is no longer possible to achieve a capital recovery of a portion of the uniform basis, unless the remainder interest is transferred simultaneously. On the other hand, so long as a high bracket life tenant may realize a capital gain (even though for the full sale price) from dispositions, the marketing of such interests may continue.

6. Franchises, trademarks and trade names

A new Sec. 1253 provides that any transfer of a franchise, trademark or trade name is not to be treated as a sale or exchange of a capital asset if the transferor retains *any* significant power, right, or continuing interest with respect to the subject matter of the transfer. Professional sports franchises are specifically excluded from the application of this new provision.

The Senate Finance Committee views the retention of these significant rights as indicative of tests used by the courts in determining that transfers of franchises, etc., are in fact licenses (producing royalties or rental income) rather than sales or exchanges (yielding capital gains); thus, the income from these transactions is treated as ordinary income.

Definitions. "Franchise" is defined to include an agreement which gives one of the parties to the agreement the right to distribute, sell or provide goods, services or facilities within a specified area. The powers, rights, or interests which are considered significant include—but are not limited to—each of the following:

- To disapprove any assignment of the interest or part thereof;
- To terminate the agreement at will;
- To prescribe standards of quality of products, services, or equipment and facilities;

• To require the sale or advertising of only products or services of the transferor;

• To require purchase of substantially all supplies and equipment from the transferor; and

• To receive payment contingent on productivity, use, or disposition of the subject matter of the transferred interest if such payments constitute a substantial element under the transfer agreement.

Contingent payments. All *contingent payments* on franchise transfers (including renewals thereof) after 1969, based on productivity, use, or subassignment of the franchise will constitute ordinary income to the transferor and ordinary trade or business expenses to the transferee, *whether or not these payments constitute a substantial element under the agreement.* Transferees making contingent payments applicable to transfers prior to 1970 may elect to currently deduct those payments. See the discussion under "Transferees benefit" below.

Initial fees. Deductions also are provided for initial franchise fees paid in a lump sum or in periodic payments over a term specified in the transfer agreement. These deductions will apply, however, only where the transferor is required by Sec. 1253 to report the payments received as ordinary income because a significant right, etc., was retained. Payments in discharge of the fixed consideration will be deductible by the transferee as follows:

• A lump sum payment may be amortized ratably over a ten-year period, or the period of the franchise agreement if less than ten years.

• Where there is a series of approximately equal payments, they may be deducted when paid if the payments are required over the entire period of the agreement, or over a period of more than ten years—whether or not the payment period coincides with the period of the agreement.

• Any method of payment other than lump sum or approximately equal installments will be deductible in the years specified in regulations to be issued.

Capital gains. Sec. 1253 does not preclude the reporting of capital gain income from transfers of franchises which are in fact capital assets in the hands of the transferor. Ordinary income results, how-

ever, where a sale or exchange is effected by a dealer in this property. Because most franchise agreements contain one or more of the features listed as *significant* rights, it appears that capital gain treatment may be difficult to achieve for future transfers of franchises which are, in fact, capital assets. While the prospects for favorable tax treatment may have dimmed for franchise transferors, the real beneficiaries of this legislation appear to be the transferees.

Transferees benefit. The IRS generally has attempted to classify franchises, trademarks or trade names as intangible assets with unascertainable useful lives. Under these circumstances, initial fee payments as well as contingent productivity payments may not be deductible either as a current expense or as a depreciation charge. Now transferees can deduct all contingent payments on franchise transfers or renewals after December 31, 1969 and payments of initial amounts for such transfers, both of which the transferor is required to report as ordinary income.

Moreover, transferees can elect to deduct contingent payments made in years ending after December 31, 1969 and beginning before January 1, 1980 on account of transfers made prior to 1970. Thus, a contingent payment made in February 1969 by a transferee with a January 31 fiscal year should be deductible on its 1969-1970 return. Regulations will be issued prescribing the time and manner for making this election which will cover only payments made before January 1, 1980. The election appears to be a liberal transitional provision to benefit transferees and should not affect the character of the payments in the hands of a transferor of a franchise which occurred before the effective date of the new legislation.

7. Letters, memorandums, etc.

The definition of a capital asset is amended to exclude a letter, memorandum, or similar property, including a collection thereof, held by a taxpayer whose personal efforts created the property or *for whom the property was prepared or produced.*[6] For this purpose, a letter or memorandum addressed to an individual is considered prepared for him. This non-capital asset treatment also applies to any person who determines his basis by reference to the basis of that property in the hands of a person who created the property

[6] See amended Sec. 1221; also amended Sec. 341.

or for whom it was prepared; e.g., gift property or transfers to partnerships. Sec. 1221 (3) was amended to include a letter or memorandum with property classified as non-capital assets under prior law, namely, a copyright, a literary, musical or artistic composition, or *similar property*. The *prepared or produced for a taxpayer* requirement was added for letters, memorandums, *or similar property*. It will be interesting to see how the forthcoming regulatons will define "similar property" to which the "prepared or produced for" language will apply. The Committee Reports offer little guidance.

This change in the classification of letters, memorandums, etc., is effective for sales or other dispositions (including charitable contributions) occurring after July 25, 1969. If such property is sold, any gain will be considered ordinary income; if it is contributed, amended Sec. 170(e) requires the amount of any charitable contribution to be reduced by the excess of the fair market value over tax basis.

8. Casualty losses and Sec. 1231

In general, Sec. 1231 requires the grouping of all recognized gains or losses on sales or exchanges of depreciable property used in the trade or business to determine whether there is an overall gain or loss for the year. Recognized gains and losses from the compulsory or involuntary conversion of such properties and of capital assets held for more than six months are also included in this grouping. A net gain is entitled to long-term capital gain treatment, whereas a net loss is an ordinary deduction.

A 1958 amendment to Sec. 1231 permitted an uninsured casualty loss of any business property, or of a capital asset held for more than six months *and* held for the production of income, to be fully deductible without regard to the normal grouping of other Sec. 1231 asset sales or involuntary conversions. This amendment was intended to equalize the treatment for self-insuring taxpayers with those who were insured and took ordinary income deductions for premium payments. As with most equitable relief measures, however, unintended results were produced; e.g., a capital gain and an ordinary loss could result from different casualties occurring in the same year.

Sec. 1231 is amended for taxable years beginning after December 31, 1969 to provide a *subgrouping* of all transactions treated as involuntary conversions—whether or not the assets were business

property or personal capital assets held for more than six months and regardless of whether these assets were insured. If the result of this subgrouping is a net gain, these transactions are then grouped with other Sec. 1231 asset dispositions for determining possible eligibility for long-term capital gain treatment. If the result is a net loss, it qualifies as an ordinary deduction without regard to any other Sec. 1231 asset transactions.

9. Other provisions affecting capital gains

The remainder of this article will deal with other provisions which, although not classified under capital gains or losses, do somehow reduce the capital gain opportunities and benefits which existed under prior law.

Holding period. As originally passed by the House of Representatives, the Tax Reform Act would have generally extended the holding period from six months to twelve months for capital and business (Sec. 1231) assets to qualify for long-term capital gain treatment. Apparently yielding to Administration comments regarding the disruptive effect on the capital markets and revenues, the Senate (and the Conference Committee) generally restored the six-month holding period for assets to qualify for this favorable treatment.[7] Sec. 1231(b) was amended, however, to increase the qualifying holding period for cattle and horses to two years.

Recapture rules broadened. The amount of gain from the disposition of depreciable business assets subject to long-term capital gain treatment under Sec. 1231 was restricted by the depreciation recapture provisions of Secs. 1245 and 1250. The scope of Sec. 1245 was expanded to include livestock. The capital gain potential of most real property has been further restricted by Sec. 1250 amendments. In addition, new Sec. 1251 treats as ordinary income gains from the disposition of farm property to the extent of certain farm losses and new Sec. 1252 denies capital gain treatment to certain sales of farm land. Finally, the Sec. 617(b) recapture rules for exploration expenses have been expanded to apply to foreign mineral properties and additional domestic properties.

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[7] Conference Committee Report, H.R. 91-782, p. 320.

Deferred compensation. The restricted property rules provided in new Sec. 83 tend to convert potential capital gain income into compensation taxed at ordinary rates as well as to accelerate the incidence of taxation. Employer contributions and reallocations of forfeitures made in employees' trust years beginning after December 31, 1969 included in lump sum distributions from qualified pension, profit-sharing, etc., plans will be treated as ordinary compensation rather than as capital gains.[8] This will become a significant change in future years for many noncontributory plans. A special seven-year averaging device is designed to provide relief from the bunching of ordinary income.

Financial institutions. Banks and other financial institutions will find their treatment of capital gains affected in several respects. An annual net gain realized by such organizations from transactions in bonds, debentures, etc., held for investment was taxable as a capital gain while an annual net loss was deductible as an ordinary loss. This led to the practice of realizing net gains and net losses in alternate years to maximize the tax benefit. In the future, except for a portion of the gain attributable to the pre-July 12, 1969 holding period of securities, an annual net gain will be recognized as ordinary income and an annual net loss will remain fully deductible as an ordinary loss.

Removal of this "everything to gain, nothing to lose" incentive from Sec. 582 could have an adverse effect on future bond investments by these organizations. Special rules are provided to defer implementation of this change for certain small business investment companies. Amended Sec. 593 requires mutual savings banks, savings and loan associations, and similar financial institutions to reduce additions to reserves for losses on loans, if computed under the percentage of taxable income method, on account of the exclusion of capital gains or portions thereof from the taxable income base.

New recognition requirements. The Act contains several provisions which subject certain "gains" to income tax for the first time. For example, amended Sec. 311 generally requires the recognition of gain when a corporation uses appreciated property (whether or not

[8] Amended Secs. 72, 402, and 403.

subject to lien) to redeem its stock. Distributions by complex trusts of capital gains accumulated in years beginning after 1968 may be taxable as capital gains in the hands of the beneficiary under the broader throwback rules provided in amended Secs. 665-669. Previously, capital gains accumulated in prior years were taxed only at the trust level.

Charitable contributions. The advantages of using appreciated "long-term capital gain property" to make charitable contributions were also curtailed or diminished by amendments to Sec. 170. In the case of a gift of such property, either the amount of the deduction may be reduced by a portion of the potential gain or the percentage limitation on contribution deductions may be decreased.

Under prior law, if a bargain sale of appreciated property was made at its tax basis to a charitable organization, the taxpayer could treat the entire sale price as a recovery of basis and deduct the full amount of appreciation. A taxpayer now must allocate his basis in the property being sold at a bargain between the portion sold and the portion contributed. The result is that capital gain must be recognized on such sales after December 19, 1969.

Exempt organizations. Private charitable foundations, which were previously exempt from tax except on unrelated business income, are subject to an excise tax based on investment income under new Sec. 4940. This tax base includes net capital gains. Amended Secs. 512 and 514 expanded the definition of unrelated business taxable income to include most capital gain income of social clubs, fraternal and similar organizations and gains from "debt-financed property" of other exempt organizations, including churches.

Tax preference, etc. The long-term capital gain deduction of individuals and a percentage of the net long-term capital gains of corporations recognized in taxable years ending after 1969 also constitute items of tax preference subject to the new Sec. 56 minimum income tax on tax preferences. (See discussions under "Alternative tax rate increase," for both corporate and noncorporate taxpayers.) Still another reduction in the advantages connected with capital gain income will occur in 1972 when a new limitation on the deductibility of "excess investment interest" becomes effective.

Amended Sec. 163, in effect, can convert net long-term capital gains into ordinary income.

10. Impact imponderable

Some of the foregoing changes are retroactive in effect to years beginning in 1969, including calendar years. The full impact, however, may not be known for some time—not until all the interactions of the revisions are tested or experienced in the light of actual transactions under varying circumstances. Then all the resultant unintended benefits and undue hardships will become apparent. Nevertheless, it is quite obvious that traditional concepts of the taxation of capital gains have been significantly reformed.

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Stock redemptions

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Before the Tax Reform Act, corporations were generally able to redeem their stock by distributing appreciated property to shareholders without recognizing any taxable income upon the distribution. Sec. 311(a)[1] states that, except as otherwise provided, no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of its stock (or rights to acquire stock) or property.

Pre-Tax Reform Act exceptions[2]

Sec. 311 has always provided for recognition of gain on the following distributions:

- Sec. 311(a), a distribution of installment obligations;
- Sec. 311(b), a distribution of Lifo inventory; and
- Sec. 311(c), a distribution of property accompanied by a liability in excess of basis.

Further, the general nonrecognition rule of Sec. 311(a) has been inapplicable to a distribution of depreciable property because the recapture rules provided in Secs. 1245 and 1250 supersede Sec.

[1] All citations to Code sections are to the Internal Revenue Code of 1954, as amended by The Tax Reform Act of 1969, unless otherwise noted.

[2] The Tax Reform Act did not eliminate any of the existing exceptions to the nonrecognition rule.

311(a). Also, Sec. 47 has provided that an early disposition of investment credit property will result in the recapture of tax (rather than recognition of gain).

In addition, the regulations have carved out exceptions to the nonrecognition rule. Regs. Sec. 1.311-1(a) provides that under the rationale of *Court Holding Co.*,[3] gain will be recognized if in form the property was distributed to the shareholders and sold by them, but in substance the "distributed property" had been sold by the corporation. Furthermore, Regs. Sec. 1.311-1(e)(1) has specified that the nonrecognition rule does not apply to distributions made to a shareholder for reasons other than his holding of stock—e.g., because the shareholder was a creditor.

New exception for redemption distributions—background

The general rule of Sec. 311(a) has long been applicable to distributions in complete or partial liquidation[4] and to dividend distributions.[5] With the enactment of Sec. 311 as part of the 1954 Code and the adoption of the final regulations,[6] the general rule was made specifically applicable to redemption distributions. Although Sec. 311(a) itself is not as explicit, Regs. Sec. 1.311-1(a) expressly provides that the term "distributions with respect to its stock" includes distributions made in redemption of stock other than distributions in complete or partial liquidation.

Reason for new rule. Although many corporations have benefited by the ability to distribute appreciated property in redemption of their stock, the most extensive and dramatic use of Sec. 311(a) has been by insurance companies.[7] Many insurance companies have bought back their own stock through a general offering to

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[3] 324 US 331 (33 AFTR 593, 45-1 USTC ¶9215).

[4] Sec. 336. See also Regs. 103, Sec. 19.22(a)-21; Regs. 111-118, Sec. 29.22(a)-20.

[5] General Utilities & Operating Co., 296 US 200 (16 AFTR 1126, 36-1 USTC ¶9012).

[6] TD 6152, 1955-2 CB 61, 97. It is interesting to note that the proposed regulations under Sec. 1.311-1(a) did not include the nonliquidation redemption. See 19 Federal Register 8237, at 8246.

[7] *Forbes Magazine*, Nov. 1969, p. 52. For further discussion, see "Insurance Companies," John A. Bernauer, p. 291.

shareholders to exchange their stock for greatly appreciated securities carried in the investment portfolios. The Senate Finance Committee was disturbed by the fact that the insurance companies were eliminating the tax liability that would have arisen had the securities been sold and the cash proceeds been distributed to the redeeming shareholders.[8] Therefore, the Senate Finance Committee rather hastily conceived of an addition to Sec. 311–Sec. 311(d)–which would have subjected to tax the unrealized value of *any* property distributed in redemption of stock, other than in connection with a partial or complete liquidation. However, the Conference Committee[9] limited this new exception to the general rule in several respects, including the addition of transitional rules.

Limitations on new exception. Sec. 311(d)(2) sets forth "exceptions and limitations" to the "general exception" provided in Sec. 311(d)(1) to the "general nonrecognition rule." Thus, with respect to the distributions described in paragraph (2), the result is to cancel paragraph (1) and to reinstate the general rule of Sec. 311(a) that no gain or loss shall be recognized on the distribution of property with respect to the distributor's stock. To avoid confusion, the "exceptions and limitations" of Sec. 311(d)(2) will be referred to as "limitations."

New exception—Sec. 311(d)(1)

Sec. 311(d)(1) provides:

- If a corporation distributes property (other than an obligation of the distributing corporation) to a shareholder in redemption of part or all of his stock in the distributing corporation, and
- If the fair market value of such property exceeds its adjusted basis in the hands of the distributing corporation,

then gain shall be recognized to the distributing corporation in an amount equal to such excess "as if the property had been sold at the time of the distribution."

Example. A corporation holds Xerox stock worth $80 a share with a basis of $20 a share. A gain of $60 a share will be recognized to the

[8] S. Rep. No. 91-552 (11/21/69), p. 279.
[9] See note 8; H. Rep. (Conf.) No. 91-782 (12/21/69), p. 333.

corporation if it distributes the Xerox stock in redemption of shares of its own outstanding stock.

Corporation's own obligation. Sec. 311(d)(1) provides, in effect, that "property" does not include a corporation's own obligation. Thus a corporation may redeem shares of its stock with its own obligation (for example, a bond or a promissory note) without recognition of gain. If, however, the obligation is satisfied by a distribution of appreciated property under such circumstances as to indicate there was a "step transaction" designed to circumvent Sec. 311(d)(1), it is possible that the IRS would telescope the redemption and payment and treat the issuance of the obligation as a taxable transaction.

Of course, if the transactions were independent of each other, gain would be recognized at the time of the distribution of appreciated property in settlement of the obligation, under established tax law. Furthermore, loss would also be recognized on the independent redemption of obligations with property whose tax basis exceeds its fair value. This suggests that if property which has declined in value may be used to redeem stock, the corporation should issue its obligations first and thereafter, in an independent transaction, redeem the stock with the declined-in-value property. At this time there is no authority on this point, but it would seem that, absent a binding commitment to redeem the stock with the specific property and assuming the redeemed shares are not held by a controlling stockholder or related persons, the loss should be recognized.

Scope of new exception. Subject to the seven limitations provided in Sec. 311(d)(2)(A) through (G) described below, the new rule applies not only to the insurance companies at which it is aimed, but also to all corporations regardless of size or type of business. Further, the rule is not limited to a distribution of securities but applies regardless of the type of appreciated property distributed.[10] Moreover, Sec. 311(d)(1) prevails over Sec. 311(b) and (c), so that gain on distributions of appreciated Lifo inventory or property subject to a liability in excess of basis will be computed only under Sec. 311(d)(1).

Whether the corporation's gain is capital or ordinary would

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[10] See note 8.

depend upon the type of asset distributed and the period for which it was held. In addition, the recognized gain (less the related tax) will increase a corporation's earnings and profits under Sec. 312(d)(3), thus resulting in an additional ordinary dividend potential upon a later dividend distribution with respect to the remaining shares—even though the "gain" has been distributed in the redemption.

Losses still go unrecognized. Sec. 311(d)(1) provides only for gains to be recognized; losses are not affected. Accordingly, if both appreciated property and depreciated (in value) property are included in a redemption distribution, the gain on the appreciated property will be recognized but no loss will be allowed on the depreciated property.

> *Example.* A corporation distributes stock of Xerox worth $70 per share with a basis of $20 per share and Penn Central stock worth $6 per share with a basis of $56 per share. The corporation would be taxed on the $50 per share appreciation on the Xerox stock without benefit of the $50 per share loss on the Penn Central stock. However, the loss problem can be avoided by selling the depreciated property first and distributing the proceeds of the sale.

Valuation problems added. Sec. 311(d)(1) provides that the gain to be recognized is to be determined "as if the property distributed had been sold at the time of the distribution." Thus, all the normal but vexing problems of valuation have now been added to Sec. 311. For example, if the appreciated property distributed is a substantial block of listed stock, should a blockage discount factor be taken into consideration? Moreover, if the stock is not publicly traded or is stock of a new corporation with growth potential but little earnings, the problem becomes more aggravated.

Limitations on new exception—Sec. 311(d)(2)

There are seven limitations to the taxing rule of Sec. 311(d)(1), in the form of subparagraphs (A) through (G) in Sec. 311(d)(2). Since Sec. 311(d)(1) applies to the redemption of "part or all" of a shareholder's stock, these limitations are vitally important, as even a complete termination of a shareholder's interest may result in tax to the distributing corporation. These limitations will be discussed

in alphabetical order, which does not necessarily coincide with the order of general importance.

Termination of a 10%-stockholder's interest—limitation (A). Subparagraph (A) of Sec. 311(d)(2) provides for nonrecognition of gain on a distribution to a shareholder who has owned at least 10% in value of the corporation's outstanding stock at all times within the 12-month period ending on the date of the distribution—but only if the redemption completely terminates his interest under the rules of Sec. 302(b)(3), determined without the application of the ten-year limitation on reacquisition rule. Thus, in determining whether the redemption is a "complete termination," the usual Sec. 318 attribution-of-ownership rules apply.

However, for purposes of permitting the distribution of appreciated property without a tax to the corporation, if the shareholder retains no equity interest after the redemption and has no interest in the corporation as an officer, director or employee,[11] it is not necessary for the shareholder to avoid reacquisition of the corporation's stock within the ten years following the redemption, even though this would ordinarily be necessary to keep the family attribution rules from adversely affecting a complete termination under Sec. 302(b)(3). In other words, while the failure to comply with the ten-year rule could adversely affect the capital gain treatment of the redemption to the shareholder, it would not create a tax to the corporation. Conversely, while the stockholder may get capital gain treatment on a redemption under a provision other than Sec. 302(b)(3), only a complete termination of his interest—and then only if the shareholder holds at least a 10% interest in the corporation—will enable the corporation to avoid tax on the distribution.

Attribution rules—a two-way street? One interesting question which the regulations should clarify is whether the attribution rules can help the corporation as well as hurt it. We have seen that

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[11] Consideration must also be given to the problems created by rulings such as Rev. Rul. 70-104, 1970-10 IRB 9, which holds that a father's interest in a family corporation is not completely terminated within the meaning of Sec. 302(b)(3) where he enters into a long-term consultation contract with the redeeming corporation.

unless the redemption completely terminates both actual and constructive ownership of an interest of at least 10%, the corporation will be subject to tax. Since the attribution rules must be applied both before and after the redemption to determine whether the termination is complete, it would seem only fair to provide that the redemption of a 10% interest which arises solely by reason of the rules of attribution precludes gain from being recognized to the corporation.[12] This problem and a suggested position is illustrated in the following example:

Example. Father (*F*) and son (*S*) have owned 11% and 6%, respectively, of the stock of *X* for more than one year. The redemption of the stock of *only F* with appreciated property will result in a tax to *X* since it will not be a complete termination, because (under Sec. 302(b)(3) and Sec. 318(a)(1)) *F* constructively owns the 6% actually owned by S after the redemption.

If the shares of both *F* and *S* are redeemed, there clearly is no gain recognized with respect to *F* since there is a complete termination of a 10% interest. But what about S? It is submitted that since S constructively owns 17% of the stock of *X* before the redemption, the appreciated property distributed to him should not subject *X* to a tax.

Divisive transactions—limitations (B) and (C). Very specific exemptions are created for certain types of divisive transactions which might not otherwise be saved by qualifying under Sec. 355. They are set forth in subparagraphs (B) and (C) of Sec. 311 (d)(2).

Limitation (B). A corporation may make a tax-free disposition of appreciated stock or obligations of a subsidiary, if:

(i) The subsidiary is "engaged in at least one trade or business,"

(ii) The subsidiary has not received a "substantial part" of its assets from the distributing corporation within the five-year period ending on the date of the distribution in a transaction to which Sec. 351 applied or as a contribution to capital, and

(iii) The distributing corporation owned at least 50% "in value" of the outstanding stock of the subsidiary at any time within the

[12] For a contrary conclusion on this point see Goldman and Binder, "New Tax on Distributions of Appreciated Property May Have Wide Application," 32 *The Journal of Taxation* (May 1970), p. 264.

nine-year period ending one year before the date of the distribution. Note that the ownership of the requisite 50% stock interest may have been as long as ten years preceding the distribution.

Example. In 1950 corporation *X* owned 100% of corporation *Y*. On January 5, 1961, *X* sold 80% of the stock of *Y* to a third party. Prior to the enactment of Sec. 311(d), *X* distributed 10% of *Y's* stock to a shareholder in redemption of his interest in *X*. On December 30, 1970, *X* plans to distribute its remaining 10% of *Y's* stock to a shareholder in redemption of his interest in *X*. Requirement (iii) is satisfied; that is, within the nine-year period (January 5, 1961-December 30, 1969) ending one year before the date of distribution (December 30, 1970), *X* owned the requisite 50% of *Y* for four days. One can merely speculate as to the reason for this time period.

Limitation (C). As a comparison to the foregoing limitation, Sec. 311(d)(2)(C) permits a corporation to distribute, without recognizing gain, appreciated stock of another corporation "substantially all" the assets of which were held by the distributing corporation (or a member of the same affiliated group—apparently even including the corporation whose stock is distributed) on November 30, 1969, if:

- Such assets constitute a "trade or business which has been actively conducted" throughout the one-year period ending on the date of the distribution, and
- Such a distribution is made before November 30, 1974.

Example. On December 31, 1969, corporation *X* transferred substantially all of corporation *Y's* assets to *Y* in a transaction qualifying under Sec. 351. Such assets constituted "a trade or business" which had been "actively conducted" for the one-year period preceding the distribution. *X* may distribute the appreciated stock of *Y* prior to November 30, 1974, without being taxed under Sec. 311(d). Note that such a transfer is specifically prohibited by requirement (ii) in limitation (B) above, but it is permissible under limitation (C) which contains no requirement as to who must have actively conducted the trade or business for the one-year period preceding net distribution.

Problem. These exceptions for divisive distributions raise several problems which have defied simple solution elsewhere. For example, in limitation (B) above, it is essential to determine what consti-

tutes "a trade or business" and what percentage of a corporation's assets constitute a "substantial part." For the answer as to what is a trade or business, one can look to the administrative and judicial rulings under Secs. 165(c), 166(d), 355(b), 502(b), 864(b), 1091(a) and 1231(a).

Note that in limitation (C) unlike limitation (B), the trade or business must be *actively* conducted, thus bringing to bear the well-settled principles of the active business requirements of Sec. 355(b).

Also in limitation (B) is the phrase "substantially all," well known (for advance ruling purposes) as meaning at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets.[13] Since there are numerous court decisions to the effect that less than 90% constitutes "substantially all," and since it would appear that a "substantial part" is less than "substantially all," it will be interesting to see how the regulations define this new term.

Effect. The effect of these limitations for divisive transactions is to permit a distribution to be made without generating a tax to the corporation even though it might not qualify under Sec. 355. It is difficult to understand, therefore, why limitation (B) will not permit the distributed corporation to have acquired a substantial part of its assets pursuant to a Sec. 351 transfer in the five years preceding the distribution, whereas such an acquisition is permitted under Sec. 355(b)(2)(C), and even in limitation (C) of Sec. 311 (d)(2). It would be interesting to know whether this prohibited acquisition clause would also apply (as it appears it might, although for no apparently good reason) to the distribution of the stock of a subsidiary which acquires its assets as a result of a perfectly permissible Sec. 368(a)(2)(C) "drop down" following a Sec. 368 (a)(1)(A), (B) or (C) acquisition. Hopefully, this problem is avoidable by reasoning that the drop-down is controlled by Sec. 368(a)(2)(C) rather than by Sec. 351 and that, since limitation (B) specifically refers only to Sec. 351, it does not preclude the drop-down.

Similarly, it is difficult to understand why limitation (C) re-

[13] See Rev. Proc. 66-34, 1966-2 CB 1232, with respect to Secs. 354(b)(1)(A), 308(a)(1)(C) and 368(a)(2)(B)(i). The Reorganization Branch has similarly interpreted "substantially all" for purposes of Sec. 368(a)(2)(D).

quires that the pre-December 1, 1974 distribution must meet the more onerous test of an actively conducted trade or business, whereas the post-December 1, 1974 distribution set forth in limitation (B) need not.

Antitrust distributions—limitation (D). Subparagraph (D) of Sec. 311(d)(2) excepts from tax the distribution of appreciated stock or securities pursuant to an antitrust judgment to which the United States is a party, but only if such distribution is in "furtherance of the purposes of the judgment." This will require the interpretation of a judgment or consultation with the appropriate federal agency involved with the particular decree. Moreover, if the antitrust judgment happens to result from the rash of recent cases instituted by competitors or customers of major corporations to which the U.S. is not a party, then the distribution would not be protected by this exception.

Sec. 303 redemption—limitation (E). Subparagraph (E) of Sec. 311(d)(2) provides that a distribution of appreciated property will not generate a tax to the corporation to the extent that the redemption qualifies under Sec. 303 relating to the payment of death taxes and funeral and administration expenses. This will be quite helpful since it will eliminate the necessity—in a Sec. 303 redemption—of a shareholder's meeting the requirement of the complete termination of a 10%-shareholder's interest.

Private foundations—limitation (F). Subparagraph (F) of Sec. 311(d)(2) provides for the non-recognition of gain on a distribution of appreciated property made to a private foundation in redemption of stock constituting "excess business holdings" under new Sec. 537(b)(2)(A) and (B). Thus, even though the private foundation may have to loosen its control by reducing its "excess business holdings," it may receive highly appreciated assets in exchange, which, where practical, might be high income-producing assets. This would at least permit the foundation to continue to receive the income currently flowing from the business, even though the foundation has reduced its shareholdings in the corporation. This might, however, give rise to other problems, such as the tax on unrelated business income.

Regulated investment companies—limitation (G). Subparagraph (G) of Sec. 311(d)(2) exempts from tax distributions by regulated in-

vestment companies of appreciated portfolio holdings in redemption of their stock "if made upon the demand of the shareholder." Although this limitation would appear to be subject to abuse, most shares of such companies are usually redeemed for cash. However, the ability to redeem with portfolio investments, if needed, gives recognition to the role of a regulated investment company as a conduit for the investing public.

Limitations not specified in Sec. 311(d)(2)

Complete and partial liquidations. Distributions of appreciated property in complete or partial liquidation will not generate a tax to the corporation. The Senate Finance Committee makes it clear that the new rule is inapplicable to either transaction, so that Sec. 336 continues to prevent a tax to the corporation.[14]

While the partial liquidation may at first blush appear to be a handy means of avoiding recognition of gain on a redemption, meeting the definition of a partial liquidation can be a frustrating task unless the requirements of Sec. 346(b) can be met. Thus, the less than clear area of what constitutes a "genuine contraction of the corporate business" under Regs. Sec. 1.346-1(a) will have expanded vitality, particularly where the redemption is not a complete termination, or, even more importantly, where the distribution is to a less than 10%-shareholder.

Reorganization redemptions. The Conference Committee's Report[15] states that the recognition rule does not apply to "redemptions in a tax-free reorganization or split-off (Secs. 355 and 356)."[16] The specific reference to Sec. 355 does not clarify the problem relating to acquisitive reorganizations, but there should be no problem so long as there is a liquidation. In a "C" reorganization, for example, the "acquired" corporation transfers its assets to the "acquiring" corporation in exchange for stock which is then "distributed" to the shareholders of the "acquired" corporation *in exchange for* their stock of the "acquired" corporation. There should be no tax upon

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[14] See note 9.

[15] H. Rep. (Conf.) No. 91-782 (12/21/69), p. 333.

[16] There is no reason to believe that this reference to a split-off is exclusive since the citation to Sec. 355 would necessarily include split-ups and spin-offs as well.

the "distribution" of the "acquiring" corporation's stock in complete liquidation of the "acquired" corporation.

In a "C" reorganization in which the "acquired" corporation is not liquidated,[17] the quoted language would presumably still protect the distribution of the acquiring corporation's stock. However, this "distribution" is not really a distribution or a redemption but rather an exchange to which Sec. 354 (Part III of subchapter C) clearly applies, with the rules of Sec. 302 (Part I of subchapter C) having no relevance.[18] To interpret the Conference Committee's language as implying that the Sec. 354 exchange may also be treated as a redemption would be to infer an indirect amendment of Sec. 354 and the other provisions of subchapter C to which it relates, which obviously was not intended. One is left in a quandary as to what the Conference Committee meant, and can only hope that it does not give birth to another 304-351 controversy.[19]

Ordinary dividends. The Committee Reports state that the corporation will be taxed whether or not the redemption is classified as a dividend with respect to the shareholder.[20] However, an outright (ordinary) dividend distribution of appreciated property (one in which no shares are redeemed from a shareholder) should not generate a tax to the corporation; in fact, the IRS has already so held in at least one private ruling involving a sole individual shareholder.[21]

Effective date

Sec. 905(c) of the Tax Reform Act makes the recognition rule effective for distributions made after November 30, 1969, subject

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[17] See Rev. Rul. 68-358, 1968-2 CB 156.

[18] Note that Sec. 311(d)(1)(A) speaks of a redemption "to which subpart A applies," presumably of Part I of subchapter C; thus Sec. 311(d) could not apply to a Sec. 354 exchange which is in subpart B of Part III of subchapter C.

[19] See Stickney (Est. of Henry Mck. Haserot), CA-6, 399 F2d 828 (22 AFTR 2d 5502, 68-2 USTC ¶9551).

[20] See note 9.

[21] Consider, however, whether in an appropriate case the IRS might construe an ordinary dividend to be a redemption even though there was no formal surrender of stock, if such surrender would have been meaningless. See, e.g., Fowler Hosiery Co., 36 TC 201, aff'd., CA-7, 301 F2d 394 (9 AFTR2d 1252, 62-1 USTC ¶9407); *cf.* James Armour, Inc., 43 TC 295; Rev. Rul. 64-155, 1964-1 CB 138.

to exceptions for distributions made before April 1, 1970 made pursuant to certain irrevocable written contracts or offers in effect on November 30, 1969.

Also the new rule does not apply to distributions of specific property made after November 30, 1969 if:

- The redeemed stock was outstanding on that date,
- Every holder of such stock had the right on that date to demand redemption of his stock in such specific property, and
- The corporation had enough of such specific property on hand on that date to redeem all of such stock.

Subchapter C complexities compounded

The enactment of Sec. 311(d) will not detract from subchapter C's reputation as one of the most complex and interrelated sets of provisions within the Code. There has been incorporated into Sec. 311 (a heretofore relatively problem-free section) some of the more troublesome concepts of some of the other sections discussed above, thus creating new traps for the unwary. In addition, as is so often the case, hastily drawn statutory language, with little legislative history, produces numerous problems to be resolved in regulations.

It is clear that additional study is needed with respect to the effects of this new rule. Indeed the Conference Committee concluded its report on this section with the following candid statement:

> The Treasury Department and Congressional staff were requested to analyze this provision both from the standpoint of whether any tax avoidance possibilities still remain and also from the standpoint as to whether the changes made by this provision constitute hardships in any areas.

Avoidance possibilities and hardships aside, one can only hope that the problems of confusion highlighted above will be resolved in the regulations. One hopeful sign might be the statement on September 18, 1970 by Deputy Assistant Secretary of the Treasury John S. Nolan, that certain "minor proposals" on this subject will be suggested by the Administration as part of its 1971 tax legislative program.

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Stock dividends

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Newly amended Sec. 305 continues the same basic general rule regarding taxability of stock dividends as under prior law:[1] "Except as otherwise provided in this section, gross income does not include the amount of any distribution . . . made by such corporation to its shareholders with respect to its stock."

However, a number of sweeping new exceptions have been added to the statute. In practical effect, these additions almost completely alter the statutory treatment of stock dividends and drastically curtail the circumstances under which tax-free stock distributions may be made. With the reinstatement of the proportionate interest test, much of the pre-1954 Code approach returns to the forefront. Furthermore, the statute provides for constructive stock dividends, enabling the Treasury to visit current tax upon a shareholder who receives nothing in hand from the corporation. Hence, the risk of incurring a taxable stock dividend is ever present, particularly when more than one class of stock is outstanding or when convertible securities exist. The new rules apply to distributions made after January 10, 1969, subject to important transitional rules which delay the effective date until January 1, 1991 in certain instances.[2]

Pre-1954 background

The subject of stock dividends probably has contributed the most celebrated of all cases in the federal tax area, *Eisner* v. *Macom-*

[1] Provisions of the Internal Revenue Code will be simply cited as "Sec."; provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" means pre-Tax Reform Act law. "Amended law," "amended Sec." or "new Sec." refers to post-Tax Reform Act law.

[2] These rules will be discussed separately at the end of the article.

ber.[3] There, the U.S. Supreme Court in 1920 held (by five to four) that a pro rata distribution of common stock by a corporation having only common stock outstanding could not be constitutionally taxed as income to the shareholders. Following that case, there were a series of enactments and decisions from which developed numerous approaches, the most significant being the proportionate interest test. When applied, this judicial test rendered shareholders taxable if the stock dividend increased their proportionate interests in the corporation. But application of this test was complicated with the result that a climate of continuing uncertainty and conflict prevailed.

1954 Code until 1969

Congress sought to remove the uncertainty in enacting the 1954 Code. Original Sec. 305[4] expressly excluded from gross income all distributions by a corporation to shareholders of its own stock or rights to acquire that stock. Two exceptions were specified:

1. A distribution of stock or rights was taxable if it was payable, at any stockholder's election, in cash or other property instead of stock. This exception is similar to a provision contained in the 1939 Code.

2. A distribution paid in discharge of preference dividends for the current or immediately preceding year also was made subject to current tax.

At the same time, Sec. 307 was added to provide for allocating the basis of the old stock between the old and new stock in proportion to their respective fair market values. Furthermore, to prevent the preferred stock bail-out (generally, a device for obtaining capital gain through a distribution of preferred stock to common stockholders), "Sec. 306 stock" was created requiring ordinary income treatment upon the sale or redemption of such stock, with no immediate tax, however, at the time of distribution.

1969 amendments to regulations. After the decision to eliminate the proportionate interest test and permit corporations considerable latitude in making distributions of their own stock to shareholders, the IRS recognized that various methods had been developed under

[3] 252 US 189 (3 AFTR 3020, 1 USTC ¶ 32).

[4] Until the exceptions were radically revised in 1969, Sec. 305 remained as originally enacted.

which some shareholders of a corporation received cash dividends and other shareholders obtained a corresponding increase in their proportionate interests in the corporation. On January 10, 1969, the regulations under Sec. 305 were amended to broaden the statutory exceptions to the tax-free dividend rule.[5]

Based on the theory that the taxpayer had an election between cash and stock, tax-free treatment was denied when two classes of common stock were outstanding and cash dividends were paid on one class while stock dividends were paid on the other. In addition, under the preference-dividends exception, automatic periodic increases in the conversion ratio of one class of stock into another class were considered to be taxable distributions. The rationale was that the first class was a preferred stock and the increases in the conversion ratio were equivalent to distributions of taxable rights to acquire stock.

New law—in general

The regulations, however, did not reach "all of the arrangements by which cash dividends can be paid to some shareholders and other shareholders can be given corresponding increases in proportionate interest."[6] Also, some doubt existed as to the validity of the regulations. If the statutory exceptions were narrowly interpreted, most of the sweeping provisions contained in the regulations would undoubtedly fall.

Briefly stated, under amended Sec. 305 the elective distribution to take stock in lieu of money has been carried over in substantially the same form as under prior law, but the exception relating to distributions on preferred stock has been expanded considerably. All distributions (actual or constructive) with respect to preferred stock are taxable, whether or not related to a taxable dividend. On the other hand, a distribution of newly created preferred to common shareholders by a corporation having only one class of stock outstanding does not give rise to immediate tax. If the stock distributed is convertible preferred, however, the Commissioner must be satisfied that it does not produce a disproportionate distribution before nontaxability is attained.

Where there is a dual distribution on common stock, with some

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[5] TD 6990, 1969-1 CB 95.

[6] H. Rep. No. 91-413, Part 2 (8/4/69), p. 113.

common shareholders receiving common and others receiving preferred, the entire transaction is tainted with the result that all recipients are subject to current tax. Finally, a cash dividend paid to one group of shareholders, combined with an increase in the proportionate interests of other shareholders, subjects to tax those whose interests are increased, whether or not they actually receive stock. The return of the proportionate interest test gives the Treasury the statutory authority to tax various transactions which it previously sought to reach merely on the basis of the shareholder election exception.

As formally arranged in the statute, the new exceptions to the rule of nontaxability are contained in five separate categories. If a stock dividend is within one of these categories, it is treated as a distribution of property to which the dividend rules of Sec. 301 apply. This still leaves a measure of uncertainty as to the valuation of a constructive distribution when, for example, a shareholder's proportionate interest increases because the interests of other shareholders are diminished. Bearing these factors in mind, a description of each of the five taxable categories follows.

Elective distributions—exception 1

Amended Sec. 305(b)(1) continues the prior law exception which makes a stock dividend taxable where any shareholder is given an election to take the dividend in either:

- Stock or stock rights, or
- Cash or other property.

The underlying theory is essentially constructive receipt; that is, since the shareholder could have had cash, but avoided it by taking stock, he should be treated as if he had received the cash. In an attempt to bring as many types of transactions as possible into the taxable sphere, the 1969 amendments to the regulations broadly defined an election to include any express or implied choice regardless of how or when exercised or exercisable.[7] For example, the mere existence of two classes of common stock, one being entitled to dividends in stock and the other in cash, would be sufficient to tax the shareholder receiving the stock dividend under the 1969 regulations.

[7] Regs. Sec. 1.305-2(b)(1).

The foregoing position carried beyond the traditional and more accepted meaning of an election, i.e., one which is made at about the time of the distribution. In effect, the election arose not from the stockholder's current choice of payment, but by reason of his purchasing, inheriting, or otherwise acquiring one of the two classes of stock. However, any question with regard to the nature of an election may be only academic. The statute, now augmented by the proportionate interest test, provides a more suitable basis for taxing stock dividends to shareholders where two classes of common stock coexist. Furthermore, the 1969 regulations probably will never be litigated because, as is likely, their effective date will be advanced to coincide with the effective date of the new law.

Disproportionate distributions—exception 2

Although this exception is new to the 1954 Code, it actually reinstates an old concept which had been temporarily set aside by Congress in 1954. New Sec. 305(b)(2) now taxes a shareholder on an increase in his proportionate interest in the assets or earnings and profits of the corporation if a related cash dividend is paid to other shareholders. The degree of "relatedness" necessary to invoke the exception is not stated in the statute or committee reports. The only guidance is provided in the Technical Explanation of Treasury Tax Reform Proposals presented to the Ways and Means Committee on April 22, 1970 which referred to a 12-month time period unless the distributions are made pursuant to a single plan.

Clearly within this exception is the basic situation involving two classes of common stock—one paying regular cash dividends and the other paying regular stock dividends (either in common or preferred) equated to the cash dividends. The shareholder receiving the stock dividend would be subject to current tax under Sec. 301; his proportionate interest in the corporation increases while the other shareholders receive cash.

No actual distribution. Also, there are those situations where nothing is actually distributed, but a taxable dividend can nevertheless be imputed to the shareholder upon an increase in his proportionate interest in the corporation. Broad authority has been given the Treasury under new Sec. 305(c) to prescribe regulations under which various events could produce a constructive distribution, such as changes in conversion ratio or in redemption price,

differences between the redemption price and issue price, redemptions that are treated as Sec. 301 distributions, or any other transaction affecting the proportionate interest of a shareholder. For example, one such arrangement, not covered by the 1969 regulations, is the periodic redemption plan. Instead of declaring any dividends, the corporation under this plan offers to redeem a small percentage, such as 5%, of each shareholder's stock annually. Shareholders who wish to receive a cash return could accept the offer while those shareholders who do not choose to have their stock redeemed automatically increase their proportionate interest in the corporation. Since the distribution in redemption pursuant to a plan in these circumstances can be viewed as essentially equivalent to a dividend, the related increase in the proportionate interest of the non-redeeming shareholder would be treated as a taxable stock dividend.

Conceivably the broad language of Sec. 305(c) might permit the Treasury to extend taxable dividend treatment to continuing shareholders in a non-pro-rata spin-off or an "A" reorganization where some shareholders take stock and others cash. To a very limited degree, the Finance Committee recognized the breadth of the authority conferred with respect to stock redemptions. It stated that the constructive distribution rules are not intended to bring isolated redemptions within the disproportionate distribution exception.[8] As illustrated, this limitation would free a small stockholder from a constructive dividend in a case where the majority stockholder causes the corporation to redeem part of his stockholdings. However, the Treasury is not prevented from declaring a constructive distribution for the majority interests of a non-dividend-paying family corporation which periodically provides cash to employee stockholders by redeeming small portions of their holdings. The same threat of dividend treatment might apply in the case of large corporations which regularly redeem stock under various compensation plans. Situations of this nature (together with the difficulty of determining to what extent a related dividend exists) tend to favor adoption of a *de minimis* rule with respect to disproportionate distributions. Such a rule appeared in the Senate version of the bill, but was dropped by the Conference Committee before final enactment.[9]

[8] S. Rep. No. 91-552 (11/21/69), p. 153.
[9] H. Rep. (Conf.) No. 91-782 (12/21/69), p. 309.

Cash in lieu of fractional shares. A literal interpretation of the disproportionate distribution exception can produce a taxable stock dividend when a corporation having only one class outstanding distributes identical paper to its shareholders and pays cash in lieu of fractional shares. However, there is no indication that the amendments were intended to have this result. Furthermore, under prior IRS rulings, such transactions were treated as though the fractional shares were part of the tax-free stock dividend and then sold by the shareholders.[10] To avoid any confusion in this area, the IRS speedily adopted temporary regulations providing that the general rule of nontaxability will govern when cash is distributed in lieu of fractional shares, provided the purpose in distributing the cash is to save the corporation the trouble, expense, and inconvenience of issuing and transferring shares rather than to give a particular group of shareholders an increased interest in the corporation.[11]

Distributions of common and preferred on common stock—exception 3

If a distribution results in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, all the shareholders are subject to immediate tax thereon under new Sec. 305(b)(3). Under prior law, the common shareholder was not currently taxed. This was true even if he had an election as to the class of the distributing corporation's stock, since the term "property" (as defined in Sec. 317(a)) for purposes of Sec. 305 does not include stock in the corporation making the distribution.[12] However, Sec. 305(b)(3) now specifies that the receipt of additional common shares by certain common stockholders plus the receipt of preferred by others in effect constitute a disproportionate distribution.

Distributions on preferred stock—exception 4

All distributions (actual or constructive) with respect to preferred stock are taxable, except increases in the conversion ratio of

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[10] Rev. Rul. 69-15, 1969-1 CB 95 and Rev. Rul. 69-202, 1969-1 CB 95.

[11] Temporary Income Tax Regs., Tax Reform Act of 1969, Sec. 13.10 (TD7039, 5/1/70).

[12] But note that preferred stock received in such a case would possess an ordinary income potential upon later disposition as Sec. 306 stock.

convertible preferred stock made solely to take account of stock dividends or splits on stock into which the convertible stock can be converted. Amended Sec. 305(b)(4) expands its predecessor (Sec. 305(b)(1)), under which a stock dividend was taxable to the recipient only when paid in discharge of preference dividends for the current or immediately preceding year of the corporation. Under the new law, stock dividends on preferred stock, aside from the limited exception, are viewed as a substitute for cash dividends. Consequently, current tax will be imposed whether or not such distribution is related to a taxable dividend.

Sec. 305(b)(4), in conjunction with the new constructive distribution rules, will affect many of the techniques recently developed to give preferred (or what may be construed as preferred) shareholders the equivalent of nontaxable dividends. Thus, the provision covers the situation, set forth in the 1969 regulations,[13] where a corporation has a preferred stock paying no cash dividends but which is convertible into its common stock in a ratio that increases annually at a specified percentage. Even if his own stock is not convertible, a shareholder can have a taxable dividend imputed to him because of a decrease in the conversion ratio of other stock which is convertible into his stock. Another instance under which the constructive dividend rules are intended to apply involves the issuance of a non-dividend-paying preferred for $100 per share that is redeemable, for example, in 20 years at $200—essentially this would be viewed in the same manner as if the corporation distributed preferred stock equal to 5% of the original stock each year in lieu of cash dividends.

Effect on recapitalizations. It is significant that under prior law the limited taxability that applied to a stock distribution in discharge of the current or preceding year's preference dividends generally could be avoided by means of a *bona fide recapitalization.*[14] The corporation would be recapitalized with additional preferred (or common) stock issued in exchange for the dividend arrearages. This would be wholly tax free provided the recapitalization was not solely for the purpose of discharging such arrearages. However, now that taxation of stock dividends has been expanded,

[13] Regs. Sec. 1.305-3(b)(2), Example (2).
[14] See Regs. Sec. 1.368-2(e)(5).

the Finance Committee has indicated that this escape route is to be blocked to the extent that preferred shareholders are given stock in a recapitalization to satisfy dividend arrearages.[15] The Treasury can be expected to provide for such taxation pursuant to the regulatory authority it has been granted under Sec. 305(c).

That regulatory authority, of course, permits the Treasury to treat changes in proportionate interests growing out of various transactions as taxable stock distributions. The question as to how it might affect a closely held corporation which is recapitalized to provide younger family members or employees with a common stock interest and the older shareholders with preferred stock was raised during the Senate's discussion of the proposed legislation. At that time, Senator Long stated that, except for payment of dividend arrearages on preferred, there is no intent to alter the tax-free status of such a recapitalization.[16] Presumably, the Treasury will adhere to the Senator's approach in promulgating its regulations.

Distributions of convertible preferred stock—exception 5

If the stock distributed is convertible preferred stock, new Sec. 305(b)(5) promptly subjects the recipients to tax unless the Commissioner is satisfied that it will not result in a disproportionate distribution. A distribution of preferred with a convertible feature is treated as a potential non-pro-rata distribution of common stock.

Some guidelines as to the application of this provision appear in the form of two examples in the Finance Committee report.[17] In one example, a corporation makes a pro rata distribution to common stockholders of preferred stock convertible into the common at a price slightly higher than the market price of the common stock at the time of distribution and provides that the stock must be converted within four months. The conclusion is that the distribution would very likely have the effect of a disproportionate distribution; those stockholders wishing to increase their interests in the corporation would convert into common stock by the end of the four-month period, whereas those who opt for cash could sell their stock. In the second example, the facts are the same except that the stock is convertible for a period of 20 years from the date of issuance. Here,

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[15] S. Rep. No. 91-552 (11/21/69), p. 154.
[16] Cong. Record (12/9/69), p. S16122.
[17] S. Rep. No. 91-552 (11/21/69), p. 152.

it is likely that substantially all of the stock would be converted into common stock, leaving the proportionate interests of the common shareholders unchanged. Thus, the four-month convertible preferred stock would be considered a taxable distribution but the 20-year convertible preferred stock might not.

Convertible debt as common stock

With respect to distributions that result in increases in the proportionate interests of some shareholders and related cash dividends to others, the Finance Committee report expressly states that any security convertible into stock is to be treated as outstanding stock.[18] The report explains that "if a corporation has common stock and convertible debentures outstanding, and it pays interest on the convertible debentures and stock dividends on the common stock, there is a disproportionate distribution, and the stock dividends are to be taxable (under Sec. 301)." Presumably, to avoid taxation of the stock dividend, the corporation would be required in all instances to adjust the conversion price so as to cancel any increase in the proportionate interests of the common stockholders.

In effect, by treating debt securities convertible into common stock as the equivalent of common stock, any distribution which diminishes the rights of the convertible holders to dilute the common stock will be taxable to those whose proportionate interests are thereby increased. This approach may complicate the financing practices of many corporations, particularly new businesses, which frequently must tie an equity option to their debt securities in order to attract lenders and investors. Thus, the corporation might be constrained to provide antidilution protection to the lenders in all cases to preclude the taxation of common stock dividends. The effect, of course, is that the lenders benefit and the common shareholders are penalized.

Are securities which are convertible into common stock the equivalent of common stock in all instances? Witness, for example, the current stock market situation where the prices of many convertible securities are evidently not enhanced at all by their convertibility, but rather are determined on the basis of yield, maturity and quality. In such cases, the convertible debenture functions in the marketplace as a debt instrument with little likelihood of con-

[18] See note 17.

version. Accordingly, it could be argued in appropriate circumstances that a common stock dividend coupled with an interest payment on convertible debt should not be taxable to the common stockholders.

What remains tax free

The general rule of nontaxability under the 1954 Code has been eroded to such a degree by introduction of the new exceptions that almost every stock dividend will be subject to current tax. As a practical matter, it becomes necessary to determine which stock distributions still will be accorded tax-free treatment at time of distribution.

Only common stock outstanding. Clearly tax exempt, as it was in the past, is a common stock dividend paid to common stockholders by a corporation having only one class of stock outstanding—assuming no option to take stock or cash and assuming that anti-dilution protection is provided for holders of convertible debt, if any. Under such circumstances a common stock dividend merely gives the stockholder additional pieces of identical paper and therefore should not be considered taxable income under the Code, aside from any constitutional questions.[19]

The distribution of unlike stock by a corporation having only one class of stock outstanding at the time of distribution (and assuming the other circumstances mentioned in the preceding paragraph) will remain nontaxable.[20] For example, if a newly created preferred stock is distributed to common stockholders, no current tax would be imposed. The preferred stock may be convertible or nonconvertible. However, in the event it is convertible, the Commissioner must be satisfied that no disproportionate distribution results. The Finance Committee indicated that clearance should be given where the dividend stock is convertible over an extended period of 20 years from the date of issuance.[21] Further-

[19] See the discussion under "Pre-1954 background."

[20] The 1954 Code, through Sec. 305 before its 1969 amendment, specified that such a distribution was nontaxable. Prior to the 1954 Code, a dividend of unlike stock issued when only one class was outstanding was considered nontaxable. See Strassburger, 318 US 604 (30 AFTR 1087, 43-1 USTC ¶ 9363).

[21] See note 17.

more, whether convertible or not, the dividend shares would usually constitute Sec. 306 stock and thus represent ordinary income potential on a later disposition.

More than one class outstanding. When more than one class of stock is outstanding at the time of the stock dividend, a very limited area of nontaxability now exists. The Finance Committee report sets forth the only clearcut example where no immediate tax will occur in this situation—a pro rata common stock dividend to common stockholders at a time when there is also outstanding a class of nonconvertible preferred stock which pays cash dividends.[22] The distribution does not increase the proportionate interest of any shareholder; that is, the common stockholder, both before and after the event, owns all of the corporate assets in excess of the liquidating value of the preferred stock and continues to be entitled to corporate earnings and profits beyond cash dividends payable on the preferred. Under the statute, a shareholder's proportionate interest in the corporation is measured by reference to his interest in the assets or earnings and profits of the corporation.

If, in the preceding example, the preferred stock was convertible into the common, the common stock dividend payable to the common shareholders (related to a cash dividend on the preferred) would be taxable, assuming no antidilution protection for the preferred. The proportionate interest of the common shareholder is increased as the preferred shareholder's right to convert to common is diminished. This is precisely the same taxable treatment that applies when two classes of common are outstanding, one class receiving cash dividends and the other stock, because those receiving stock necessarily have their proportionate interests in the corporation increased.

Until the 1969 regulations were finalized, existence of more than one class of stock at the time of distribution did not directly affect taxation of stock dividends under the 1954 Code. However, before Congress acted to eliminate the proportionate interest test in 1954, a stock distribution in such circumstances was the most likely to produce a taxable result under the proportionate interest test then applicable.[23] Under the pre-1954 proportionate interest test, no related cash dividend was necessary. In addition, the meaning of

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[22] See note 17.

[23] But see Wiegand, CA-3, 194 F2d 479 (41 AFTR 721, 52-1 USTC ¶9199; and Tourtelot, CA-7, 189 F2d 167 (40 AFTR 668, 51-1 USTC ¶9319).

a proportionate interest was not solely limited to net assets or earnings and profits of the corporation, but could also include the shareholder's voting rights as well. Nevertheless, there was a tendency to regard dividends of common on common as tax free, despite the fact there was also preferred stock outstanding.[24]

In the event the dividend stock paid to the common shareholders was preferred stock, rather than common, at a time when there is also outstanding the same type of preferred paying regular cash dividends, the proportionate interests of the common shareholders automatically increase. But in given circumstances it would be unrealistic to regard the preferred stock dividend as a taxable distribution.

Example. A corporation with a net worth of $1,000,000 has $100,000 of preferred already outstanding. If it issues a $100,000 preferred stock dividend to the common shareholders, the technical change in their proportionate interests will have no practical significance unless the net worth of the corporation shrinks to less than $200,000. Unfortunately, in this and in other borderline cases it will be difficult to obtain a ruling before regulations are issued under the new law.[25]

Effective date and transitional rules

In general, the new law applies to distributions (actual or constructive) made after January 10, 1969. However, important transitional rules are contained in the new legislation to lessen its immediate impact to a considerable extent.[26]

Transitional rules for disproportionate distributions. The provision for taxation of disproportionate distributions will not affect stock distributions before January 1, 1991 if made with respect to:

1. Stock outstanding on January 10, 1969;
2. Stock issued under a contract binding on that date;
3. Additional stock of the class having the largest fair market value outstanding (normally common) at such date;
4. Preferred stock convertible into the type of stock described in (3); or

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[24] Mertens, *Law of Federal Income Taxation* (Mundelein, Illinois: Callaghan & Company, 1969 Revision), Vol. 1, Sec. 9.93.

[25] Rev. Proc. 70-5, IRB 1970-8, 32.

[26] Act Sec. 421(b) which, although dealing only with effective date and transitional rules, is more verbose than new Sec. 305 which contains the substantive rules.

5. Dividend stock previously issued within one of the four prior categories.

Further, if the dividend would not have been taxable under the 1969 regulations, then April 22, 1969 is substituted for January 10, 1969 as the effective date. Whichever is the pivotal date, it is the capital structure and dividend policy on that date which governs the tax results.

But the transitional relief for disproportionate distributions will be denied unless the stock as to which related cash dividends are paid also was outstanding on January 10, 1969 (or April 22, 1969). In addition, if such stock was outstanding for at least a year before the applicable general effective date, but had not been used prior to the effective date in a way which would give rise to tax under the new law, the corporation cannot begin to make disproportionate distributions after the effective date without the distributions becoming subject to tax. Most importantly, the transitional rules cease to apply if, at any time after October 9, 1969, the corporation issues stock (other than a distribution of the same class) which is not additional stock of the class having the largest fair market value of all classes outstanding on the general effective date, or is not preferred stock (either nonconvertible or convertible with antidilution protection). This still would permit the continued tax-free treatment of stock dividends where two classes of common stock existed on the critical date and the dividend is in stock of the largest of the two classes.

Transitional rules for dividends on preferred stock. January 1, 1991 also becomes the important date with respect to the provision for taxation of dividends on preferred stock (including any increase in the conversion ratio of convertible stock). That date would govern if the distribution is made pursuant to terms of the stock issuance which were in effect on January 10, 1969.

Overlapping situations. The new law provides no guidance in the event a dividend on preferred stock also falls within the disproportionate distribution rules. For example, this may occur if cash dividends are paid on common stock while preferred shareholders receive only periodic increases in the conversion ratio of their stock into the common stock. Presumably, in such case the preferred shareholder should be permitted to avail himself of the more favorable transitional rule.

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Antitrust violations

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With a stroke of his pen on December 30, 1969, President Nixon signed into law a measure which will have a far reaching impact on both individual and corporate taxpayers for many years to come. Public Law 91-172,[1] otherwise known as the Tax Reform Act of 1969, contains a number of very important and often controversial changes in the Code, many of which have been summarized or discussed in the pages of this publication.

One provision, dealing with the deductibility of treble damage payments under the antitrust laws, has been largely overlooked or ignored by the business community, although it will undoubtedly increase the cost of doing business on the part of many corporate taxpayers in future years. Somewhat surprisingly, the major formal opposition to the inclusion of this provision in the Reform Act came, not from organized business, but rather from the American Bar Association.[2] It is true, of course, that corporate taxpayers had other, and perhaps more important, problems to contend with in the course of the consideration of the Reform Act, but its addition of Sec. 162(g) to the Code (through Act Sec. 902) may prove to be a "sleeper" which deserves more attention than it has received to date.

Background

In order to understand what Congress did and why, some background is necessary. Until 1964 there was no official pronouncement,

[1] 91st Cong., 1st Sess., 1969; 83 Stat. 487.

[2] Statement of H. Francis DeLone, Hearings Before the Senate Finance Committee on Tax Reform Act of 1969, P.L. 91-172 (1969), Part 6, pp. 5278-5287.

either from the IRS or from the courts, dealing specifically with the deductibility of treble damage payments made pursuant to the provisions of Sec. 4 of the Clayton Act.[3]

Rev. Rul. 64-224. In 1964, however, largely as a result of the so-called "Philadelphia Electric cases," the IRS issued Rev. Rul. 64-224.[4] That ruling held:

- Treble damage payments to private litigants (and related legal expenses) were deductible as ordinary and necessary business expenses; and
- Payments to the United States under Sec. 4A of the Clayton Act,[5] and legal expenses incurred in an unsuccessful defense of an action brought by the United States under that section were not deductible.[6]

There is conflicting evidence as to whether the publication of this revenue ruling represented a change in policy on the part of the IRS, but in any event it provided an announced position for the guidance of taxpayers generally.

Reactions to Rev. Rul. 64-224. The publication of Rev. Rul. 64-224 caused an immediate furor among certain members of Congress who believed that the position taken by the IRS was erroneous. As a result, the staff of the Joint Committee on Internal Revenue Taxation was directed to make a study of the entire matter, and its report was issued on November 1, 1965.[7] After a full review and discussion of the subject, the Staff Study concluded that it could not be said that Rev. Rul. 64-224 was "wrong" or "improper," but suggested possible legislation to clarify the matter for the future. This suggested legislation in large part forms the basis for new Sec. 162(g).

As the Staff Study pointed out there were several arguments pro and con with respect to the validity of the position taken by the IRS

[3] U.S. Code, Vol. 15 (*Commerce and Trade*), Sec. 15.

[4] 1964-2 CB 52.

[5] U.S. Code, Vol. 15 (*Commerce and Trade*), Sec. 15a.

[6] The disallowance of a deduction for legal fees in these circumstances was later modified in Rev. Rul. 66-330, 1966-2 CB 44.

[7] Staff Study of Income Tax Treatment of Treble Damage Payments Under the Antitrust Laws for the Joint Committee on Internal Revenue Taxation, Committee Print (1965), (hereinafter referred to or cited as "Staff Study").

in Rev. Rul. 64-224. In the first place, there was the feeling on the part of some that the treble damage provisions of the antitrust laws were intended to be penal in character, rather than remedial, and that a deduction for penalties should not be allowed. The difficulty with this position was that there was no clear-cut judicial support for it, and even the legislative histories of both the Sherman Act and the Clayton Act were inconclusive on this point. Thus, while many could agree that there may well be an element of punishment involved in the treble damage provision, it was far from clear that this was the predominant purpose for which this provision was enacted. On the other hand, there were judicial decisions indicating that the purpose of similar statutes was remedial, but there was nothing directly in point, and with the legislative history as vague as it was, no definite conclusions could be drawn.[8]

The second major argument in opposition to the IRS position was that public policy dictated a contrary result. Thus, it was argued, the "sting" of the treble damage provision in the antitrust law would be substantially reduced by the allowance of a tax deduction for treble damage payments. Again, however, the difficulty was that there were no clear-cut judicial precedents for the denial of such a deduction. In fact, there was some authority to the contrary in the sense that somewhat similar deductions had been permitted by the courts,[9] and the Supreme Court had carefully limited denial of deductions on public policy grounds to cases involving items that were clearly fines or penalties, or expenditures to influence legislation, or bribes or kickbacks.[10] This reluctance on the part of the Supreme Court to widen the applicability of the public policy doctrine was even more vividly illustrated by its decision in *Tellier*,[11] which was decided after the Staff Study was completed. The *Tellier* case actually involved the allowance of a deduction for legal expenses in connection with an unsuccessful defense against a criminal prosecution (an action for fraud against a securities dealer). More important, however, was the clear enun-

[8] See, generally, Staff Study, pp. 2-6.

[9] See, e.g., Heininger, 320 US 467 (31 AFTR 783, 44-1 USTC ¶9109); Lilly, 343 US 90 (41 AFTR 591, 52-1 USTC ¶9231); Jerry Rossman Corp., CA-2, 175 F2d 711 (38 AFTR 112, 49-2 USTC ¶9333).

[10] Tank Truck Rentals, 356 US 30 (1 AFTR2d 1154, 58-1 USTC ¶9366); Textile Mills Securities Corp., 314 US 326 (27 AFTR 322, 41-2 USTC ¶9784); Cammarano, 358 US 498 (3 AFTR2d 697, 59-1 USTC ¶9262).

[11] Tellier, 383 US 687 (17 AFTR2d 633, 66-1 USTC ¶9319).

ciation by the Supreme Court in its opinion of a cautious and conservative approach to the public policy issue.

Hesitancy and uncertainty as to legislation. Finally, at least at the time the Staff Study of this matter was made, there appeared to be some hesitancy as to whether a solution should be sought as a matter of legislative policy. The Staff Study makes it clear that this was not an issue which either the Administration or congressional leaders were willing to stand up and say should be handled one way or the other.[12] If one word could describe the general consensus of prevailing opinion, that word would be "uncertainty." In the absence of a judicial determination on the point, no one could be certain of the outcome of litigation. No one knew for sure what result public policy dictated, and apart from a few concerned individuals such as Senator Hart, there was no one to champion a course of action one way or the other.

Nevertheless, there were congressional efforts to reverse the position of the IRS, illustrated by bills introduced by Senators Long and Hart and Congressman Celler, among others.[13] These suggested legislative solutions to the problems that were felt to exist in this area; such solutions were almost as varied as the problems themselves. Suffice it to say, however, that the course eventually adopted by Congress followed a fairly narrow path.

Tax Reform Act's solution. As introduced in the House of Representatives, H.R. 13270, which became the Reform Act, did not contain any provision with respect to the deductibility of treble damage payments. It was not until the bill reached the Senate Finance Committee that the subject arose. There, in executive session on October 15, 1969, the Finance Committee adopted an amendment to the bill which added the text of S. 2631,[14] a bill previously introduced by Senator Long. In a slightly revised version this ultimately became Sec. 162(g).

New Sec. 162(g) provides that if a taxpayer is convicted of an antitrust violation in a criminal proceeding, or if he pleads guilty

[12] See Staff Study, pp. 9-13.

[13] See, e.g., Senator Hart, 89th Cong., 2d Sess., 1965, S2479; Senator Long, 89th Cong., 2d Sess., 1965, S3650; Representative Celler, 89th Cong., 2d Sess., 1965, H.R. 12319; Senator Hart, 90th Cong., 1st Sess., 1967, S2804; Senator Long, 90th Cong., 2d Sess., 1968, S2963.

[14] 91st Cong., 1st Sess., 1969.

or *nolo contendere* in such a proceeding, then no deduction is allowed for two-thirds of any amount paid or incurred on a judgment for damages under the treble damage provisions of the Clayton Act on account of such violation or in settlement of any such action for damages.

Limitations on application. It is important to note two things. First, the disallowance applies only where there has been a prior conviction in a criminal proceeding (or plea of guilty or *nolo contendere*) in a related case. Thus, it is limited to the so-called "hard core" type of case. The Department of Justice, of course, brings a number of suits against violators of the antitrust laws each year, but only a small portion of those are criminal actions (as opposed to civil actions), and not all of the criminal actions result in convictions or guilty pleas. Thus, only those whose conduct is so flagrant as to warrant criminal prosecution and whose intent has been clearly proved so as to result in conviction of criminal action, will suffer the additional penalty of a disallowance of a portion of any treble damage payments that may be made to private litigants thereafter.[15]

Second, Sec. 162(g) disallows only two-thirds of the treble damage payments. The other one-third, i.e., the payment of actual damages, continues to be deductible. The rationale here, of course, is that such damages, even in a case which involves a criminal conviction, are an ordinary and necessary business expense, but that the additional amounts payable as a result of the trebling provision are in the nature of a penalty and should not be deductible.

Effective dates. When first considered by the Senate Finance Committee, the antitrust damages provision was to be applicable with respect to convictions or pleas after December 31, 1969. When finally reported by the Finance Committee, the effective date was still January 1, 1970—but with a proviso that the new law was not to apply to any conviction or plea on or after such date in a new trial following an appeal of a conviction before such date. There were several instances, notably in the area of plumbing supplies and drugs, where convictions had been obtained prior to January 1,

[15] This rationale may be somewhat strained in the instance where a defendant pleads *nolo contendere* ("no contest") but the same result is obviously required in such a case to prevent avoidance.

1970,[16] but appeals were pending. To avoid any possible implication that the new rules were applicable if such appeals were successful (as indeed turned out to be the case with the drug companies)[17] and a new trial was held which ultimately resulted in a conviction, this exception to the effective date was engrafted.

Even as it stands, however, the provision has a retroactive effect in the sense that it would deny a deduction for two-thirds of treble damage payments, where a conviction is obtained after January 1, 1970, made on account of a violation which occurred prior to such date. It has been suggested that such retroactive effect may be unconstitutional under the *ex post facto* provision.[18] Perhaps it was to avoid this very problem that the recommendation contained in the Staff Study had an effective date relating to antitrust *violations* after the date of enactment.

Related TRA provisions

A discussion of this subject would not be complete without pointing out that the Reform Act also made two other changes which, while not directly concerned with treble damages, nevertheless are related in terms of the legislative expression of public policy.

Statutory disallowance of fines. The first change, in new Sec. 162 (f), specifically disallows a deduction for any fine or similar penalty paid to a government for the violation of any law. This is, of course, nothing more than the legislative expression of the effect of Supreme Court decisions in similar situations. [19] Now, however, there can be no doubt about the matter.

Bribes and kickbacks. Secondly, the provisions of Sec. 162(c) were enlarged to disallow deductions for bribes or kickbacks to *any* government official or employee and for similar payments made to others if the taxpayer is convicted (or pleads guilty or *nolo contendere*) of making such an illegal payment. Previously, Sec. 162(c) had denied a deduction in the case of such payments to foreign of-

[16] American Radiator & Standard Sanitary Corp., DC, Pa., 5/2/69; Charles Pfizer & Co., Inc., DC, N.Y., 12/29/67.

[17] *Trade Cases,* Chicago, Ill. (Commerce Clearing House, 1970); ¶73,149.

[18] U.S. Const., Art. 1, Sec. 9.

[19] See, e.g., Tank Truck Rentals, note 10.

ficials, but the Reform Act broadened this category. Again, this seems merely to put into the statute what had been the rule laid down by the courts.[20]

Burden of proof requirements distinguished. However, it is certainly worth noting that there is a very definite difference in the burden of proof requirement in connection with the disallowance of deductions for bribes and kickbacks. Where the payment is made to a government official or employee (whether foreign or domestic) the burden of proof as to whether such a payment is in fact an illegal bribe or kickback is on the Secretary or his delegate (i.e., the Commissioner). In this respect the Commissioner has the affirmative obligation, as he does in fraud cases, to show that the payment in question is or would be illegal and, therefore, nondeductible.

On the other hand, with respect to alleged bribes or kickbacks to others, Sec. 162(c)(2) specifically requires that the taxpayer be convicted in a criminal proceeding of making a payment which is an illegal bribe or kickback or must plead guilty or *nolo contendere* to such a charge before any such payment can be disallowed. In this respect the test is essentially the same as that required in connection with the disallowance of treble damage payments.

Although there is obviously some similarity in the treatment of the deductibility of bribes and kickbacks, whether made to government officials or not, there is also dissimilarity in the requirements for disallowance and the burden of proof, differences that now reflect public policy decisions.

With respect to nongovernment officials and employees, all the Commissioner must show is that a taxpayer was convicted or pleaded guilty or *nolo contendere* to making payment of an illegal bribe or kickback. The standards for this, of course, will vary from state to state. On the other hand, where a government official or employee is involved, conviction in a criminal proceeding (or a plea of guilty or *nolo contendere*) is not required, but the Commissioner must show that such payment was in fact illegal. In the latter instance the Commissioner is, in effect, the prosecutor.

Summary

In summary, it can be said that those who wanted to see congressional intention clearly expressed in the areas of fines, bribes

[20] Boyle, Flagg & Seaman, Inc., 25 TC 43.

and kickbacks, and treble damage payments are no doubt gratified that these provisions were included in the Reform Act. At the same time, there are those who feel that the provision dealing with treble damages is still too narrow and should be broadened to deny deductions for treble damage payments even though a criminal conviction was not involved, and perhaps to deny a deduction for treble damage payments in their entirety. An effort by Senator Hart to accomplish just this objective was defeated on the floor of the Senate in the waning hours of debate on the Reform Act.[21]

Underlying this thought, however, is the idea that the tax laws should be used to accomplish socially desirable results in other areas. Thus, it is argued that the tax laws should deny a deduction for treble damages as an additional penalty for violators of the antitrust laws. Whatever the merits of this philosophy may be generally, there are many who would question its application to this specific situation. Certainly, however, the law that is now on the books in this respect will serve to increase the cost of at least some antitrust violations, and it behooves those concerned, or who might be concerned, to examine carefully any attempts to broaden this provision.

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[21] Cong. Rec., Vol. 115 (12/10/69), pp. S16375-S16379.

Excise tax: constructive sales price

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Among the last-minute additions to the Tax Reform Act of 1969 were provisions expanding the constructive sales price rules for the manufacturers excise tax.[1] Added by the Senate, new paragraphs (3) and (4) of Sec. 4216(b) cover the computation of constructive

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[1] The Tax Reform Act made several other changes in the excise tax laws. Another amendment added by the Senate provides that concrete mixers designed to be mounted on automobile truck, truck trailer or semi-trailer chassis are to be exempt from the manufacturers excise tax on motor vehicles. (Sec. 931 of the Tax Reform Act, adding Sec. 4061(a)(5).) This amendment in effect nullifies the Treasury position in Rev. Rul. 67-282, 1967-2 CB 363, that concrete mixers are taxable on the ground that their use on highways is more than incidental. The committee reports indicate that even where highway use is more than incidental, the tax is not intended to apply if highway transportation use is functionally incidental or subordinate to some nonhighway use—in this case, the mixing of concrete. Rev. Rul. 67-282 applied only to sales of concrete mixers made after June 30, 1968. The amendment, accordingly, applies only to sales after that date.

Also, the scheduled reductions in the present excise taxes on passenger automobiles and on communications services (local and toll telephone services and teletypewriter exchange service) have been postponed for one year. (Sec. 702 of the Act, amending Secs. 4061(a)(2)(A) and 6412(a)(1).) The present rates of 7% and 10%, respectively, are continued through the end of 1970.

Finally, it should be noted that the provisions of the Act dealing with private foundations are "excise" taxes. (Sec. 101(b) of the Act, adding Chapter 42 to the Code.) The Tax Court has been given jurisdiction over these excise taxes. (Sec. 101(f) of the Act, amending Secs. 6211, 6212 and 6213.)

sale prices for certain transfers of taxable goods among corporate members of an affiliated group. The amendment applies to articles sold after December 31, 1969.[2]

Background

The main articles subject to manufacturers excise taxes are passenger cars and trailers, trucks, buses, trailers and tractors, truck parts and accessories, tires and tubes, gasoline, lubricating oil, fishing equipment, and firearms.[3] The tax is generally paid by the manufacturer, producer or importer,[4] with liability being incurred at time of sale. The tax is included in or added to the sales price. It is imposed as a percentage of the manufacturer's selling price, as defined in Sec. 4216(a), at the point of distribution or sale.[5]

Why constructive prices?

The manufacturers' excise taxes are based on the price at which manufacturers sell at the wholesale level. One situation where competitive inequities arise is where a manufacturer sells at a level of distribution other than (or in addition to) the wholesale level. Without constructive sales prices, the excise tax would penalize the manufacturer who sells at the retail level and consequently charges a higher price because of increased expenses of distribution at retail.

A constructive sales price is also required for articles sold on consignment.

Third, and perhaps most obvious, a constructive price is justified when sales are not made at arm's length. Otherwise, a manufacturer might sell a taxable article to an affiliated entity below the price at which it would be sold to an unrelated distributor.

While much more has been written about Sec. 482, the income tax counterpart of Sec. 4216, the determination of a fair price for intercompany sales may be far more consequential in terms of excise tax liability than income tax liability. That is, more excise tax dollars than income tax dollars can be saved by reducing the sale price

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[2] Sec. 932 of the Tax Reform Act, adding Sec. 4216(b)(3) and (b)(4).

[3] These taxes are imposed under Chapter 32 of the Code; see Secs. 4061, 4071, 4081, 4091, 4161 and 4181.

[4] "Manufacturer," as used herein, includes "producer" and "importer."

[5] The question of price does not apply to some articles. For example, the gasoline tax is based on gallons and the tire and tube tax is based on weight.

of an article to an affiliated company. This would be obviously so when the affiliated manufacturer and distributor are domestic corporations in the same (48%) tax bracket.

Sales to retailers and at retail

General rule. Under the general rule provided in Sec. 4216(b)(1)(A), the constructive sales price of an article sold *at retail* is the lower of:

- The actual price for which the article is sold, or
- The highest price for which such articles are sold to wholesale distributors in the ordinary course of trade as determined by the Treasury. The constructive price may accordingly be set by the Treasury when this rule applies.

Special rule. A special rule is provided in Sec. 4216(b)(2) that covers sales *to retailers,* as well as sales *at retail* to consumers. Sec. 4216(b)(2) applies only if all four of the following conditions are met.

- The manufacturer regularly sells the article at retail or to retailers. This means that the special rule does not apply where the sales at retail or to retailers are merely casual sales.
- The manufacturer regularly sells the article to one or more wholesale distributors at arm's length, and at a price determined without regard to any possible tax benefit. This requirement provides a basis for actual computation of the constructive price. It suffices that the sales to wholesalers are to only one person so long as the sales are made regularly.
- If the articles are automobiles, trucks or similar items taxable under Sec. 4061(a), the normal method of sales within the industry[6] must be other than at retail or to retailers. This third limitation is intended to deny the use of the special rule where at least half of the volume of sales is made to retailers or at retail.
- The transaction is at arm's length.

The constructive sales price is determined with reference to the taxpayer's own prices where the special rule of Sec. 4216(b)(2) applies. The tax is based on the lesser of:

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[6] The term "industry" generally means the specific category of articles that embrace the article for which a constructive price is to be determined. Temp. Regs. Sec. 148.1-5(d)(3).

- The actual sales price of the article, or
- The highest price at which sales are made to wholesale distributors.[7]

Consignment sales

Sec. 4216(b)(1)(B) provides that if a manufacturer sells an article on consignment, the tax is based on the price for which the article is sold in the ordinary course of trade by manufacturers as determined by the Treasury. Costs of shipment from the manufacturer to the dealer are excluded from the tax base.[8]

Sales not at arm's length—pre-Tax Reform Act

What is arm's length? Where there is a special arrangement or relationship between the manufacturer and the purchaser, a sale will not be treated as at arm's length unless the price is based on fair market price. Occasions of this sort often happen where a related company makes a transfer at cost or at a price above cost, but for less than the full amount which an independent third party would be charged. Where the manufacturer sets up a sales affiliate and guides the sales through the new affiliate to the same ultimate purchasers, there is a strong presumption that because of the relationship between the companies the sales are not at arm's length.[9]

Prior statutory law. Prior to the Tax Reform Act, there was only one statutory way of computing tax on sales not at arm's length and for less than the fair market price. Sec. 4216(b)(1)(C) required the tax to be based on the price as determined by the Treasury, for which the articles were sold in the ordinary course of trade by manufacturers.

Under this rule, the constructive price is usually determined to be the wholesale price at which the person acquiring the article at less than arm's length resells it. This, in effect, ignores the price at which the article was sold to the selling affiliate by the manufacturer. Where the shareholders of the manufacturing company

[7] A wholesale distributor is one who customarily resells to others who in turn resell. Temp. Regs. Sec. 148.1-5(d)(1).

[8] Rev. Rul. 60-138, 1960-1 CB 500.

[9] Rev. Rul. 60-241, 1960-2 CB 323; Campana Corp., CA-7, 114 F2d 400 (25 AFTR 648, 40-2 USTC ¶9642).

formed a sister corporation to handle domestic sales, using the same office space and records and not bothering to prepare sales invoices, the Treasury held there were no actual sales to the sister corporation. The taxable event for purposes of the manufacturers excise tax, was deemed to have occurred when title to the article passed to the first independent distributor or jobber.[10]

Where the manufacturer has in the past made arm's-length sales to independent wholesalers, the constructive price under the "ordinary course of trade" test can be based on the manufacturer's own former price to others.[11]

Revenue Ruling. As indicated, prior to the Tax Reform Act, the Treasury was authorized to set the constructive price where the article was sold at less than arm's length. Pursuant to this power, the Treasury issued Rev. Rul. 62-68 (1962-1 CB 216). The ruling provides that on intercompany sales at less than arm's length and for less than fair market price, a manufacturer may elect to use a constructive sale price equal to 95% of the related distributor's lowest established resale price for the article to unrelated wholesale distributors. The 5% margin represents an allowance for certain exclusions and readjustments under Secs. 4216 and 6416.

If the manufacturer does not make this election, the constructive sale price is based on the actual selling price at which the article leaves the corporate family; in other words, the actual wholesale price to unrelated customers. If the sale is at retail, the constructive price is the lower of actual price or the highest price at which the selling company sells to wholesale distributors. In this event, the exclusions and readjustments of Secs. 4216(f) and 6416(b)(1) apply.

New statutory rules

The Act added two new rules for figuring the constructive sale price in less-than-arm's length situations. If both Rule 1 and Rule 2 apply, the fair market price shall be the lower of the two prices determined under the rules.

Rule 1. Sec. 4216(b)(3) applies only if all of the following considerations are satisfied:

[10] Rev. Rul. 59-163, 1959-1 CB 353.
[11] Rev. Rul. 59-74, 1959-1 CB 350.

• The manufacturer regularly sells the article to an "affiliated" distributor.

• The relationship between the manufacturer and the distributor must be that of members of an affiliated (consolidated) group of corporations as defined in Sec. 1504(a).

• The affiliated distributor regularly sells the article to one or more independent retailers.

• The affiliated distributor does not regularly sell to wholesale distributors.

Where all these conditions are met, the fair market price of the article shall be 90% of the lowest price for which the distributor regularly sells such articles in arm's length transactions to independent retailers.

A sales affiliate's lowest price to independent parties should be determined as if the price were in a taxable sale. For example, this price would be the net price after taking trade discounts into account. The sales affiliate need not make any given percentage of its sales at a particular price in order for these to be the lowest price, so long as they are bona fide. Where some sales include and some exclude the transportation charge, the lowest price would exclude the charge.[12]

Rule 2. The second rule, Sec. 4216(b)(4), applies only if all of the following conditions are satisfied:

• The manufacturer regularly sells (except for tax-free sales) *only* to an affiliated distributor.

• As in Rule 1, the relationship between the manufacturer and the distributor must be that of members of an affiliated (consolidated) group of corporations as defined in Sec. 1504(a).

• The affiliated distributor must regularly sell (except for tax-free sales) the article *only* to retailers.

• The normal method of selling within the industry is to sell the articles in arm's-length transactions to distributors.

Where all the conditions are met, the fair market price of the article shall be the price at which the article is sold to retailers by the distributor, reduced by a percentage of such price. The percentage is equal to the ratio of:

1. The difference between (a) the price for which comparable

[12] Senate Report No. 91-552, p. 294.

articles are sold to wholesale distributors in the ordinary course of trade by manufacturers and (b) the price at which such wholesale distributors in arm's-length transactions sell such comparable articles to retailers, to

2. The price at which such wholesale distributors in arm's-length transactions sell such comparable articles to retailers.

Examples. Rules 1 and 2 may be illustrated as follows:

Example 1. M manufacturer sells articles to related affiliated distributor *D* at $1.40 apiece. *D* regularly sells the articles only to retailers at $2.00 apiece. Comparable articles are sold by other manufacturers to wholesale distributors for $1.50 each, and resold to retailers for $2.00 apiece. Under *Rule 2, M*'s constructive sales price is $1.50, that is, $2.00 less 25% of $2.00. The 25% figure represents the percentage that $.50 (the difference between the $2.00 price of other distributors and the $1.50 price of other manufacturers) is of $2.00 (the sale price of other distributors).

Example 2. Continuing the above example, suppose other manufacturers begin to sell to wholesale distributors at $2.00, and the latter begin to resell at $2.20. *M's* and *D's* prices remain at $1.40 and $2.00 *M's* constructive sales price will rise to $1.8182. Such figure represents $2.00 less 9.09% (20/200).

Example 3. Suppose *Rule 1* also applied in the above illustrations. The price under *Rule 1* would be $1.80 (90% of $2.00) in both cases. Thus, in Example 1, *Rule 2* would apply ($1.50 being less than $1.80); in Example 2, *Rule 1* would apply.

Effect of new rules. The committee reports make it plain that no changes from present policy are contemplated by the new provisions. The 90% test of *Rule 1* follows prior holdings of the Treasury, where the manufacturer sells to a subsidiary at less than fair market price and the subsidiary resells the articles to independent retailers but does not regularly sell to wholesale distributors.

The reports say that *Rule 2* in effect allows a manufacturer to establish a fair market price on its products with an opportunity for the Treasury to comment on the adequacy of the determination under the guidelines set forth. The constructive price provisions of prior law will continue to apply in other situations, such as a sale by a manufacturer to an affiliate, which in turn regularly resells to independent wholesale distributors, as well as at retail.

The affiliated group requirement. Both *Rule 1* and *Rule 2* require that the manufacturer and the distributor be members of the same

affiliated group under Sec. 1504(a), that is, they would be includable in a consolidated income tax return if one were filed.

In appropriate situations, it may be possible to avoid the new rules. Both the manufacturing and the selling corporation must be "includable" corporations. But, according to Sec. 1504(b), foreign corporations, insurance companies, most exempt organizations, etc., are not includable in an affiliated group. Nor are sister corporations or unincorporated selling agencies.

In addition, the subsidiary of a corporation which is not includable is also excluded. Thus, the rules could be avoided by making the distributor, for example, the subsidiary of a foreign corporation. For this purpose, Canadian or Mexican corporations could apparently be used since they are considered nonincludable foreign corporations except under certain circumstances.[13]

Example. P corporation has two subsidiaries, *M* manufacturer and *F* foreign corporation. *P* forms S, a selling corporation, as a subsidiary of *F* to handle *M*'s product; *M* and *S* are not members of an affiliated group.

Effect of new provisions. The new rules, as noted above, are merely a codification and clarification of existing Treasury practices. They accordingly should have limited impact. Their estimated effect on the revenue is negligible.

Summary

Sec. 4216(b) now provides four rules for setting constructive prices. These rules may be generally summarized as follows:

- If the sale is at retail, on consignment or made at less than arm's length, the Treasury may set the constructive price. If the sale is at retail, the price will be the lower of actual price or highest wholesale price.
- If the sale is either at retail or to a retailer, the price will be the lower of the manufacturer's actual price or his highest wholesale price, provided the manufacturer regularly sells both to retailers (or at retail) and to wholesalers.
- In setting less-than-arm's length constructive prices, the price

[13] See Jack Crestol and Anthony P. Rua, *New Consolidated Return Rules* (Chicago: Commerce Clearing House) 1968 edition, p. 3.

will be 90% of the resale price to retailers on regular sales to an affiliate which regularly sells to retailers but not to wholesalers.

- Also for less-than-arm's-length sales, the constructive price will be geared to the markup by independent distributors if the manufacturer sells only to a related distributor which sells only to retailers.

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Financial institutions

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From the viewpoint of most financial institutions in the United States, "reform" in the Tax Reform Act of 1969[1] took the form of a substantially increased tax bite. Whereas other individuals and businesses may receive some benefits as well as incur some detriments as a result of the 1969 tax reform, the tax picture for most financial institutions is primarily one of gloom.

Increases in tax liabilities

Although, of course, the exact revenue impact upon financial institutions cannot be predicted, it appears that when the Reform Act is fully effective, taxes of commercial banks will be increased by $250 million per year as a result of the change in the computation of bad debt reserves and increased $50 million as a result of the change in treatment of gains on the sale of bonds.[2] It appears that the taxes of mutual savings banks will be increased by $35

[1] For brevity and clarity, provisions of the Internal Revenue Code will be simply cited as "Sec."; provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" means pre-Tax Reform Act law. "Amended law," "amended Sec." or "new Sec." refers to post-Tax Reform Act law.

The committee reports relating to the Tax Reform Act (P.L. 91-172) are cited as follows: H. Rep. No. 91-413, Part 1 (8/2/69) or Part 2 (8/4/69), refers to the House Ways and Means Committee Report; S. Rep. No. 91-552 (11/21/69) refers to the Senate Finance Committee Report; and H. Rep. (Conf.) No. 91-782 (12/21/69) refers to the Conference Committee Report.

[2] Based upon a table of revenue estimates appearing in S. Rep. No. 91-552 (11/21/69), p. 20.

million a year and the taxes of savings and loan associations will be increased by about $80 million per year as a result of changes in the computation of their bad debt reserves.[3]

Moreover, the new minimum tax, the repeal of the investment credit, the disallowance of extra depreciation, changes in treatment of capital gains, the elimination of the surtax exemption, and other changes in the 1969 Tax Reform Act affecting all taxpayers will have an unestimated tax impact on financial institutions.

Reserves for losses on loans of commercial banks

Under prior law, commercial banks were permitted, by administrative rulings, more generous bad debt reserves than most taxpayers. To protect banks against possible catastrophic losses, the Treasury Department in 1947 permitted banks to accumulate reserves not exceeding three times the moving average of their annual percentage loss during the last 20 years. This was modified in 1954 to allow banks to determine their average loss experience on the basis of any 20 consecutive years after 1927. In 1965, Rev. Rul. 65-92[4] granted commercial banks on an industry-wide basis the privilege of building up a bad debt reserve equal to 2.4% of outstanding loans not insured by the federal government. The 2.4% figure used for this purpose was roughly three times the annual rate of bad debt losses of commercial banks during the period 1928 to 1947.[5] Under Rev. Rul. 68-630[6] the IRS limited the loan base used for computing the allowable bad debt reserve to only those loans on which banks could suffer an economic loss.

The bill as originally passed by the House would generally have limited commercial banks to an addition to their reserves for losses on loans based on their own experience as indicated by losses for the current year and the five preceding years.[7] The Senate Finance

[3] For savings and loan associations the House-passed bill was expected to yield $125,000,000 per year when fully effective, based upon an addition to the reserve for losses on loans of 30%; the estimate for the Senate-passed bill was $40,000,000, based upon a 50% allowance. No revenue estimate was made in the Conference Committee Report, but a splitting of the difference yields about $80 million. S. Rep. No. 91-552 (11/21/69), p. 20.

[4] 1965-1 CB 112.

[5] See H. Rep. No. 91-413, Part 1 (8/2/69), p. 120.

[6] 1968-2 CB 84.

[7] See H. Rep. No. 91-413, Part 1 (8/2/69), p. 121.

Committee agreed with the general objective of curtailing the tax advantages that banks enjoyed in regard to their bad debt reserves, but believed it was undesirable to require banks to make such a large change—that is, from 2.4% of loans to an amount estimated at 0.2% of loans. Therefore the Senate Finance Committee recommended[8] and the Senate approved a provision allowing commercial banks to build up their reserves for losses on loans to 1.8% of eligible outstanding loans. Ultimately, the House version was adopted but it will not become fully effective until taxable years beginning after 1987—with a four-stage reduction in the percentage of outstanding loans for the transition period between 1969 and 1988.[9]

Under new Sec. 585(b), a bank is permitted to make additions to reserves for losses on loans for taxable years beginning before 1988 under either the "percentage method" or the "experience method," whichever results in a greater addition. For taxable years beginning after 1987, only the experience method may be used by commercial banks.[10] The amendments are applicable to taxable years beginning after July 11, 1969.

Percentage method. Under the percentage method provided by Sec. 585(b)(2), a bank[11] is permitted to bring its reserves for losses on loans up to the "allowable percentage" of eligible loans outstanding at the close of the taxable year. The allowable percentages for this purpose are as follows:

- For taxable years beginning before 1976—1.8%;
- For taxable years beginning after 1975 and before 1982—1.2%;
- For taxable years beginning after 1981—0.6%.

The percentage method is not available to banks for taxable years beginning after 1987. For convenience, each of the years in which

[8] S. Rep. No. 91-552 (11/21/69), p. 157.

[9] H. Rep. (Conf.) No. 91-782 (12/21/69), p. 310.

[10] For a discussion of the question whether mutual savings banks, etc., may use the percentage method after 1987, see the discussion under "Q reserve: percentage method."

[11] "Bank" is defined for this purpose in Sec. 585(a) to include any bank (as defined in Sec. 581) other than banks to which Sec. 593 applies; and any bank which would qualify under Sec. 581 except for its being a foreign corporation, but only with respect to loans the interest on which is effectively connected with the conduct of a banking business within the U.S. In general, Sec. 585 relates to commercial banks.

the allowable percentage is reduced is referred to in this article as "a percentage reduction year." Sec. 585(b)(2)(B) refers to a year immediately prior to a percentage reduction year as a "base year."

Most banks may be expected to have reserves at least equal to the allowable percentages during the transition from a base year into a percentage reduction year; for those banks that do not have reserves equal to the percentages, provision is made for filling up the reserves to the allowable maximum percentages. Under Sec. 585(b)(2)(A), however, only one-fifth of the dollar amount of the difference between the maximum allowable percentage and the actual bad debt reserves may be added in any single taxable year with respect to the difference.

Example. At the close of calendar year 1969, a bank has eligible loans outstanding of $1 million and a reserve for losses on loans of $13,000. Assume that during 1970 the eligible loans increase to $1,100,000 while $1,000 of bad debts are charged to the reserve. The tentative addition would be computed as follows:

Reserve balance allowable at the end of 1970 (1.8% × $1,100,000)		$19,800
Reserve balance before addition for 1970:		
Reserve 1/1/70	$13,000	
Less charge-offs	1,000	$12,000
Tentative addition		$ 7,800

However, of the tentative addition, $5,000 ($18,000 less $13,000) is attributable to the difference between the allowable percentage and the actual amount of the reserves at the end of 1969. Therefore, only one-fifth of such difference may be reflected in the increase for 1970. Thus, four-fifths of $5,000, or $4,000, must be subtracted from the tentative addition, leaving an addition of $3,800 for the year. This, in essence, allows 1.8% of the growth in eligible loans during the year, plus one-fifth of the base year difference, plus charge-offs during the year, computed as follows:

1.8% × $100,000 =	$1,800
1/5 of difference	1,000
Charge-offs	1,000
Deductible	3,800[12]

[12] If in a subsequent year there are declines in the eligible loans, the method of computation of the allowable addition is not clear. Whereas under Rev. Rul. 66-26, 1966-1 CB 41, the factors which make up the addition to the reserve are set out in order (in guideline (8)), no such guidance is contained in the new law—which is similar in some respects to the rules set out in Rev. Rul. 65-92 (note 5) as supplemented by Rev. Rul. 66-26.

In most situations banks will be at or above the allowable percentage going into a percentage reduction year. In such case, Sec. 585(b)(2)(B) generally permits the banks to claim an addition to the reserve to replace amounts charged off during the year. However, if the eligible loans outstanding at the taxable yearend are less than the loans outstanding at the close of the base year, the allowable addition is limited to an amount necessary to increase the balance of the bad debt reserve to an amount which bears the same ratio to eligible loans outstanding at the taxable yearend as (i) the reserve's balance at the close of the base year bears to (ii) the eligible loans outstanding at the close of the base year. If for some reason the taxpayer has been on the experience method rather than the percentage method, for purposes of this rule, the base year will be the last taxable year before the most recent adoption of the percentage method.

Example. At the close of 1969, the balance of a bank's reserve is $24,000 and the eligible loans outstanding are $1 million. The bank can maintain the reserve at $24,000 as long as its eligible loans equal or exceed $1 million. Thus, if it has charge-offs to the reserve of $2,000 during 1970, it may add $2,000 to the reserve—even though the reserve already exceeds the otherwise allowable maximum of $18,000 (allowable percentage of 1.8% × loans of $1 million).

However, if the amount of eligible loans declines to $950,000, the maximum allowable reserve is $22,800, computed as follows:

$$\frac{\$24{,}000 \text{ (reserve, 12/31/69)}}{\$100{,}000 \text{ (loans, 12/31/69)}} = 2.4\%$$

$$2.4\% \times \$950{,}000 \text{ (loans, 12/31/70)} = \$22{,}800$$

Therefore, if $2,000 is charged off to the reserve in 1970 (reducing the balance of the reserve to $22,000), only $800 can be added ($22,800–$22,000).

A further limitation under the percentage method is that the addition shall not exceed the greater of:

- 0.6% of eligible loans outstanding at the end of the year, or
- An amount sufficient to increase the reserve to 0.6% of such loans.

Experience method. The alternative method of computing the addition to the reserve for losses on loans of banks—and the only method for taxable years beginning after 1987—is the "experience method." This method, prescribed in Sec. 585(b)(3), is essentially the same as the method available to all taxpayers. It is based upon the Black

Motor Car formula, so called because it was first recognized by a court in the *Black Motor Co.* case.[13]

Under the general rule set forth in Sec. 525(b)(3)(A), a bank may bring its reserve at the close of the taxable year up to the moving average experience percentage of the loans outstanding at the close of the taxable year. The moving average experience percentage is that percentage which (i) the total bad debts sustained during the taxable year and the five preceding years bears to (ii) the sum of the loans outstanding at the close of each of the six years. With the approval of the Secretary or his delegate, a shorter period may be utilized. Presumably a shorter period would be allowed where the taxpayer was not in existence for the whole six-year period or where some material change occurred in the taxpayer's business. For this purpose, the total bad debts sustained during the period must be adjusted for recoveries of bad debts during the period.

This method appears to be almost identical to the "probable experience method" which was set out in Sec. 7 of Rev. Proc. 65-92[14] as an alternative to the industrywide 2.4% formula. Its application, and that of the Black Motor Car formula are very familiar to tax practitioners and do not require further comment here.

Under Sec. 585(b)(3)(B)(i), a bank is always free to bring the balance of its reserve back up to an amount equal to the balance at the close of its base year. For purposes of the experience method, the "base year" is the last taxable year before the most recent adoption of the experience method—not the year before each percentage reduction year. However, for taxable years beginning after 1987, the base year is the last taxable year beginning before 1988. The effect of these rules is to permit the taxpayer in any case to replenish the reserve for bad debts for amounts which were charged off through the reserve for bad debts.

If the amount of loans of the taxpayer declines after the base year, Sec. 585(b)(3)(B)(ii) limits the taxpayer's ability to fill up the reserve to equal the balance as of the base year. In such a case a bank can add only an amount to the reserve to bring it up to an amount which bears the same ratio to loans outstanding at the close of the taxable year as (i) the balance of the reserve at the close of

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[13] 41 BTA 300, aff'd CA-6, 125 F2d 977 (28 AFTR 1193, 42-1 USTC ¶9265).
[14] See note 4.

the base year bears to (ii) the amount of loans outstanding at the close of the base year.

Example. At the end of 1987 a calendar year bank, which has been on the percentage method, has loans outstanding of $1 million and a balance in the reserve losses on loans of $8,000 (0.8%). As long as the loan balance does not fall below $1 million at subsequent yearends, the bank can replenish the reserves for bad debts in order to maintain a balance of $8,000. However, if the loans outstanding decline, additions are limited to amounts necessary to restore the reserve to its former percentage. Thus, if loans decline to $900,000, additions cannot be made to increase the reserve above $7,200 (0.8% × $900,000).

Sec. 585(b)(4) empowers the Secretary or his authorized delegate to define the terms "loan" and "eligible loan" and to prescribe such regulations as may be necessary to carry out the purposes of new Sec. 585. However, it is specified that the term "eligible loan" shall not include certain types of loans—in general, the types of loans to which little or no risk of loss attaches (e.g., loans to or guaranteed by the U.S.). These loans are essentially the same loans which the IRS has carved out from the commercial bank bad debt formula in Rev. Rul. 68-630.[15] Thus, in effect, the law affirms the IRS's previous position and gives it flexibility to carve out other loans which it may find have little risk attached to them.

Losses on securities. Although Sec. 166 specifically states that a loan evidenced by a security as defined in Sec. 165(g)(2)(C) may not be claimed as a bad debt or considered in adding to a reserve for bad debts, Sec. 582(a) makes an exception in the case of banks. Formerly, a bank using the reserve method of computing bad debts could not consider such securities in its computation under Rev. Rul. 65-92.[16] However, under administrative rulings of the IRS, a separate reserve could be maintained for such securities.[17]

Under the new law, it appears that a bank utilizing the percentage method could not make any provision with respect to possible losses on such securities. This is because a loan evidenced by a security as defined in Sec. 165(g)(2)(C) is specifically excluded

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[15] See note 6.

[16] See note 4.

[17] Rev. Rul. 66-26, 1966-1 CB 41.

from the term "eligible loan" by Sec. 582(b)(4)(E). Further, it appears that when a bank elects the percentage method it is the exclusive method for computing the reserve for bad debts and no other reserve may be maintained.

It is not even clear that a bank would be able to maintain a reserve for losses on such securities under the experience method. Under the experience method, the base for computing the additions to the reserves for losses on loans is "loans outstanding" as opposed to the percentage method base which is "eligible loans outstanding." However, discretion is left with the Secretary or his delegate in Sec. 584(b)(4) in defining both "loan" and "eligible loan." It is only with respect to "eligible loan" that the Secretary does not have discretion to include "a loan evidenced by a security as defined in Sec. 165(g)(2)(C)."

It would appear desirable for the Secretary to promulgate regulations to include all evidences of indebtedness, including Sec. 165(g)(2)(C) type securities, in the base under the experience method. Such inclusion would not be detrimental to the Treasury because, even if the loss experience is very low, it will manifest itself in a lower percentage to be applied to the larger base.

At a minimum, it should be clarified that, if such evidences of indebtedness are not includable under either method, specific charge-offs may be claimed outside of the reserve. See guideline (10) of Rev. Rul. 66-26.[18]

Difficulty foreseen for new banks. Until 1988 new banks will be able to avail themselves of the percentage method, and thus build up a reserve of at least 0.6% of eligible loans. However, banks organized after 1987 may have some difficulty in claiming any additions to the reserve. They will no longer be able to use the percentage method, and initially they will not have sufficient experience of their own to establish a percentage under the experience method.

The House-passed bill had provided that new banks could, for the first ten years of their existence, establish bad debt reserves on the basis of any industrywide average for the six years preceding the taxable year.[19] The Senate deleted this provision, since the Senate version allowed all banks to maintain a 1.8% reserve indefinitely.[20] However, when the conferees reinstated the experience

[18] See note 17.
[19] See H. Rep. No. 91-413, Part 1 (8/2/69), p. 121.
[20] S. Rep. No. 91-552 (11/21/69), p. 157.

method as the exclusive method for taxable years beginning after 1987, they did not restore the experience-borrowing provision.[21]

In view of the legislative history, it is questionable whether the IRS could by either ruling or regulation allow for the borrowing of experience.[22] It would certainly appear desirable to permit some sort of borrowing of experience. It is true that taxpayers which are not financial institutions do not have this option, but reserves for bad debts of those taxpayers are generally not as vital to them as are reserves to banks.

Reserves for losses on loans of mutual savings banks, etc.

The Tax Reform Act also made significant changes in the computation of the bad debt reserves of mutual savings banks, domestic building and loan associations and co-operative banks.

Under Sec. 593, since 1963,[23] these institutions have been allowed to add to reserves for losses on loans the sum of the additions to two reserves—the reserve for losses on qualifying real property loans, and the reserve for losses on nonqualifying loans. (*Respectively, these reserves are hereafter referred to as the "Q reserve" and the "non-Q reserve."*)

The addition to the Q reserve could be calculated under one of three methods, whichever produced the largest amount, namely:

- The percentage of taxable income method, which allowed an addition equal to 60% of the taxable income of the institution, reduced by the addition to the non-Q reserve;
- The percentage of real property loans method, which allowed generally an addition equal to 3% of the increase in qualifying real property loans (as defined) during the year; and
- The experience method, which followed the general rules of Sec. 166(c), allowing the taxpayer an addition based upon his own experience.

Both the House Ways and Means Committee and the Senate

[21] Such a provision was provided for new small business investment companies in Sec. 586(b)(2).

[22] In Rev. Rul. 57-350, 1957-2 CB 144, banks were permitted to borrow the bad debt experience of other similar banks, preferably in the same locality.

[23] Sec. 593 was completely revised by the Revenue Act of 1962, P.L. 87-834, Sec. 6.

[24] S. Rep. No. 91-552 (11/21/69), p. 311.

Finance Committee agreed that the 3% of real property loans method was too generous in the case of many institutions.[24] This method was therefore eliminated. The 3% method had been utilized particularly by mutual savings banks which were able to increase their investments in qualifying real property loans by switching from nonqualifying assets to qualifying real property loans. Savings and loan associations were not able to do this to any significant extent because they were already fully invested in qualifying real property loans before the effective date of Sec. 593, as amended in 1962.

The 1969 bill as originally passed by the House reduced the allowable percentage under the percentage of taxable income method from 60% to 30% over a ten-year transition period. The Senate-passed bill would have reduced the percentage from 60% to 50% over a four-year period.[25] In conference a 40% figure was agreed upon with a ten-year transition period.[26]

The new provision continues the structure of former law in that amended Sec. 593 provides that an allowable addition to the reserve for bad debts of the described taxpayers shall be an amount equal to the sum of a reasonable addition to the non-Q reserve and a reasonable addition to the Q reserve. However, the computation of the addition to the non-Q reserve and the three alternative methods of computing the Q reserve are changed significantly.

Reserve for nonqualifying loans. Sec. 593(b)(1)(A) provides that the addition to the non-Q reserve will be computed in the same manner as is provided with respect to additions to reserves for losses on loans of banks under Sec. 585(b)(3)—see the "experience method" earlier in this article. Nonqualifying loans of course are all loans which are not "qualifying real property loans as defined in Sec. 593(e)." Qualifying real property loans are generally loans secured by an interest in improved real property or secured by an interest in real property which is to be improved out of the proceeds of the loan. No change was made by the Tax Reform Act in the definition of qualifying real property loans. However, as discussed below ("Eligible nonqualifying loans . . ."), the concept of qualifying real property loans may be of less importance under the new law.

25 See note 24 and H. Rep. No. 91-413, Part 1 (8/2/69), p. 126.
26 H. Rep. (Conf.) No. 91-782 (12/21/69), p. 311.

Reserve for qualifying real property loans. The addition to the reserve is the amount determined by the taxpayer to be a reasonable addition to the Q reserve, but not in excess of the largest of the amounts determined under three different methods. (However, see discussion on limitations below.) The three methods are "the percentage of taxable income method," "the percentage method," and the "experience method."

Q reserve: percentage of taxable income method. After a transition period of ten years, a fully qualified institution will be permitted to claim a deduction for an addition to the Q reserve in an amount equal to 40% of the taxable income for the year, reduced by the addition during the year to the non-Q reserve. Thus, in effect, for taxable years beginning after 1978, the sum of the additions to the two reserves generally may not exceed 40% of the taxable income for the year.

The allowable percentages for the transition years are as follows:

Year beginning in	*Applicable percentage*
1969	60%
1970	57%
1971	54%
1972	51%
1973	49%
1974	47%
1975	45%
1976	43%
1977	42%
1978	41%
1979 or thereafter	40%

Reduction in allowable percentage. A savings and loan association or co-operative bank is qualified to take the full percentage deduction (from 60% to 40%, depending upon the year in which its taxable year begins) providing 82% or more of its total assets are assets described in Sec. 7701(a)(19)(C), as amended. In general, that section provides that, in order to qualify as a domestic building and loan association, at least 60% of an association's assets must consist of residential real property loans, and certain described assets.[27]

[27] Sec. 7701(a)(19)(C), as amended by the Tax Reform Act, will be discussed more fully later in this article.

If less than 82% of the total assets of a savings and loan association consist of Sec. 7701(a)(19)(C) assets, the percentage by which taxable income is multiplied to obtain the allowable addition to the Q reserve during the year is decreased by three-quarters of one percentage point for each percentage point below 82%. Thus, if only 74% of an association's assets consisted of qualifying assets in a taxable year beginning in 1970, when the applicable percentage is 57%, it would be allowed a deduction of only 51% of taxable income (57% reduced by three-quarters of the excess of 82% over 74%).

The statute and committee reports are not clear as to what would happen if the percentage was not a whole number, e.g., 73.9%. It is possible that the answer is to take a proportion of the three-quarter percentage point, based upon the fraction of the whole percentage point. Thus, in the case of an institution which had 73.9% of its assets invested in qualifying assets there would be an extra reduction of one-tenth of three-quarters of 1%, for a total reduction of 6.075%. Other possible solutions are to require no reduction for any fraction of a percentage point (or for a fraction of less than one-half of 1%), or to require a full reduction or differences of each percentage point and *any* fraction thereof (or of fractions of one-half of 1% or more). Under these "full or nothing" approaches to fractional percentages of qualifying assets, the answer in the 73.9% example would be a 6% or 7% reduction, depending upon which approach is adopted.

A savings and loan association cannot use the percentage of taxable income method in any case where the percentage of assets consisting of qualifying assets falls below 60%.

In the case of mutual savings banks, the reduction in the applicable percentage commences only when the institution falls below 72% investment in qualifying assets, and in that case the reduction is 1½ percentage points for each percentage point below 72%. A mutual savings bank is not permitted to use the percentage of taxable income method when its percentage of investment in qualified assets falls below 50% for a taxable year beginning before 1973.

Reduced reduction for non-Q reserve. As stated above, a fully qualifying institution must reduce the addition to the Q reserve under the percentage of taxable income method by the amount of the addition to the non-Q reserve. However, where there is a reduction in the applicable percentage by reason of the fact that the

institution has less than 82% (72% in the case of mutual savings banks) of its assets invested in qualifying assets, only a portion of the addition to the non-Q reserve must be deducted from the addition to the Q reserve. That portion is equal to the percentage which 18% (28% in the case of mutual savings banks) bears to the percentage of assets of the taxpayer which are not qualifying assets under Sec. 7701(a)(19)(C).

Example. A calendar year S&L has tentative taxable income of $100,000 for 1979 and an allowable addition to its non-Q reserve of $1,000. If 82% or more of its assets consisted of qualifying assets it would be entitled to an addition to its Q reserve of $39,000, computed as follows:

Tentative taxable income	$100,000
Applicable percentage	40%
	$ 40,000
Reduction for non-Q reserve addition	1,000
Allowable addition to Q reserve	$ 39,000

If only 74% of its assets were qualifying assets, its additions would be limited to $33,308, computed as follows:

Tentative taxable income		$100,000
Applicable percentage:		
Unadjusted percentage	40%	
Reduced by: 82%		
74%		
8% × 3/4 =	6%	34%
		$ 34,000
Reduction for non-Q reserve addition:		
$\frac{18\%}{26\% \text{ (nonqualifying assets)}} \times \$1,000 =$		692
Allowable addition to Q reserve		$ 33,308

It should be noted that the addition to the non-Q reserve is reduced only for purposes of computing the addition to the Q reserve. Also note that the "qualifying assets" referred to are those which qualify under Sec. 7701(a)(19)(C), and that these are not the same as "qualifying real property loans" as defined in Sec. 593(e).

Computation of taxable income. Prior law and regulations thereunder provided for several adjustments to taxable income for purposes of determining the addition to the Q reserve under the per-

centage of taxable income method.[28] The Tax Reform Act provides several additional adjustments which are designed to make the percentage apply in general only to the income earned from the investments which give rise to the special bad debt deduction.[29] In addition, certain changes were made to eliminate items of income that were not otherwise fully taxable.

Thus, new Sec. 593(b)(2)(E)(iii) requires taxable income to be reduced by excluding net gains arising from the sale or exchange of stock of a corporation or of obligations the interest on which is excludable from gross income under Sec. 103. Accordingly, if an institution sells the stock of a private corporation or sells a municipal bond at a gain, the capital gain otherwise includable in gross income is not included for purposes of computing the addition to the Q reserve under the percentage of taxable income method.

As to other capital gains, however, under Sec. 593(b)(2)(E)(iv) only three-eighths[30] of the amount of the net long-term capital gain is excluded from the taxable income base for this purpose unless the total net long-term capital gain of the taxpayer is less than the net long-term capital gain from the sale or exchange of the other property. In such case three-eighths of the total net long-term gain is excluded. This might arise where the taxpayer had a loss on the sale of corporate stock or municipal bonds.

Example. Assume an S&L has the following categories of net long-term capital gains:

Sale of corporate stock and municipal bonds	$300
Sale of business (Sec. 1231) property	400
Total	$700

Under clause (iii) of Sec. 593(b)(2)(E) the S&L would reduce taxable income by the full amount of the $300 gain on the sale of the stocks and municipal bonds.

Under clause (iv) the S&L would exclude three-eighths of the $400 gain on the sale of Sec. 1231 property ($150).

If the sales of corporate stock and municipal bonds had resulted

[28] Sec. 593(b)(2) and Regs. Sec. 1.593-6(b)(2).

[29] See H. Rep. No. 91-413, Part 1 (8/2/69), p. 126.

[30] The "three-eighths" fraction comes about as a result of the preferential treatment given capital gains of corporations. The excess of the regular corporation rate of 48% over the alternative capital gains tax rate of 30% is 18%; and 18% is three-eighths of 48%. See S. Rep. No. 91-552 (11/21/69), p. 162.

in a net loss of $300, so that the total net long-term capital gain had been $100, then the S&L would only reduce taxable income by three-eighths of the total net long-term gain of $100, or $37.50.[31]

Exclusion of certain dividends. Under Sec. 593(b)(2)(E)(v), dividends eligible for the special dividends received deduction allowed corporations are excluded from the computation of taxable income for purposes of the percentage of taxable income method. However, to the extent that a portion of the dividends received deduction which the corporation is otherwise entitled to is disallowed by virtue of Sec. 596, the amount of the exclusion is to be reduced.[32] In effect, the taxpayer includes in taxable income only the disallowed portion of the dividends received deduction. This prevents a double penalty from occurring—once when the dividends received deduction is reduced under Sec. 596 and again when the taxable income is reduced under Sec. 593(b)(2)(E)(v). The portion of the dividend consisting of the allowed portion of the dividends received deduction and the 15% which is included in taxable income are excluded from taxable income for purposes of the percentage of taxable income method.

Q reserve: percentage method. One of the alternative methods available to savings and loan associations, mutual savings banks, and co-operative banks is the percentage method. Revised Sec. 593(b)(3) states that the additions under this method shall be computed in the same manner as is provided with respect to additions to the reserves for losses on loans of banks under Sec. 585 (b)(2), which is discussed earlier in this article, reduced by the addition to the non-Q reserve during the taxable year. It should be noted that under the percentage of real property loans method of prior law, no reduction was required for the addition to the non-Q reserve.

If read literally, Sec. 593(b)(3) in conjunction with Sec. 585(b) (2) would appear to allow to these institutions the indefinite use of the percentage method because nothing in Sec. 585(b)(2) indicates that it is not available after 1987. That limitation is found in Sec. 585(b)(1)(A). As indicated previously, the percentage gradually declines under Sec. 585(b)(2). However, the percentage

[31] These exclusions are, as previously indicated, only for purposes of determining the additions to the Q reserve.

[32] The limitation on the dividends received deduction is discussed on page 275.

never falls below 0.6%. One must read Sec. 585(b)(1)(A) to discover that the method is not available after 1987.

It is certainly possible to interpret the percentage method as being limited to the percentage method as applied to commercial banks in any given year. Thus, since it is not available to commercial banks after 1987, it can be reasoned that it is not available to the other institutions. The rule in Sec. 585(b)(1)(A) may be engrafted upon the rule in Sec. 585(b)(2) to achieve this interpretation. It is probable that the draftsmen of the statute intended this latter result.

Effect of prior reserves. In determining the addition to the reserve under the percentage method, the balances of all the reserves of the taxpayer must be considered—including the non-Q reserve, the Q reserve, and the supplemental reserve for losses on loans. The supplemental reserve for losses on loans was required to be established by Sec. 593(c), as added by the Revenue Act of 1962. All pre-1963 reserves which were not allocated to the Q and non-Q reserves were allocated to the supplemental reserve. It was thought at the time that supplemental reserves would not be used to prevent the fill-up of the reserve calculated under the 3% method. Now, although the 3% method is eliminated, the supplemental reserve balance will be utilized to diminish the addition to the Q reserve. The inclusion of the balance of the supplemental reserve will make the percentage method that much less likely to be used by many institutions.

"Eligible nonqualifying loans," and "ineligible qualifying loans." Several problems are raised under the new law as a result of the difference in definition between "eligible loans" and "qualifying real property loans" and in the difference between "ineligible loans" and "nonqualifying loans."

Although it cannot be certain until regulations are prescribed, it appears that certain loans which are not considered "qualifying real property loans" under Sec. 593(e) will be treated as "eligible loans" under Sec. 585(b)(4). Similarly, it appears that certain loans which meet the definition of "qualifying real property loans" will not fall within the meaning of "eligible loans."

Examples of what might be considered "eligible nonqualifying loans" include student loans not guaranteed or insured by the government, and unsecured commercial loans. They would certainly

not qualify as "qualifying real property loans," and yet they would appear to qualify as "eligible loans" because they have the inherent risk of ordinary loans. They are not of the type of loan which is carved out specifically in Sec. 585(b)(4).

Examples of what might be treated as "ineligible-qualifying real property loans" are FHA and VA insured real property loans. These are specifically excluded from the definition of "eligible loans" in Sec. 585(b)(4)(D).

As indicated previously in this article, the computation of the addition to the Q reserve under the percentage method is made in the same manner as is provided for commercial banks in Sec. 585 (b)(2). Under that section, the addition is based on a percentage of "eligible loans."

It is not clear from such wording whether S&Ls and mutual savings banks are:

1. To include eligible-nonqualifying loans and are to exclude ineligible-qualifying loans in the base for the percentage method, or
2. To apply the allowable percentage only to their qualifying real property loans.

If the second result is intended, the effect may be to give commercial banks a greater deduction with respect to nonqualifying loans than is given to S&Ls and mutual savings banks.

The Senate Finance Committee Report indicates that the former result is intended, stating:[33]

> The committee amendments also give savings and loan associations and mutual savings banks the option of computing their bad debt reserves on the basis of the commercial bank formula (1.8% of eligible outstanding loans plus their actual losses on ineligible loans), in lieu of the bad debt reserves outlined above. An institution may use either the percentage deduction method [percentage of taxable income method], or the commercial bank formula method in any year, but not both. In making this computation, the institution would apply the 1.8% to the eligible outstanding loans (using only those loans eligible for this formula), deduct the existing balance of the reserve, and the difference would be the addition that may be made to the reserve for that year.

It is possible that the parenthetic material "using only those loans eligible for this formula" has reference to "qualifying real property loans" rather than "eligible loans." However, if the loan base for

[33] S. Rep. No. 91-552 (11/21/69), p. 165.

the addition to the Q reserve is limited to Q loans, there appears to be no logic in subtracting the addition to the non-Q reserve from the addition to the Q reserve, as required in Sec. 593(b)(3).

Application of the percentage method to "eligible nonqualifying" loans can lead to strange results. Consider the following example.

Example. The facts are:

Increase in qualifying real property loans	$80,000
Increase in commercial loans	$20,000
Increase in loans evidenced by registered securities	$10,000

The amounts in the various categories of loans are computed as follows:

As to qualification	
Q loans	$ 80,000
Commercial loans	$ 20,000
Securities loans	10,000
Non-Q loans	$ 30,000

As to eligibility	
Q loans	$ 80,000
Commercial loans	20,000
Eligible loans	$100,000
Ineligible loans	$ 10,000

Assume for purposes of simplification that both the allowable percentage and the moving average experience percentage are 1%.

The addition to the non-Q reserve under Sec. 593(b)(1)(A) would be $300 ($30,000 × 1%). The addition to the Q reserve under Sec. 593(b)(3) would be $700 ($100,000 × 1% = $1,000 minus $300). The total addition would thus be only $1,000 whereas 1% of the total increase of $110,000 would have been $1,100. The difference comes about because the full amount of addition to the non-Q reserve (including the portion attributable to ineligible loans which were not in the base for the Q loan addition) is subtracted from the addition to the Q reserve.

Substituting more realistic percentages than 1%, assume the allowable percentage was 1.8% and the moving average experience percentage is 0.2%. In such case the $20,000 increase in commercial loans (eligible, but nonqualifying) would serve to increase the deduction by $360 (1.8% × $20,000), but the reduction for the addition to the non-Q reserve would decrease the addition to the reserve by only $40 (0.2% × $20,000).

Of course, similar problems come about because of the fact that certain qualifying real property loans are not considered eligible

loans. The effect may be to give no bad debt deduction at all with respect to FHA and VA insured loans. They are not included in the base for the purpose of the percentage method, so they are not added to the Q reserve; and they are not considered nonqualifying real property loans, so no addition is allowed to the non-Q reserve.

One way out of this dilemma would be to abandon altogether the concept of qualifying real property loans and nonqualifying loans in favor of eligible loans and ineligible loans. The 6% limitation of Sec. 593(b)(2)(D) would be based upon eligible loans rather than qualifying real property loans.

It is doubtful whether the IRS has authority to bring about the changes suggested. Whether Congress would consider making a technical change such as suggested remains to be seen. Probably, the question is of limited concern, since most institutions will be using the percentage of taxable income method, rather than the percentage method.

Q reserve: experience method. The third alternative method of computing the addition to the Q reserve is the experience method authorized by Sec. 593(b)(3). The calculations under this method are the same as under the experience method for commercial banks.

When is a loan worthless? In view of the fact that Regs. Sec. 1.595-1(e)(1) (relative to foreclosure on property securing loans) gives some discretion to S&Ls and mutual savings banks as to when loans can be charged off, the question may arise in calculating the moving average experience percentage as to exactly when a particular loan is worthless. Is the actual worthlessness or partial worthlessness to govern, or is the actual charge-off on the books to govern? Since Sec. 595 is fairly new (1963) and the experience method is relatively unused with respect to loans to which Sec. 595 applies, there has been little guidance provided under existing law.

This calculation may, however, be very important for institutions in computing the amount of their tax preference under new Sec. 57(a)(7) for purposes of the new minimum tax.

Limitations. As under former law, there are two limitations to the foregoing rules. One limitation, applicable only to the percentage of taxable income method, is that the addition to the Q reserve under that method cannot cause the reserve to exceed 6% of qualifying real property loans at the end of the taxable year.

Another limitation, which applies to all methods except the ex-

perience method, is that the additions cannot cause the sum of an institution's surplus, undivided profits, and reserves to exceed 12% of the total deposits or withdrawal accounts of depositors of the taxpayer at the close of the taxable year. This is a holdover from the pre-1963 law.

Immediate consideration required

Since most of the older S&Ls and mutual savings banks will have reserves exceeding the 1.8% of loans, it is likely that most will use the percentage of taxable income method for taxable years beginning after July 11, 1969. Two matters should therefore be considered immediately.

First, if the institution was on the 3% method and had been holding back in adding to reserves for any reason, it probably should claim (or have claimed) the largest reserve addition possible in calendar 1969 (or fiscal year beginning before July 12, 1969).[34] Any net operating losses thus generated may be carried forward for five years under Sec. 172. Of course, the loss should not be built up so much in 1969 that it is not likely to be used up in the succeeding five years. Building up the reserve in 1969 to the full 3% will not in itself reduce the deduction in 1970 and thereafter under the percentage of taxable income method, unless the institution is near the 12% limit.

Second, an institution should examine its asset position under Sec. 7701(a)(19)(C). If it is below the minimum amount (82% for S&Ls and cooperative banks, and 72% for mutual savings banks), it should compare the additional tax cost with any advantages in retaining nonqualifying assets; then, if warranted, it should plan to divest itself of those assets before the end of 1970 (or other fiscal year).

Until regulations are promulgated

Many questions which taxpayers and practitioners may have about the effect of the new law on the bad debt reserves of financial

[34] Regs. Sec. 1.593-5(b)(1) provides that the additions must be made by the close of the taxable year, or as soon as practicable thereafter. Generally, this would be by the time the tax return is filed. See Rio Grande Building and Loan Association, 36 TC 657.

institutions are answered in the statute itself, the committee reports, or, hopefully, in this article. Certainly this article has raised some questions which have not been answered. It is hoped that early regulations or interim rulings will provide the answers to these and other questions which will undoubtedly arise.

Presumably, wherever possible, the IRS will carry over existing rules. Thus, it is reasonable to assume, where applicable, that regulations pertaining to accounting for reserves, the 12% limitation, various definitions, and many other concepts will be retained. It may be expected that some of the concepts found in Rev. Ruls. 65-82, 66-26, and 68-30, discussed above, will be adopted in the forthcoming regulations.

Thus, although the Tax Reform Act made very substantial changes in the taxation of financial institutions, the old cases, regulations, and rulings may continue to be pertinent.

Many problems which existed before continue under the new law—perhaps even more acutely. For example, how are the reserves of two banks having different experience percentages handled upon a reorganization? For a general discussion of the problems involved, see *Federal Income Taxation of Banks and Financial Institutions.*[35]

Investment standards

Sec. 432(c) of the Act substantially revises the definition of "domestic building and loan association" in Code Sec. 7701(a)(19) and, by cross reference, the definition of "cooperative bank" in Sec. 7701(a)(32). This amendment also affects mutual savings banks because the addition to the bad debt reserve under Sec. 593(b)(2) (the percentage of taxable income method) is dependent upon the percentage of an institution's assets which consist of the assets listed in Sec. 7701(a)(19) as amended.

Under prior law, in order for an association to qualify as a "domestic building and loan association" it had to meet three tests for a taxable year. These tests are referred to in Regs. Sec. 301. 7701-13(a) as the

- Supervisory test,
- Business operations test, and
- Assets test.

[35] Banking Law Journal. *Federal Income Taxation of Banks and Financial Institutions* (Boston: Warren Gorham and Lamont, 1968).

The business operations test is in turn made up of two tests, and the assets test is made up of several assets tests. Although retaining all three tests, the new law has made substantial revisions in the business operations test and the assets test. These tests will be discussed individually below.

If an association (or a cooperative bank) fails to meet any of the tests, it will fail to qualify as a domestic building and loan association (or cooperative bank) and will not be entitled to compute the addition to the reserve for losses on loans under Sec. 593. (This would be true under both the pre-TRA and post-TRA law.) Presumably, if the institution met the definition of "bank" under Sec. 581, it would be taxed as a bank. Furthermore, even if an S&L does not meet the definition in Sec. 7701(a)(19) it will still be entitled to the deduction for dividends paid on deposits under Sec. 591 if it is "a savings institution chartered and supervised as a savings and loan or similar associaton under federal or state law."

The significance of Sec. 7701(a)(19) under former law was that if an association failed to meet any of the tests it was not entitled to the special bad debt deduction provided in Sec. 593. The old Sec. 7701(a)(19) had no applicability to mutual savings banks. However, the section has additional significance under the new law. To the extent that the assets of a mutual savings bank, a cooperative bank, or a domestic building and loan association consist of less than 82% (72% for mutual savings banks) of the assets described in Sec. 7701(a)(19)(C), the addition to the bad debt reserves under the percentage of taxable income method is reduced.

The changes to Sec. 7701(a)(19) and (32) are effective for taxable years beginning after July 11, 1969.[36]

Supervisory test. The supervisory test in new Sec. 7701(a)(19)(A) is unchanged from the old law. This test provides that the association must be either an institution insured by the Federal Savings and Loan Insurance Corporation or subject by law to supervision and examination by the state or federal authority having supervision over domestic building and loan associations.

Business operations test. In order to qualify as a domestic building and loan association under former law,[37] *substantially all* of an

[36] Act Sec. 432(e).
[37] Sec. 7701(a)(19)(B).

association's business had to consist of acquiring the savings of the public and investing in loans. Under the new law the business must consist *principally* of acquiring the savings of the public and investing in loans.

As pointed out by the regulations under former law:[38]

> An association must utilize its assets so that substantially all of its business consists of acquiring the savings of the public and investing in the [described loans]. . . . Even though an association meets the supervisory test . . . and all the assets tests . . . , it will nevertheless not qualify as a domestic building and loan association if any substantial part of its business consists of activities which are not directly and primarily related to such acquisition and investment, such as brokering mortgage paper, selling insurance, or subdividing real estate.

The regulations provide a series of tests to determine whether the institution is engaged in the qualifying activities. There is an "acquiring the savings of the public test" which restricts deposits by family or related business groups or persons who are officers or directors of the association to 15% of the dollar amount of total deposits. There is a "gross income test" in which unrelated income is limited to 15% of the gross income of the association. And there is a "sales activity test" in which the sales of loans and participations are limited, in general, to 15% of the loans acquired during the taxable year.

These rules were promulgated by the Treasury Department to insure that only bona fide associations were entitled to the favorable bad debt deductions allowed by the law. They were made rather strict, partly in reaction to cases such as *Perpetual Building and Loan Association,*[39] to prevent such situations from continuing.

The new amendment to the business operations test appears only to affect the test quantitatively, in that it reduces the required proportion of business from "substantially all" to "principally." That is certainly a substantial liberalization. The regulations have de-

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[38] Regs. Sec. 301.7701-13(c)(1).

[39] Perpetual Building and Loan Association of Columbia, 34 TC 694, aff'd CA-4, 291 F2d 831 (8 AFTR 2d 5045, 61-2 USTC ¶9548). The Court found that regardless of what name it may have or how it may be designated or classified under state law, the organization was not a domestic building and loan association, but rather acted to a large extent as an alter ego of its controlling shareholders.

fined "substantially all," in general, to be 85%.[40] It would appear that use of the word "principally" would permit a reduction of the percentage (if it is in fact stated as a percentage) to somewhere in the vicinity of 50% or 60%. Since the percentage of an association's assets required to consist of the specified assets was reduced in Sec. 7701(a)(19)(C) from 90% to 60%, it appears reasonable that, if the regulations do in fact provide a set percentage, the percentage would be no higher than 60%, to be symmetrical with the assets test. It is also possible the IRS will provide different percentages for different aspects of the business operations test. There is no guidance on this point, however, in the committee reports.

Although the Act made only a quantitative change in the business operations test, it is by no means clear that the regulations to be promulgated will be limited to a mere reduction in the quantitative percentages. It could be that the sentiment in the Treasury Department will be toward not requiring a restriction on certain activities, such as the sale of loans and participations. Although the goal of the Treasury Department in promulgating the old regulations—that is, to restrict the favorable bad debt deductions to bona fide institutions—was praiseworthy, it is not clear that the restriction of bona fide savings and loan associations in the sale of loans and in the realization of unrelated income is a desirable thing. It is understood that those tests have been a real burden to some institutions which, by no stretch of the imagination, could be characterized as "mortgage brokers."

It is hoped that the Treasury Department will reconsider the types of activities which will disqualify an institution under the business operation test as well as the quantitative percentages. Thus, possibly the Treasury would consider sales of loans and participations as "good" activities and eliminate the test altogether.

Assets tests. Under former law, there were four partially overlapping assets tests, namely:

- More than 90% of an association's assets were required to consist of real property loans, certain liquid assets and property used in the association's business.[41]
- No more than 18% of an association's assets could consist of

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[40] Regs. Sec. 301.7701-13(c)(2), (3)(ii), and 3(iv)(a).
[41] Sec. 7701(a)(19)(C).

nonresidential real property loans and other assets not qualifying for the first test.[42]

- No more than 36% of an association's assets could consist of apartment loans, nonresidential real property loans, and other assets not described in the first test.[43]
- No more than 3% of an association's assets could consist of stock.[44]

Under the new law, in Sec. 7701(a)(19)(C), the assets tests are reduced to one test, namely that at least 60% of the amount of the total assets of an institution must consist of ten specified types of assets, each of which is discussed individually below.

The thrust of the new assets test is that, in addition to reducing the basic test from 90% to 60%, the Code now:

- Allows substantially more assets to be considered as qualifying assets.
- Eliminates the distinction between apartment loans and other residential real property loans.
- Eliminates the prohibition against ownership of more than 3% of its assets in stock.

The only assets which are treated less favorably under the new law (Sec. 7701(a)(19)(C)(ii)) than under the old law are obligations the interest on which is excludable from gross income under Sec. 103—that is, principally municipal bonds.

The regulations under the old law contained rather detailed definitions of some of the terms used in the assets tests and provided rather detailed rules for the computation of the percentages involved. It would appear that many of those rules will be adaptable to the new law. For example, many of the terms used in the new statute are the same as the terms used in the old statute. Some of the rules for determining the amount and character of loans still seem pertinent. Some of the rules for the computation of percentages may also be relevant. It is likely that similar reporting requirements will be retained. Therefore, taxpayers and their advisers should be able to follow the existing regulations to the extent there has clearly been no change in the relevant Code provisions.

It is specifically provided in the new law that loans made to

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[42] Sec. 7701(a)(19)(E).

[43] See note 42.

[44] Sec. 7701(a)(19)(F).

finance the acquisition or development of land shall qualify if, under the regulations to be prescribed, there is reasonable assurance that the property will be residential real property within three years and within such period that land does become residential real property.

The ten specific qualifying items of property are discussed below:

1. *Cash.* Presumably the existing regulations and interpretative rules applicable to former law will apply.

2. *Governmental obligations.* Current regulations and rulings should govern the interpretation of this category, except that tax exempt obligations are no longer included.

3. *Deposit insurance company securities.* Existing regulations and interpretative rules should continue to govern.

4. *Passbook loans.* Existing regulations and interpretative rules should continue to govern.

5. *Residential real property and church loans.* This category includes regular loans and construction loans for residential real property and church property. It also includes loans for facilities and residential developments dedicated to public use (e.g., schools and libraries), for property used on a nonprofit basis by residents (e.g., swimming pools and playgrounds) and for mobile homes not used on a transient basis. Presumably guidelines will be issued to aid in the determination of when a mobile home is "not used on a transient basis."

6. *Urban renewal loans.* These include loans secured by an interest in, or for the improvement of, commercial or residential property in an approved urban renewal area or in an area eligible for assistance under the Demonstration Cities and Metropolitan Development Act of 1966. As long as the program is an approved program and is predominantly for residential use, all real property loans are qualifying, including commercial loans.

7. *"HEW" loans.* This class includes loans secured by an interest in health, educational, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities. This descripton of loans, found in subdivision (vii) of Sec. 7701(a)(19)(C), appears

to be ambiguous in certain respects. It is not clear whether the word "including" is used as a word of limitation or a word of explanation. Thus, it is not clear whether the institutions or facilities referred to *must* include structures designed or used primarily for residential purposes, or whether such institutions or facilities *may* include such structures. A literal interpretation of the language in the statute would appear to require the latter interpretation—that is, that all loans secured by an interest in educational, etc., institutions or facilities qualify, including loans on residential facilities and all other facilities of the institution. It is hoped that the forthcoming regulations will clarify this point.

8. *Foreclosure property.* This item covers property acquired at foreclosure or as a result of other means of liquidation of defaulted qualifying loans.

9. *Student loans.* This category includes loans made for the payment of expenses of college or university education or vocational training, in accordance with regulations to be prescribed. No indication is given in the committee reports as to the type of limitations, if any, the regulations may impose.

10. *Business property.* This refers to property used by the association in the conduct of its business. Presumably existing rules will be of some guidance in interpreting this category of property.

Dividends received deduction

Under former law, S & Ls, mutual savings banks, and cooperative banks were entitled to the same dividends received deduction to which other taxpayers were entitled (principally, the 85% dividends received deduction). This fact, combined with the 60% of taxable income bad debt deduction, led Congress to believe that some taxpayers may have been claiming a double deduction—that is, a deduction for 85% of dividends received and a bad debt deduction of 60% of such dividends. Thus, it was feared that on $100 of dividend income an organization might be receiving a dividends received deduction of $85 and a bad debt reserve addition of $60—or a total deduction of $145 on account of $100 of income.

However, Regs. Sec. 1.593-6(b)(2) and (g), Example (1), under former law clearly indicates that taxable income must be reduced by the dividends received deduction in computing the base

against which the 60% may be applied. Therefore, no double deduction should have resulted under former law.

It appears that Congress, when it enacted the 1969 Tax Reform Act, was either not familiar with this provision or questioned the validity of the regulation. In the Senate Finance Committee Report, S. Rep. 91-552 (11-21-69), it is stated on page 163, "Under present law the income on which the 60% . . . deduction is computed includes . . . dividend income qualifying for the intercorporate dividends received deduction."

To eliminate this possible "loophole," new Sec. 596[45] limits the dividends received deduction in the case of organizations which are computing the reserve for losses on loans under the percentage of taxable income method provided by Sec. 593(b)(2). Sec. 596 requires that dividends received deductions under Secs. 243, 244, and 245 be reduced by the applicable percentage for such year under subparagraph (A) or (B) of Sec. 593(b)(2).

Example. If an organization receives $100 of dividends and the applicable percentage of taxable income under Sec. 593(b)(2) is 40%, the dividends received deduction will have to be reduced by 40% of the deduction. Therefore, if $100 of dividends is received, the 85% dividends received deduction of $85 will have to be reduced by 40% thereof, or $34. Thus, only $51 ($85 less $34) will be excluded and $49 will be included in taxable income.

As noted earlier in this article, an adjustment is made to the computation of taxable income for purposes of the percentage of taxable income method in order to eliminate the double penalty which would result from both the disallowance of a part of the dividends received deduction and the exclusion of dividends from the taxable base for purposes of computing the bad debt deduction. Nevertheless, the effect of the two provisions is that a taxpayer can end up receiving less deductions by receiving dividends and claiming a bad debt deduction than if the income was received by two different taxpayers, or if it was received in two different years. This may be illustrated by the following examples:

Example 1. A mutual savings bank receives dividends of $1,000 and taxable interest of $1,000 and computes its deduction for the reserve

[45] Added by Act Sec. 434.

for losses on loans under the percentage of taxable income method (at a rate of 40%).

Its dividends received deduction is computed as follows:

85% of dividends received	$ 850
Reduction: 40% thereof	340
Deduction allowed	$ 510

Its addition to the reserve for losses on loans is computed as follows:

Dividends		$1,000
Interest		1,000
Total		2,000
Exclusion (only for computing reserve addition):		
Dividends	$1,000	
Reduced by 40% × $850	340	660
Adjusted taxable income		1,340
Applicable percentage		40%
Addition to reserve		536
Total deduction ($510 plus $536)		$1,046

Example 2. If the same institution had received the dividends in one year[46] and the interest in another, or if two different institutions had received the items of income, the combined deduction would be computed as follows:

Year 1:	
Interest	$1,000
Applicable percentage	40%
Allowable addition to reserve	400
Year 2:	
Dividends	$1,000
Percentage deductible	85%
Dividends received deduction	850
Total deduction ($400 plus $850)	$1,250
Deductions allowed on separate basis	$1,250
Deductions allowed on combined basis (Ex. 1)	1,046
Difference	$ 204

The difference between the two situations ($204) comes about because in Example 1 the bank is required to reduce its dividends

[46] This assumption is made only to illustrate the principle graphically. An institution would not qualify as a mutual savings bank or an S&L if it had only dividend income.

received deduction by $340 (40% × $850) and it receives an additional bad debt deduction attributable to the dividends of only $136 (40% × $340); thus, $340 less $136 proves out to $204.

One possible remedy for this situation is to set up a wholly owned subsidiary corporation to invest in stock.[47] The subsidiary would be entitled to the full dividends received deduction and the parent would be entitled to the full reserve addition based upon a net income which would not include any dividends. Payments of dividends from the subsidiary to the parent could be eliminated by filing a consolidated return.[48] Stock could also be held by a sister corporation of the S&L.

It would seem to have been simpler and more equitable for the law merely to have allowed the full dividends received deduction, and not to have included any portion of otherwise excludable dividends in the base for the computation of the bad debt deduction under the percentage of taxable income method.

Mergers of savings and loan associations

General case law has for a long time provided that the balance of the reserve for bad debts for tax purposes must be restored to income when the need for the reserve ceases.[49] For example, a taxpayer does not need a bad debt reserve when it sells all its assets including its accounts receivable.[50] Another example of when the bad debt reserve is not needed is when amounts are paid out of the bad debt reserve, or the bad debt reserve is used for some purpose other than the charging of bad debts and losses.

Subsection (f)(1) of Sec. 593, added by the Revenue Act of 1962, provides a priority for determining the source of distributions of dividends and redemptions of stock in partial or complete liquidations of associations. It provides that dividend distributions by stock savings and loan associations (not deductible under Sec. 591) will be treated as made first out of earnings and profits accumulated since December 31, 1951, then out of the reserve for losses on qualifying real property loans (to the extent additions

[47] This could be accomplished tax free under Sec. 351.

[48] Regs. Sec. 1.1502-14(a)(1).

[49] Geyer, Cornell & Newell, Inc., 6 TC 96; Rev. Rul. 57-482, 1957-2 CB 49. But see Nash, Sup. Ct., 5/18/70 (25 AFTR 2d 70-1177, 70-1 USTC ¶9405) and Israel J. Erlich, 54 TC No. 117.

[50] S. Rep. No. 91-552 (11/21/69), p. 168.

exceeded the amount which would have been allowable under the experience method), then out of the supplemental reserve for losses on loans, and lastly out of pre-1952 surplus and any other appropriate accounts.

Although not stated in the committee reports,[51] it is understood that the purpose of this priority was to prevent cash payouts of pre-1952 surplus to regular stockholders of a stock savings and loan association, when the association retained relatively large amounts of tax-free bad debt reserves. The reasoning was that maintenance of bad debt reserves in excess of reserves allowable under the experience method was incompatible with dividend payouts.

Sec. 593(f)(1) provided a different priority of the source of cash payouts where the distributions were in redemption of stock or in partial or complete liquidation of the association. In that case, the payouts were deemed to be made first out of the reserve for losses on qualifying real property loans (to the extent additions exceeded the amount allowable under the experience method), second out of the supplemental reserve for losses on loans, third out of earnings and profits accumulated in taxable years since 1951, and lastly out of pre-1952 surplus and any other appropriate accounts.

The Tax Reform Act added a sentence to Sec. 593(f)(1), which provides that the particular priority of determining the source of payouts of dividends and other distributions with respect to stock of nonwithdrawable shareholders shall not apply to any transaction to which Sec. 381 (relating to carryovers of tax attributes in certain liquidations and reorganizations) applies.

The announced purpose of the amendment is to clarify existing law which states that where there is a merger of a savings and loan association which is treated under present law as a tax-free reorganization (or liquidation), the association is not required to restore its bad debt reserve to income.[52]

Clarifying or confusing? It is not clear to this writer how the amendment to Sec. 593(f)(1), dealing as it does with priority of payments, will clarify the existing law on carryover of bad debt reserves on tax-free reorganizations. The Senate Report language is clear. Presumably such language plus the normal operation of Sec. 381 will serve to clarify the issue; but the statutory change by itself

[51] S. Rep. No. 1881 (8/16/62), p. 47.

[52] S. Rep. No. 91-552 (11/21/69), p. 169.

leaves much to be desired insofar as clarification is concerned. Since Sec. 593(f)(1) deals only with the priority of determining the source of payments or distributions of property, the addition of the sentence by the Tax Reform Act would seem to change solely the priority of payments. In a merger or complete liquidation, in the absence of Sec. 381, all amounts are deemed paid out in any event, and therefore the order of priority seems to be irrelevant. Perhaps it was intended that the amendment be made to paragraph (2) of Sec. 593(f) which deals with amounts charged to reserve accounts and included in gross income rather than paragraph (1) which covers priority of distributions to shareholders.

Treatment of bonds held by financial institutions

Prior law—nonparallel treatment. Before the Tax Reform Act of 1969, commercial banks, mutual savings banks, and savings and loan associations received special treatment on their sales of bonds and other corporate and governmental evidences of indebtedness. Under Sec. 582, the excess of losses over gains on transactions in bonds, etc.,[53] during a taxable year was fully deductible as an ordinary loss—even though the securities constituted capital assets in the hands of the bank. On the other hand, in a year in which long-term capital gains exceeded capital losses on such transactions, the excess was taxable as a long-term capital gain. Thus, these financial institutions received nonparallel treatment with respect to capital gains and losses on bonds, etc.

Small business investment companies were also allowed ordinary loss treatment on certain convertible debentures under Sec. 1243, but the usual capital gain or loss rules applied to their other securities.

It was common practice for banks to time transactions in debt securities so that gains would be lumped in one taxable year and taxed at the capital gain rate, and losses would be grouped in another taxable year and offset against ordinary income. The big advantage, of course, was that other corporate taxpayers were not entitled to offset capital losses against ordinary income.

[53] "Bonds, etc." as used herein, includes debentures, notes, certificates, or other evidence of indebtedness, whose sale or exchange would produce capital gain or loss under the rules generally applicable to corporate taxpayers.

New law—parallel treatment. Both the House Ways and Means Committee and the Senate Finance Committee found that this treatment was inequitable.[54] They therefore provided for parallel treatment of gains and losses realized from transactions in bonds, etc., by eliminating the capital gain treatment. Of course, the Committees could have gone the other way by eliminating ordinary loss treatment, but they concluded that the debt securities are more closely related to inventory or stock in trade in view of the size of the bank holdings of these items and the extent of their transactions in them. Furthermore, allowing an ordinary loss deduction serves as an additional buffer in the event of a recession and compensates for the restrictions placed on reserves for losses on loans discussed in the first two installments.

Sec. 582(c), as amended, now provides that in the case of a financial institution to which Sec. 585, 586, or 593 applies, the sale or exchange of a bond, etc., shall not be considered a sale or exchange of a capital asset. By reference to those sections, the rule is applicable to commercial banks, mutual savings banks, savings and loan associations and cooperative banks; however, as to small business investment companies and business development corporations (to which Sec. 586 applies), see the discussion below.

Effective dates. Act Sec. 433(d) provides, in general, that the new rule applies to years beginning after July 11, 1969. Special transitional rules are provided only for banks and savings and loan associations;[55] small business investment companies and business development corporations are not covered by these rules.

In general, the transitional rule allows a gain on the sale of a bond, etc., on or after July 12, 1969—to the extent allocable to the period before such date—to be treated as a long-term capital gain. Specifically, Sec. 582(c)(2) provides that if the net long-term capital gains from sales or exchanges of "qualifying securities" exceed the net short-term capital losses from such sales or exchanges for the taxable year, the excess shall be considered a capital gain, but only if it does not exceed the net gain on sales or exchanges of all (both qualifying and nonqualifying) bonds, etc.

"Qualifying security" means a bond, etc., held by a bank (or

[54] S. Rep. No. 91-552 (11/21/69), p. 166.

[55] Sec. 582(c)(2) as amended refers only to banks. However, for this purpose, Sec. 581 specifically defines "bank" to include savings and loan associations. Mutual savings banks meet the general definition of bank.

an S&L) on July 11, 1969.[56] The amount to be treated as capital gain (loss) is determined by multiplying the gain (loss) on each security by a fraction the numerator of which is the number of days the security is held before July 12, 1969 and the denominator of which is the total number of days the security was held by the bank. Arithmetically, the rule may be expressed as follows:

$$\text{Gain(loss) on sale X } \frac{\text{No. of pre-7/12/69 days}}{\text{Total days security held}} = \text{Capital gain(loss)}$$

Presumably, if the basis of the security is determined with reference to a transferor's basis, the period of time that the security was held by the transferor will be included in the computation.

The application of the new transitional rules is illustrated in the following examples:

Example 1. In 1970 a bank realizes a net long-term capital gain from the sales of bonds, etc., in the amount of $100,000. One of the bonds was acquired on December 23, 1968 and was sold on October 19, 1969 at a gain of $3,000. Of the $3,000 gain, the sum of $2,000 qualifies for capital gain treatment, that is:

$$\$3{,}000 \times \frac{200 \text{ days}}{300 \text{ days}} = \$2{,}000$$

Being less than the total long-term gain for the taxable year, the entire $2,000 qualifies for capital gain treatment.

Example 2. In the above example, if the total gain for the taxable year was $1,500, only $1,500 (rather than $2,000) would be eligible for capital gain treatment.

It should be noted that, although the opportunities for tax saving by timing sales of bonds, etc., are now severely limited, to the extent that a financial institution holds appreciated debt securities acquired before July 12, 1969, attention should be given to the timing of the sales. Subject to the more important investment considerations, such securities should be sold in a year when they will not have to be reduced by virtue of other losses in the year. Also, they should be sold as early as possible so that the denominator of the fraction is as small as possible.

[56] Sec. 582(c)(3)(A).

Sec. 433(d)(2) of the Act permits small business investment companies and business development corporations to continue to claim capital gain treatment on the sale of bonds, etc., for all taxable years beginning before July 11, 1974 unless they elect to treat such sales as not being sales or exchanges of a capital asset.[57] Once the election is made, it is irrevocable and applies to all the open years.

Net operating loss carryback

Historically, financial institutions have argued that they were entitled to larger bad debt reserves than other organizations because, due to long-term market fluctuations, they were subject to periodic large losses. Congress and the Treasury Department have recognized this to a certain extent in the promulgation of rather generous bad debt reserves. Recognizing that the changes in the bad debt reserves provided in the 1969 Tax Reform Act will reduce drastically the ability to build up tax-free bad debt reserves,[58] Congress has provided a measure of relief by allowing financial institutions a longer carryback period.

For taxable years beginning after December 31, 1975, net operating losses of financial institutions (to which Sec. 585, 586, or 593 applies) may be carried back to the ten taxable years preceding the taxable years of the loss.[59] Although tax deductible reserves cannot now be set up in anticipation of catastrophic losses, at least if and when they occur financial institutions should get immediate tax relief by virtue of the longer net operating loss carryback period.

The ten-year net operating loss carryback provisions are not effective until 1976. Evidently the deferred effective date is based upon the belief that the reserve additions allowable until 1976 (that is, up to 1.8% of loans) are generous enough not to require the extra safety measure of the long net operating loss carryback.[60] The delay of the longer carryback may prevent or delay full tax benefits from large bond losses experienced by some institutions in the recent declining bond market.

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[57] This provision is not incorporated in the Code proper.

[58] H. Rep. No. 91-413, Part 1(8/2/69), p. 128.

[59] Sec. 172(b)(1)(F).

[60] Indicative of this thinking is the fact that the bill as passed by the Senate, which allowed a permanent 1.8% reserve, contained no increase in the carryback period.

Small business investment companies

Under Rev. Rul. 64-48,[61] small business investment companies (SBICs) have been permitted to establish bad debt reserve ceilings equal to 10% of their outstanding loans as reasonable reserves under Sec. 166(c). That ruling provided that the 10% ceiling applies for a period of ten years beginning with 1959. The exception to the general rule that bad debt reserves should be based upon an institution's individual experience was premised on the fact that the concept of SBICs was new and therefore there was no individual or collective experience to refer to. With the passage of time, the basis for the exception was no longer true and the regular rules of computing bad debt reserves were restored.

However, in the 1969 Tax Reform Act, Congress found that problems were created for new companies, since they would not have any loss experience. Therefore, Sec. 581(b) was added to the Code; it provides that a new SBIC or a new business development corporation (BDC)[62] may, during the first ten years of its existence, base its bad debt reserves upon its respective industry average. After the first ten years of its existence, an SBIC or a BDC must then base additions to its bad debt reserves on its own experience. Act Sec. 531(d) specifies that the new rules are effective for taxable years beginning after July 11, 1969.

Experience method. The experience method formula prescribed in Sec. 586(b) for computing bad debt reserves of SBICs and BDCs is essentially the same as the formula for calculating bad debt reserves of commercial banks.[63] SBICs and BCDs are not entitled to utilize the percentage method available to banks.

Industry average method. The industry average for bad debts is the percent which the total bad debts sustained by all SBICs (or

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[61] 1964-1 CB (Part 1) p. 104.

[62] Small business investment companies are those which operate under the Small Business Investment Act of 1958. See Secs. 1242-1244. Business development corporations are defined to mean corporations which are created by or pursuant to an act of a state legislature for purposes of promoting, maintaining, and assisting the economy and industry within said state on a regional or statewide basis by making loans to be used in trades and businesses which would generally not be made by banks within such region or state in the ordinary course of their business, and which are operated primarily for such purposes. See Sec. 586(a)(2).

[63] See beginning of article.

BDCs) during the six preceding taxable years (adjusted for recoveries of bad debts during such period) bears to the sum of the loans by all of those institutions outstanding at the close of those taxable years. The actual calculation and application of the formula should be relatively simple.

However, the ascertainment of the industry-wide figures will present some problem. Obviously the figures are not available to each institution. It is hoped that the IRS will publish the statistics for the preceding six taxable years, but doing this on a timely basis may not be possible because there is generally some delay in the publication by IRS of statistics of income. If the IRS cannot publish current statistics, perhaps the Small Business Administration can do so.

Foreign deposits in U.S. banks

Under present law, interest received by nonresident aliens and foreign corporations which is not effectively connected with the conduct of a trade or business in the United States is generally subject to U.S. tax at a rate of 30%[64] or a lower rate if specifically provided by an income tax treaty. However, there has been an exception to this rule for interest paid by banks to their foreign depositors. Such interest is not taxable unless it is effectively connected[65] with the conduct of a trade or business of the recipi-

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[64] Sec. 871(a)(1)(A) for nonresident aliens; and Sec. 881(a)(1) for foreign corporations.

[65] The question of whether income is effectively connected with the conduct of a trade or business in the U.S. must be resolved under the rules set forth in Sec. 864(c). That section provides several factors which are to be taken into account in making the determination. One factor is whether the income is derived from assets used in or held for use in the conduct of the trade or business. Another factor is whether the activities of the trade or business were a material factor in the realization of the income. Sec. 864(c) provides that, in determining whether an asset is used in or held for use in the conduct of a trade or business or whether the activities of the trade or business were a material factor in realizing the income, due regard shall be given to whether or not such asset or such income was accounted for through the trade or business. Apparently deposits in banks held for the purpose of meeting current operating expenses of a trade or business are effectively connected with the trade or business; whereas deposits maintained for the purpose of meeting the long-range needs of the business, for example, future diversification into a new trade or business, will not be assets effectively connected with the trade or business. See proposed Regs. Sec. 1.864-4(c)(2)(iii).

ent.[66] In such case, it is taxable not at the flat 30% or lower treaty rate, but at the ordinary graduated or corporate tax rates, after deduction of allocable expenses.[67]

Further postponement of repeal of general exemption. In the development of the Foreign Investors Tax Act of 1966, Congress recognized that it was inequitable not to tax depositors on bank interest which was obviously from U.S. sources at the same time it was taxing all other U.S. source income.[68] However, Congress also recognized the problem with the U.S. balance of payments. It was fearful that if it suddenly caused such interest to be taxable there would be a substantial withdrawal by foreign depositors from U.S. banks. Therefore, Congress delayed the taxability of such interest payments until the end of 1972.

In the development of the 1969 Tax Reform Act, Congress found that the balance of payments problem still existed, and therefore provided for further postponement of the time when the interest paid by banks to foreign depositors would be subject to U.S. tax.[69] The time was extended until December 31, 1975. Thus, Sec. 861(c), as amended, provides that effective with respect to amounts paid or credited after December 31, 1975, the special rules exempting interest paid by banks to foreign depositors will cease to be effective.[70]

Immediate repeal of special exemption. In the development of the 1969 Act, Congress also concluded that there was no reason to continue an inequitable distinction drawn between domestic banks and domestic branches of foreign banks with respect to interest paid to nonresident aliens and foreign corporations. Under former law, interest on a bank deposit paid to a nonresident alien or a foreign corporation by a domestic branch of a foreign bank was generally not considered U.S. source income, and therefore was not taxable even though it was effectively connected with the conduct

[66] Sec. 861(a)(1) treats such income as income from sources outside the U.S.; and Secs. 871(a)(1)(A) and 881(a)(1) tax only income from U.S. sources.

[67] Sec. 871(b) for nonresident aliens and Sec. 882(a) for foreign corporations.

[68] H. Rep. No. 1450 (4/26/66), p. 7.

[69] S. Rep. No. 91-552 (11/21/69), p. 169.

[70] Act Sec. 435(a)(2).

of a U.S. trade or business carried on by that foreign person.[71] If paid by a U.S. bank, however, such "effectively connected" interest was treated as U.S. source income and therefore was taxable to nonresident aliens and foreign corporations.[72] In the Foreign Investors Tax Act of 1966, Congress had provided for elimination of this distinction after 1972. In the Tax Reform Act of 1969, Congress terminated this distinction effective for amounts paid or credited after December 31, 1969.[73]

Estate tax. The foregoing distinction had generally been applicable in determining whether deposits in U.S. branches of foreign banks were considered under Sec. 2104(c) to be property within the United States for estate tax purposes. Congress eliminated this distinction between domestic banks and foreign banks as of December 31, 1969.[74]

Minimum tax

The 1969 Tax Reform Act added a new overall minimum tax of 10% on tax preferences applicable to all taxpayers, including financial institutions.[75] While the minimum tax is generally outside the scope of this article,[76] one of the tax preference items does fall within the scope of this article since it applies only to financial institutions. Sec. 57(a)(7) includes as an item of tax preference, in the case of a financial institution to which Sec. 585 or 593 applies, the amount by which the deduction allowable for the taxable year for a reasonable addition to a reserve for bad debts exceeds the amount that would have been allowable had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience.

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[71] Sec. 861(a)(1)(C), before amendment by 1969 Act.

[72] Sec. 861(a)(1)(A), before amendment by 1969 Act.

[73] Act Sec. 435(a)(1).

[74] Act Sec. 435(b).

[75] Act Sec. 301 added Secs. 56-58 to the Code. The minimum tax applies for taxable years ending after December 31, 1969. For a fiscal taxable year ending in 1970, the tax is determined by multiplying the total tax by a fraction, the numerator of which is the number of days in the taxable year in 1970 and the denominator of which is the total days in the taxable year. Act Sec. 301(c).

[76] The 10% minimum tax is the subject of an article by Solon O'Neal, which appears on page 91.

Example: A bank claims a $100,000 addition to the reserve for losses on loans for 1971. The addition was calculated under the percentage method of Sec. 585(b)(2) by providing additions to the reserve for losses on loans to bring the reserve up to 1.8% of eligible loans outstanding at the end of such year. Assume that, had the institution maintained its bad debt reserve for all taxable years on the basis of actual experience, an allowable addition for the year would have been only $25,000. The difference of $75,000 ($100,000 less $25,000) would constitute an item of tax preference. This item together with any other items of tax preference, and subject to an exclusion of $30,000 and a deduction for the regular income tax payments, would be subject to the 10% minimum tax.

Ambiguity. The phrase "for all taxable years" in Sec. 57(a)(7) may cause some interpretive problems. It may be argued that the phrase was intended to modify the word "experience"; if so, the section could be read as meaning "the amount which would have been allowable had the institution maintained its bad debt reserve on the basis of actual experience for all taxable years."

On the other hand, it may be argued that the phrase "for all taxable years" should modify the word "maintained." If so, the section would mean "the amount that would have been allowable had the institution for all taxable years maintained its bad debt reserve on the basis of actual experience." The difference, of course, is that under the first interpretation the period taken into consideration for experience computation purposes would encompass all taxable years of the taxpayer, whereas under the second method the taxpayer is considered to have been on the experience method for all taxable years.

Although not absolutely clear, the position of the phrase in the sentence appears to require the latter interpretation.

Further, it does not appear logical that Congress would have intended an institution to compute its experience percentage based upon its actual experience for all taxable years (rather than the six most recent years). An experience percentage based upon the actual experience for all taxable years of an institution is no more reliable than the experience percentage for the most recent six-year period. In fact, the more recent experience of an old bank is presumably more relevant to an institution's current operations, and therefore more reliable as an indicator of possible loss experience. In addition, it does not appear likely that Congress would have provided a six-year period for the regular tax and a much longer period for the less significant minimum tax.

What is probably meant by the phrase "for all taxable years" is that, in analyzing the addition for the current year, the institution will be considered as if it had been on the experience method of Sec. 585(b)(3) for all taxable years. Therefore, the reserve at the beginning of the year will be considered to consist of the exact amount that it would have contained had the institution been on the experience method for all its taxable years. Thus, an institution will not be penalized in a taxable year by reason of the fact that the reserve was actually larger at the beginning of the year than it could have been under the experience method; nor would an institution receive a benefit because the reserve was smaller at the beginning of the year than it could legally have been under the experience method.

Example. At the beginning of 1971, a bank's outstanding loans are $1 million and its reserve for losses on loans is $18,000 (1.8% of loans). The bank's moving average experience percentage is .2%. At the end of the year the bank has loans outstanding in the amount of $1.1 million. There were no charge-offs during the year. The amount of the addition to the reserve for losses on loans for 1971 which is not subject to the minimum tax would be equal to $200 (.2% × $100,000 increase in loans). This is because, even though the bank has a reserve balance at the beginning of the year of $18,000 (equal to 1.8% of loans), it is considered to have been on the experience method for all taxable years, and therefore it would only have had a beginning balance of $2,000 (.2% × $1 million).

Keep in mind that this analysis only applies for the purpose of determining the amount of each year's addition to the reserve for losses on loans which is not subject to the minimum tax.

Experience method computation. Although Sec. 57(a)(7) contains no guidance as to how the actual experience of an institution is to be computed, as stated above it is probable that it will be done with reference to its own experience for a six-year period. In the case of a new institution, the Senate Report indicates it will be computed with reference to experience in the industry.[77]

The determination of when a loan is worthless may present some problem. As stated, this results partly from the fact that some discretion is given savings and loan associations and mutual savings banks in the charge-off of loans pursuant to Sec. 595 and Regs. Sec.

[77] S. Rep. 91-552 (11/21/69), p. 114.

1.595(e)(1). This problem has theoretically existed since 1963 when Sec. 595 first became effective, but it has been of little practical significance because there has been virtually no utilization of the experience method by these institutions. Under the other methods (the 3% method and the percentage of taxable income method), when an institution considered a loan as being worthless, it was charged against the reserve and that was the end of it. However, under the experience method, it is not only important to determine what is in the reserve and what may be charged in the current year, but it is necessary to calculate what the "charge-offs" were in the current and five preceding taxable years.

Now, although it is likely that there will continue to be very few institutions on the experience method for regular tax purposes, nevertheless virtually every institution will have to annually compute the amount of addition which would have been allowable under the experience method solely for minimum tax purposes.

In view of the importance of charging to the reserves, it is hoped that the draftsmen of the regulations will provide some additional guidance under the experience method (or in the regulations under Sec. 595) regarding the timing of charges for purposes of the experience method.

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Insurance companies

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Several years ago, Congress applied new income tax formulas to all life insurance companies and to mutual property and liability insurance companies by the enactment of the Life Insurance Company Income Tax Act of 1959 and the Revenue Act of 1962, respectively. Each Act, encompassing substantial changes from the prior taxing statutes applicable to such insurance companies, was enacted only after considerable study by both Congress and the Treasury Department. While retaining some of the aspects of the prior taxing statutes (aimed principally toward taxation of investment income), each Act also extended the tax base to total net income by taking into account underwriting income and losses with certain modifications. As a result, both Acts contained extremely complex provisions which inevitably would produce controversy and some unintended results. To date, almost every subsequent revenue act has included an amendment to correct an inequity or clarify some provision of these two insurance company taxing statutes.

Tax Reform Act—generally

Consistent with such prior record, the Tax Reform Act of 1969 contains one clarifying amendment to implement the intention of Congress with respect to certain deductions allowed to life insurance companies relating to group contingency reserves, and two changes to avoid unintended hardships or inhibitions—such as could result from the spin-off of a non-insurance company subsidiary by a life insurance company or the denial of loss carryforward deductions due to changes in the business or the organizational

structure of the insurance company. In addition, in response to some well-publicized redemptions by insurance companies of outstanding capital shares in exchange for appreciated securities, the Reform Act closed a "loophole" available to all corporations under prior law to avoid the tax on appreciation of property used for this purpose.

Reform Act Sec. 907[1] contains all the amendments specifically directed to insurance companies; Reform Act Sec. 905 affects all corporate taxpayers but, as just indicated, was inspired by insurance company practices. All the Code sections amended or added by the Reform Act, which are within the scope of this article, may be summarized as follows:

Applicable to life insurance companies.

Amended Sec. 805(e)(4) allows a deduction from investment income for interest paid on special contingency reserves under group contracts.

New Sec. 810(c)(6) allows a deduction from underwriting income for increases in special contingency reserves under group contracts (or inclusion in underwriting income for decreases in such reserves).

New Sec. 815(f)(5) exempts from Phase III tax the spin-off of the stock of a controlled corporation to the parent holding company of a life company.

Applicable to all insurance companies.

New Sec. 844 provides that if an insurance company during a taxable year is subject to a different tax formula than it was for a prior year, the operating loss deductions for the current year shall include the loss carryover from such prior year or years with certain limitations.

Applicable to all corporations.

New Sec. 911(d), with certain exceptions, provides that when appreciated property is distributed by a corporation to its shareholders in redemption of its stock, the appreciation in value shall be in-

[1] Provisions of the Internal Revenue Code will be simply cited as "Sec." Provisions of the 1969 Tax Reform Act will be referred to as "Reform Act Sec." "Prior law" means pre-Tax Reform Act law. "Amended law," "amended Sec." or "new Sec." refers to post-Tax Reform Act law.

cluded in taxable income of the corporation, just as though the property had been sold at the time of the distribution.

Taxation of insurance companies

An understanding of the significance of the Reform Act amendments peculiarly applicable to insurance companies requires a basic knowledge of how insurance companies are subjected to federal income taxes. Therefore, the scheme of taxation for the three principal categories of insurance companies is outlined below, prior to a review of the background and the specific changes embodied in the Reform Act. For federal income tax purposes, insurance companies are classified into three broad categories.

- Life insurance companies (both stock and mutual).
- Mutual insurance companies other than life (principally mutual property and liability companies).
- Other insurance companies (principally stock property and liability companies).

Life insurance companies. The tax base for this category of insurance companies (life insurance company taxable income) consists of the sum of the following three phases:

Phase I: The lesser of:

a. Taxable investment income (net investment income in excess of "interest required" to service policy reserves and other interest paid), or

b. Gain from operations (total net income, including investment income) computed with certain deductions and modifications including:

- A non-participating contract deduction.
- An accident and health insurance and group life deduction.
- An operations loss carryover and carryback deduction.
- Limitations on dividends to policyholders.

Phase II: One-half of the gain from operations (referred to above) in excess of taxable investment income.

Phase III: (Stock life companies only)—Amounts paid to or segregated for the benefit of shareholders from the total gain from operations not subjected to tax in Phase I or II.

Mutual property and liability insurance companies. The tax base for mutual property and liability insurance companies, except for certain small or special class fire and flood companies, consists of the net aggregate of:

- Taxable investment income or loss.
- Statutory underwriting income or loss (total net income less (1) net investment income and (2) protection against loss deduction).
- Losses and other amounts required to be subtracted from the protection against loss account.
- Unused loss deduction.

Stock property and liability insurance companies. The tax base for stock property and liability insurance companies consists of taxable income computed, in general, in the same manner as for non-insurance and non-special class corporations, except that (1) the accrual basis of accounting must be used, (2) unearned premium income need not be taken into income, and (3) a deduction is allowed for losses and loss expense incurred but unpaid as defined.

Group contingency reserves

Background. The history of life insurance is a history of innovations, but none has been more immediately successful than the idea of group insurance. Introduced scarcely more than 50 years ago, this concept has had such general acceptance that coverage under group plans accounts for nearly one-third of the total life insurance in force in the United States today,[2] and represents a significant portion of all health insurance written.[3]

The earliest group life policies were issued by the Equitable Life Assurance Society covering employees of the Pantasote Leather Company of Passaic, New Jersey, and Montgomery Ward in Chicago in 1911 and 1912, respectively; however, the most rapid and dramatic growth occurred in the 1940s and subsequent years.[4]

In the 1940s several factors acted to accelerate all types of group insurance. During World War II, a period of strict economic con-

[2] Greider and Beadles, *Principles of Life Insurance* (Homewood, Ill.: Richard D. Irwin, Inc., 1964) Ch. 13, p. 311.

[3] Gregg, *Life and Health Insurance Handbook* (Homewood, Ill.: Richard D. Irwin, Inc., 1964) 2nd ed., Ch. 28, p. 345.

[4] See note 2 above, Ch. 13, p. 313.

trols, government wage freezes led employers to compete vigorously in the labor market by offering fringe benefit programs to attract and keep their work force. Group insurance of all kinds was a way to compete. Immediately after World War II, the famous *Inland Steel* decision by the Supreme Court, which held that pensions and other fringe benefits are subject to the collective bargaining process, brought organized labor fully into the group insurance picture.[5]

Group insurance premiums are customarily paid on a monthly basis. This is most convenient for the employer as a matter of accounting, and it provides a maximum of flexibility in making adjustments for changes in personnel. In the development years practically all group plans were contributory, with employees sharing a major part of the costs, but in recent years, due to union organizing and for competitive reasons, a greater part of the group insurance costs have been assumed by employers.

Probably due to the employee sharing of costs, premium rates for group life plans, unlike ordinary life premiums, are subjected to direct regulation by some states.[6] Since the required minimum premium was frequently more than adequate to provide for losses, it was quite customary to provide that a policyholder would receive an experience rating refund, depending on the actual experience of the group.

Practically all group insurance is term insurance for one year, but renewable for subsequent years on the basis of terms negotiated at the time the contract is written. This system contemplates the payment of claims in any one year out of premiums paid for such year. Actually, deaths do not always occur as anticipated; at times a large number of claims may become payable in a year, after several years of fewer claims than contemplated in an appropriate mortality table. In view of this likelihood, prudent life insurance companies established contingency reserves for excess mortality fluctuations and the possibility of catastrophe claims. For the most part, such reserves were neither required by law, nor accountable to the group policyholder and thus were characterized by some insurance texts as "merely segregated portions of surplus."[7] With the

[5] See note 3 above, Ch. 28, pp. 355, 356.

[6] For example, New York, Ohio, Pennsylvania and Michigan have established minimum initial premium rates for group life insurance.

[7] See note 1 above, Ch. 13, p. 322.

passage of time, the character of the group contingency reserves changed for two principal reasons.

First, it was not unusual for an employer group policyholder to accept experience rating refunds in favorable mortality years, but to resist an increase in premium rates following high mortality experience by negotiating with another carrier. In response to this situation, the insurance industry negotiated group contracts based on actual costs of claims paid, plus a charge for overhead costs and profit. Under this arrangement, the excess of provisional premiums over such actual costs and handling charges were put into a contingency reserve, sometimes designated as a "premium stabilization reserve" for the benefit of the specific policyholder's account, and such account was credited with interest at rates negotiated with the policyholders. In future years when unfavorable loss experience was developed by the group, instead of increasing premium rates for the group, the premium stabilization reserve was used to fund such losses. However, if the group policy was terminated, the insurance company was obligated to return the balance of the reserve to or for the benefit of the group policyholder.

The second and perhaps even more important change in the character of reserves labeled "group contingency funds" was the designation of such reserves to provide insurance for retired employees.

Group insurance is frequently an important part of an individual's total life insurance. If this insurance is lost due to the loss of employment, particularly when this occurs at retirement age, the individual may find, despite his right to convert to individual insurance, that he cannot afford to replace the lost group insurance. Many employers, because of this problem, provide for the continuation of insurance upon retired employees, but for a reduced amount. This practice results in a gradually increasing amount of insurance upon older covered lives. Since mortality, and thus premiums, are directly related to the ages of the lives insured, and since the group insurance is on the one-year renewable term plan, continuation of the insurance on retired employees results in an increasing cost to the employer—a cost which should be recognized and paid by the employer during the time the employee is actively working. To provide for such additional costs, therefore, an employer policyholder often foregoes any refunds of current provisional premiums in excess of current costs, and allows them to accumulate with the insurance company at interest to provide for all or a portion of the in-

surance cost of retired employees. Again, under this arrangement, the life insurance company is prohibited from using these funds held at interest for any purpose but to provide benefits for the employees covered or to return unused funds to the employer.

An example of a group contract with special contingency reserves of the character described above is the Federal Employees' Group Life Insurance contract written by the Metropolitan Life Insurance Company under the Federal Employees' Group Life Insurance Act of 1954.

Problem. The Life Insurance Company Act set forth the tax rules applicable to contingency reserves carried under the Federal Employees' Group Life Insurance contracts; however, the proper tax treatment of similar reserves under other group contracts appeared unclear. This condition led to tax controversies of major proportions for life insurance companies with substantial group business.[8]

In the determination of taxable investment income, Phase I of the life insurance taxation formula, net investment income is divided into two parts—a policyholder's share and a company's share, with the latter forming the tax base (provided it is less than gain from operations). The policyholders' share of investment income and the items comprising such statutory policyholders' share are frequently referred to as deductions from net investment income. The policyholders' share consists of:

- "Interest" deemed necessary to service life and annuity reserves, plus interest paid on indebtedness—Sec. 805(e)(1).
- Amounts in the nature of interest credited to other policyholders' funds—Sec. 805(e)(2).
- Discounts allowed on prepaid premiums—Sec. 805(e)(3).
- Interest on certain contingency funds—Sec. 805(e)(4).

In the determination of gain from operations, there are taken into account:

- Increases or decreases in the life and annuity policy reserves—Sec. 810(c)(1).
- Reserves for unearned premiums and unpaid losses—Sec. 810 (c)(2).

[8] See Occidental Life Insurance Company of California, D.C., Cal., 2/5/70 (25 AFTR2d 70-796,70-1 USTC ¶9225).

- Certain other policyholder funds not at risk—Sec. 810(c)(3).
- Dividend accumulations and other amounts held at interest—Sec. 810(c)(4).
- Premiums received in advance—Sec. 810(c)(5).[9]

Life insurance companies that carried group contingency reserves as outlined above claimed the interest paid on or credited to such contingency reserves as an interest deduction from investment income and reflected the increases and decreases in such reserves in the gain from operations. In the examination of income tax returns of such life insurance companies, revenue agents quite generally disallowed such interest deductions from investment income and eliminated the effects of increases or decreases in contingency reserves from the computation of gain from operations.

Solution. As indicated at the outset, the Reform Act amended Sec. 805(e)(4) so that it clearly allows a deduction for interest paid on special contingency reserves under group contracts, and added Sec. 810(c)(6) so as to specifically require that fluctuations in such reserves be reflected in computing gain from operations. These Reform Act provisions are retroactive to 1958, the first year to which the present life insurance company taxation formula applied, thus confirming the insurance companies' position that such deductions were proper. The committee reports dealing with these sections indicate that Congress, in enacting the Life Insurance Company Act of 1959, had intended that such deductions should be allowed.[10]

These specific changes represent a happy conclusion for the life insurance companies selling group insurance. However, the time, expense, and frustrations involved in arguing the merits of such a position with IRS field personnel, in efforts to resolve the conflict by a number of requests for technical advice from the National Office of the IRS, and in actual litigation—all due in part to some unfortunate draftsmanship in the 1959 Act and what to some life insurance company taxpayers must have appeared to be adherence

[9] This treatment is consistent with the Annual Statement prescribed for life insurance companies by the National Association of Insurance Commissioners.

[10] S. Rep. No. 91-552 (11/21/69), p. 281.

to inordinately narrow technical interpretations of existing Code sections by the IRS—offer sufficient grist for a separate article.

Spin-off of controlled corporation by life companies to parent holding companies

Background. Under the Life Insurance Company Act of 1959, one-half of the excess of gain from operations over taxable net investment income, together with certain special noncash deductions allowed, represent untaxed current income of the company. These amounts are intended to provide an additional reserve or cushion for losses on certain classes of business. For income tax purposes, stock life insurance companies must identify these amounts as "Policyholders Surplus" in a tax memorandum account. Further, such amounts become taxable when either paid to or segregated for the benefit of shareholders. To implement the determination of whether or when such payments are made from Policyholders Surplus, an additional memorandum account is established for taxed income and income not subject to tax[11] in a "Shareholders Surplus" account. All distributions of cash or property to shareholders of the life company are charged against the Shareholders Surplus account until it is exhausted and then are deemed to be made from the Policyholders Surplus account until it has been exhausted. Any such payment from the Policyholders Surplus account is subject to income tax at rates in effect during the period of the distribution.

It is also important to note that the regulations issued under Sec. 815 which deal with such distributions and the tax accounting for both the Shareholders Surplus and Policyholders Surplus accounts require that property distributions be accounted for on the basis of the fair market value of the property on the date distributed.[12]

In general, this scheme appeared apt and equitable in dealing with the complex problem of an industry involved with very long-term contracts and economics quite different from most commerce and industry. Nevertheless, Sec. 815, providing the rules to account for distributions to shareholders, has had to be amended

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[11] Income not subject to tax such as municipal interest exempt under Sec. 103 and portions of certain dividends excluded by Sec. 246.

[12] Note that under Sec. 312, for computation of undistributed earnings, property distributions are accounted for at tax basis.

several times to remove unintended restrictions on certain corporate reorganizations and certain inequities contained in the literal application of Sec. 815 rules.[13]

In 1962 this section was amended, by P.L. 87-858, to permit a spin-off of shares of a property and liability insurance company to shareholders of a life insurance company without any impact on Shareholders or Policyholders Surplus. The required conditions for this result, however, were so restrictive as to present no continuing practical effect. However, in 1964, Sec. 815 was again amended, by P.L. 88-571, to permit a company to spin-off to its shareholders the stock of property and liability insurance companies without impact on the tax surplus accounts provided:

1. The spin-off met the qualifications of Sec. 355, and
2. 80% control of the subsidiary, property and liability insurance company had been acquired prior to January 1, 1958; or if 80% control was acquired after December 31, 1957, at least 50% control had been acquired prior to January 1, 1958 and the balance was acquired in a tax-free transaction qualifying under Sec. 368(a)(1)(A), (B) or (C).

An additional amendment was made in 1967, by P.L. 90-225, to permit a similar spin-off of a life insurance company subsidiary provided:

1. At least 80% of control had been owned at all times since December 31, 1957, and
2. The distribution qualified under Sec. 355 and was made to the parent of the distributing life insurance company.

Under both the 1964 and 1967 amendments, any increase in the basis of the shares of the distributed stock, attributable to capital contributions by the parent company after December 31, 1957 is required to reduce the Shareholders or Policyholders Surplus accounts in the proper sequence.

Although the 1964 and 1967 amendments were not entirely parallel, they permitted stock life insurance companies to divest them-

[13] As originally enacted, certain special deductions added to Policyholders Surplus became taxable income even though such deductions had resulted in no tax benefit. Sec. 815(d)(5), added by P.L. 88-571, corrected this condition.

selves of subsidiaries in the insurance business without incurring a Phase III tax on Policyholders Surplus to the extent that such divestiture under the tax rules was not deemed to represent untaxed, but taxable earnings accumulated since 1958. However, no similar relief was extended for non-insurance company subsidiaries of life insurance companies.

Problem. In recent years, it has become quite common for stockholder-owned life insurance companies to form holding companies as an integral part of their plans to broaden services to policyholders (such as sales of mutual fund shares) and to maximize return on funds available for investment (such as formation of real estate investment companies). In most cases, such new endeavors were organized as subsidiaries of the holding company and, therefore, were brother or sister corporations to the life insurance company. Nevertheless, some non-insurance activities had been engaged in for some time prior to the formation of holding companies and were subsidiaries of the life insurance companies. In part to simplify the operations of groups of corporations along functional lines, to respond to the threat of certain states to legislate against the ownership of non-insurance business interests by life insurance companies,[14] and perhaps gain some tax flexibility,[15] it is desirable for non-life insurance subsidiaries to be owned directly by the ordinary business corporation parent.

Solution. Congress expressed its approval of the desired objectives of such a corporate reorganization by adding a further amendment to Sec. 815; however, in order to assure the probability that any Phase III tax properly due would be paid, it included a number of limitations. The Reform Act amendment provides that a distribution after December 31, 1968 of the stock of a subsidiary by a life insurance company need not be accounted for as a reduction of Shareholders or Policyholders Surplus, if the following conditions are met:

[14] S. Rep. No. 91-552 (11/21/69), p. 284.

[15] A life insurance company may not join in a consolidated income tax return with a non-life insurance company; furthermore, a non-life subsidiary of a life insurance company cannot join the consolidated income tax returns of the ordinary company parent of the life insurance company. See Sec. 1504 (a)(1) and (b)(2).

- The distribution is to the parent which owns 100% of the life insurance company.
- The distribution meets the provisions of Sec. 355, and
- All of the outstanding stock of the subsidiary has been owned by the life insurance company continuously since December 31, 1957.

Like the prior amendments applicable to certain distributions of property and liability or life insurance company subsidiaries, any increase in the basis of the ordinary business corporation shares, subsequent to December 31, 1957, attributable to capital contributions by the parent life insurance company must be applied to reduce Shareholders or Policyholders Surplus accounts.

Furthermore, additional transactions involving any subsidiary which was distributed by a life company to a parent holding company under the rules of the Reform Act amendments will be treated for Phase III tax purposes just as though the spin-off had not occurred and such transactions had been channeled through the life insurance company. Under these rules, distributions by such subsidiary to its new parent, or a sale of the stock of the subsidiary by the new parent shall be treated as reducing the life company's Shareholders or Policyholders Surplus. These effects on the tax surplus accounts are limited to the amount of the fair market value of the stock of the ordinary business corporation at the time of the spin-off.

Loss carryovers of insurance companies

Background. A life insurance company which incurs a loss from operations and is subject to income taxation under Sec. 802 may offset this loss against a gain from operations in other years. The rules for determining the amount of such loss carryover and the years to which such carryover may be applied are set forth in Sec. 812. Such a deduction is designated an "operations loss deduction" and is in lieu of the net operating loss deduction permitted to certain other taxpayers under the provisions of Sec. 172. Mutual property and liability insurance companies subject to taxation under the provisions of Sec. 821 are entitled to the unused loss deduction defined in Sec. 825 rather than Sec. 172 net operating loss deduction. Stock property and liability insurance companies, subject to taxa-

tion under the provisions of Sec. 831, are permitted the net operating loss deduction as defined in Sec. 172.

The computational rules under Sec. 172 for net operating losses, Sec. 812 for net operations losses, and Sec. 825 for unused losses are similar in nature; yet such sections contain a number of specific differences, so that materially different deductions could result, depending upon which section was applied to a particular set of facts. Further, the originating years and the priority of application of loss carryovers and carrybacks are different, due to the timing differences in enactment of such sections.[16] Therefore, in the computation of a gain or loss from operations for a life insurance company, the net operating loss deduction provided by Sec. 172 is specifically denied by Sec. 809(e)(5). Similarly, in the computation of a "statutory underwriting income or loss" of a mutual property and liability insurance company, the Sec. 172 net operating loss deduction is denied by Sec. 823(b)(1).

Problem. Consistent with such disallowance of Sec. 172 loss deduction for life companies and mutual property and liability companies, the loss deductions permitted under Secs. 812 and 825 are limited to companies subject to the Sec. 802 taxation formula for life companies and the Sec. 821 formula for certain mutual insurance companies. Furthermore, the IRS has ruled that a life insurance company previously taxable under Sec. 831 could not convert a net operating loss carryforward under Sec. 172 to an "operations loss deduction" by applying Sec. 812 to such prior year.[17] Regs. Sec. 1.825-2(a)(2) contains a similar prohibition for unused loss deductions from years in which the mutual company was not taxed under the Sec. 821 formula.

It is possible for an insurance company to be taxable under one set of rules for one year and another set of taxation rules for a succeeding year. For example, to be taxed as a life insurance company, the life reserves of the insurance company must be more than 50% of its total reserves. Thus a new or small life insurance company selling a large volume of accident and health policies may be subject to the tax rules for property and liability insurance companies, due to the fact that its life reserves are not sufficiently large to

[16] Sec. 172 enacted with the 1954 Code, Sec. 812 enacted in 1959, and Sec. 825 enacted in 1962.

[17] Rev. Rul. 62-43, 1962-1 CB 90.

qualify it as a life insurance company. Yet as the company grows, and as life reserves become larger, it may become subject to the life insurance company tax formula. Also, a mutual property and liability company, taxable as such under Sec. 821, may be converted to a stock company; subsequently, therefore, it would be subject to taxation under the provisions of Sec. 831. Further, due to special circumstances, each of these examples may be reversed.

Solution. Since 1962, underwriting losses of all types of insurance companies are taken into account for tax purposes. Therefore, Congress believed it no longer appropriate to continue to prevent losses from being carried over when an insurance company shifts from one set of tax rules to another. As a matter of fact, denying the deduction of a loss carryover in this manner inhibits an insurance company from engaging in transactions, which it would otherwise consummate in its own best business interest, such as changing the form of its organization or the nature of its insurance business.[18]

New Sec. 844 permits an insurance company to carry over and deduct a net operating loss when its insurance company tax status changes. It should be noted that these provisions do not apply to loss carrybacks, but only to loss carryovers. Such amendment limits the amount of the allowable loss carryover to the lesser of:

- The loss carryover as computed under the rules applicable to the company before the change, or
- The loss carryover as computed under the rules which apply to the company after the change.

In addition, if the change in form of organization is from a mutual property and liability insurance company (taxable under Sec. 821) to a stock company (taxable under Sec. 831), the deduction for dividends to policyholders is limited to 75% of the amount otherwise allowable for such year in computing the loss carryover amount from the Sec. 821 year.

These new, more liberal rules for permitting a net loss carryover deduction apply only with respect to insurance companies whose tax status has changed since December 31, 1962, and apply only to losses incurred in 1963 and subsequent years. Furthermore, loss deductions permitted under this new section cannot be applied to

[18] S. Rep. No. 91-552 (11/21/69) p. 286.

years prior to 1967. Also in applying these new rules, the eight-year provisions for a new life insurance company are not available.

Use of appreciated property to redeem corporate shares

Background. Sec. 311 was introduced into the 1954 Code as a new section, there having been no similar statutory provision in the 1939 Code. Sec. 311 codified the Supreme Court's *General Utilities*[19] decision, which stated that a corporation derived no taxable gain from the distribution of appreciated property (fair value exceeds basis) to its shareholders. This section, as originally enacted, provided that generally no gain (or loss) would be recognized to a corporation on the distribution of property with respect to its stock. Before the Reform Act, the statutory exceptions were limited to distributions of certain properties, namely: installment obligations, Lifo inventories, property subject to liabilities in excess of basis, and depreciable property.[20] However, Regs. Sec. 1.311-1(a) emphasized that the *Court Holding*[21] rationale would be applied to any transaction in which an attempt was made to avoid the corporate level tax by having shareholders (in form) sell distributed property for the corporation. Further, Regs. Sec. 1.311-1(e)(1) provides that Sec. 311 does not extend to transactions between a corporation and any shareholder where such shareholder relationship was merely incidental to the primary transaction in which the shareholder was a purchaser, employee, etc.

Sec. 311 and the related regulations seem to have been understood by taxpayers generally; at least there has been very little litigation centering on the intent or the lines of demarcation of the statute or regulation.[22]

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[19] See General Utilities & Operating Co., 296 US 200 (16 AFTR 1126, 36-1 USTC ¶9012). In the context of the current income tax environment this was a remarkable holding, as the distribution of appreciated securities was accompanied by adverse facts, such as:

a. Immediate sale of securities by shareholders upon terms negotiated by distributing corporation, and

b. Satisfaction of a dividend liability denominated in terms of dollars.

[20] See, respectively, Secs. 311(a) and 453(d), 311(b), 311(c), and 1245 and 1250.

[21] Court Holding Co., 324 US 331 (33 AFTR 593, 45-1 USTC ¶9215).

[22] There are only five court decisions cited under Sec. 311 by the Standard Federal Tax Reporter of CCH.

Problem. In 1966 Alleghany Corporation tendered its entire holdings in New York Central Railroad Co. capital stock to both its preferred and common stock shareholders in exchange for a portion of such shares. This tender offer was squarely within the purview of Sec. 311 and presumably was accomplished without any tax to Alleghany Corporation on the appreciation in New York Central Railroad Co. shares.[23]

It was certain that this redemption and the distributing company's tax consequences would interest certain members of the insurance industry. Historically, the stock property and liability insurance companies have had an investment commitment in equity securities nearly equal to capital and surplus.[24] With a generally rising price level of stocks during the 1960s, this industry had available substantially appreciated property with a readily determinable market value which could be used to redeem shares, if necessary or desirable. There are at least three reasons why insurance companies might desire to use appreciated property to redeem shares.

- Earnings per share could be increased by (1) decreasing the number of outstanding shares, and (2) including appreciation in reported income.
- The treasury shares acquired could be used for future acquisitions on a tax-free basis, whereas use of an appreciated portfolio or the proceeds from the sale of the portfolio for acquisitions would cause a capital gains tax.
- Reduction of the number of outstanding shares could make it less likely for the insurance company to become an unwilling partner in a takeover attempt.

Thus during 1968, INA Corporation acquired 544,750 of its own shares in exchange for marketable securities which had appreciated $14,654,000.[25] This transaction, plus an additional redemption of

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[23] It appears fairly certain that the conclusion set forth in Rev. Rul. 68-21, 1968-1 CB 104 was applied to the Alleghany redemption.

[24] See Aggregate Admitted Assets, Liabilities and Policyholder Surplus for approximately 800 Stock Property and Liability Insurance Companies contained in *Bests Aggregates and Averages.*

12/31/68 totals	1969 Volume, page 52
12/31/67 totals	1968 Volume, page 54
12/31/66 totals	1967 Volume, page 56

[25] INA Corporation annual report of 1968, note 6 to Consolidated Financial Statements, p. 10.

shares by INA in 1969 and similar redemptions by two other insurance companies were reported by a financial magazine in an article entitled, "The Great Tax-Free Cash-In."[26] The article implied that this was a tax "loophole" which could cost the United States Treasury enormous lost revenue with IRS approval. The amount of potential loss of tax revenue was suggested by a sample listing of appreciated securities owned by five major insurance companies—the sample listing indicated amounts of appreciation totaling one-half billion dollars, on which taxes could be avoided if the securities were used to redeem shares.

It is not surprising that this situation was quickly brought to the attention of the Senate Finance Committee while it was considering the Tax Reform Bill in November 1969. Upon consideration, this committee did not believe that any corporation should be permitted to avoid tax on appreciated property (investments, inventory, or business property) by disposing of the property in that manner.

Solution. Accordingly, the Senate added paragraph (d) to Sec. 311—to apply to all corporations, not merely insurance companies. This amendment requires, in general, that if a corporation distributes appreciated property to a shareholder in redemption of part or all of a shareholder's stock, gain is to be recognized to the distributing corporation to the extent of the appreciation. Whether the Congress overreacted in blanketing all taxpayers under the new rule,[27] there is no doubt that Sec. 311(d) will discourage insurance companies (as well as any other type of corporation) from making a practice of distributing its own stock with appreciated securities or other properties.

The following distributions are excepted from the general rule, in the statute itself.

- Distributions in complete termination of the interest of a shareholder owning at least 10% of the outstanding stock of the corporation.

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[26] *Forbes Magazine,* Nov. 1969, p. 52.

[27] Because Sec. 311(d) was added to the Reform Act at the last minute, the Conference Committee requested both the Treasury Department and the congressional staff to analyze the new provisions to determine whether any tax-avoidance possibilities still remain and whether the changes will result in hardship in any areas. See. H. Rep. (Conf.) No. 91-782 (12/21/69), p. 333.

• Distributions of stock of a 50% or more owned subsidiary conducting an active trade or business.

• Distributions of stock of a newly created subsidiary carrying on a business formerly conducted by the distributing corporation.

• Distributions pursuant to certain antitrust decrees.

• Redemptions which qualify under Sec. 303, relating to payment of death taxes.

• Redemptions from private foundations to eliminate excess business holdings.

• Distributions by regulated investment companies upon demand of their shareholders.

It is stressed that the above exceptions to the general rule, as well as the transitional rules below, are merely listings—and that there are significant limitations and qualifications on the exceptions which are not covered here.[28]

Note that Sec. 311(d) changes the prior rule of Sec. 311 only with respect to recognition of gain; the rule that no loss is deductible by a corporation on the distribution of depreciated-in-value property remains unchanged. Also noteworthy is that Sec. 311(d) does not affect the tax treatment of property distributed pursuant to a declined dividend, since there would be no redemption. But if a purported stock redemption were subsequently held to be essentially equivalent to a dividend, gain would be recognized.[29]

New Sec. 311(d) generally applies to distributions after November 30, 1969, but it does not apply to certain planned but uncompleted redemptions as of such date, namely distributions made pursuant to:

• Written contracts entered into on or before November 30, 1969.

• Written offers made by the corporation before December 1, 1969.

• Written offers made pursuant to a ruling request filed with the IRS or a registration statement filed with the SEC prior to December 1, 1969.

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[28] It is doubtful whether any of the exceptions would apply to the publicized utilization of Sec. 311, before its Reform Act amendment, by insurance companies.

[29] See H. Rep. (Conf.) No. 91-782 (12/21/69), p. 333.

Real reforms

Tax reform means different things to different people, depending on their points of view. To some it means legislation necessary to close "loopholes" which give unfair advantages to some taxpayers. To others, it means change necessary to remove an onerous and unfair burden. Both points of view fit the dictionary definition, "A correction of an abuse." As to the amendments aimed at the insurance industry by the Reform Act, it is fair to conclude that they truly represent reform. Three of the changes definitely assist insurance companies in eliminating an onerous tax burden or unfair restrictions on operations or corporate reorganizations, and one change appears to eliminate the possibility of an unfair advantage to taxpayers without disturbing the fundamentals of a long-standing tax concept.

Thus the group contingency reserve amendment is a giant step forward in eliminating problems and uncertainty in the taxation of group insurance business of life insurance companies. The amendments permitting certain rearrangements of parent and subsidiary relationships for life insurance companies allow desirable corporate reorganization without disturbing the basic tax formula to be applied to incomes of life insurance companies. Further, the allowance of loss carryovers for economic losses of insurance companies, even though a new tax formula is applied, is a step toward tax equity. Finally, the amendments regarding use of appreciated property to redeem shares appear to not only prevent an unfair tax avoidance, but also provide some additional desirable guidelines for the use of appreciated property in the redemption of outstanding corporate shares.

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Natural resources

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During the eight months following the Administration's request for tax reform to eliminate special preferences in the law which permit too many Americans to pay less than their fair share of taxes, Treasury Department personnel, committees of both the House and Senate and interested individuals and organizations probably expended more continuous time and effort on the 1969 Tax Reform Act than on any tax bill ever passed. One of the principal problems which concerned Treasury Department officials was that of persons with high incomes paying little tax.

Assistant Secretary Edwin S. Cohen stated[1] that, "in large part this is due to a series of provisions in the tax law which are clearly tax preferences," and listed as the first of these provisions percentage depletion on minerals and intangible drilling and exploration expenses to the extent they exceed what would be normal deductions under regular accounting rules. From start to finish, the oil and gas industry was included prominently in the proposals for tax reform as having certain "tax preferences" which needed to be eliminated or reduced in some manner. However, it is interesting to note that the widely publicized 154 individuals who had adjusted gross income of $200,000 or more in 1966 and paid no federal income taxes apparently had deductions for depletion which accounted for less than 1% of their total deductions.

The changes in the 1969 Act will be discussed under the following headings:

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[1] Statement Before the House Ways and Means Committee on the President's Tax Program, April 22, 1969.

Carved-out production payment
What is a carved-out production payment?
Reasons for TRA change
Exception
Retained production payment on sale of mineral property
What is a retained production payment?
Reasons for TRA change
Production payment retained in leasing transaction
Effective dates for mineral production payment changes
Transitional rules
Scope of mineral production payment provisions
Transactions not involving sales
Take-or-pay gas contracts
Carried interest arrangements
Percentage depletion changes
Rate changes
Miscellaneous changes
Depletion as tax preference item
Foreign tax credit with respect to certain foreign mineral income
Mine exploration expenditures
Conclusion

In addition, Exhibit A and the supporting schedules, pages 322 to 329, project the estimated tax revenues realizable under alternative tax treatments of sales of oil and gas properties.

Of the various provisions, the addition of new Sec. 636 will probably have more impact on mineral transactions than any other single provision of the 1969 Act. Prior to the advent of Sec. 636, the tax treatment of mineral production payments was not specifically covered by statute; instead the IRS and the courts developed the ground rules.

A brief discussion of prior law has been provided where it may facilitate the understanding of the changes made by the 1969 Act pertaining to natural resources, particularly with respect to oil and gas.

Carved-out production payment

New Sec. 636(a) provides generally that a production payment carved out of a mineral property shall be treated as if it were a

mortgage loan on the property and shall not qualify as an economic interest in the mineral property.

What is a carved-out production payment? In its simplest form a carved-out production payment is an economic interest in minerals in place created by an owner out of an economic interest he holds in a mineral property. It is limited to a fixed period of time, a specified dollar amount or a number of production units extending over a period less than the full economic life of the mineral property.

The IRS has ruled[2] and the Supreme Court has held[3] that the assignment of a production payment carved out of any depletable interest for a consideration which is not pledged for use in the development of the property results in ordinary income to the assignor and is subject to the allowance for depletion.

Example. T, who owns an oil and gas lease, conveys to *P* (purchaser) for a cash consideration of $200,000 a production payment right entitling *P* to receive $250,000 payable solely from the sales of one-half of the production of his lease.

Under prior law, the sale results in the present realization by *T* of future income in the amount of $200,000. The amounts utilized to pay out the production payment are excluded from the income of *T*, but he deducts any expenses attributable to producing such amounts in the year they are incurred. Since *P* has acquired a depletable interest in property, he reports the income when he receives it and claims cost depletion as a deduction from such income. In this example, *P*'s cost depletion is computed as 80% of gross income as received:

$$\frac{\text{Cost—\$200,000}}{\text{Expected proceeds—\$250,000}} = 80\%$$

T's income from the property is computed as follows:

Gross income from sales of oil and gas	$100,000	
Gross income from sale of carved-out production payment	200,000	$300,000
Deductions (severance taxes, depreciation, operating expenses, intangible drilling costs and overhead)		130,000
Net income before depletion		170,000
Less—allowable depletion (27½% of $300,000, not to exceed 50% of $170,000)		82,500
Net taxable income		$ 87,500

[2] GCM 24849, 1946-1 CB 66; I.T. 4003, 1950-1 CB 10.

[3] P. G. Lake, Inc., 356 US 260 (1 AFTR2d 1394, 58-1 USTC ¶9428).

If *T* in the previous example had not sold the $200,000 carved-out production payment, he would have been entitled to no percentage depletion on the gross income of $100,000 from the property because Sec. 613(a) limits the percentage depletion allowance to 50% of the taxable income (before depletion) from the property. There would be no taxable income from the property without including the production payment.

From the viewpoint that no percentage depletion would have otherwise been allowable, it may be asserted that the net effective percentage depletion rate on the $200,000 production payment is 41¼% (i.e., $82,500 ÷ $200,000). However, to put the concept in proper perspective, it should be emphasized that the taxpayer's overall *percentage* depletion rate can never exceed 27½% of gross income from the property. In the above example, *T* could have obtained the same percentage depletion, without selling a carved-out production payment, by controlled timing of his drilling program. Many critics who use the depletion argument in opposing the carved-out production payment transaction fail to acknowledge this fact.

In the above example, under new Sec. 636(a), the $200,000 carved-out production payment is treated as a loan and not as present income subject to percentage depletion. Furthermore, *T* is not entitled to any percentage depletion on the $100,000 of gross income. As far as *P* is concerned, he would treat the $50,000 in excess of his $200,000 "loan" as interest income.

Reasons for TRA change. The reasons given for the provision by the Treasury and the congressional committees are essentially the same. In its report to accompany H. R. 13270, the Senate Finance Committee stated that by advancing the time that income (but not the related expense) is reported for tax purposes, taxpayers have been able to avoid limitations based on net or taxable income —not only the 50% limitation on taxable income from the property for percentage depletion purposes, but also the limitations on amount of foreign tax credit and the periods for carrying over net operating losses and unused investment credit.[4]

The above example illustrates how a taxpayer was able to increase his effective rate of percentage depletion by selling a production payment and thereby raising net taxable income before

[4] S. Rep. No. 91-552 (11/21/69), p. 183.

depletion to a level which will give him a deduction for the full percentage depletion allowance. It should be pointed out that the IRS has always taken the position that the sale of a carved-out production payment is ordinary income subject to depletion—so taxpayers have been merely applying the rules as determined by the IRS.

It is understood that when taxpayers in the hard minerals industry began using carved-out production payments several years ago, instances were created where the sale of a carved-out production payment to maximize depletion in one year could result in losses in future years being carried back to recover taxes paid for the production payment year. Over a several year cycle of this procedure, the hard minerals taxpayers were actually paying no federal income tax, primarily because of the depletion allowance. Only in an isolated instance would this be possible in the oil and gas industry. It is the writer's opinion that the use of carved-out production payments in the oil and gas industry to prevent NOLs from being lost because of the expiration of the five-year carryover period should be permitted.

Exception. There is an exception to the mortgage loan treatment for carved-out production payments. Sec. 636(a), in general terms, provides that a production payment carved out for exploration or development of a mineral property will not be treated as a loan if and to the extent that, under present law, gross income would not be realized by the creator of the production payment. Sec. 636(a) itself does not refer to present law, but the committee reports[5] refer to treatment under existing law as a result of the *Rawco*[6] case and several rulings.[7]

> *Example.* *T* needs funds to drill and complete a test well on an oil and gas lease he owns. To secure the $75,000 needed, he agrees to pay the lender the sum of $100,000 payable out of one-half of the first oil and gas produced from the property. *T* also agrees to return to the lender any portion of the $75,000 not spent for drilling and equipping the well, with the production payment being reduced proportionately.

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[5] H. Rep. No. 91-413, Part 1 (8/2/69), p. 141; S. Rep. No. 91-552 (11/21/69), p. 185.

[6] 37 BTA 128.

[7] GCM 22730, 1941-1 CB 214; GCM 24849, 1946-1 CB 66; I.T. 4003, 1950-1 CB 10.

In the above example, the taxpayer has pledged to use the consideration received from sale of the production payment to develop the property from which the production payment is carved. Where the production payment is assigned in consideration of equipment installed on the property or the drilling of wells on the property out of which it is carved, or where the funds are pledged for such use, no taxable income is received by the assignor.

To qualify under this exception, the following conditions must be met:[8]

- The production payment must not be given to satisfy a liability previously incurred.
- The production payment must be carved out of the unit of property on which the development is to occur.
- The assignee of the production payment must look solely to production of oil and gas for the recovery of his capital investment.
- The assignor must either return to the assignee any excess funds not used for the development of the property or subject the excess proceeds to the tax treatment accorded to carved-out production payments.

Under new Sec. 636(a), it would seem that any excess proceeds not returned to the lender would be treated as a loan under the general rule.

Retained production payment on sale of mineral property

New Sec. 636(b) provides that a production payment retained on the sale of a mineral property shall be treated as if it were a purchase-money mortgage loan and shall not qualify as an economic interest in the mineral property.

What is a retained production payment? A retained production payment is generally created when the owner of a mineral property disposes of such mineral property but reserves a production payment for himself. As in the case of a carved-out production payment, the retained production payment is an economic interest which does not extend over the economic life of the mineral property out of which it was retained. Under prior law, receipts from the retained production payment are depletable income to the transferor of the

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[8] See notes 6 and 7.

mineral property and are excludable from the income of the transferee.[9]

The retained production payment comes into play most often in the so-called ABC transaction. In a typical ABC transaction, the owner of the mineral property, *A*, sells the property to a second person, *B*, and reserves an interest-bearing production payment, generally for a substantial part of the total purchase price. *A* contemporaneously sells the production payment to a third party, *C*, who then becomes the owner of an economic interest in a mineral property, i. e., the production payment. The tax consequences, to the various parties, before TRA, were as follows:

- *A* has disposed of his entire interest in the mineral property and, therefore (assuming that he is not a dealer in mineral properties and a more than six-month holding period), any gain from the sale of the mineral property and the production payment would be treated as long-term capital gain.
- *B* has purchased an interest in a mineral property and must allocate the cash payment to *A* between depreciable equipment and depletable leasehold costs in the ratio of their respective fair market values. Any amounts of production going to satisfy the production payment purchased by *C* will be excluded from *B*'s taxable income.
- *C* has purchased an economic interest in a mineral property—the retained production payment. Since normally the amount paid for the production payment will exceed 27½% of the total income to be received, *C* will compute cost depletion with respect to amounts received in satisfaction of the production payment. Thus, if he pays $200,000 for a production payment which should produce $250,000 over its productive life, he will claim cost depletion at the rate of 80%.

Reasons for TRA change. Without going into detail with respect to the general reasons for change in the law with respect to ABC transactions, it appears that the principal objections relate to:

- The fact that a substantial part of the purchase price of a mineral property was satisfied out of pre-tax dollars.

[9] Perkins, 301 US 655 (19 AFTR 538, 37-2 USTC ¶9315); Delacroix Corp., 13 TC 827.

- The use of the ABC transaction had spread to industries other than oil and gas (e. g., the coal industry).
- There was allegedly a substantial tax revenue loss from ABC transactions and carved-out production payments.

The analogy between a sale of a mineral property under an ABC transaction and an apartment building with the use of a mortgage, as spelled out in the House Committee Report, appears to be a weak case.[10]

In explaining the reasons for changing the tax treatment of both ABC transactions and carved-out production payments, the House Committee[11] made reference to an estimated annual revenue loss of between $200 and $350 million from such transactions which could be expected to accelerate if not corrected. No estimate was mentioned for ABC transactions only.

A strong argument can be made that the increase in tax revenues which will actually result will not be material as a result of the elimination of the ABC transaction with respect to sales of oil and gas properties. See Exhibit A and supporting schedules at the conclusion of this article, which estimate tax revenues to be realized by the Treasury Department from the sale of the same oil and gas property under different assumptions as to tax treatment.

Although it is too early to analyze the total impact of the change in tax treatment of ABC transactions, it is evident that prospective purchasers of producing properties are applying a greater discount to arrive at a fair market value. With sales prices depressed, more owners will undoubtedly hold onto producing properties which will result in a current tax revenue loss to the government when compared with a sale to third parties under any of the plans set forth in Exhibit A at the end of this article.

Production payment retained in leasing transaction

New Sec. 636(c) provides that a production payment retained in a mineral property by a lessor in a leasing transaction shall be treated insofar as the lessee (or his successors in interest) is concerned, as if it were a bonus payable in installments by the lessee to

[10] The purported reasons why it was proposed that the ABC transaction be eliminated are spelled out in H. Rep. No. 91-413, Part 1 (8/2/69), pp. 139-141.

[11] H. Rep. No. 91-413, Part 1 (8/2/69), p. 141.

the lessor. On the other hand, Sec. 636(c) specifies that the treatment of the production payment in the hands of the lessor shall be determined without regard to the tax treatment required of the lessee. In explaining Sec. 636(c), the House Committee stated that the lessee will be required to capitalize the payments and then recover them through depletion. The House Committee apparently does not take into account that the lessee is not entitled to claim depletion with respect to the bonus paid to the lessor. At least to that extent, the justification given for adopting the installment bonus treatment is without merit. In the hands of the lessor, the production payment would be treated in the same manner as under present law, i.e., as income subject to the deduction for percentage depletion.

Effective dates for mineral production payment changes

The 1969 Act applies to mineral production payments created on or after August 7, 1969—other than mineral production payments created before January 1, 1971 – pursuant to a binding contract entered into before August 7, 1969. (This effective date, prescribed in Act Sec. 503(c), is a compromise between the April 22, 1969 date set by the House Committee and the October 9, 1969 date proposed by the Senate Committee.)

Transitional rules. In accordance with regulations to be prescribed by the Secretary, the taxpayer may elect to have the new rules apply to all mineral production payments which he carved out of mineral properties after the beginning of his last taxable year ended before August 7, 1969. If such an election results in any refund or credit for an overpayment of tax for any taxable year ended before August 7, 1969, no interest will be allowed on such refund or credit.

If a taxpayer does not make the election mentioned in the previous paragraph, and he carves out one or more mineral production payments on or after August 7, 1969, during the taxable year which includes such date, the new rules will apply to such production payments only to the extent that the aggregate amount of such production payments exceeds the *lesser of:*

• The excess of – (1) the aggregate amount of production payments carved out and sold by the taxpayer during the 12-month period immediately preceding his taxable year which includes

August 7, 1969, over (2) the aggregate amount of production payments carved out before August 7, 1969, by the taxpayer during his taxable year which includes such date; or

- The amount necessary to increase the amount of the taxpayer's gross income for the taxable year which includes August 7, 1969, to an amount equal to the amount of deductions (other than any NOL deduction) allowable for such year.

However, in applying the old rules, the taxpayer will not be permitted to deduct percentage depletion or foreign tax credit with respect to such carved-out production payment.

Scope of mineral production payment provisions

From a reading of the committee reports, it appears that the new provisions pertaining to production payments were intended to apply to a few special types of situations, the principal ones being ABC transactions and sales of carved-out production payments which would increase allowable depletion. Thus, it would appear that the new provisions should have limited applicability and should be construed accordingly. Since no regulations or rulings have yet been issued, it may be some time before we can get answers to questions raised by the new Act.

Transactions not involving sales. Sec. 636(b) refers to production payments retained on the sale of a mineral property. In other subchapters of the Code, the word "sale" has been defined to include "exchange." Consequently, tax-free exchanges should not come within the mortgage-loan provisions.

Following the same reasoning, the gift of a mineral property subject to a retained production payment should be accorded the treatment followed prior to the new Act. Similarly, a dividend paid in the form of a mineral property where the payor corporation retains a production payment would not appear to meet the test of sale carve out or retention in a leasing transaction.

Take-or-pay gas contracts. The IRS has consistently taken the position that advance payments for gas received by a seller under a gas purchase contract are income in the year of receipt under the "claim of right" doctrine. The advance payments for gas, which normally must be recovered solely out of gas produced and taken from the

properties covered by the gas purchase contract, appear to be nothing more than purchases of carved-out production payments. Under the new provisions, the advance payments would be treated as a mortgage loan on the properties and the seller of the gas would have no taxable income until the gas is delivered in satisfaction of the advance payments. However, the treatment accorded such advance payments would have to be determined in the light of the contract between buyer and seller. If the requisite elements are present, the advance payment could constitute proceeds from sale of a carved-out production payment.

Carried interest arrangements. It is to be expected that the IRS will attempt to apply the loan treatment concept to certain types of carried interests. For example, the IRS may contend that an overriding royalty convertible by the assignor into a percentage of the working interest after payout is a production payment retained in a leasing transaction. Such treatment would appear to be contrary to the intent of the new Act.

A full discussion of carried interests is beyond the scope of this article. However, certain rules and guidelines have been established by the IRS[12] and the courts[13] with respect to the tax treatment of carried interests. The carried interest is a common sharing arrangement in the oil industry which is used for bona fide business reasons. It does not appear to contain any of the "inequities" the Tax Reform Act was intended to eliminate.

Percentage depletion changes

Rate changes. For years beginning after October 9, 1969, Sec. 613(b) provides for lower percentage depletion rates with respect to many mineral deposits. The most significant change is the reduction of the percentage depletion rate with respect to oil and gas wells from 27½% to 22%. Correspondingly, in order to bring other depletion rates to this maximum, the rates for sulphur, uranium and certain other minerals, if from deposits within the United States, were changed to 22%. Slight reductions were made in the rates with respect to some other minerals, but many rates remain the same.

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[12] GCM 22730, 1941-1 CB 214.

[13] Manahan Oil Co., 8 TC 1159; W. H. Cocke, CA-5, 399 F2d 433 (22 AFTR2d 5267, 68-2 USTC ¶9502).

EXHIBIT A

Summary of effect of Tax Reform Act on fair market value of and tax revenue from oil and gas properties

	Tax treatment		
	1	2	3
	Cash purchase	ABC transaction (prior to Tax Reform Act)	ABC transaction (production payment treated as mortgage loan)
Fair market value of property			
Cash flow from property (after federal income taxes)	$1,259,100	843,800	675,200
Principal amount of production payment	—	500,000	500,000
Total after-tax cash flow	1,259,100	1,343,800	1,175,200
Fair market value (present value of after-tax cash flow discounted at 12½%)	572,400	781,800	668,900
Federal income taxes			
Seller	104,300	162,900	131,300
Purchaser of the property	549,400	303,400	472,000
Purchaser of production payment	—	77,400	77,400
Total	653,700	543,700	680,700
Present value of federal income taxes discounted at 7%			
Seller	97,500	152,200	122,700
Purchaser of the property	346,700	147,200	280,500
Purchaser of production payment	—	66,300	66,300
Total	$ 444,200	365,700	469,500

Basic assumptions applicable to each tax treatment:

• An oil and gas property initially produces annual gross income of $150,000. After the third year, annual production decreases at a rate of 5% of the production of the preceding year.

• Seller's basis in lease and well equipment is $200,000; the purchaser of the working interest allocates $200,000 to lease and well equipment.

- Operating expenses are $15,000 annually.
- Percentage depletion is 22% of gross income limited to 50% of net income.
- All taxpayers involved are corporations.
- Federal income tax rate is 48% of ordinary income and 28% of capital gains. In all examples, it is assumed that the taxpayer corporations have other income in excess of $25,000 each year.
- No minimum tax on tax preference items has been computed. It is assumed that the sum of the $30,000 exemption and the federal income taxes exceeds the tax preference items.
- Federal income taxes are discounted to present value using a 7% rate. This discount factor is believed to be realistic in view of the cost of long-term money to the government.
- The fair market value of the property is the present value of the annual after-tax cash flow from the property discounted at 12½%. This discount factor is believed to be realistic in view of the average rate of return of the oil and gas industry.

It is notable that the percentage depletion rate for molybdenum was increased from 15% to 22%.

Miscellaneous changes. In the "catch all" section covering the depletion rate for "all other minerals," Sec. 613(b)(7) was amended to the effect that minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake in the United States shall not be considered minerals from an inexhaustible source. Prior to the addition of this particular provision, the IRS took the position that percentage depletion was not available with respect to minerals extracted from the Great Salt Lake because it is considered to be an inexhaustible source. The changes with respect to the percentage depletion rates and the classification of certain minerals as being from an inexhaustible source apply for taxable years begun after October 9, 1969.

In order to clear up questions concerning what constitutes gross depletable income from an oil shale property, a new Sec. 613(c)(4)(H) was added to the Code. It defines ordinary treatment processes in the case of oil shale as extraction from the ground, crushing, loading into the retort and retorting, but not hydrogenation, refining, or any other process subsequent to retorting.

Depletion as tax preference item

Numerous other suggestions for changes were offered with respect to depletion and intangible drilling and development costs before the 1969 Act was finalized. Suggested changes were very

complex in nature and would have placed a tremendous accounting burden upon oil and gas operators. These were all discarded along the way with the exception of the inclusion of depletion as a tax preference item to be taken into account in the computation of the minimum tax.

The amount of depletion to be included as a tax preference item is computed on a property-by-property basis, and is the excess of the deduction for percentage depletion for the taxable year over the adjusted basis of the property at the end of the taxable year, determined without regard to the depletion deduction for the taxable year.

Example. The adjusted basis of an oil and gas lease at December 31, 1970 (before the 1970 depletion deduction) is $10,000, and percentage depletion allowable for 1970 is $15,000. The excess depletion of $5,000 would be included as a tax preference item.

Foreign tax credit with respect to certain foreign mineral income

A new Sec. 901(e) provides generally that a foreign tax credit is not to be allowed for foreign taxes imposed on foreign mineral income, considered on a country-by-country basis, to the extent the foreign tax is attributable to the percentage depletion allowance granted by the United States. In other words, excess foreign tax credits attributable to the percentage depletion allowance on mineral income from a foreign country cannot reduce United States tax payable on other foreign income. This is illustrated in the following example:

Example:

	Foreign country	Normal U.S.	U.S. without depletion
Taxable income	$100,000	$78,000	$100,000
Income tax	58,000	39,000	50,000
Net after tax	$ 42,000	$39,000	$ 50,000
Foreign tax			$ 58,000
Reduced by excess of — U. S. tax			
without depletion		$50,000	
Over normal U. S. tax		39,000	
			11,000
Foreign tax available for credit			$ 47,000

Cash purchase

SCHEDULE 1

	20-Year Total	1	2	3	4	5	6	7	Years 8-20
A—Seller—capital gains on $372,400 at 28%	$ 104,300	104,300							
B—Purchaser of the property									
Gross income	2,108,500	150,000	150,000	150,000	142,500	135,400	128,600	122,200	1,129,800
Deductions									
Operating expenses	300,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000	195,000
Depreciation	200,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	130,000
Depletion	463,900	33,000	33,000	33,000	31,400	29,800	28,300	26,900	248,500
Total deductions	963,900	58,000	58,000	58,000	56,400	54,800	53,300	51,900	573,500
Taxable income	1,144,600	92,000	92,000	92,000	86,100	80,600	75,300	70,300	556,300
Federal income tax at 48%	549,400	44,200	44,200	44,200	41,300	38,700	36,100	33,700	267,000
Present value of future payments of federal income tax discounted at 7%				—	—	—			
Seller	97,500	97,500	—	—	—	—	—	—	—
Purchaser of the property	346,700	42,700	39,900	37,300	32,600	28,500	24,900	21,700	119,100
Total	444,200	140,200	39,900	37,300	32,600	28,500	24,900	21,700	119,100
Cash flow to purchaser of the property	1,259,100	90,800	90,800	90,800	86,200	81,700	77,500	73,500	667,800
Present value of cash flow discounted at 12½%	$ 572,400	85,700	76,100	67,700	57,100	48,100	40,600	34,200	162,900

Additional assumptions applicable to the cash purchase treatment:

- The oil and gas property described above is sold outright for $572,400 cash.
- In the present example, the proceeds from the sale are received in the year of sale. If the proceeds were received in installments and the seller elected the installment method of reporting, the present value of federal income taxes would decrease.
- No interest expense has been computed in this example as the purchaser has the available cash for purchasing the property. Giving effect to a rate of return which an alternative investment would yield would result in a decrease in the fair market value of the property.

SCHEDULE 2

ABC transaction
(Prior to Tax Reform Act)

	20-Year Total	1	2	3	4	5	6	7	Years 8-20
A—Seller—capital gains on $581,800 at 28%	$ 162,900	162,900							
B—Purchaser of the property									
Gross income	1,447,200	45,000	45,000	45,000	42,700	40,600	38,600	60,500	1,129,800
Deductions									
Operating expenses	300,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000	195,000
Depreciation	200,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	130,000
Depletion	314,900	9,900	9,900	9,900	8,800	7,800	6,800	13,300	248,500
Total deductions	814,900	34,900	34,900	34,900	33,800	32,800	31,800	38,300	573,500
Taxable income	632,300	10,100	10,100	10,100	8,900	7,800	6,800	22,200	556,300
Federal income taxes at 48%	303,400	4,800	4,800	4,800	4,300	3,700	3,300	10,700	267,000
C—Purchaser of production payment									
Gross income—70% of production	661,300	105,000	105,000	105,000	99,800	94,800	90,000	61,700	—
Less—depletion	500,000	63,200	68,800	75,000	76,400	78,100	80,200	58,300	—
Taxable income	161,300	41,800	36,200	30,000	23,400	16,700	9,800	3,400	—
Federal income taxes at 48%	77,400	20,100	17,400	14,400	11,200	8,000	4,700	1,600	—

Present value of future payments of federal income tax discounted at 7%									
Seller	152,200	152,200	—	—	—	—	—	—	—
Purchaser of the property	147,200	4,600	4,300	4,100	3,400	2,700	2,100	6,900	119,100
Purchaser of production payment	66,300	19,400	15,700	12,200	8,800	5,900	3,200	1,100	—
Total	365,700	176,200	20,000	16,300	12,200	8,600	5,300	8,000	119,100
Cash flow to purchaser of the property	843,800	25,200	25,200	25,200	23,400	21,900	20,300	34,800	667,800
Present value of cash flow discounted at 12½%	$ 281,800	23,800	21,100	18,800	15,500	12,900	10,600	16,200	162,900

Additional assumptions applicable to pre-Tax Reform Act treatment of ABC transactions:

- The oil and gas property is sold by the owner corporation for $781,800 in an ABC deal, purchaser paying cash and taking the property subject to a production payment of $500,000 plus interest at 9% of the unpaid balance, payable out of 70% of gross income. Owner corporation simultaneously sells this reserved production payment to investor for $500,000 cash.
- Purchaser of production payment uses its own funds to make the purchase.

SCHEDULE 3

ABC transaction (after Tax Reform Act)

	20-Year Total	1	2	3	4	5	6	7	Years 8-20
A—Seller—capital gains on $468,900 at 28%	$ 131,300	131,300							
B—Purchaser of the property									
Gross income	2,108,500	150,000	150,000	150,000	142,500	135,400	128,600	122,200	1,129,800
Deductions									
Operating expenses	300,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000	195,000
Interest	161,300	41,800	36,200	30,000	23,400	16,700	9,800	3,400	—
Depreciation	200,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	130,000
Depletion	463,900	33,000	33,000	33,000	31,400	29,800	28,300	26,900	248,500
Total deductions	1,125,200	99,800	94,200	88,000	79,800	71,500	63,100	55,300	573,500
Taxable income	983,300	50,200	55,800	62,000	62,700	63,900	65,500	66,900	556,300
Federal income taxes at 48%	472,000	24,100	26,800	29,800	30,100	30,700	31,400	32,100	267,000
C—Purchaser of production payment									
Gross receipts—70% of production	661,300	105,000	105,000	105,000	99,800	94,800	90,000	61,700	—
Less—Payments applied to principal	500,000	63,200	68,800	75,000	76,400	78,100	80,200	58,300	—
Taxable income	161,300	41,800	36,200	30,000	23,400	16,700	9,800	3,400	—
Federal income taxes at 48%	77,400	20,100	17,400	14,400	11,200	8,000	4,700	1,600	—

Present value of future payments of federal income tax discounted at 7%									
Seller	122,700	122,700	—	—	—	—	—	—	—
Purchaser of production payment	66,300	19,400	15,700	12,200	8,800	5,900	3,200	1,100	—
Purchaser of the property	280,500	23,300	24,200	25,200	23,800	22,600	21,600	20,700	119,100
Total	469,500	165,400	39,900	37,400	32,600	28,500	24,800	21,800	119,100
Cash flow to purchaser of the property	675,200	5,900	3,200	200	(2,400)	(5,100)	(7,800)	13,400	667,800
Present value of cash flow discounted at 12½%	$ 168,900	5,600	2,700	200	(1,600)	(3,000)	(4,100)	6,200	162,900

Additional assumptions applicable to post-TRA treatment of ABC transaction:

- The oil and gas property is sold by the owner corporation for $668,900 in an ABC deal, purchaser paying cash and taking the property subject to a production payment of $500,000 plus interest at 9% of the unpaid balance payable out of 70% of gross income. Owner corporation simultaneously sells this reserved production payment to investor for $500,000 cash
- Under the Tax Reform Act, the production payment is treated as a mortgage loan on the mineral property.
- Purchaser of production payment uses its own funds to make the purchase.

The limitation applies to taxable years beginning after December 31, 1969. Taxpayers who previously elected the overall limitation on the foreign tax credit may revoke the election without consent of the IRS for the taxpayer's first taxable year beginning after 1969.

Mine exploration expenditures

Sec. 615, relating to deductions (or deferral) of up to $400,000 (not to exceed $100,000 per year) of mine exploration expenditures, was repealed as to expenditures incurred after December 31, 1969. This change brings all taxpayers under Sec. 617 which provides, generally, that mine exploration expenditures incurred after December 31, 1969 are now subject to recapture. Thus, if a mine becomes productive, all exploration expenditures incurred with respect to that mine are subject to recapture. It should be noted that the recapture rules do not apply to amounts deducted or deferred under Sec. 615 prior to December 31, 1969.

There is an overall limitation of $400,000 on the deduction for mine exploration costs incurred in foreign activities. Not only is the $400,000 allowable for foreign activities to be reduced by amounts previously deducted under either Sec. 615 or 617, but both U. S. and foreign costs are taken into account in determining the maximum deduction. If it is feasible, taxpayers should plan to spend the first $400,000 abroad if foreign mining operations are involved.

The Senate Committee Report indicates that the intent is to have Sec. 617 and its recapture rules apply only to exploration costs incurred prior to the beginning of the development stage of a mine.[14] Such costs incurred after beginning of the development stage, and not for the purpose of discovering a new mine, are to be deductible in full as development or operating expenses.

This would seem to repudiate the Court of Appeal's decision in *Santa Fe Pacific*,[15] which the IRS has considered as authority for

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[14] S. Rep. No. 91-552 (11/21/69), p. 188.

[15] Sante Fe Pacific Ry. Co., CA-7, 378 F2d 72 (19 AFTR2d 1504, 67-1 USTC ¶9457).

requiring that all exploration type expenditures incurred after the development stage of a mine has been reached must be capitalized.

Conclusion

Whenever there is a radical change in provisions of the Internal Revenue Code, there are usually many questions as to the extent of its applicability. The changes made by Sec. 636 are radical in nature and it may well be years before guidelines are established under that section. It is fortunate that the various congressional committee reports spell out quite clearly the "abuses" which the Tax Reform Act is intended to cure. The difficulty will come when there is an attempt to extend the applicability of Sec. 636 to transactions other than those set forth as reasons for the change.

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Depreciation and amortization

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The 1969 "reformation" of the depreciation and amortization provisions of the Code consists of:

- Limiting the use and benefits of applying accelerated methods of depreciation to real estate, which methods had been available under Sec. 167(b) since its enactment in 1954;[1]
- Expanding the rules for recapture of post-1969 depreciation on real estate so as to conform them more closely to the recapture rules for tangible personal property;
- Decelerating the impact of depreciation on earnings and profits;
- Freezing depreciation methods used by regulated industries;
- Permitting amortization of pollution control facilities over a five-year period;
- Allowing railroads faster write-offs of certain expenditures;
- Allowing coal mines to amortize safety equipment over five years; and
- Indirectly imposing additional taxes on gains attributable to the use of accelerated methods of depreciation (e.g., the minimum tax and the increased capital gains tax).

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[1] Provisions of the Internal Revenue Code will be simply cited as "Sec.", while provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" will refer to the law as it existed prior to the Tax Reform Act amendments while "amended Sec." or "new Sec." will refer to sections of the Code as they exist after such amendments.

Restrictions on accelerated real estate depreciation[2]

"Tax shelter" has often been associated with investments in real estate. Where an accelerated depreciation method is employed, a real estate project can show a loss for tax purposes even though the venture is economically sound and would otherwise (under the straight-line method) show a profit. By financing with a large mortgage indebtedness venturers in real estate were able to deduct losses far in excess of their relatively small equity investment. If the real property could produce both a "cash flow" (after servicing the mortgage indebtedness) and a tax deductible loss (by use of an accelerated depreciation method), the appeal to the high-bracket taxpayer was undeniable. The possibility of capital gain on a later sale was an added incentive.

Prior law. Under prior law, real estate was depreciable under one of the following accelerated methods, if the taxpayer was the original user of the property:

- Declining balance method at a rate not exceeding twice the straight-line rate (double declining balance method); Sec. 167 (b)(2).
- Sum of the years-digits method: Sec. 167(b)(3).[3]

If the taxpayer was not the original user, the property was depreciable under the declining balance method but only at a rate not exceeding 150% of the straight-line rate (the 150% declining balance method).

New rules generally. In general, new Sec. 167(j) restricts the computation of depreciation as follows:

- For original use property—except newly constructed residential housing: No accelerated method of depreciation, other than the 150% double declining balance method, may be used.

[2] It may be useful to note that with respect to tangible personal property generally, the Tax Reform Act does not affect the use of accelerated depreciation or the Sec. 1245 rules for recapture.

[3] Sec. 167(b)(4) permits the use of any other consistent method which does not produce total depreciation allowances during the first two-thirds of the useful life of the property in excess of the total amount allowable under the double declining balance method. As a matter of convenience, references to the double declining methods will comprehend depreciation under a method which would be allowable under Sec. 167 (b)(4).

• For previously used property—except for certain residential property: No accelerated method may be used. Sec. 167(j) is prospective in its application, and does not require a taxpayer who was entitled to use any accelerated method under prior law to discontinue doing so.

New nonresidential rental property. Under new Sec. 167(j)(1), the "reasonable allowances" for depreciation of new buildings (other than residential housing and certain pre-July 25, 1969 construction and acquisitions) are limited to amounts computed under:

• The straight-line method,
• The 150% declining balance method, or
• Any other consistent method which during the first two-thirds of the useful life of the property does not produce allowances exceeding the total amount allowable under the 150% declining balance method.

The foregoing limitation on depreciation methods applies specifically to "Sec. 1250 real property." Consequently, real property which is classified by the Code[4] as Sec. 1245 property is not affected and, like tangible personal property, may be depreciated under one of the accelerated methods sanctioned by Sec. 167(b). Real property which falls under the Sec. 1245 classification includes depreciable tangible properties (but excludes a building or its structural components) which constitute:

• An integral part of manufacturing, production, extraction, or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or
• A research or storage facility used in connection with any activity described in the preceding item, or
• An elevator or escalator, or
• The portion of a pollution control facility (Sec. 169) and of a railroad grading bore or tunnel (Sec. 185) which is amortizable.

Furthermore, an accelerated method of depreciation may be employed in accordance with Sec. 167(b) for property:

• The construction, reconstruction or erection of which was begun before July 25, 1969, or
• With respect to which, prior to July 25, 1969, the taxpayer

[4] See Secs. 1250(c) and 1245(a)(3).

entered into a written construction or permanent financing contract, that was continuously binding.

New residential rental property exception. To encourage the construction of residential housing, new "residential rental property," if the taxpayer is the original user, has been excepted from the limitation on accelerated depreciation methods. To qualify as residential rental property, 80% or more of the gross rental income must be rental income from dwelling units. Dwelling units, for this purpose, do not include units in hotels, motels or other establishments in which more than one-half of the units are used on a transient basis. Sec. 167(i)(2)(C) specifies that a change in depreciation method required because the 80% test is not met in a given year is not considered a change of accounting method requiring approval.

Previously used nonresidential real estate. As previously indicated, the 150% declining balance method cannot be applied to "Sec. 1250 real property" acquired after July 24, 1969, unless the taxpayer is the original user of the property. For nonresidential real property, Sec. 167(j)(4) limits the depreciation allowance to the amount computed under the straight-line method or other method approved by the IRS. (Such other method cannot be a declining balance method or any accelerated method.) The new limitation on depreciation methods does not apply to "Sec. 1250 real property" for which a binding contract to acquire (or to permanently finance the acquisition of) existed at July 24, 1969.

Previously used residential property exception. For used residential property acquired after July 24, 1969 and having a life of 20 years or more, the taxpayer is limited, in effect, to the use of either the straight-line method or the 125% declining balance method. As with respect to used nonresidential property, the new limitation on depreciation methods does not apply to used "Sec. 1250 residential real property" for which a binding contract to acquire (or to permanently finance the acquisition of) existed at July 24, 1969. Consequently, the declining balance method at a 150% (instead of 125%) rate may be used for properties acquired under pre-July 25, 1969 commitments.

Used realty which is "newly" converted to business or income-producing use after July 24, 1969 will nevertheless be treated as

used property. Used residential property with a life of 20 years or less must be depreciated under the straight-line method or such other method as approved by the Commissioner. (Presumably, the Commissioner would not approve any "other method" which would result in substantially greater depreciation in the early years.)

Amortization of low-income rental housing rehabilitation costs. Expenditures made to rehabilitate low-income rental housing after July 24, 1969 and before January 1, 1975 may be amortized on a straight-line method over a period of 60 months, using no salvage value. "Rehabilitation expenditures" means capital expenditures for property or improvements thereto with a useful life of at least five years, but does not include the purchase price of a building or any interest therein.

To qualify for amortization, the expenditures must, over a two-year period, exceed $3,000 per dwelling unit; however, no more than $15,000 per unit may qualify. Low-income housing is limited to housing occupied by those with "low or moderate income," and will have to be defined further by the regulations in accordance with the Housing and Urban Development Act of 1968. A dwelling unit means a house or apartment used to provide living accommodations, but does not include a unit in a hotel, motel, or other establishment in which more than half the units are used on a transient basis. Amortization of these expenditures is subject to recapture as ordinary income as noted below.

Recapture of depreciation on real estate

Until the recapture rules were inserted into the Code, the accelerated depreciation methods offered another tax incentive to invest in real estate. Such methods produced large deductions against ordinary income, but the gain on a subsequent sale was taxed as long-term capital gain under Sec. 1231. Sec. 1245 (introduced in 1962) changed the tax treatment of the gain on the sale of tangible personal property, so that the gain was recaptured as ordinary income to the extent of the amount of depreciation allowable after December 31, 1962.

In 1964, Sec. 1250 was added to the Code in order to recapture as ordinary income gains on the sale of real estate. The depreciation recapture rules for Sec. 1250 property were, however, of a limited nature. They were fully applicable only to a gain realized on the disposition of property held for more than 12 months. For property

held more than 12 months, all of the "additional depreciation" (excess of the accelerated depreciation over straight-line depreciation) was subject to ordinary income treatment. For each month the realty was held for more than 20 months, the percentage of additional depreciation taxed as ordinary income was reduced 1%. Consequently, after ten years (120 months) of ownership, the recapture rules became inapplicable and full capital gains status was accorded any gain on sale.

New rules. The recent act "reformed" the real estate recapture rules for depreciation of real estate so as to conform them more closely to the rules for full recapture of depreciation (to the extent of gain) on tangible personal property. For depreciation attributable to periods after December 31, 1969, with limited exceptions, 100% of the additional depreciation is recaptured as ordinary income; in other words, there is no reduction in the percentage recaptured because of an increase in the holding period. However, the old rules (1% reduction for each month the property is held in excess of 20 months) remain applicable to the following situations:

- Realty disposed of pursuant to a written, binding contract in effect on July 24, 1969.
- Certain government-assisted housing projects (either by FHA insurance or by direct loans or tax abatements by state and local government) on which the rent and investment return is limited and which are constructed or acquired before January 1, 1975.

Other exceptions to the full recapture of additional depreciation for post-1969 periods are:

- Residential rental property—1% reduction for each month held after 100 months,
- Rehabilitation expenditures for low income housing—1% reduction for each month held after 100 months, and
- Property sold in one year or less—full recapture of all depreciation as under prior law.

Example. To illustrate the new rules (and old rules) for depreciation recapture, assume that on January 1, 1963, X acquires an office building with a 40-year life at a cost of $100,000 and continuously computed depreciation on the double declining balance method until January 1, 1971 when he sells the building for $80,000. The depreciation allowed to the sale date is $33,659 and the adjusted basis is $66,341. Depreciation recapture is computed as follows:

	Pre-1964	1964-1969	1970
Double declining depreciation	$5,000	$25,167	$3,492
Straight-line depreciation		15,000	2,500
Excess		10,167	992
Less: Reduction of 76%–1% per month for 76 months (96-20)		7,727	–
Ordinary income	$ –	$ 2,440	$ 992

X, therefore, realizes a gain of $13,659, of which $3,432 is taxed as ordinary income. Note that the additional depreciation for periods after 1969 is first recaptured as ordinary income, and the pre-1970 reduction rules are applied only to the extent the gain exceeds the post-1969 depreciation. Thus, if the property had been sold for $67,000, so that the gain would be only $659, the entire gain would be taxed as ordinary income. In other words, there would be no percentage reduction, even though seven years of the eight-year holding period elapsed before 1970.

Decelerating the impact of depreciation on earnings and profits

A dividend is defined under Sec. 316(a) as a distribution by a corporation to its shareholders "out of its earnings and profits accumulated after February 28, 1913 or out of its earnings and profits for the taxable year. . . ." Therefore, distributions in excess of both the current and accumulated earnings and profits will not be taxable as an ordinary dividend. The portion of the distribution which does not constitute a taxable dividend under Sec. 316(a) is first applied against the tax basis for the stockholder's shares with any excess being taxed at capital gain rates. Consequently, while there is a deficit in a corporation's earnings and profits, the shareholders can receive capital distributions free of ordinary income tax.

The increasing number of corporations paying partially or fully tax-free dividends (particularly in the public utility industry) is apparent from the yearly lists received from the capital adjustment and dividend reporting services. Many of these corporations have taken advantage of accelerated depreciation to reduce not only the taxable income of the corporation, but also to reduce the taxable income of the shareholders by eliminating earnings and profits.

Limit depreciation charge against E&P. New Sec. 312(m) attacks the tax-free dividend attributable to the accelerated depreciation method. In computing earnings and profits for any year begin-

ning after June 30, 1972, Sec. 312(m), in effect, requires that depreciation be computed under the straight-line method even though an accelerated method of depreciation is allowable in computing taxable income. (The use of a method other than the straight-line method is permitted at the discretion of the Commissioner, but such method cannot be a declining balance method or the sum of the years-digits method.) In other words, this new rule does not limit the methods of depreciation that may be used in the computation of taxable income, but rather only restricts the method that can be used in the determination of earnings and profits. The effective date of the provision was deferred in order to avoid a drastic effect upon the market value of the stock of those corporations which are now making tax-free distributions.

"Earnings and profits basis." Regulations in respect to other items affecting earnings and profits appear imperative because of the new provision. Sec. 312(a)(3) requires that earnings and profits be decreased by the "adjusted basis" of the assets distributed. Sec. 312(c)(3) provides that earnings and profits should be increased upon the distribution of Sec. 1245 or Sec. 1250 assets. Because of differences between the depreciation methods used in determining the "adjusted basis" of the property and the method used in determining earnings and profits, it may become necessary to provide a definition of an "earnings and profits basis." Also, since the corporation's income tax is a charge against earnings and profits, the question arises as to whether the amount charged should be the actual tax paid or the tax which would have been paid if the straight-line method of depreciation had been used on the income tax returns.

Freezing depreciation methods of regulated industries

The complex depreciation reformation provisions for regulated industries are designed to prevent what Congress considers a bad situation from getting worse. The objective is expressed as an intention to "freeze" the existing situation. This freeze in methods is accomplished by new provisions of considerable complexity. The complexity is due partly to the different depreciation methods used by utilities in computing taxable income, but more to the differences in reporting by the utilities to their regulatory authorities.

New Sec. 167(l) applies to public utility property used in furnish-

ing electricity, water, sewage disposal services, gas or steam through a local distribution system, telephone services, and transportation of gas by pipeline, if the rates for such sales or services are regulated by a governmental authority. The provisions are effective for all taxable years for which a tax return had not been filed prior to August 1, 1969.

Alternative treatment of tax savings. The permissible alternatives are written in terms of the manner in which the utility using accelerated depreciation methods for federal income tax purposes reports to the regulatory authorities for rate-making purposes. There are, in this context, two methods of reporting to rate-making authorities:

- *Flow through:* The reduction in income taxes resulting from accelerated depreciation is reflected in the provision for income taxes in the income statement for rate-making purposes. Since the income statement is charged with the taxes actually paid, net income is higher than it would be if taxable income were computed on a straight-line method. Therefore, the utility presumably is required to charge a lesser rate to customers than would otherwise be charged.
- *Normalize:* Even though accelerated depreciation is used for income tax purposes, the provision for income taxes in the income statement for rate-making purposes is computed as if straight-line depreciation had been used and a reserve for deferred taxes is provided for the future tax liability.

The Treasury was concerned with the movement toward the "flow-through" method in recent years. The contention is that the "flow through" of the tax savings from accelerated depreciation results in a double loss of revenue—first from the tax reduction resulting from the accelerated depreciation deduction and secondly from the reduction in utility rates (and taxable income) caused by flowing through the tax savings to customers by rate-making authorities.

New rules. Under the new rules, in general, the utility must continue to use the depreciation method which it used in its last accounting period ended prior to August 1, 1969. Different rules are provided for public utility property owned prior to January 1, 1970 and property acquired on or after that date.

For pre-1970 public utility property (owned at January 1, 1970), the rules can be summarized as follows:

1. If the taxpayer has been using a straight-line method (or any method other than a declining balance method or a sum of the years-digits method), it must continue to use such method.

2. If the taxpayer used an accelerated method for its latest taxable year for which a return was filed prior to August 1, 1969, together with the normalization method of accounting, it may continue this method.[5]

3. If the taxpayer used an accelerated method of depreciation for its latest accounting period ending before August 1, 1969, together with a flow-through method of accounting, the taxpayer may continue to use the accelerated method.

For post-1969 public utility property (acquired after 1969), the available methods may be summarized as follows:

1. The straight-line method (or any method other than a declining balance method or sum of the years-digits method).

2. An accelerated method, if the normalization method of accounting is employed.

3. An accelerated method of depreciation, although the flow-through method of accounting is used, if the same depreciation method was used for pre-1970 public utility property of the same (or similar) type most recently placed in service and the flow-through method of accounting was used for its latest accounting period ending before August 1, 1969.

For taxable years beginning after December 31, 1970, a taxpayer using the flow-through method of accounting may elect to change to a straight-line method; or if normalization accounting is permitted by the regulatory agency, an accelerated depreciation method with respect to property which increases its productive or operational capacity. The election is not available for replacement property. The election must be made within 180 days of enactment of the new law, that is, no later than June 28, 1970.

Amortization of pollution control facilities

One of the social goals of the new law is to encourage the use of pollution control facilities. New tax incentives were deemed partic-

[5] See TD 7049 providing temporary regulations relating to the normalization method.

ularly necessary because of the repeal of the incentive that had formerly been provided by the investment credit. New Sec. 169[6] allows a "certified pollution control facility" to be amortized over a period of 60 months, at the election of the taxpayer, effective for years ending after 1968. Amortization replaces regular depreciation, but additional first-year depreciation can be claimed.[7] An investment credit is not allowable for any pollution control facility for which amortization is claimed. The amortization period can begin in the month following acquisition or completion of the facility or with the succeeding taxable year. Regulations are to prescribe the form of and time for filing the statement of election. The taxpayer who regrets an amortization election may terminate it by simply filing a notice of revocation, and claiming a depreciation deduction on the unamortized portion beginning with the month following the last month of the amortization period. Revocation is irrevocable; re-election of amortization is barred by Sec. 169(c).

"Certified pollution control facility." Essentially, the tax incentive is limited to a new air and water pollution control facility installed in an old plant. To qualify for the rapid amortization, the facility must be a new identifiable treatment facility used in connection with a plant or other property which was in operation before January 1, 1969. The facility may be for the purpose of abatement or control of water or atmospheric pollution. The facility, for this purpose, includes only depreciable tangible personal property (not including buildings or structural components, unless the building is exclusively a treatment facility). The construction of the property must be completed after December 31, 1968, or the facility must be acquired after that date and the original use must begin with the taxpayer. The facility must be placed in service before January 1, 1975. Furthermore, the state authority having appropriate jurisdiction must certify that the facility conforms with the state program or requirements for pollution abatement. The state certification must be made to and, in effect, acceptable by an appropriate federal authority which is required to establish national guidelines.

Then the federal authority must certify that the facility meets federal requirements. In this connection, note that Sec. 169(e) pro-

[6] Prior Sec. 169, dealing with amortization of grain storage facilities, was deleted from the Code since its usefulness had expired.

[7] See S. Rep. No. 91-552 (11/21/69).

hibits federal certification of any property to the extent that its cost will be recovered over its actual useful life through profits from the operation of the property (e.g., from the recovery of wastes).

Amortizable portion. The five-year amortization deduction is limited to the portion of the cost of the property attributable to the first 15 years of its normal useful life. If the useful life of a facility exceeds 15 years, the facility is treated as if it were two separate assets. The portion of the cost attributable to the first 15 years of life can be amortized in five years, and the remaining portion (less salvage value, presumably) must be depreciated over the full useful life of the facility. The amortizable percentage of the facility equals the ratio that 15 years bears to the useful life. The amortizable portion is determined by multiplying the cost by the resultant percentage. For example, if a facility has a useful life of 25 years and costs $30,000, the amortization portion would be $18,000 (15/25 × $30,000).

Faster write-offs of certain railroad expenditures

There were several other incentive provisions designed to replace the investment credit, which are of interest only to the railroad industry.

Rolling stock—amortization. The original House bill provided that a railroad could amortize its rolling stock (other than locomotives) over a seven-year period. The Senate rewrote the provision on a more liberal basis, shortening the amortization period to five years and including locomotives. On the other hand, the Senate apparently decided to provide no more incentive than was necessary. Regulations are to be issued indicating the particular classes of cars and locomotives not in short supply. Rolling stock in these classes placed in service after 1972 or 30 days after the regulations become effective, whichever is later, is not eligible for the five-year amortization.

This amortization provision, new Sec. 184, is applicable to domestic railroads, to terminal and switching companies whose stock is owned by railroads, and rolling stock of lessors who lease to railroads. The original use of the rolling stock must begin with the taxpayer.

Rolling stock placed in service in 1969 is eligible for a four-year amortization period, as to the undepreciated balance at January 1,

1970. The five year amortization period applies to qualified rolling stock placed in service before January 1, 1975. The taxpayer may terminate the election for five-year amortization and revert to depreciation of the unamortized balance.

Expensing rehabilitation expenditures. Another tax incentive with respect to railroad rolling stock, though not in the form of amortization, may be noted here. New Sec. 263(e) permits the current deduction of repairs and rehabilitation expenditures with respect to railroad rolling stock (except locomotives) which otherwise would be classified as capital items. To be accorded this special treatment, the expenditures in any 12-month period must not exceed 20% of the unadjusted basis of the unit. The new provision applies to taxable years beginning after 1969.

Grading and tunnel bores. The Senate also added new Sec. 185, permitting railroad gradings and tunnel bores to be amortized over a 50-year period. Previously, expenditures for these purposes could not be depreciated because of uncertainty as to the useful life. The provision applies to new properties and improvements to existing properties, the use of which begins after December 31, 1968.

Amortization of coal mine safety equipment

Five-year amortization was also made available under new Sec. 187 for certified coal mine safety equipment required to conform with recent legislation. This provision applies to years ending after December 31, 1969 and to property placed in service before January 1, 1975. The rules relating to amortizing certified coal mine safety equipment are similar to those for amortizing certified pollution control facilities.

Other TRA provisions affecting depreciation

While outside the scope of the article, it should be noted that there are a number of other Tax Reform Act provisions which can, in individual situations, adversely affect the tax benefits, flowing from depreciation on real estate investments. For example, Secs. 56-58 impose a 10% additional tax on tax preference items in excess of the sum of $30,000 plus the tax liability otherwise incurred for the year. The untaxed portion of long-term capital gains (50% for

individuals; a varying percentage, depending on the year, for corporations) is a tax preference. Thus, the portion of the gain of real estate which escapes recapture may be subjected to an additional tax.

The excess of accelerated depreciation over straight-line depreciation on Sec. 1250 property and the amortization deduction on low-income housing are also considered tax preference items. In addition, to the extent that realty acquisitions are financed with mortgage indebtedness, any resultant "excess investment interest" (the excess of investment interest expense over net investment income) will be considered a tax preference item for years beginning before 1972. After 1971, Sec. 163(d) imposes separate limitations on the deduction of such "excess investment interest."

Also, the provisions increasing the long-term capital gains tax rates of both individuals and corporations take away some of the incentive for investing in real estate.[8]

Generalization

Generally, the Tax Reform Act has taken away many of the tax benefits which had been available to investors in real estate and public utilities (and their customers) by limiting or denying the use of accelerated methods of depreciation. On the other hand, the Tax Reform Act retained or extended accelerated depreciation or amortization methods in several areas in order to further certain social or economic objectives.

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[8] See "Capital Gains and the Tax Reform Act of 1969," Gayford L. Hinton, Jr., *The Tax Adviser*, April 70, p. 216.

A checklist-summary on private foundations

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The Tax Reform Act of 1969 has brought about substantial changes in the treatment of most tax-exempt foundations. Under the Act, all charitable-type foundations are divided into two major categories—"private" foundations, referred to specifically in the law, and all other foundations, referred to here as "public" foundations.

Summary of taxes

Private foundations are now subject to a series of new taxes and to complex rules that could have the effect of greatly restricting their activities and investments. They are imposed separately, and a particular foundation could be subject to any or all of them. For several of the taxes, the pattern is an "initial" tax on an annual basis at relatively low rates (in some cases imposed on both the foundation and participating "foundation managers"), followed by an extremely severe "additional" tax if the proscribed act is not "corrected" within a defined "correction period." In several cases, there is a maximum dollar limit on the amount of tax that may be imposed on managers. For repeated acts, a "third level" of tax may be imposed, namely the repayment of all prior tax benefits or all of the foundation's assets, whichever is less.

Since the new rules apply only to private foundations, a foundation will first wish to establish whether it is private or public. In this regard, a foundation will be treated as "private" unless it establishes to the contrary. Public foundations generally are those such as churches, schools, hospitals, and publicly supported charities,

contributions to which are eligible for the higher 50% limitation on charitable contributions. It will be most difficult for family-supported foundations to qualify.

The analysis presented here relates primarily to private foundations. Public foundations will be permitted to operate substantially as they have in the past. All foundations will be required to prove public status if they desire it, and those organized after October 9, 1969 will be required to establish their right to tax exemption. Exceptions to these qualification rules are provided for churches and church-related organizations, small public foundations (those with gross receipts of less than $5,000 annually) and other organizations that may be named by the Treasury Department in the future.

Private foundations must include in their governing instruments specific provisions prohibiting activities that would give rise to the new taxes. Private foundations in existence on January 1, 1970, in order to retain exempt status in 1972 and later years, must amend their instruments to include the same provisions or to show by court action that they cannot be amended.

The new taxes generally are effective for taxable years beginning after December 31, 1969. Those that apply to specific acts generally apply to acts taking place on or after January 1, 1970, and thus could apply in a year of the foundation prior to taxable years when other taxes become applicable.

Excise tax on investment income (Sec. 4940). This is an annual tax at the rate of 4% of net investment income for taxable years beginning after December 31, 1969. This tax is intended at least in part to defray the cost of administering the new foundation provisions.

Taxes on self-dealing (4941). Almost all transactions on and after January 1, 1970 between a foundation and its "disqualified persons" (managers, substantial contributors, and entities related to substantial contributors), are subject to an initial tax of 7½% of the amount involved in the transaction. Five per cent is payable by the "self-dealer" and 2½% by any foundation manager who participates in the transaction. If the act is not corrected within a specified time, additional taxes totaling 250% of the amount involved may be imposed. Examples of "self-dealing" are sales or exchanges of property (even for fair market values) and loans or other extensions of credit. Thus, with minor exceptions, the previous rules under which private foundations could deal with their creators and managers on

an "arm's-length" basis generally no longer apply.

Some payments to specified types of government officials are also treated as self-dealing types of payments subject to the taxes.

Taxes on failure to distribute income (Sec. 4942). Private foundations are required to distribute (or set aside in a pre-approved manner) all income by the end of the year following receipt or be subject to a tax of 15% of the undistributed amount. An additional tax of 100% of the undistributed amount is imposed if the failure to distribute is not later corrected.

As a means of forcing foundations to invest in income-producing assets, distributions out of corpus will be required if the foundation fails to have sufficient income. Generally the minimum required income is 6% of the value of the foundation's assets. However, for private foundations in existence on May 27, 1969, minimum earnings are not required before 1972 and lesser percentages are applicable through 1974. An exception to the required distribution rules is provided for "operating foundations." These generally are those private foundations that operate a facility, such as a museum, and use substantially all income in the operation.

Taxes on excess business holdings (Sec. 4943). For taxable years beginning in 1970, limitations are placed on the amount of investment that can be held by a private foundation in any one corporation or other business enterprise. Generally this limitation is 20% of the voting stock (35% where the corporation is controlled by others). If holdings on May 26, 1969 were greater, they may be retained for a ten-year period (in some cases 15 or 20 years) during which ownership must be brought down to a maximum of 50%. (In some very limited cases continued ownership of more than 50% will be permitted.) Special rules are provided for amounts received as gifts or bequests and from trusts.

The limiting percentages relate to the total holdings of the foundation and "disqualified persons." These include substantial contributors to the foundation, members of their family and entities related to them, and foundation managers. If this group of disqualified persons holds more than the permitted percentage, then the private foundation may not be permitted any holding.

The basic tax on these holdings is 5% of the value of the excess over permitted holdings. If not corrected, an additional tax of 200% may be imposed.

Taxes on investments which jeopardize charitable purpose (Sec. 4944). If a private foundation invests on or after January 1, 1970 any amount in a manner that jeopardizes the carrying out of its exempt purposes, it becomes subject to an initial tax of 10% of the amount invested, 5% on the foundation and 5% on any foundation manager who knowingly participates in the investment. There are additional taxes totaling 30% if the investment is not timely corrected.

The type of investment that will cause imposition of this tax is not stated in the law, but the Senate Committee Report indicates that warrants, commodity futures, options, and purchases on margin are the type of investment that has given rise to the new tax. An exception is provided for investments related to the private foundation's programs, such as loans in urban renewal areas. The report also states that a "prudent trustee" approach and not hindsight will be used in determining whether an investment is proscribed.

Taxes on taxable expenditures (Sec. 4945). Taxes are imposed totaling 12½% of amounts expended by private foundations for certain proscribed activities. This generally applies to expenditures made on or after January 1, 1970. If not corrected, additional taxes totaling 150% may be imposed.

The types of expenditures subject to the tax include, with certain specific and narrow exceptions in each case, those made (1) to influence legislation, (2) to influence specific elections and carry on voter registration drives, (3) as grants to individuals for travel, study or similar purposes, unless the program under which the grant is made is approved *in advance* by the IRS, (4) as grants to other private foundations, unless the contributing foundation exercises full and complete control over the manner in which the funds are spent, and (5) as expenditures for any noncharitable purpose.

Termination of private foundation status (Sec. 507). The various punitive taxes may lead a private foundation to conclude that it should give up its exempt status. However, this may give rise to an extremely severe penalty. This penalty is the lowering of (1) all of the tax benefits enjoyed by substantial contributors from deductions for amounts given to the foundation and by the foundation during the period of its existence plus interest, or (2) the entire value of the foundation's assets. An exception is provided for foundations that terminate their private status either by converting to public status or by distributing all their assets to a public founda-

tion, or which obtain a certificate from their state. Conversion to a public status requires operating essentially as a public foundation for a 60-month period. However, for foundations in existence on October 9, 1969, this may be accomplished by operation during the 12 months of their taxable year beginning in 1970.

Checklist for foundation managers

In conjunction with its activities in reviewing the Tax Reform Act as it wended its way through Congress, the committee on taxation of special entities and industries* of the AICPA tax division has developed an analysis of actions that will be expected of private foundations and their managers under the Act. This analysis is presented in a checklist beginning on p. 352. It is intended to provide guidance to CPAs in advising their private foundation clients in conducting activities under the new rules—investments and expenditures to be watched, records to be kept, and deadlines to be met.

The checklist is keyed to related sections of the Internal Revenue Code. Reference must be made to the Code in every case since it is replete with special exceptions and conditions.

The new rules include a number of detailed definitions, including that of a private foundation. The committee has prepared a summary of several of the more important of these definitions. This summary begins on page 359, and is cross-referenced to the checklist for private foundation managers.

Of special interest is the identification of "foundation managers," on whom several of the taxes may be imposed. These include officers, directors, and trustees (or employees who have authority or responsibility for specific acts—or failure to act). A special annual report, in addition to the foundation's annual return, is now required of the foundation managers of every private foundation having assets of at least $5,000. A notice that this annual report has been prepared and is available for inspection must be published in a general newspaper in the county of the private foundation's principal office.

*Members of the committee are: T. Milton Kupfer, chairman, New York City; John A. Bernauer, Chicago; Donald D. Casson, Easton, Maryland; Edwin I. Davis, Houston; William Etkin; New York City; James W. Robertson, Dallas; Roy Soll, Chicago; A. Martin Sterling, Atlanta; and Nelson Tabachnick, St. Louis.

Checklist for private foundation managers under the Tax Reform Act of 1969

Action	Related IRC Section	Definition (See pages 359-362)	Time
1. Determine status as "public" or "private."	509 170(b)(1)(A)	(A)	Immediate — as of January 1, 1970.
2. If "public," submit proof of status to Internal Revenue (except churches and public foundations having annual receipts under $5,000).	508(b)		Time to be announced—no sooner than 90 days after regulations become final.
3. Foundations organized after October 9, 1969, submit application for tax-exempt status.	508(a)		Time to be announced—no sooner than 90 days after regulations become final.

(The remainder of this checklist applies only to private foundations.)

Action	Related IRC Section	Definition (See pages 359-362)	Time
4. Identify the following with respect to the foundation:			As of October 9, 1969.
A. Substantial contributors	507(d)(2)	(D)	Update at end of each subsequent year.
B. Foundation managers	4946(b)	(E)	As of January 1, 1970 and all changes as they occur.
C. Disqualified persons	4946(a)	(F)	As of January 1, 1970 and all changes as they occur.

5. Amend governing instrument to conform specifically with Code requirements:	508(e)(1)	January 1, 1972.
If instrument cannot be amended, institute court proceeding to so establish.	508(e)(2)	January 1, 1972.
6. Consider terminating private status:		
A. If desirable, notify IRS of intent.	507(a)(1)	To be announced — 90 days after regulation becomes final.
B. Operate as public foundation for 12 or 60-month period or	507(b)(1)(B)	Twelve months begin on first day of taxable year beginning in 1970.
C. Distribute all assets to public charity.	507(b)(1)(A)	
7. Excise tax based on investment income:		
A. Review chart of accounts so as to be in a position to compute "net investment income."	4940(c)	As of start of first year beginning after December 31, 1969.
B. Determine fair market value of investment assets for purpose of computing gains.	4940(c)(4)(B)	As of December 31, 1969.

Action	Related IRC Section	Definition (See page 359)	Time
C. Consider timing of losses since capital loss carryovers are not allowable.	4940(c)(4)(C)		Continuing.
8. Taxes on self-dealing:			
Compare each foundation action against list of "self-dealing" acts.	4941(d) 101(l)(2) of Act		Continuing.
9. Taxes on failure to distribute income:			
A. Determine whether foundation is an "operating" foundation that is exempt from distribution requirements.	4942(j)(3)		Immediate.
B. Review chart of accounts to determine that "adjusted net income" can be readily computed.	4942(f)		As of start of first year beginning after December 31, 1969.
C. Review amounts paid out to determine whether they are "qualifying distributions."	4942(g)		Immediate and continuing.

D. Request approval of IRS for amounts proposed to be accumulated for future distribution.	4942(g)(2)	Immediate and continuing.
E. For foundations organized before May 27, 1969, determine whether governing instrument requires accumulation of income or prohibits distributions of corpus.	101(l)(3)(B) and (E) of Act	Immediate.
F. Analyze assets between those used carrying out foundation's exempt purpose and investment assets, and consider values of investment assets.	4942(e)	As of start of first year beginning after 1969.
G. Review investments for possible changes in order to achieve minimum investment return that will be required starting in 1972 (starting immediately for foundations organized on or after May 27, 1969).	4942(e) 101(l)(3)(A) of Act	Immediate and continuing.

Action	Related IRC Section	Definition (See page 359)	Time
H. Maintain analysis of source of distributions on a year-by-year basis.	4942(h) and (i)		Continuing.
10. Taxes on excess business holdings:			
A. Analyze investments to determine percentage of ownership (voting and nonvoting) of each "business enterprise" (corporate or other).	4943(d)(1) 4943(d)(4)		As of May 26, 1969 and continuing as investments are made or gifts received.
B. If less than 2% in value (including holdings of related foundations), no further action.	4943(c)(2)(C)		
C. If more than 2%, obtain lists of holdings of "disqualified persons" and determine whether there are "excess business holdings." Begin planning for any required dispositions.	4943(c) 4946(a)	(F)	As of May 26, 1969 and continuing as holdings change.

11. Taxes on investments which jeopardize charitable purpose:	4944	As of January 1, 1969 and continuing as investments are made.
Review investments for those that might be regarded as "jeopardizing" the foundation's exempt purpose.		
12. Taxes on taxable expenditures:		
A. Review each expenditure made by the foundation and compare with list of "taxable expenditures."	4945(d)	Starting January 1, 1970.
B. For grants to individuals, submit *in advance* request for approval of program under which grants are made.	4945(g)	Starting January 1, 1970.
C. For grants to other foundations, ascertain whether the foundation is "public" or "private." If private, ascertain that "expenditure responsibility" can be exercised.	(4945(d)(4) 4945(h)	Starting January 1, 1970.

Action	Related IRC Section	Definition (See page 359)	Time
13. Annual reports by foundation:			
File annual information returns of foundation.	6033		4½ months after year-end.
14. Annual report by foundation managers:			
A. File annual report of information required of foundation manager.	6056		4½ months after year-end.
B. Publish notice in newspaper in county of principal office that report of foundation managers is available for inspection.	6104(d)		4½ months after year-end.

Summary of selected definitions relating to private foundations under the Tax Reform Act of 1969

A. Private foundations (Sec. 509(a))

Private foundations are organizations described in Sec. 501(c)(3) *other than:*

1. Churches, schools, hospitals, fund raisers for schools, states and political subdivisions, and publicly supported charities.

2. Organizations which:

a. Normally receive more than one-third of their support (See definition B) from gifts, grants, contributions, membership fees or gross receipts from admissions, sales, or services, from activities not unrelated to purpose of organization; however, gifts, receipts, etc., from disqualified persons may not be included in determination of such contributions to support, nor may receipts from any one person to the extent they exceed $5,000 or, if greater, 1% of support, and

b. Normally receive no more than one-third of their support from gross investment income. (See definition C.)

3. Organizations organized and operated exclusively for the benefit of one or more organizations described in (1) or (2) above and which are controlled by one or more of these organizations, or are operated in connection with one of these organizations, and are not controlled by disqualified persons, other foundation managers (disqualified only as such), and

4. Organizations which are organized and operated exclusively for testing for public safety.

B. Support (Sec. 509(d))

Support includes (1) gifts, grants, contributions, membership fees, (2) gross receipts from admissions, sales, services from any activity not unrelated to purposes of organization, (3) net income from unrelated business activities, (4) gross investment income (definition C), (5) tax revenues received by an organization or paid on behalf of the organization and (6) the value of certain services furnished by any state, territory, or political subdivision thereof. Support does not include any gain from the sale or disposition of a capital asset nor the value of any exemption from taxes.

C. Gross investment income (Sec. 509(e) and 4940 (c)(2))

The term "gross investment income" means the gross amount of income from interest, dividends, rents, and royalties, but not including any such income to the extent included in computing the tax on unrelated business income.

D. Substantial contributor (Sec. 507(d)(2))

A substantial contributor is a contributor of the greater of $5,000 or 2% of total contributions received by the foundation to the end of the year in which contribution is made. For purpose of measuring aggregate amounts of contribution:

1. Contributions made by an individual include those of his spouse.
2. Contributions in property are valued at fair market value on date received.
3. For foundation in existence on October 9, 1969, all contributions made prior to that date are deemed to have been made on that date, but valued as of the actual date of contribution.

In the case of a trust, a substantial contributor also includes the creator of the trust. Also, any person who is a substantial contributor on any date shall remain so identified for all subsequent periods.

E. Foundation manager (Sec. 4946(b))

A foundation manager is an officer, director or trustee or any individual having similar powers with respect to a private foundaton (including employees if they have responsibility for specific acts).

F. Disqualified person (Sec. 4946(a))

Disqualified persons with respect to a private foundation include:

1. A substantial contributor (definition D).
2. A foundation manager (definition E).
3. An owner of 20% or more of a nonindividual substantial contributor such as:
   a. A corporation (voting power).
   b. A partnership (profit interest).
   c. A trust (beneficial interest).

4. A member of the family (definition G) of a substantial contributor, foundation manager, or owner of a 20% or more interest in a substantial contributor described in 3 above.

5. A corporation, partnership, or trust in which other disqualified persons have an ownership interest of more than 35% (definition H).

6. For purposes of the tax on excess business holdings (Sec. 4943), a private foundation which received substantially all of its contributions from disqualified persons who made such contribution to the private foundation in question, or which is controlled by the same persons who control the foundation in question.

7. For purposes of tax on self-dealing (Sec. 4941), a government official (definition I).

G. Members of family (Sec. 4946(d))

For purposes of identifying disqualified persons, the members of an individual's family include only his spouse, ancestors, lineal descendants, and the spouses of his lineal descendants.

H. Stock holdings (Sec. 4946(a)(3))

For purposes of determining whether or not a corporation is a disqualified person by reason of more than 35% of its stock being owned by other disqualified persons, the rules of attribution of Sec. 267(c) are applied, except that members of a family should include those members described in Sec. 4946(d) rather than those described in Sec. 267(c)(4).

I. Government official (Sec. 4046(c))

A government official includes an individual who holds any of the following offices or positions:

1. Elective office in legislative or executive branch of U.S. government.

2. A Presidential appointment to the executive or judicial branch of the U. S. government.

3. A position in any branch of the federal government, either covered by civil service with a rating of GS16 or higher, or any appointive position compensated at an annual rate of at least as much as the lowest rate of a civil service employee rated GS16.

4. A position under the House of Representatives or Senate of the

U.S. compensated at an annual rate of $15,000 or more.

5. Any elected or appointed official of a state, territory, possession (or political subdivision thereof), of the U.S. compensated at an annual rate of $15,000 or more.

6. A position as personal or executive assistant or secretary to any of the above.

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Private foundations

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Composition and concepts

Normally, tax bills are designed to be revenue-raising measures rather than economic, social or penal tools. But there are exceptions. The exceptions include the enactment, suspension, restoration, and repeal of the investment credit (economic); provisions giving credit for state unemployment taxes against the federal unemployment tax (social); and the excise tax on marijuana (penal). Probably the most complex tax legislation with a nontax motivation is that enacted by the 91st Congress to assure itself and the public that private foundations would function in the public interest or pay the price for their transgressions.

The new taxes—general

There are several unique concepts built into the foundation provisions of the Tax Reform Act of 1969.[1] Of significance is the fact that the persons knowingly responsible for violating any of the substantive terms and conditions of the legislation may be subjected to personal penalties. Secondly, the degree of sanction differs from provision to provision by utilizing varying rates, bases and taxable persons.[2]

Taxes and penalties. There are six taxes imposed as excise taxes under the new Chapter 42 of the Code, namely:

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[1] P.L. 91-172. The Tax Reform Act of 1969 will be cited herein as the "Act." Unless otherwise noted, all references to sections are to those in the 1954 Code.

[2] See Ready Reference Chart on page 365.

- An excise tax on investment income (Sec. 4940),
- A tax on self-dealing (Sec. 4941),
- A tax on failure to distribute income (Sec. 4942),
- A tax on excess business holdings (Sec. 4943),
- A tax on jeopardy investments (Sec. 4944), and
- A tax on taxable expenditures (Sec. 4945).

The provisions other than the investment income tax normally apply a two-tier set of taxes—an "initial" tax and an "additional" tax—to deter the acts (or failures to act) specified in the provisions.. With the first tier, the initial tax is normally an annual tax running for the years (or parts thereof) in the taxable period.[3] The taxable period begins to run when the act (or failure to act) occurs and closes upon issuance of a notice of deficiency for the initial tax. The second tier, the additional tax, is a tax based upon failure to correct or cure the proscribed transactions after the imposition of the initial tax. The correction period, the time allotted by the IRS to correct the substantive violation (to the extent possible), normally closes 90 days after the notice of deficiency for additional tax is mailed to the taxable person. The period may be extended by the IRS, if appropriate. Both the initial taxes and the additional taxes, in three of the five substantive provisions, have two sets of taxable persons for each tax[4]—the foundation and the foundation manager(s), or the self-dealer and the foundation manager(s).

A 100% penalty, assessable under Sec. 6684, can double any initial tax or any additional tax, or both. Finally, under Sec. 507, a "termination tax," which would have the effect of ending the life of the foundation, may be imposed on the lower of the aggregate tax benefits which accrued to the foundation and all of the substantial contributors by reason of exempt status or the value of the net assets of the foundation. These last two sanctions are supposed to apply only for "horror" cases involving flagrant[5] and willful acts.[6]

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[3] As indicated in the listing, only Sec. 4945 (taxable expenditures) has no taxable period provision.

[4] In Sec. 4942 (taxes on failure to distribute income) and Sec. 4943 (taxes on excess business holdings), the initial tax and additional tax are only on the foundation.

[5] "Flagrant" is evidently only found in one other Code provision, dealing with alcohol seizures. See Sec. 5673.

[6] The penalty may be imposed without regard to willfulness if there are repeated Chapter 42 violations.

Ready reference chart[1]

Items taxed	Taxable persons	Rates	Base	Effective date	100% penalty (Sec. 6684)	Termination tax[5]
1. Investment income (Sec. 4940)	PF	4%	Net investment income	Years beginning after 1969	No	No
2. Self dealing (Sec. 4941)	FM, SD	FM: Initial, 2½%; Additional, 50%[2] SD: Initial, 5%; Additional, 200%	Amount involved in self-dealing act	January 1, 1970	Yes	Yes
3. Distributions of income (Sec. 4942)	PF	Initial, 15%; Additional, 100%	Undistributed income	Years beginning after 1969	Yes	Yes
4. Excess business holdings (Sec. 4943)	PF	Initial, 5%; Additional, 200%	Excess business holdings	Years beginning after 1969	Yes	Yes
5. Jeopardy investments (Sec. 4944)	PF, FM	PF: Initial, 5% Additional, 25% FM: Initial, 5%; Additional, 5%[3]	Amount invested	January 1, 1970	Yes	Yes
6. Taxable expenditures (Sec. 4945)	PF, FM	PF: Initial, 10%; Additional, 100% FM: Initial, 2½%; Additional, 50%[4]	Amount of taxable expenditures	January 1, 1970	Yes	Yes

NOTES:

1 Abbreviations: PF—Private foundation; FM—Foundation manager; and SD—Self-dealer.

2 With respect to any one act of self-dealing, Sec. 4941(c)(2) provides that the maximum amount of initial and additional tax shall be $10,000 each.

3 With respect to any one jeopardy investment, Sec. 4944(d)(2) limits the amount of the initial tax to $5,000 and the amount of the additional tax to $10,000.

4 With respect to any one taxable expenditure, Sec. 4945(c)(2) limits the amount of the initial tax to $5,000 and the amount of the additional tax to $10,000.

5 If there have been either "willful repeated acts" or a "willful and flagrant act" giving rise to liability for one of the above taxes (except, of course, the investment income tax), the status of an organization as a private foundation will be terminated and it may become liable under Sec. 507(c) to a tax equal to the lesser of (i) the aggregate tax benefit resulting from its Sec. 501(c)(3) status or (ii) the value of its net assets.

All of the Chapter 42 taxes (including the investment income tax), the termination tax, and the penalties may be petitioned to the Tax Court.[7]

Organizations taxed. The substantive provisions are operative only in respect to Sec. 501(c)(3) organizations which are classed as "private foundations."[8] The term "private foundation" also includes certain nonexempt trusts with charitable income or remainder interests, or both. There are special rules with respect to the treatment of foreign organizations which would be private foundations if they were domestic organizations.

The new Chapter 42 provisions supersede Sec. 503 (denying exemption to organizations engaging in prohibited transactions) and Sec. 504 (denying exemption to organizations which unreasonably accumulated income, etc.). Sec. 504 was repealed outright for years beginning after 1969; Sec. 503 was repealed as to Sec. 501 (c)(3) organizations effective on January 1, 1970.[9] Curiously, Chapter 42 has less of an applicable perimeter than these other provisions had. Certain Sec. 501(c)(3) organizations formerly subject to Sec. 503 and Sec. 504 are not subject to Chapter 42 because of broad exceptions from private foundation classification found within Sec. 509. For example, organizations testing for public safety, religious trusts, and any affiliated or subordinate Sec. 501(c)(3) organization operated by or in connection with a Sec. 501(c)(6) business league can conceivably be sheltered from the application of Chapter 42, although they were subject to Secs. 503 and 504. What is, perhaps, more remarkable is the fact that Congress did not apply any limitations whatsoever on activities of schools, churches or public charities (including hospitals), either as to self-dealing, jeopardy investments or suspect expenditures, although abusive

[7] Secs. 6211 and 6659.

[8] A Sec. 501(c)(3) organization is one which is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation, and which does not participate in or intervene in political campaigns on behalf of any candidate for public office.

[9] As to Sec. 504, see Act Secs. 101(j)(15) and 101(k)(2)(B). As to Sec. 503, see Act. Secs. 101(j)(7) and 101(k)(1).

situations are manifest in these areas for all classes of Sec. 501(c)(3) organizations.[10] The most troublesome consideration is that there is no recapture provision like the termination tax (Sec. 507) for all Sec. 501(c)(3) organizations although the area is ripe for restriction.[11]

Procedure and notice

Sec. 509(b) provides that any Sec. 501(c)(3) organization which meets the definition of a private foundation on October 9, 1969, or any time thereafter, is to be treated for all subsequent periods as a private foundation unless its status as such is terminated under Sec. 507. With limited exceptions, a Sec. 501(c)(3) organization (whether in existence on October 9, 1969 or created thereafter) will be presumed to be a private foundation unless it files a notice (in accordance with regulations to be issued under Sec. 508(b)) disclaiming private foundation status. Until such regulations are promulgated, however, no notice rebutting the presumption is required.[12] In addition, a new Sec. 501(c)(3) organization (post October 9, 1969) is required by Sec. 508(a) to file notice that it is applying for recognition of status in order to be treated as a Sec. 501(c)(3) organization; failure to file timely notice has the effect of making Sec. 501(c)(3) status prospective only.

Churches (and their auxiliaries), organizations which are not private foundations and normally have annual gross receipts of less

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[10] As to schools, see Emerson Institute, CA-DC, 356 F2d 824 (17 AFTR2d 362, 66-1 USTC ¶9227), aff'g unreported DC; Texas Trade School, CA-5, 272 F2d 168 (4 AFTR2d 5859, 59-2 USTC ¶9786); Birmingham Business College, CA-5, 276 F2d 476 (5 AFTR2d 1175, 60-1 USTC ¶9371). As to hospitals, see Maynard Hospital, Inc., 52 TC 1006; Sonora Community Hospital, Inc., 46 TC 519, aff'd *per curiam*, CA-9, 397 F2d 814 (22 AFTR2d 5442, 68-2 USTC ¶9528). As to religious organizations, see Founding Church of Scientology, Ct. Cls., 412 F2d 1197 (24 AFTR2d 69-5187, 69-2 USTC ¶9538).

[11] Under the Treasury Department's reform proposal, a form of national *cy pres* was proposed to preclude return of assets to the donor where previously dedicated to charitable uses. See, Tax Reform, 1969: Hearings Before the Committee on Ways and Means, House of Representatives, 91st Cong., 1st Sess., on the Subject of Tax Reform (hereinafter, House Hearings) at pp. 5110 and 5346. *Cf.*, "Keeping Public Monies Public: A Federal Receivership for Charity," *The American Bar Association Journal* 53, (Oct. 1967): 920.

[12] S. Rep. No. 91-552, at p. 54.

than $5,000, and such organizations (including schools) as may be excepted by the regulations are not required to comply with any of the notice requirements.[13]

Private foundation defined

A private foundation is any domestic or foreign organization described in Sec. 501(c)(3) other than an organization excluded from such status by Sec. 509(a)(1) through (4). There is no indication in the legislative history that these provisions (Sec. 509(a)(1)-(4)) are mutually exclusive. Thus, an organization may not be considered a private foundation in one year because it qualifies as an organization described in Sec. 509(a)(1), in another year because it falls under Sec. 509(a)(2) and in a third year because it satisfies both provisions.[14]

Sec. 509(a)(1) exclusion. If an existing Sec. 501(c)(3) organization is an organization described in Sec. 170(b)(1)(A) (other than clauses (vii) and (viii), relating to private foundations) as of October 9, 1969, then it is not treated as a private foundation. Thus, the following organizations are initially excluded from private foundation status:

- A church or convention or association of churches;
- An educational institution with faculty, curriculum and student body;
- A hospital or other organization under certain limitations) providing medical research if operating in conjunction with a hospital;
- An organization which normally receives a substantial part of its support (exclusive of exempt function income) from direct or indirect contributions of the general public or from the United States and which is organized and operated to receive and administer property and make expenditures for the benefit of a state college or university;
- A governmental unit described in Sec. 170(c)(1); and

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[13] Sec. 508(c) excludes churches (and their auxiliaries), and any Sec. 501(c)(3) organization which is not a private foundation and the gross receipts of which are normally not more than $5,000.

[14] Cf. Department of Employment, 385 US 356. Pickwick Electric Membership Corporation, CA-6, 158 F2d 272 (35 AFTR 509, 46-2 USTC ¶9409).

• An organization which normally receives a substantial part of its support (exclusive of exempt function income) from a governmental unit or from direct or indirect contributions from the general public.

Many organizations having public support (including membership support) may seek to exclude themselves from private foundation status by reason of status as a public charity within the meaning of Sec. 170(b)(1)(A)(vi). To be an organization of this character, it would have to be shown that a charitable organization satisfies either the "mechanical" test or the "facts and circumstances" test of the present Sec. 170 regulations.[15] It is understood these regulations will be modified to allow more flexible application of the "facts and circumstances" test.

Sec. 509(a)(2) exclusion. Also excluded from the definition of a private foundation is an organization which normally[16] receives more than one-third of its support in each taxable year from any combination of:

(i) gifts, grants, contributions or membership fees,[17] and

(ii) gross receipts from admissions, sales of merchandise, performance of services or furnishing of facilities (provided such activities do not constitute an unrelated trade or business), not including receipts from admissions or sales or performance of services, any amounts to the extent that such receipts exceed the greater of $5,000 or 1% of the organization's support in any taxable year.

The one-third test may be satisfied with receipts from governmental units described in Sec. 170(c)(1), from organizations described in Sec. 170(b)(1)(A) (other than clauses (vii) and (viii)) and from persons other than disqualified persons as defined in Sec. 4946. Thus, a disqualified person's gift or membership fee is excluded altogether from the numerator but is included in the denom-

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[15] See Regs. Sec. 170-2(b)(5)(iii)(b) and (c).

[16] "Normally" is conceived as a four-year moving average and if the exempt organization meets the Sec. 509(a)(2) test in three out of four years, it is excluded from private foundation status. S. Rep. No. 91-552, at p. 58. *Cf.* S. Rep. No. 78-627, 1944 CB 973, 1008, for the "normally" test under former Sec. 6033(a)(2).

[17] Apparently membership fees need not be in the form of "gifts" (see Rev. Rul. 68-432, 1968-2 CB 104) but may represent payments for services rendered members, as is the case with professional societies and the like. H. Rep. No. 91-413, Part 1, at p. 41.

inator in the computation of the percentage of support. Gross income derived from an unrelated trade or business also does not enter into the computation of the numerator while only income from "net" unrelated business actvities (whether or not regular) is added to the support denominator.[18] Gross income from *related* business activities (whether or not regular) is included in the numerator subject to the $5,000/1% limits.

Total support. The support denominator is derived from present regulations under Sec. 170. Support, as defined in Sec. 509(d), includes (but is not limited to):

- Gifts, grants, contributions and membership fees;
- Gross receipts for admissions, sales of merchandise, performance of service, or furnishing of facilities in any activity which is not an unrelated trade or business;
- *Net* income from unrelated business activities, whether or not such activity is carried on as a regular unrelated trade or business;[19]
- Gross investment income;
- Tax revenues levied for the benefit of an organization and either paid to or expended on its behalf by the governmental unit which levied the tax; and
- Value of services or facilities (exclusive of the value of services or facilities generally furnished to the public without charge) furnished by a governmental unit referred to in Sec. 170(c)(1) as an exempt organization without charge to such organization.

An organization's support does not include any gain from the sale, exchange or other disposition of property which would be considered as gain from the sale or exchange of a capital asset but

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[18] For organizations whose total support exceeds $500,000 receipts from any sale or contract for services (other than government contracts), the addition to the numerator is the amount of such sale or contract but not in excess of 1% of total support. Smaller organizations (support under $500,000) may exceed this 1% limit since they may add to the numerator up to $5,000 per sale or contract.

[19] The term "net income from unrelated business activities" (Sec. 509(d)(4)) is taken from Regs. Sec. 1.170-2(b)(5)(ii)(a) and apparently means an amount greater than "unrelated business taxable income," apart from additional irregular business income. It may be that certain modifications provided under Sec. 512(b) (net operating loss carryback, specific deduction, etc.) are not deducted in making this computation.

would include, however, the recovery by the organization of its basis (or, in the case of a capital loss, the amount realized). The term "support" does not include the value of any exemption from any federal, state, or local tax or any similar benefit.

Investment income limitation. An organization which meets the one-third public support test is nevertheless barred from this exclusion by Sec. 509(a)(2)(B) if it normally receives more than one-third of its support from gross investment income. For this purpose, Sec. 509(e) defines gross investment income as the gross amount of income from interest, dividends,[20] rents and royalties, not including any such income to the extent it is included in computing unrelated business income tax. Thus, gross investment income does not include any part of the amount realized from the sale, exchange or other disposition of property whether or not it would be considered as gain (or loss) for the sale or exchange of a capital asset.

Government grants. Receipts from government agencies would have to be in the nature of gifts rather than contracts for services to be treated as "grants" under Sec. 509(a)(2)(A)(i) and thus be free of the $5,000/1% limitation. Congress obviously wanted research organizations doing government contract work to be covered by the limitations unless engaging in multi-agency projects.[21] Amounts received for research purposes although labeled grants, will probably be treated as income from the performance of services where tangible benefits (e.g., a research report, prototype, etc.) flow back to the granting agency. Thus,

> . . . a grant by a corporation to a foundation to finance scientific research would be a gift rather than trade or business income (either related or unrelated) if the results of the research were to be made freely available to the public. However, a "grant" by a corporation to be used for research by a foundation with the results of the research to be given only to the grantor would clearly not be a gift. . . .[22]

[20] The term "dividend" evidently contemplates any amounts received which may or may not have such characterization for purposes of Sec. 316. Compare Cong. Rec., Dec. 9, 1969, at S. 16261, and Act Sec. 101(1)(8) where redemption income may be a dividend for Sec. 509 and Sec. 4942 purposes but not for Sec. 4940 and Sec. 4948 purposes.

[21] S. Rep. No. 91-552, at p. 58.

[22] S. Rep. No. 81-2375. 1950-2 CB 483, 505.

On the other hand, a government grant, not in the nature of a fee,[23] which provides for no significant services or tangible benefits flowing back to the grantor agency would be in the "gift" classification. It is likely that the term "'grant" will be construed to include a form of restricted or conditional gift. For the $5,000/1% exclusion computation, receipts from performance of services for a government unit described in Sec. 170(c)(1) are not treated on an individual contract or sale basis but are aggregated on a bureau or agency basis of the governmental unit.[24] Thus, all contracts with the same government bureau must be aggregated; of the aggregate amount, only the greater of $5,000 or 1% of the organization's support (but not any excess) is added to the numerator.[25]

Disqualified supporters. For existing Sec. 501(c)(3) organizations (including private foundations) an important consideration in determining whether an organization qualifies under the Sec. 509 (a)(2) exclusion is the status of its substantial contributors.[26] If a contributor is a "substantial contributor" and, thus, a disqualified person under Sec. 4946(a)(1)(A), amounts received from such contributor (and any other disqualified person) must be excluded from the numerator in computing the one-third test. A substantial contributor, as defined in Sec. 507(d)(2), is any "person"[27] who contributes to an organization amounts which, in the aggregate:

- Exceed $5,000, and
- Constitute more than 2% of the aggregate contributions and bequests which have been received by the donee computed as of

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[23] See, e.g., Regs. Sec. 1.170-2(b)(5)(ii)(c)(1).

[24] Sec. 509(a)(2)(A)(ii). The final version "liberalized" the initial House proposal in H.R. 13270 which could have had the effect of assuring that all United States research would be treated as received from one grant and subject to a 1% limit for inclusion in the numerator.

[25] If an organization was supported exclusively by government research work (and total support exceeded $500,000 annually) the research institute would have to do business with at least 34 different government bureaus to be excluded from private foundation status.

[26] Sec. 501(c)(3) organizations (e.g., colleges) required to file an exempt organization information return under Sec. 6033 will be required to list their "substantial contributors" (but not publicly) on their Forms 990-A for 1970. See Sec. 6033(b)(5).

[27] "Person" includes trusts, corporations, etc. See Sec. 7701(a)(1); compare note 29.

the close of the organization's taxable year in which the contribution is received.

For every donor (other than governmental units),[28] each of his contributions and bequests received on or before October 9, 1969 is deemed to have been received on such date.[29] Thus, an organization in existence on October 9, 1969 must compute the total amount of contributions and bequests received from each donor before, as well as after, that date—whether or not such amounts were deductible by the donors. If, on a donor-by-donor basis, the aggregate amount per donor exceeds $5,000, the first part of the test for substantial contributor status is met. For purposes of computing the aggregate amount of any individual's contributions, an individual is treated as making all the contributions and bequests of his or her spouse.[30] Thus, a spouse's individuality is lost with respect to ascertaining additional disqualified persons under the attribution rules. For example, if a wife contributed $1 and her husband gave $5,000 to an organization, she (as well as he) is considered a substantial contributor if the 2% test is also met. Consequently, lineal and antecedent members of the wife's family are treated as disqualified persons[31] notwithstanding the fact that her personal contributions did not meet the $5,000/2% test. It makes no difference how the $5,000 figure is exceeded—whether in one year (e.g., 1969) or over a period of years (e.g., $2,000 in 1963 and $3,000 in 1966), or whether it includes the amount contributed by both the husband and wife in one year or over a period of years.

Valuation is made on the date of the actual gift, not October 9, 1969.[32] For those persons who contributed an aggregate over the years of more than $5,000, the amount so contributed is compared with 2% of the aggregate contributions and bequests (as of October 9, 1969, or thereafter), received by the organization since it was organized. If the aggregate contribution by any person is more than $5,000 and the aggregate amount so contributed is more than 2% of the aggregate contributions received over the years by the Sec.

[28] A government unit, not being a "person" within the meaning of Sec. 7701 (a)(1), can never be a "substantial contributor" within the meaning of Sec. 507(d)(2)(A). *Cf.*, S. Rep. No. 91-552, at p. 58.

[29] Sec. 507(d)(2)(B)(ii).

[30] Sec. 507(d)(2)(B)(iii).

[31] Sec. 4946(a)(1)(D).

[32] Sec. 507(d)(2)(B)(i).

501(c)(3) organization, then such person is a substantial contributor and, accordingly, a disqualified person. The amounts so contributed by such person must be deleted from the numerator in the computation of the one-third support test. If a person is ever regarded as a substantial contributor, he forever retains such characterization regardless of the amount of future contributions, if any, to the subject organization.[33]

In the case of amounts received from persons who have been characterized as disqualified persons by reason of attribution, all such amounts must be omitted from the support numerator. It appears that a person who would be a "foundation manager" if the Sec. 501(c)(3) organization was a private foundation but otherwise is merely an officer or director of the organization, must be treated as a "disqualified person" by reason of his manager characteristics and his contributions omitted from the numerator in the years he holds office.

Consequently, if a person was an officer or director in prior years, but was not an officer or director as of October 9, 1969, his contributions in prior years would probably be excluded for such years as being from a disqualified person (i.e., foundation manager) to determine whether the one-third test was met in the years in which the person was a manager. The foregoing considerations are relevant when the Sec. 501(c)(3) organization is assessing its support during the four years preceding 1970 to ascertain its Sec. 509(a)(2) status.

Sec. 509(a)(3) exclusion. This exclusion removes from foundation status organizations or trusts closely related to publicly supported organizations described in Sec. 509(a)(1) or 509(a)(2). The premise was that organizations operating for the benefit of and controlled by organizations which were not private foundations should not be treated as foundations solely by reason of their status as a separate entity.

Three tests. There are three tests, all of which must be met:

- The organization is organized, and at all times thereafter, operated for the benefit of, to perform the functions of, or carry out the purposes of, one or more specified organizations described in Sec. 509(a)(1) or 509(a)(2); and

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[33] Sec. 507(d)(2)(B)(iv).

• The organization is operated, supervised or controlled by, or operated, supervised or controlled in connection with, one or more organizations described in Sec. 509(a)(1) or 509(a)(2); and

• The organization is not controlled directly or indirectly by one or more disqualified persons (as defined in Sec. 4946) other than foundation managers (Sec. 4946(b)). The control limitation does not apply to disqualified persons which are organizations described in Sec. 509(a)(1) or 509 (a)(2).

For purposes of Sec. 509(a)(3), an organization exempt under Sec. 501(c)(4) (social welfare), Sec. 501(c)(5) (labor union) or Sec. 501(c)(6) (business league) will be treated as an organization described in Sec. 509(a)(1) or 509(a)(2) if it can otherwise meet the terms of those sections. Thus, a foundation controlled by a business league[34] will not be treated as a private foundation if the business league is, for example, supported by membership fees and not more than one-third of the league's support is from investment income.[35]

A Sec. 509(a)(3) organization cannot be controlled, directly or indirectly, by disqualified persons, except foundation managers or organization(s) described in Sec. 509(a)(1) or (2). If a private foundation attempted transition to public status, e.g., under Sec. 509(a)(2), by creating a charitable trust using a portion of its excess endowment,[36] it could maintain control over such trust even though the foundation had the character of a "disqualified person," since its transition to Sec. 509(a)(2) status allows it to maintain such control. However, a foundation cannot create a trust for a Sec. 509(a)(1) organization (e.g., a college) and expect such trust to qualify under Sec. 509(a)(3) if it maintains control over it while keeping its own status as a private foundation.

As originally drafted, Sec. 509(a)(3) did not require that the beneficiary be a specified (i.e., named) organization. Conceivably,

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[34] *Cf.* Testimony of Ross L. Malone, Hearings Before Committee on Finance, United States Senate, 91st Cong., 1st Sess., on H.R. 13270 (October 22, 1969) at pp. 5684-92, regarding American Bar Foundation.

[35] Sec. 509(a)(3). S. Rep. No. 91-552 at p. 59.

[36] See Cong. Rec., December 8, 1969, at S. 16095-96. The foundation would be a "disqualified person" as to such trust by reason of being the creator (Sec. 507(d)(2)(A)) and probably by reason of being a substantial contributor. Sec. 507(d)(2). However, since Sec. 509(a)(2) character overrides disqualified person characterization, Sec. 509(a)(3(C) is not violated.

the Treasury Department may treat the "organized. . . for one or more specified organizations" to mean initially organized for such purpose rather than reorganized for such purpose.[37]

"In connection with." The provision of Sec. 509(a)(3)(B) allowing exclusion for an organization operated, supervised or controlled *in connection with* (in contrast to controlled *by*) was to aid a particular trust which could not be considered as controlled by the benefited organizations, since the latter could not control election of the trustees of the subordinate trust.[38] The subordinate trust is deemed controlled *in connection with* the beneficiary.

The Senate Finance Committee version of the Act added the "specified" requirement and allowed Sec. 509(a)(3) status to an organization operated, supervised or controlled in connection with *one* organization described in Sec. 509(a)(1) or (2), one hospital, community chest or school, or *more than one* educational institution described in Sec. 170(b)(1)(A)(ii), such as three colleges (but not with a hospital as co-beneficiary.)[39] The Finance Committee also added the provision allowing certain non-Sec. 501(c)(3) organizations to have a Sec. 509(a)(1) or (a)(2) identity. The final version, adopted in conference, followed the Senate amendments but enlarged Sec. 509(a)(3)(B) to exclude from foundation status an organization operated, supervised or controlled in connection with *one or more* organizations described in Sec. 509(a)(1) or (2), such as two schools and two hospitals. This very significant change was made without substantial comment appearing in the Conference Report.[40]

Since the "in connection with" provision may have been originally drafted to benefit one charitable trust which was not operated or supervised *by* the beneficiary organization, the term "in connection with" will principally be interpreted in contrast to the term "by." The connection required may mean no more than the existence of benefits being provided the specified Sec. 509 (a)(1) or (2) organizations by a charitable trust with an independent trustee.

[37] *Cf.* Sec. 4947(a)(1). S. Rep. No. 91-552, at p. 57, footnote 24.

[38] It is popularly assumed that the "in connection with" provision was placed in H.R. 13270 at the request of the Hershey Trust, Hershey, Penna. See H. Rep. No. 91-413, Part 1, at p. 41. See Cong. Rec., December 6, 1969, at S. 15982 and 15983.

[39] S. Rep. No. 91-552, at p. 59.

[40] Conference Rep. No. 91-782, at p. 289.

Although this would make Sec. 509(a)(3)(A) somewhat redundant, the piecemeal course of the liberalization of the provision undoubtedly accounts for part of this. Moreover, there is redundancy inherent in Sec. 509(a)(3)(A) (e.g., "benefit" vs. "carry out purposes") and in Sec. 509(a)(3)(B) (e.g., "supervised" vs. "controlled"), so that redundancy is no real answer to the problem of the breadth of "in connection with."

The organizations principally benefited by the "in connection with" provision are those charitable trusts which had noncharitable income interests (now expired) with remainders being held for public institutions. Upon "expiration" of the private interest and the qualification for exemption under Sec. 501(a), these trusts are treated, for Sec. 509(a)(3)(A) purposes, as being organized when they first become subject to Sec. 4947(a)(1).[41] Upon qualification for exempt status under Section 501(a), the trust becomes a Sec. 509(a)(3) organization and loses its Sec. 4947(a)(1) classification. Although the income (upon death of private annuitant, etc.) and remainder are in trust and there is an independent trustee exercising his own fiduciary judgments, payments to the specified organizations seem to create the necessary "connection" for purposes of Sec. 509 (a)(3)(B). Likewise, a charitable trust, with an independent trustee, which never had private interests, probably qualifies for Sec. 509(a)(3) status where there are specified public beneficiaries and no control is exercised by any donor, creator or other disqualified person (other than the trustee acting as a foundation manager).

Sec. 509(a)(4) exclusion. An organization organized and operated for the purposes of testing for public safety is not a private foundation. This provision was added to Sec. 501(c)(3) in 1954 to overturn a court decision to the contrary.[42] Because the provision was enacted to assist one particular organization, it is of limited utility. No regulations have been issued thereunder and only a few rulings have attempted to establish activities within the scope of testing for public safety. These organizations were excluded from private foundation status since they are not eligible to receive deductible contributions for income, gift and estate tax purposes.

[41] S. Rep. No. 91-552, at p. 57, footnote 24.

[42] Underwriters' Laboratories, Inc., CA-7, 135 F2d 371 (30 AFTR 1451, 43-1 USTC ¶9430).

Nonexempt trusts

Certain nonexempt trusts are made subject to the substantive provisions of Chapter 42 where they have charitable interests regardless of the fact that they are not exempt under Sec. 501(a) from income tax. Sec. 4947 was drafted to prevent the avoidance of the substantive provisions by creating nonexempt charitable or split interest trusts.[43]

Charitable trusts. A nonexempt charitable trust, all of the unexpired interests of which are devoted to charitable purposes (and for which a deduction was allowed a donor under appropriate sections), is generally treated as a private foundation.[44] Such a trust is subject to the Chapter 42 excise taxes as well as the Sec. 507 termination tax and the special rules of Sec. 508(d) and (e). In determining whether or not such a nonexempt charitable trust which later qualified for exemption is excluded from private foundation status by reason of Sec. 509(a)(3), the trust is treated as if it were "organized" on the day on which it first became subject to Sec. 4947 (a)(1). This has the effect of disregarding, for purposes of Sec. 509(a)(3)(A), the prior private interests which thereafter expired.

A nonexempt charitable trust includes one whose private interests have expired and a charitable organization becomes the sole beneficiary of the income and remainder interests. For example, a trust for the life of "A" with a remainder held for specific public charities for their benefit, upon expiration of "A's" income interest becomes a nonexempt charitable trust within the meaning of Sec. 4947(a)(1). During the transition from a nonexempt split interest trust to a nonexempt charitable trust to a tax exempt private foundation (or nonfoundation under Sec. 509(a)(3)), it is made subject to Chapter 42.

A nonexempt charitable trust would be permitted to qualify under Sec. 501(a) for tax exempt status (even an untimely request) without adverse effect; Sec. 4947(a)(1) specifies that the notice requirements of Sec. 508(a) to (c) are not applicable to a nonexempt charitable trust while it is nonexempt. A nonexempt trust which was a split interest trust and ripens into a charitable trust is treated as a newly created organization only for the exclusion purposes of Sec. 509(a)(3) and not for the notification purposes of

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[43] S. Rep. No. 91-552, at p. 93.

[44] Sec. 4947(a)(1).

Sec. 508(a). As a consequence, the nonexempt trust may file an untimely application for exempt status and qualify retroactively for exemption under Sec. 501(a) without regard to the time limitation contained in Sec. 508(a)(2).

Split interest trusts. In the case of a split interest trust which is not exempt from tax under Sec. 501(a) (with some but not all of its unexpired interests devoted to one or more charitable purposes and for which some deduction was allowed a donor), Sec. 4947(a)(2) selectively applies many of the substantive provisions. Initially, the various provisions of Chapter 42 do not apply to any amounts transferred in trust before May 27, 1969.[45] Amounts transferred in trust after May 27, 1969 are subject to restrictions to the extent that the donor received a deduction for such transfer under the appropriate provisions. Regardless of the time consideration, any amounts transferred in trust for which a deduction was not allowed the transferor are not subject to the substantive provisions, providing that the amounts for which no deductions were allowed the transferor are segregated in separate accounts from amounts for which a deduction was allowed.[46] In the case of amounts earned by a split interest trust which are payable under the terms of the trust to an income beneficiary, the substantive provisions do not apply to such amounts payable to the income beneficiary, unless a deduction was allowed a donor under Sec. 170 (f)(2)(B), Sec. 2055(e)(2)(B), or Sec. 2522(c)(2)(B).[47] For example, an amount payable to a charity under a charitable income unitrust or annuity trust created after January 1, 1970 is treated as an amount subject to the substantive provisions.

With the foregoing exceptions in mind, the substantive provisions which apply to split interest trusts (such as charitable income trusts or charitable remainder trusts) include:

- Sec. 507, relating to termination of status;
- Sec. 508(e), relating to governing instruments, but only to the extent that the substantive provision in Sec. 508(e) is itself applicable to the split interest trust;
- Sec. 4941, self-dealing;

[45] Sec. 4947(a)(2)(C).
[46] Sec. 4947(a)(2)(A).
[47] Sec. 4947(a)(2)(B).

- Sec. 4943, excess building holdings;
- Sec. 4944, jeopardy investments.

However, Secs. 4943 and 4944 are not applied in the case of a split interest trust where all the income interest (and none of the remainder interest) of such trust is devoted solely to one or more charitable purposes, and all amounts in such trust for which deductions were allowed have an aggregate value of not more than 60% of the aggregate fair market value of all amounts in the trust.[48] In addition, these two provisions do not apply to a trust if a deduction was allowed under the appropriate provisions for amounts payable under the terms of such trust to every remainder beneficiary but not to any income beneficiary.[49]

Foreign foundations

Due basically to problems of situs, foreign foundations have been treated less harshly than domestic foundations. The Senate Finance Committee adopted Sec. 4948 which excluded imposition of Chapter 42 taxes on foreign foundations where substantially all of their support (other than investment income) was derived from other than United States sources.

Foreign foundations with substantial United States support are treated in the same way as domestic foundations. The excluded foreign foundation is subject to the excise tax on the investment income derived from United States sources (and the unrelated business tax),[50] but otherwise the Chapter 42 provisions operate in the same fashion as old Sec. 503. Accordingly, a self-dealing transaction can only cause a foreign foundation loss of exemption *prospectively* (which obviously allows for some planning). Sec. 507 (termination of status) and Sec. 508 (notice, governing instruments, etc.) do not apply to the excluded foreign foundation, regardless of how large its corpus has grown using United States source investment income.

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[48] Sec. 4947(b)(3)(A). S. Rep. No. 91-552, at p. 94.
[49] Sec. 4947(b)(3)(B).
[50] Sec. 4948(a), Sec. 511(a)(2).

Accounting and administrative problems

The Tax Reform Act dramatically expanded the responsibilities and potential liabilities of foundations and their managers to file returns and reports, and to publicize information with respect to foundation affairs. These matters will be dealt with in this article under the following captions:

Overview of report, penalty and publicity provisions
Annual reports by private foundations
Accounting information required for report and return
Other new private foundation returns
  Transferor return
  Liquidation or contraction return
Penalties
  Form 990-A (foundation)
  Form 990-A (foundation managers)
  Termination return
  Annual report, notice and inspection
    Additions to tax, failure to file
    Assessable penalties, other failures
    Fines and prison, fraudulent returns
Outline of general foundation recordkeeping responsibilties
Publicity of information
  Effective dates of return requirements
  Penalties
    Form 990-A, foundation and foundation manager
    Annual report
    Disclosure of contributors, etc.
Termination of private foundations
  The final distributee
  The termination return
  The first and final annual report
  The final Form 990-A
  Form 4629 (transfers of income-producing property)
  Penalties
Transition from private foundation to public charity
Governing instruments
    Existing (pre-January 1, 1970) foundations
    New (January 1, 1970 and later) foundations and Sec. 4747 trusts
    Changes in state laws governing foundations and trusts

Overview of reporting, penalizing and publicizing provisions

Private foundations continue to be required to file an exempt organization information return (Form 990-A). The Act requires additional information in the form of an annual report which (like Form 990-A) is available to the IRS and the public. The foundation must advise the public of the availability of its annual report by a newspaper ad. Copies of the report must be kept handy at the foundation's office to permit inspection after publication of the notice of availability. There are personal (as contrasted with organizational) penalties imposed for failure to file a timely or complete report, and for failure to make the report available to the public. A $1,000 penalty is assessable for willful failure to (i) file the annual report, (ii) file a copy of the public notice with the annual report, or (iii) comply with publication and inspection requirements.

Personal penalties may be imposed for failure to file a timely or complete Form 990-A (but only after failure to comply with an IRS delinquency notice). If a private foundation (among others) makes a transfer of $50,000 or more of income-producing property to an exempt organization which is subject to the unrelated business income tax, it is required to file a return within 90 days of the transfer. If the foundation terminates or substantially contracts its operation (e.g., distributes one-third of its corpus), it would be required to a file a termination return.

State enforcement agencies are allowed to obtain previously confidential IRS information on foundation activities. Any time a private foundation (among others) applies for exempt status or has its exempt status altered, the appropriate officers of the state of the situs of the foundation are notified. If the foundation becomes liable for a tax imposed under Sec. 507 or Chapter 42, state officers are notified. The IRS will make available, at the request of state officers, any returns, statements, records, or other information relating to the termination, exemption or excise tax controversy.

Annual reports by private foundations

The foundation manager of every private foundation (including operating foundations but not Sec. 4947(a)(2) trusts) which had at least $5,000 in assets during the taxable year, is required by Sec. 6056(a) to file an annual report at such time and in such manner as regulations prescribe. The annual report will be filed for foundation taxable years beginning after December 31, 1969.

Sec. 6034 continues to require a return of nonexempt trusts claiming a Sec. 642(c) deduction. Although unclear, it appears that a Sec. 4947(a)(1) trust is not required to file an annual report; regulations will probably clarify the status of these trusts.

Sec. 6056(d)(1) provides that the annual report is to be filed at the same time as the foundation's exempt organization information return, probably meaning no later than the 15th day of the fifth month after close of the taxable year. The report will probably be filed with IRS Mid-Atlantic Service Center, Philadelphia, Pennsylvania. In addition, under the mandate of Sec. 6056(d)(3), the foundation manager shall make available copies of the annual report to such state officials and other persons, at such time and under such conditions, as shall be prescribed by IRS regulations. Regulations may require that foundations mail copies of their annual report (but not Form 990-A) to interested persons.

Sec. 6056(c) permits the annual report to be printed, typewritten or prepared in any other legible form which the foundation may choose. It is anticipated that IRS will provide forms which may be used at the option of the private foundation as part of a combined "form" package for use by all Sec. 501(c)(3) organizations.

Sec. 6104(d) specifies that no later than the day prescribed for the filing of the annual report, the foundation manager must place a notice of availability of the private foundation's annual report in a newspaper having general circulation in the county in which the foundation's principal office is located. The notice is to state the address of the foundation's principal office, the name of the principal manager, and the fact that the annual report is available for inspection during the foundation's regular business hours by any *citizen* who requests it. The citizen's request for inspection must be made within 180 days after the publication of notice of the report's availability; otherwise, the foundation need not honor the request to inspect the report.

Accounting information required annually

The items listed below must be provided by private foundations on either or both the annual report and Form 990-A.

- Total contributions and gifts received during year: Annual Report, Sec. 6056(b)(6); and Form 990-A, Sec. 6033(b)(5).
- Names and addresses of substantial contributors: Form 990-A, Sec. 6033(b)(5).

There is a question whether *all* substantial contributors must be listed or only those substantial contributors who contributed to the foundation during the year.

Since disclosure of substantial contributors is limited to the exempt organization information returns (Form 990-A) of private foundations so as not to prevent gifts to charities,[51] it would seem that existence of any contribution in the year in question is a prerequisite to listing. This will have to be clarified by regulations. Indeed, because there is no cross-reference to Sec. 507(d)(2) (definition of substantial contributor), there is no certainty that the term "substantial contributor" will have the same meaning for reporting purposes as it does under Sec. 507(d)(2).

- Gross income for the year: Annual Report, Sec. 6056(b)(1); and Form 990-A, Sec. 6033(b)(1).
- Expenses attributable to such income and incurred within the year: Annual Report, Sec. 6056(b)(2); and Form 990-A, Sec. 6033(b)(2).
- Disbursements (including administrative expenses) within the year: Annual Report, Sec. 6056(b)(3).
- Disbursements within the year for the purposes for which the foundation is exempt: Form 990-A, Sec. 6033(b)(3).
- An itemized list of all grants and contributions made, or approved for future payment, during the year showing the amount of each grant or contribution, the name and address of the recipient, and any relationship between any individual recipient and the foundation's managers or substantial contributor and a concise statement of the purpose of each grant or contribution: Annual Report, Sec. 6056(b)(7).

This expands on current requirements set forth in Regs. Sec. 1.6033-1(a)(4)(i)(c), Rev. Rul. 56-304 (1956-2 CB 306), and Rev. Rul. 68-489 (1968-2 CB 210).

- Balance sheet showing assets, liabilities and net worth as of the *beginning* of the year: Annual Report, Sec. 6056(b)(4); and Form 990-A; Sec. 6033(b)(4).
- An itemized statement of the foundation's securities and all other assets at the close of the year, showing both book and market value: Annual Report, Sec. 6056(b)(5).

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[51] See Sec. 6104(b) and S. Rep. No. 91-552 (11/21/69), p. 53.

• Names and addresses of foundation managers: Annual Report, Sec. 6056(b)(9); and Form 990-A, Sec. 6033(b)(6).

A Sec. 501(c)(3) organization which is not a private foundation does not have "foundation managers." Whether Sec. 501(c)(3) organizations (other than foundations) will be required to list officers and directors who have positions equivalent to foundation managers will probably be the subject of regulations.

• Names and addresses of foundation managers who are substantial contributors: Annual Report, Sec. 6056(b)(10).

• Names and addresses of all foundation managers that own 10% or more of the stock of any corporation of which the foundation owns 10% or more of the stock, or corresponding interests in partnerships or other entities, in which the foundation has a 10% or greater interest: Annual Report, Sec. 6056(b)(10).

• Names and addresses of highly compensated employees: Form 990-A, Sec. 6033(b)(6).

• The compensation and other payments (e.g., expense accounts) made during the year to each foundation manager: Form 990-A, Sec. 6033(b)(7).

• The compensation and other payments made during the year to highly compensated employees: Form 990-A, Sec. 6033 (b)(7).

• The address of the principal office of the foundation and (if different) the place where its books and records are maintained: Annual Report, Sec. 6056(b)(8).

• Copy of the notice required by Sec. 6104(d) relating to public inspection of foundations' annual reports) and *proof* of publication of notice: Annual Report, Sec. 6056(d)(2).

• Questions regarding transactions within the ambit of Chapter 42: Form 990-A, Sec. 6033.[52]

Each of the foregoing items is available to the public through either Form 990-A or the Annual Report or both. The purpose of an annual report and inspection is to "restrain a staff of a foundation that might be a little overanxious to do . . . extreme social action . . . They know what they are going to do will have to be disclosed."[53]

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[52] Also see S. Rep. No. 91-552 (11/21/69), note 3, p. 33.

[53] Cong. Rec., Dec. 4, 1969, at S15647. Statement of Senator Curtis, sponsor of the annual report provision.

Other new private foundation returns

Private foundations (among others) are required to file additional returns under certain circumstances.

Transferor return. If a foundation transfers (by gift, sale or otherwise) income-producing property to an exempt organization subject to unrelated business tax (including church, college, public charity) worth in excess of $50,000 (without regard to any lien), Sec. 6050(a) requires it to file a return showing such transfer within 90 days of the transfer. The return is filed with the Mid-Atlantic Service Center, Philadelphia, Pennsylvania (regardless of the situs of the transferor foundation or transferee exempt organization). This is not a public return and there is no penalty for failure to timely file. Form 4629 is used for this purpose.

If a private foundation gives away some of its excess business holdings to a church or college, the return would be filed. It is unclear whether the return is required where the aggregate value of all property transferred in the year (e.g., shares of stock and real estate) to one transferee or whether a return is filed only for single transfers of more than $50,000 in property to a transferee.

Liquidation or contraction return. If a private foundation terminates (e.g., under Sec. 507) or liquidates, or substantially contracts, it must file a return in the form and at the time prescribed by IRS regulations. Penalties are provided for failure to file (see below) but the returns are not open for public inspection. Sec. 6043(b)(2) permits the IRS to relieve any organization (including foundations) from this filing requirement where it determines that "such filing is not necessary to the efficient administration of the Internal Revenue Laws." By reason of Sec. 6043(b)(1), an exempt organization with gross receipts normally below $5,000 need not file unless it is a private foundation.

Penalties

Under prior law, a foundation which failed to file a Form 990-A could have had its exemption terminated.[54] Criminal penalties for filing false or fraudulent returns under Secs. 7203, 7206, and 7207

[54] See e.g., Rev. Rul. 59-95, 1959-1 CB 627; Rev. Rul. 58-617, 1958-2 CB 260; Oxygen Therapy Research Foundation, TC Memo 1958-192.

may be imposed.[55] Under the new law, there are civil penalties which may be imposed upon both the foundation and its managers.

Form 990-A (foundation). Failure to file a Form 990-A (or other information required by Sec. 6033) on the date and in the manner prescribed (as extended by IRS extensions), unless failure is due to *reasonable cause,* renders a foundation liable under Sec. 6652-(d)(1) for a penalty of $10 per day (maximum $5,000) per return. Reasonable cause in connection with any failure means exercise of ordinary care and prudence. If a foundation assigns the responsibility for preparing and filing a return to an outside accountant, and the return is not timely filed, it may be argued that reasonable cause for failure exists and, therefore, no penalty should attach to the organization.[56]

Form 990-A (foundation managers). For failure to timely comply with an IRS written demand upon the private foundation for (i) Form 990-A, if unfiled, or (ii) additional data, if returned incomplete, Sec. 6652(d)(2) imposes a $10-per-day penalty upon the foundation manager(s) who were under a duty to perform the act which precipitated the penalty. If failure of managers was due to reasonable cause, no penalty is imposed. There is joint and several liability on all managers with a maximum penalty of $5,000 per return.

Termination return. The Form 990-A penalties described above also apply to the foundation and its managers for failing to file a timely or complete termination return.

Annual report, notice and inspection. All annual report penalties are *personal* penalties, imposed upon the foundation manager or other person (possibly including an outside accountant or attorney) who is under the duty to perform the act in respect of which the violation occurs. Three separate penalties are involved in connection with the duties imposed under the annual report provisions, namely:

1. Additions to tax, failure to file;
2. Assessable penalties, other failures; and
3. Fines and prison, fraudulent returns.

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[55] See e.g., Regs. Sec. 1.6033-1(f); Beck, CA-9, 298 F2d 622 (9 AFTR2d 770, 62-1 USTC ¶9227).

[56] *Cf.* Orient Investment and Finance Co. CA-DC, 166 F2d 601 (36 AFTR 818, 48-1 USTC ¶9162).

1. *Additions to tax, failure to file.* Failure to file timely annual report (Sec. 6056) or failure to comply with public inspection requirements (Sec. 6104) renders person(s) liable for a $10-per-day penalty ($5,000 maximum) under Sec. 6652(d)(3), unless reasonable cause is shown. The term "person" means *any* individual who is under a duty to perform the act in respect of which the violation occurs. Thus, an outside accountant can be liable. The failure to publish timely notice in a newspaper does not incur the $10-per-day penalty, but where a willful failure is involved, a more substantial penalty is imposed under Sec. 6685. The important consideration is that an IRS delinquency notice is not required in advance of assessment of the civil penalty on foundation managers as is the case where the information return (Form 990-A) is delinquent.

2. *Assessable penalties, other failures. Willful* failure to file timely report, *willful* failure to publish notice, or *willful* failure to comply with public inspection requirements renders the person or persons responsible for the failure liable under Sec. 6685 for a $1,000 penalty with respect to each report or notice. If a citizen makes a timely request for inspection of the annual report, and he is willfully refused access, the manager, director or other responsible person can be assessed this penalty.

3. *Fines and prison, fraudulent returns.* Any person who is required to furnish IRS information pursuant to Sec. 6056 or Sec. 6104(d) and willfully furnishes fraudulent information, is subject to a $1,000 fine, one year in prison, or both, under Sec. 7207.

What is distracting about all the civil penalties imposed by Sec. 6652(d) is the lack of interpretive statements in the committee reports on the right of judicial appeal without prepayment of the penalty. It appears that Sec. 6659 would permit (but not require) the IRS to issue a "notice of deficiency" for the amount of the civil penalty and have such deficiency treated as a tax to which the Tax Court petition provision of Sec. 6211 would apply. One can only suppose that the repairs needed on remedies will be performed by regulations. In the case of the $1,000 "assessable penalty" provided by Sec. 6685 for violations of the annual report provisions, there exists no reference, in either Sec. 6659 or the Act's legislative history, that this is an assessment over which the Tax Court has jurisdiction.

Outline of general foundation recordkeeping responsibilities

Foundation managers should be gathering and maintaining records such as:

- Record of all gifts and bequests since inception of foundation to determine substantial contributor status, as of October 9, 1969, and thereafter. Sec. 507(d)(2).
- Record of all disqualified persons, their family interests in corporations, trusts, partnerships, and all government officials receiving any form of compensation. Sec. 4946.
- Record of all compensation, leases, contracts, facilities, etc., involving any dealings between the foundation and persons found to be disqualified persons. Sec. 4941.
- Records on investment assets and determination of basis and valuation (Secs. 4940 and 4942):
  - (a) As of December 31, 1969.
  - (b) As of date of receipt thereafter.
  - (c) As of other dates as may be required by regulations under Sec. 4942.
- Records as to holdings in any business enterprise and holdings of the foundation and all disqualified persons in the same, including under attribution rules, as of May 26, 1969 and all times thereafter under Sec. 4943.
- Records on "charitable" assets and determination of their basis (see the preceding item), as to:
  - (a) Character of investment as excludable from investment return computation. Sec. 4942.
  - (b) Character of asset as "program related investment." Sec. 4944.
  - (c) Character of asset as "functionally related business." Sec. 4943.
- Records on amounts of "acquisition indebtedness." Secs. 4942 and 514.
- Records on allocation of all foundation expenses between:
  - (a) Carrying out charitable programs. Sec. 4942.
  - (b) Earning investment income. Secs. 4940 and 4942.
  - (c) Earning unrelated business income. Secs. 511-514.
- Records with regard to status of grantee organizations and nature and purpose of grant. Secs. 6056(b)(7), 4942, and 4945.

  (a) Classification, as "private foundation," "private operating

foundation," "other than private foundation," etc., of grantee.

(b) Specific purpose of the grant.

(c) Report of use of the grant by grantee.

(d) Evidence that equivalent expenditure was made out of corpus not later than year after grant received by grantee (if private foundation).

(e) Legal opinions of counsel of grantee on Sec. 509 status for Secs. 4942 and 4945 purposes.

- Evidence that expenditures do not violate Sec. 4945, including:
  - (a) Explicit restrictions in grants that they are not to violate Sec. 4945.
  - (b) Written requests from governmental bodies where technical assistance on legislative matters is rendered.
  - (c) Procedure with regard to travel and study grants in accordance with regulations. T.D. 7022, 1/20/70, prescribing Temp. Regs. Sec. 143.1.

Publicity of information

Private foundation finances are public information. Form 990-A, already available to the public at the IRS offices, continues to be publicly available. The annual report is likewise available to the public. Unlike Form 990-A, a timely request to see the annual report requires the foundation to make available at its offices a copy of the annual report. For the small foundations with no real office (e.g., where the books are kept in the donor's place of business or home), arrangements must be made to give each private foundation a "principal office" within the meaning of Sec. 6104(d).

Refusal to make the report available can lead to the imposition of a $1,000 assessable penalty upon the managers as well as the $10-per-day penalty for failing to make the report available on a timely basis. The foundation's annual report may have to be mailed to citizens timely requesting the same if the regulations so prescribe. Unlike prior years, the substantial contributors to private foundations will be disclosed to the public together with the aggregate amounts of their contributions. All salaries of foundation managers and "highly paid employees" will be disclosed.

Over the years, state officers concerned about abuses of charitable corporations and trusts in their states were continually frustrated by the failure of the IRS to share information. Under Sec. 6103-

(b)(1) liberally interpreted, much information on corporate foundations could have been made available had the government decided to work with the states in enforcement efforts. Responding to the pleas of state officials, Congress opened the files of the IRS where private foundations are concerned. Sec. 6104(c)(1)(A) requires the IRS to notify the proper state authorities:

- When a Sec. 501(c)(3) organization (including a church) has been denied exemption or had its tax exempt status revoked.
- Of the operations of the organization which indicates it does not meet, or no longer meets, the requirements of exempt status. (This last notice would relate to activities prior to the issuance of any denial letter or revocation letter presumably to allow the state to take its own appropriate action against the foundation during the period of IRS administrative appeals.)
- IRS is required by Sec. 6104(c)(1)(B) to notify the appropriate state officer of the mailing of a notice of deficiency of tax imposed under Sec. 507 or Chapter 42. Because of an oversight in drafting, the notice does not apply to instances where a Chapter 42 violation has been uncovered but no deficiency notice has been issued.

On the other hand, pursuant to Sec. 6104(c)(1)(C), a state officer may request and receive from the IRS any returns, filed statements, records, reports or other information relating to exempt status, a Sec. 507 or Chapter 42 notice of deficiency, which is relevant to a determination under state law. State officers are not entitled to such information where the organization is exempt from tax under any provision other than Sec. 501(c)(3).

Effective dates of return requirements. Form 990-A is already required of private foundations. Under Act Sec. 101(k)(2)(B), the first annual report must be filed in connection with a taxable year beginning after December 31, 1969. As for the transferor returns, Act Sec. 121(g) calls for them to be filed in connection with transfers of property occurring after December 31, 1969. Act Sec. 101 (k)(2)(B) provides that a termination return must be filed for terminations occurring in taxable years beginning after December 31, 1969. Since forms or regulations make this provision operative, nothing needs to be done about a termination until forms or regulations are prescribed.

Penalties.

Form 990-A, *foundation and foundation manager.* Act Sec. 101(k)(2)(B) makes a Form 990-A filed for taxable years beginning after December 31, 1969 the object of the penalty under Sec. 6652; thus, 1969 returns are unaffected.

Annual report. Penalties for failure to file timely or complete annual reports apply to taxable years beginning after December 31, 1969, by reason of Act Sec. 101(k)(2)(B). However, under Act Sec. 101(k)(1), the assessable penalties for willful failures to comply or file annual reports, notices, inspections, etc., required on or after January 1, 1970, apply to any such event occurring on or after January 1, 1970.

Disclosure of contributors, etc. Since Form 990-A is already open to inspection, prior year returns of foundations are available. Due to an ineffectively worded effective date provision governing all exempt organization returns, it is unclear whether returns of all other exempt organizations (Form 990) are now available to the public, regardless of the year or filing date, or only available for years beginning after December 31, 1970.[57] If a private foundation filed with its 1969 Form 990-A a list of contributors, then the IRS is not precluded from making the list public. Annual reports filed for taxable years beginning after December 31, 1969 are available any time after January 1, 1970, including those filed for short taxable years beginning after December 31, 1969. Act Sec. 101(k)(1) indicates that information on foundations may be disclosed to state officials any time after January 1, 1970, without regard to the period or year in which such information relates. Thus, acts of foundations occurring in prior years and described in revenue agents' reports will probably go to states wanting complete dossiers on certain foundations.

Termination of private foundations

As the breadth of the private foundation provisions becomes apparent, many tax advisers will have to ask their clients if they really want that little foundation. With the limitations on gifts of appreciated property, the taxes, mandatory payouts, limits on investments, limits on grants and the extensive recordkeeping re-

[57] Act Sec. 101(k)(1) as applied to Act Sec. 101(j)(36).

sponsibilities, there is little to commend continuing the life of a small private foundation. Given the client's decision to forsake the family name, what rules govern winding up the affairs of a foundation? The safest way of winding up the affairs of a foundation is to give away all its property to a public charity (Sec. 509(a)(1)) and dissolve the corporation. However, under Sec. 507(b)(1), only those foundations which have not engaged in a single, willful and flagrant act, or have not engaged in willful, repeated acts, giving rise to tax under Chapter 42, may terminate in this fashion.

The final distributee. Under Sec. 507, a private foundation which terminates may only do so by making its termination payments to Sec. 170(b)(1)(A) organizations, other than those described in clauses (vii) and (viii), which have been in existence for 60 months immediately preceding a termination distribution to them. Termination payments cannot be made to another private foundation, an individual for travel or study, etc., or to a church, college, hospital, etc., which has not been in existence for the prescribed time. For safety's sake, the foundation managers should adopt a corporate resolution (cf. Sec. 337) setting forth the intention to terminate in proper fashion. At the meeting, letters from prospective final distributees stating their age and tax status should be entered into the record. One officer should be delegated the responsibility for taking all necessary steps, including preparation of returns, for properly terminating the foundation. If the foundation owns property, rather than having only cash, it should be distributed in its present form to avoid any excise tax on investment income upon its sale. A private foundation which will terminate by making distributions need not advise the Internal Revenue Service in advance of termination of its intentions. After all distributions are made to proper distributees, receipts should be obtained showing delivery of the cash or property and the date of receipt. The corporation should not be immediately dissolved under state law in the event minor expenses must be paid by a donor out of his own pocket. If the corporate shell exists during the termination period, a donor can still claim a contribution deduction for amounts paid for the use of his private foundation.

The termination return. As noted above, any exempt organization (with special exceptions) which terminates must file a special termination return, not yet available, or information prescribed by

regulations, not yet published. Information required by any return may be prescribed by regulations or simply stated in instructions contained in the IRS form.

The first and final annual report. If the foundation terminates after the beginning of its first fiscal year after December 31, 1969, then the managers must file a first and final annual report. No such annual report need be filed where the foundation had less than $5,000 for such short taxable year.

The final Form 990-A. Regardless of the timing of the termination, the foundation will have to file a final Form 990-A for the period ending at the point of termination. Any tax on investment income will have to be paid with such return, together with any Chapter 42 tax arising out of a nonwillful transaction, to make the return complete.

Form 4629 (transfers of income-producing property). If the foundation had income-producing property which it was giving to a distributee the value of which exceeded $50,000 (regardless of any lien), then this form would be filed as part of the termination process, as to each such transferee. Since this return focuses on the transferee and the value of the property, the fact that individual properties do not meet the $50,000 mark may not be material. If four or five different securities were given to a single transferee, then the return probably should be filed as to that transferee where the aggregate value of a single transfer exceeded $50,000.

Penalties. If a private foundation fails to terminate as directed, no civil penalty or excise tax is imposed. The consequence is simply that the status as a private foundation continues although, in fact, the entity may be dissolved. The consequences of continuing status as a private foundation where there are no assets or income arise only as to returns which must be filed for the year subsequent to the year of the purported termination. Failure to file the required returns for the nonexistent foundation could lead to the imposition of personal penalties on the nonexistent managers. This may sound rather incongruous, but that is seemingly the literal statutory effect. Regulations are obviously needed to perform the interstitial rites necessary to make the termination provision sensible.

Transition from private foundation to public charity status

Under Sec. 507(b)(1)(B), if a private foundation has not committed a single, willful and flagrant violation of Chapter 42, or committed willful, repeated violations, then it may terminate its status as a private foundation by becoming a public charity. This may be accomplished, for any foundation, in its first taxable year beginning after December 31, 1969; otherwise, the foundation must undertake a 60-month transition period. The transition must be completed by the end of the 12-month or 60-month period to terminate status under these procedures. Transition may validly occur only if the foundation notifies the IRS *before* it begins the process. In lieu of a notice before transition, the notice may be filed within 90 days after finalization of the transition regulation under Sec. 507(b)(1)(B)(ii). The foundation must also establish (possibly by ruling) to the satisfaction of the IRS that it has complied with definitions of public charity (Sec. 509(a)(1)-(a)(3)) "immediately after" expiration of the 12-month or 60-month transition period. Failure to provide notice as required has the effect of postponing termination of status until there is compliance. It appears that a termination return (Sec. 6043(b)) will be required of foundations completing the transition to public charity status since they have "terminated" status as a "private foundation."

A private foundation which undertakes transition in 1970 is not treated as a private foundation for purposes of Chapter 42 during the 12-month period, if by the end of such year, it meets the public charity definition. If by the end of 1970 (for a calendar year foundation) it has established itself as a public organization, it need not pay the taxes due under Chapter 42, file the annual report, etc. There is the obvious problem of establishing satisfactory termination to the IRS in the interim between the close of the 12-month period and the due date for all returns, tax payments, etc. For example, a foundation obtains the necessary public financial support during 1970 to be treated, by the close of the year, as a public charity under Sec. 509(a)(1). If IRS approval of status termination is not received by May 15, 1971, the foundation would have to pay any taxes due, and when approval is received later, obtain a refund. If a private foundation begins the 60-month transition and does not successfully complete transition in that period, then for any taxable

year within the 60-month period for which the foundation did meet the public charity test, it is treated as a public charity for such year.

Governing instruments

Under prior law, Regs. Sec. 1.501(c)(3)-1(b) required for applicants for exemption after 1959, that Sec. 501(c)(3) organizations meet an "organizational test" regarding the purposes and powers stated in their corporate charter or trust indenture. This continues to be effective but with supplementary statutory provisions (Sec. 508(e)) applicable only to private foundations. The governing instruments of all private foundations must contain language to expend its income so as not to be taxed by Sec. 4942; to prohibit the foundation from self-dealing acts covered by Sec. 4941 and from holding excess business holdings (Sec. 4943), from making any jeopardy investments (Sec. 4944) or taxable expenditures (Sec. 4945). Acceptable language was recently published by IRS in Rev. Rul. 70-270 covering both corporate charters and trust indentures.[58]

All private foundations, whenever organized, are subject to the governing instrument provisions of Sec. 508(e) as are nonexempt charitable trusts and charitable split interest trusts created after May 26, 1969 or, if created before such date, which received contributions after May 26, 1969 from a donor. A private foundation is not exempt from tax if it fails to meet the governing instrument test. Under Sec. 508(d), contributions to a private foundation, or trust described in Sec. 4947, are not deductible by donors for federal income, estate or gift tax purposes, if such foundation or trust fails to meet the requirements of Sec. 508(e). Requiring specific prohibitions relating to acts or failures to act under Chapter 42 gives the states in which the foundation was organized, or is operating, the opportunity to assert jurisdiction over the foundation for *ultra vires* acts where a violation occurs through *quo warranto* or similar proceedings. Congress expects the states to share in the burden of policing foundation activities.

Existing (pre-January 1, 1970) foundations. For existing foundations, the governing instrument need not include the necessary provisions for taxable years beginning before January 1, 1972 according to

[58] IRB 1970-22, 8.

Sec. 508(e)(2)(A). Thus, a calendar year corporate foundation does not have to have inserted in its charter all such provisions until December 31, 1971 to maintain its exempt status and eligibility for deductible contributions. Many private foundations are trusts which contain (due to a pre-1955 IRS internal rulings position) a provision which bars any amendments to the governing instrument. In such cases, and for split interest trusts which received a transfer in trust after May 26, 1969, the statute assumes the trustee will file an action in a court of equity seeking reformation of the governing instrument. Under Sec. 508(e)(2)(B), such action must be undertaken before January 1, 1972 to assure that during the pendency of such action after such date, exemption is retained where the instrument has not yet been amended. If the court of equity refuses to allow reformation to insert the required provisions, then exemption can be continued under Sec. 508(e)(2)(C) but contributions are not deductible by donors if made on or after January 1, 1972. In fact, contributions by a donor to a trust seeking reformation are only deductible for taxable years of the trust beginning before January 1, 1972, where the instrument was not reformed by the close of such year but an equity court eventually allowed reformation. Thus, for taxable years of a trust beginning on or after January 1, 1972, contributions are not deductible except in those taxable years where the trust has met the governing instrument requirements for the entire year.

New (January 1, 1970 and later) foundations and Sec. 4747 trusts. Any private foundation organized on or after January 1, 1970 is not entitled to exemption or eligible for deductible contributions unless the Sec. 508(e) rules are satisfied. For a charitable income or remainder trust subject to Sec. 4947 created on or after January 1, 1970, no deduction is allowed the donor thereto if the trust instrument fails to contain the proper provisions. If the new foundation's instrument did not initially contain the provisions, it would not lose exempt status where it subsequently amended its charter. However, the contribution provision is based on a taxable year requirement so that an improperly organized foundation (organized January 1, 1970 or after) which permitted a year to lapse before making the proper amendments would be entitled to exemption but the donor would lose his contribution deduction where the gift was made in a year in which the governing instrument was faulty. It is incumbent on tax advisers with clients who have created a private foun-

dation in their will (still ambulatory) to make sure that the trust created contains the proper language since such a testamentary trust may be treated as created on the date of death; and if a taxable year of the testamentary trust goes by without the provisions being in the trust, the decedent would lose his estate tax deduction.

Changes in state law governing foundations and trusts. Under T. D. 7040 (May 5, 1970) IRS provides that if the law of a state is amended to include the effect of the Sec. 508(e) provisions in its rules governing the powers of corporations or trusts operating in such states or organized under its laws, then the instrument of the foundation (or split interest trust) need not be amended. Thus, if the laws of a state are amended to bar private foundations organized under its nonprofit corporation laws from engaging in, for example, acts of self dealing, then the foundation need not have such terms in its government instrument. At this point in time, it appears only Virginia has passed such legislation for corporations and charitable trusts.[59]

Jeopardy investments

The Revenue Act of 1950 provided the forerunner[60] of Sec. 504 (a)(3) which denied certain Sec. 501(c)(3) organizations an income tax exemption for the year or years in which they invested their *income* "in such a manner as to jeopardize the carrying out of . . . [their] charitable" or other purpose or function constituting the basis for exemption. The 1969 Tax Reform Act has replaced Sec. 504(a)(3) with new Sec. 4944.

Effective dates overlap

The repeal of Sec. 504 is effective for taxable years beginning after December 31, 1969; Sec. 4944 applies to investments made on or after January 1, 1970.[61] Thus, a curious overlap results. A private

[59] 1970 Acts of Virginia Assembly, Chapter 549 (amending powers of non-stock corporations), April 4, 1970 and Chapter 714 (relating to terms of charitable trusts), April 5, 1970.

[60] 1939 Code Sec. 3814(3), added by Sec. 331 of the 1950 Revenue Act.

[61] As to the repeal of Sec. 504, see TRA Sec. 101(j)(15) and 101(k)(2)(b); as to the effective date of Sec. 4944, see TRA Sec. 101(k).

foundation with a fiscal year ending in 1970 (other than on December 31) may violate both provisions during such a period by making a jeopardy investment, for example, on January 2, 1970. On account of such an event, the foundation would be denied exemption for the 1969-70 fiscal year under Sec. 504(a)(3) and also be subject to the Sec. 4944 excise tax.

Initial tax on foundations

Under Sec. 4944(a)(1), a 5% "initial" tax is imposed upon the amount invested in the manner which jeopardized "the carrying out of any of [the] exempt purposes" of the private foundation for each year (or part thereof) in the taxable period. Under Sec. 4944(e)(1), the taxable period means the aggregate period which begins with the date on which the entire amount (if made at one time), or the initial amount (if made in "installments"), is invested in the jeopardy investment and ends on whichever of the following dates is the earlier:

- The date of mailing of a notice of deficiency with respect to the initial tax imposed on the foundation, or
- The date on which all of the amounts tied up in the jeopardy investment are "removed from jeopardy."

The use of the taxable period concept means that two separate taxes can be imposed even though the total elapsed period for the jeopardy investment was less than one full year. This is the case because the provision applies to any part of a taxable year which falls within the taxable period.

Example. A calendar year foundation invests $100 in a jeopardy investment on December 1, 1970 and on January 31, 1971 removes the investment from jeopardy. The total initial tax payable by the foundation would amount to $10. Since the calendar year 1970 and the calendar year 1971 both fell within the 60-day taxable period, a 5% ($5) initial tax will be imposed for both years.

The term "removed from jeopardy" (for terminating a taxable period) means that the proceeds from the disposition of a jeopardy investment must be clear from any further jeopardy.[62] Thus, if the proceeds from a jeopardy investment are placed in the foundation's

[62] See Sec. 4944(e)(1) and (2).

checking account, this would be a sufficient removal from jeopardy to terminate the taxable period. The question occurs: If there are little or no proceeds remaining, when would the investments be deemed to have been removed from jeopardy for purposes of the alternative termination period? Perhaps the regulations will indicate what affirmative acts will be considered as equivalent to removing a "worthless investment" from jeopardy.

Initial tax on managers

To be liable for the 5% initial tax imposed under Sec. 4944(a)(2) on the making of the jeopardy investment, the foundation manager must have made the investment *knowing* that it jeopardized the carrying out of any of the foundation's exempt purposes; however, he may avoid the penalty by showing that his participation in the investment was not willful *and* was due to reasonable cause. In view of the conditions attached, before a foundation manager becomes liable for the initial tax on a jeopardy investment, the prospects of a manager unwittingly being subject to tax seem minimal. Under the standards provided by present law for imposition of penalties having similar standards, reliance upon the advice of an independent adviser (retained to provide investment counseling) would provide a basis for relief from a tax on managers.[63] If the foundation manager(s) is found liable for the 5% initial tax, regardless of the size of the jeopardy investment, the aggregate initial tax imposed upon all managers may not exceed $5,000 under Sec. 4944 (d)(2). The aggregate tax would be imposed jointly and severally with respect to all members of the foundation's management who participated in making the prescribed investment (i) knowingly and (ii) willfully or without reasonable cause.

Additional tax on foundations

If an initial tax is imposed on the private foundation for making a jeopardy investment and the foundation fails to remove the investment from jeopardy during the "correction period," the IRS may impose an "additional" tax of 25% of the amount of the invest-

[63] Calvert Iron Works, Inc., 26 TC 770; Wong Goo Shee Estate, 7 TC Memo 918. Under Knollwood Memorial Gardens, 46 TC 764, 794, the Tax Court stated that "good faith belief" as to nonliability cannot be equated with "reasonable cause" for a failure to act where IRS rulings or regulations state the proper position.

ment. The additional tax is a "one shot" tax since there is no equivalent to the "taxable period" in this provision. If the investment is removed from jeopardy during the "correction period," the tax may be abated under Sec. 6404(a).

Under Sec. 4944(e)(3), the correction period begins on the date when the investment is "entered into" and ends 90 days after the mailing of a notice of deficiency for the *additional* tax, as extended by:

- Any period in which a deficiency cannot be assessed under Sec. 6213(a), and
- Any other period which the IRS determines is "reasonable and necessary" to bring about removal of jeopardy. The statutory grant to the IRS under Sec. 4944(e)(3)(B) to extend the correction period (and postpone assessment of additional tax) is designed to allow state officials to come in[64] and take charge of the foundation or investment. In this connection, the Senate Finance Committee Report states:

> The committee amendments further provide that before the second stage sanctions are imposed the State Attorney General is to be given an opportunity to intervene in the case to exercise whatever powers he has to correct the situation. When the Treasury Department finds the situation is corrected, the second level sanctions are not to be imposed.[65]

Where a foundation has moved in and out of a particular investment, it may be difficult to determine the "amount" of the investment for imposition of tax. For example, suppose a foundation makes a number of separate purchases and sales of a jeopardy investment but never removes itself from it completely, always having some balance. The initial tax seems to apply to the aggregate purchases (without regard to sales, or net balance) while the "additional" tax seems to focus on the net amount of investment at the time the notice of deficiency for the initial tax is imposed.

Additional tax on managers

In any case in which an additional tax is imposed upon the private foundation, an additional tax may be imposed, under Sec.

[64] Under Sec. 6104(c)(1)(B), state officers are automatically sent copies of IRS deficiency notices for Chapter 42 taxes.

[65] S. Rep. No. 91-552 (11/26/69), p. 46.

4944(b)(2), upon managers equal to 5% of the amount of the investment if the managers refused to agree to part or all of the removal from jeopardy. It appears that refusal, in order to be effective, would have to be directed to an affirmative act of the IRS, such as notice to correct a jeopardy investment within a specified period. The joint and several liability for this tax accrues to any foundation manager who participated in the refusal. Sec. 4944(d)(2) provides that the maximum amount of tax imposed on all managers cannot exceed $10,000 with respect to any one investment.

Character of jeopardy investment[66]

The determination as to whether an investment jeopardizes a foundation's charitable purpose is to be made at the time the investment is made under the "prudent trustee" approach.[67] The IRS is not permitted to use hindsight. Examples of per se jeopardy investments may be investments in warrants, commodity futures, and options; also, purchases of securities using a margin account.[68] The Senate Finance Committee Report makes a parenthetical reference to a court decision (apparently, the Ninth Circuit's decision in *Randall Foundation, Inc.*,[69] although not cited) involving a foundation's risky investment of corpus and income. In that case, a confused Court of Appeals denied exemption to a foundation which had vigorously engaged in investment activities, mostly involving oil stocks of a highly speculative nature. Should the Treasury Department translate the opaque reference to the *Randall Foundation* case into practice there are a number of investment characteristics which are significant, namely:

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[66] The pertinent regulations under the 1954 Code (Sec. 1104-1(b) and (d)) followed its 1939 counterpart (Regs. 118, Sec. 39.3814-1(b) and (d)) by not giving examples of jeopardy assessments. Moreover, no exemplifying rulings have ever been issued by the IRS.

[67] *Cf.* "Proposals for Federal Prudent Man Rule in Employee Benefit Plans," *Real Property Probate and Trust Journal* (Chicago, Ill.: American Bar Association, Spring 1970) Vol. 5, No. 1, pp. 21-29.

[68] See e.g., Summary of H.R. 13270 (Tax Reform Act of 1969), Staff Report of Joint Committee on Internal Revenue Taxation and Committee on Finance (as passed by House of Representatives), 8/18/69, p. 16; S. Rep. No. 91-552 (11/21/69), p. 45; and Summary of H. R. 13270 (Tax Reform Act of 1969), Staff Report of Joint Committee on Internal Revenue Taxation (as reported by the Committee on Finance), 11/18/69, p. 9.

[69] CA-9, 244 F2d 803 (51 AFTR 457, 1957-1 USTC ¶9352). See S. Rep. No. 91-552 (11/26/29), p. 45.

- The foundation profited in all its transactions in the speculative securities and there was no loss of corpus.
- All investments were in securities traded on a registered stock exchange through a registered broker.
- The board of directors gave the principal foundation manager power to engage in investment activity without formal authority for each trade and without regard to the relative security of the investment.

Thus, the mere fact that foundation managers invest on the advice of their investment broker in listed securities, and profit thereby, may not foreclose application of Sec. 4944 to the foundation if much risk was evident at the time the investment was made. Because of the vagueness of the trigger word—"jeopardize"—this provision will undoubtedly limit the investment flexibility of management in dealing with the foundation's portfolio.

Security, not success, is the test. In this perspective, security for the investment which could meet the "adequate security" test from prior law[70] seems to assure that no "jeopardy" would attach to any investment. If a debt or equity investment is unsecured, the test is the "likelihood" that such investment would jeopardize the conduct of exempt purposes. Thus the great success of an investment, from an economic standpoint, will not necessarily deter application of the tax since the judgment on possible jeopardy (failure) is focused on the point at which the investment is made. Since the Treasury Department is not given to magnanimity, it would have to be a sympathetic court which would interpret this provision so as to sharply restrict its potential breadth of application.

Risk of substantial corpus. In the legislative history of this provision it is noted:

> Under present law, a private foundation manager may invest the assets (other than accumulated income) in warrants, commodity futures, and options, or may purchase on margin or otherwise *risk the entire corpus of the foundation without being subject to any sanctions*. . . . The [Senate Finance] committee agrees with the

[70] *Cf.* Sec. 503(b)(1) (as amended by TRA); Van Products, Inc., 40 TC 1018; Rev. Proc. 69-3, 1969-1 CB 389 (Sec. 9.02) dealing with adequacy of security.

House that the same reasoning should apply to investments which jeopardize the foundation's corpus.[71]

These comments suggest that jeopardy must attach to an investment which represents a rather large part of the corpus of the foundation before the provision is effective. A modest, bad investment may not be affected.

Such inferences are supported by *Samuel Friedland Foundation*,[72] the only reported case construing Sec. 504(a)(3). There, a foundation borrowed from its founder and a bank 100% of the purchase price to buy NYSE securities and make other investments. The central issue in the case involved investment in a common stock (Food Fair) with borrowed capital. Had the stock exchange price declined by three points, the entire net worth of the Friedland Foundation would have been eliminated. Furthermore, a three-point decline in value of the stock would have resulted in the debt exceeding the value of the stock purchased. The District Court held that the mere existence of a possibility for the Foundation to be "wiped out" was insufficient to revoke exemption. It was the "likelihood" of such an occurrence; there, the likelihood was rebutted by evidence showing the investment acumen of the creator and principal manager of the Foundation (and principal owner of Food Fair). The District Court did not look to see whether (at the date of trial or date of decision) the investment in the common stock rose or declined in value in relation to its value at the time of its purchase. It was apparent that the court recognized that the prospect of jeopardy was present. But the more important question, for Sec. 4944 purposes, deals with the degree of corpus invested in the risky investment (even assuming jeopardy is present) which would trigger operation of the provision. The Court stated:

The test of the third subdivision of Sec. 3814 [under 1954 Code Sec. 504(a)(3)] seems to be not whether any one or two investments made with accumulated income were likely to founder, but whether

[71] Summary of H. R. 13270 (8/18/69), note 5; also, S. Rep. No. 91-552 (11/21/69), p. 45. But *cf.* "Limitation on Use of Assets.—Assets of a private foundation cannot be used *to any degree* for purposes or functions other than those constituting the basis of the organization's exemption or invested in a manner which jeopardizes the carrying on of its exempt purpose," Committee on Wage and Means, House of Representatives Press Release, Announcing Tentative Decisions on Tax Reform Subjects (5/27/69), p. 4.

[72] 144 F. Supp. 74 (50 AFTR 316, 1956-2 USTC ¶9896).

whatever loss was apt to occur would imperil the capability of the organization to carry out its charitable purposes . . . minor investments may be disregarded, as even a total loss would have no substantial adverse effect upon the continued operation of the Foundation and the promotion of its purposes.

The *Friedland* case squarely held that the Sec. 4944 predecessor did not apply to risky investments which are so minor as not to pose any real threat of loss of the entire corpus. Realistically, a small, bad investment simply cannot jeopardize "the carrying out of any of [the foundation's] exempt purposes. . . ." in the totality of a foundation's balanced portfolio.

Exception for program related investment

Under Sec. 4944(c), a high risk "investment" made primarily for a charitable purpose (i.e., described in Sec. 170(c)(2)(B)) is classed as a "program related" investment and is excepted from the jeopardy investment taxes. Program related investments are not subject to operation of Sec. 4944 where they retain that character during the term such investment is held. A program related investment is an "investment" in which "no significant purpose . . . is the production of income or the appreciation of property. . . ." In other words, the realization of income or profit must be a *less-than-important reason* for the making of an investment if it is to qualify as a program related investment. A program related investment may still be productive but the prospect of significant income or significant appreciation is lacking; thus, it appears that a very successful investment from a financial standpoint could declass an investment from program related status. Examples in the committee reports[73] of typical program related investments are low interest or interest free loans to students,[74] high risk investments in low income housing, and loans to small businesses, where commercial sources of funds are unavailable. If a foundation maintains several checking accounts in small inner city banks (at no interest) to assist in stabilizing the surrounding community and provide a source of capital for inner city business, this would presumably meet the test for program related investment.

[73] S. Rep. No. 91-552 (11/21/69), p. 46. Summary of Senate Amendments to H. R. 13270 (Tax Reform Act of 1969), Staff Report of Joint Committee on Internal Revenue Taxation, 12/12/69, p. 12.

[74] Rev. Rul. 63-220, 1963-2 CB 208.

Disqualified persons and self-dealing

The self-dealing provisions, concentrated in new Sec. 4941, will be explained in the context of their historical development and in relation to prior rulings and decisions under Secs. 501(c)(3) and 503, since they shed some (but not much) light on the new law.

Introduction

On and after January 1, 1970, private foundations (or other organizations subject to Sec. 501(c)(3)) may no longer be penalized for engaging in "prohibited transactions" under Sec. 503. Instead of the exempt organizations, "disqualified persons" and foundation managers are themselves made taxable with respect to "self-dealing" transactions, i.e., those acts or failures to act prescribed in new Sec. 4941(d). The self-dealing taxes consist of:

- Initial taxes at the rate of 5% on the self-dealer and 2½% (subject to maximum) on the foundation manager, and
- Additional taxes, for failing to undo the self-dealing act, of 200% on the self-dealer and 50% (subject to maximum) upon the foundation manager.

The initial tax (and the additional tax) may be imposed upon the self-dealer even though he did not know he was committing the proscribed act, did not engage in such act willfully, or had reasonable cause to believe that he was not engaging in an act of self-dealing or was not a "disqualified person." The foundation manager, however, is not subject to the initial tax (nor the additional tax) unless (a) he knew he was engaging in a self-dealing transaction and (b) his conduct in that regard was willful *and* without reasonable cause.

Historical development of prohibition on self-dealing transactions

Before 1950. Prior to 1950, Sec. 501(c)(3) organizations had to engage in rather substantial adverse transactions to have their exempt status challenged. The basis for any IRS challenge was that the organization was not operating "exclusively" for the charitable or other purposes stated in the exemption provision. If a private party obtained some benefits from a foundation or other charitable

organization, the courts generally approved the exemption and allowance of contribution deductions where charity was the principal (or ultimate) beneficiary. Thus, exemption was sustained although assistance was furnished to needy relatives,[75] old family servants,[76] and employees of the donor's corporation;[77] or a donor was allowed to reserve small annuities to his relatives out of income which would be exempted through the use of a charitable organization.[78] These and other uses of foundation income or corpus were able to continue through a weighing approach to the benefits derived by charity or private parties.

1950-1969. In 1950, the House of Representatives adopted a provision which would have prohibited a foundation from entering into financial transactions with its contributors, officers, directors, trustees and certain parties related to these individuals.[79] The Senate Finance Committee agreed that there were abuses under pre-1950 law but believed that the abuses could be corrected or prevented without prohibiting all transactions.[80] Thus, the final version of what was Sec. 503 permitted private parties to engage in financial dealings with charities where the transactions were, in effect, at arm's length.[81] In a 1965 report on private foundations, the Treasury Department urged Congress to bar certain described transactions:

> . . . It is recommended that private foundations be prohibited from engaging in any transaction with a donor or parties related to the donor involving the transfer or use of the foundation's assets. Illustrative of the self-dealing transactions which a private foundation will

[75] Mallery, 40 BTA 778, nonacq. 1939-2 CB 57.

[76] Havemeyer, CA-2, 98 F2d 706 (21 AFTR 788, 38-2 USTC ¶9456).

[77] Barker Annuity Fund, CA-7, 90 F2d 286 (90 AFTR 833, 37-2 USTC ¶9306).

[78] Stockton, 260 US 3 (3 AFTR 3182, 1 USTC ¶69) and Emerit E. Baker, Inc., 40 BTA 555, *Cf.* for post-1950 years: McGillick Foundation, CA-3, 278 F2d 643 (5 AFTR2d 1514, 60-2 USTC ¶9481); Lewis, 189 F. Supp. 950 (7 AFTR2d 537, 61-1 USTC ¶9231); Rev. Rul. 69-279, 1969-1 CB 152; Rev. Rul. 69-176, 1969-1 CB 150; and Rev. Rul. 69-256, 1969-1 CB 151.

[79] Sec. 301(c), H.R. 8920 (June 23, 1950. 81st Cong., 2d Sess.

[80] S. Rep. No. 2375, 81st Cong., 2d Sess. (8/22/50), 1950-2 CB 483, 510.

[81] Sec. 301, P.L. 814 (Revenue Act of 1950), 81st Cong., 2d Sess. (9/23/50), adding 1939 Code Sec. 3813.

be prohibited from entering into under this general rule (though the rule would not be limited to these transactions) would be—
1. Lending any part of its income or corpus to;
2. Paying compensation (other than reasonable compensation for personal services actually rendered) to;
3. Making any of its services available on a preferential basis to;
4. Purchasing or leasing of its property from; and
5. Selling or leasing its property to—

the donor and certain parties who are so closely connected with the foundation as to lead to potential abuse. Indirect transactions, such as a loan by the donor to a corporation which he controls, followed by a gift of the corporation's note to the foundation would also be prohibited.[82]

An exception to the proposed rules would have allowed a foundation to purchase incidental supplies from the donor or business organizations with which he was connected. This would, for example, allow a foundation to purchase its office supplies from a stationery concern owned by a contributor.

Many of the abuse situations described in the Treasury Department's report were uncovered by Congressman Wright Patman (D-Texas) in his investigations of the activities of foundations.[83] In fact, it would appear that Mr. Patman's continuing agitation about (and aggravation over) the Treasury Department's enforcement acts (or failures to act) was instrumental in the initiation and conduct of a study on foundations and the issuance of the report. The report received mixed reviews by interested individuals and organizations.[84] The criticism of the report generally (but not the

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[82] Treasury Department Report on Private Foundations (2/2/65), pp. 21-22.

[83] Tax Exempt Foundations and Charitable Trusts: Their Impact on our Economy, Chairman's Report to the Select Committee on Small Business, 87th Cong. (12/31/62); 2d inst., (and subsequent) Subcommittee Chairman's Report to Subcommittee No. 1, 88th Cong. (10/16/63); 3rd inst., 88th Cong. (3/20/64); 4th inst., 89th Cong. (12/21/66); 5th inst., 90th Cong. (4/28/67); 6th inst., 90th Cong. (3/26/68); 7th inst., 91st Cong. (6/30/69); see also Hearings Before Subcommittee No. 1 on Foundations, Select Committee on Small Business, 88th Cong., 2d Sess. (7/21/64-9/4/64), as continued, 90th Cong., 1st Sess. (10/30/67-11/17/67). See also Hearings before the Committee on Ways and Means, 91st Cong., 1st Sess. on the Subject of Tax Reform, Part 1 (2/18/69), pp. 12-79.

[84] Written Statements by Interested Individuals and Organizations on Treasury Department Report on Private Foundations issued on February 2, 1965, Submitted to Committee on Ways and Means, 89th Cong., 1st Sess. (1965), 2 vols.

self-dealing provisions) was substantial enough to impel the principal author of the report to rebut a number of the arguments made against the report's suggested changes in the tax laws.[85] However, it was not until the public clamor for tax reform in early 1969 that Congress decided to hold hearings on matters related to foundations.[86]

Effects of amendment of Sec. 503 and repeal of Sec. 681(b)

Amendment of Sec. 503. Sec. 501(c)(3) organizations (other than those excepted by pre-Tax Reform Act Sec. 503(b)) were denied exemption by Sec. 503(a) for taxable years after the year in which the organization was "notified" by IRS that it had engaged in a prohibited transaction, unless a substantial, purposeful diversion of income or corpus occurred. If a substantial, purposeful diversion occurred, exemption would be denied beginning with the year within which the prohibited transaction commenced, and thereafter, until exemption is reestablished under Sec. 503(c). Loss of exemption for any prohibited transaction could continue until the transaction was rectified[87] and the IRS was satisfied by the Sec. 501(c)(3) organization that it would not knowingly again engage in a prohibited transaction.[88] The Tax Reform Act amended Sec. 503 to exclude from its coverage all Sec. 501(c)(3) organizations, with the amendment of relevant portions to take effect January 1, 1970.[89]

Amendment in such fashion means that any IRS action on insubstantial prohibited transactions pending in the National Office

[85] "The Treasury Department's Report on Private Foundations: A Response to Some Criticisms," Thomas A. Troyer, 13 *UCLA Law Review* (1966), p. 965.

[86] See Sec. 110, Revenue and Expenditure Control Act of 1968, P.L. 90-364, 90th Cong., 2d Sess. (6/28/68), 82 Stat. 251, requiring the Treasury Department to submit reform proposals. Press release (1/29/69) announcing public hearings to be conducted by the Ways and Means Committee on the subject of tax reform, beginning February 18, 1969. See also, Tax Reform Studies and Proposals, U.S. Treasury Department, Joint Publication of the Committee on Ways and Means and Committee on Finance (2/5/69), 4 vols.

[87] Regs. Sec. 1.503(a)-1(c); Rev. Rul. 67-9, 1967-1 CB 143.

[88] Sec. 503(d).

[89] Act Sec. 101(j)(7) through (14), as effectuated by Act Sec. 101(k)(1).

or a field office are mooted since the IRS, after December 31, 1969, has no authority to issue notices in 1970 to take effect in 1971 with respect to any prohibited transaction (whenever it occurred).[90] Accordingly, transactions in 1968 and 1969 cannot cause loss of exemption for the year following the year in which notice is received unless the notice was issued by the IRS on or before December 31, 1969.

However, in the case of substantial, purposeful diversion by a Sec. 501(c)(3) organization, exemption can still be denied for the prior years in which the transaction occurred since the efficacy of a "notice" in 1970 is not affected by the repeal. Denial of exemption for such transaction is on authority of Sec. 503, and a provision requiring notice as to such transaction need not be in effect in the year in which denial of exemption occurs as to such prior year transaction.

Repeal of Sec. 681(b). For split interest trusts, the results of the repeal of Sec. 681(b) are rather favorable for the conduct of otherwise questioned transactions. Repeal of Sec. 681(b) is to take effect on January 1, 1970.[91] Sec. 4947(a)(2)(C) provides that the Chapter 42 provisions are not to apply to any split interest trust which received all its transfers in trust before May 27, 1969.

Up to December 31, 1969, split interest trusts which took deductions under Sec. 642(c) were subject to the limitations of Sec. 681(b), a provision affecting the extent of any Sec. 642(c) deduction for charitable contributions if the trust committed a prohibited transaction. A trust which engaged in a prohibited transaction was entitled only to a deduction of 20% (or 30%, depending on the Sec. 170(b)(1)(A) status of the donee) of the amount of its charitable contribution. The repeal of Sec. 681(b) plus the nonapplicability of Chapter 42 means that there are no specific limits on the general activities of such trusts except the rather general concepts applicable to dealings of charitable organizations. This means that such trusts can make loans to donors,[92] buy or sell property to donors[93]

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[90] Sec. 503(a)(2); Regs. Sec. 1.503(a)-1(b); Donald G. Griswold, 39 TC 620, 639-640, acq. 1965-1 CB 4. *Cf.* Rev. Proc. 57-5, 1957-1 CB 727.

[91] Act Sec. 101(j)(18), as effectuated by Act Sec. 101 (K)(1).

[92] See Note 90, Donald G. Griswold; Caruth Foundation, DC, Texas, 1960 (6 AFTR2d 5919, 60-2 USTC ¶9780).

[93] William Waller, 39 TC 765, acq. 1963-2 CB 5.

and make grants for legislative activity[94] on and after January 1, 1970. This freedom may be shortlived since the Treasury Department will shortly ask Congress to rectify this oversight, and a number of others, in a technical amendments act scheduled for presentation next spring.

Restoration of exempt status. Under prior law, a Sec. 501(c)(3) organization, in order to have its exemption restored, had to affirm to the IRS that it would not knowingly engage in another prohibited transaction.[95] If a Sec. 501(c)(3) organization or split interest trust using Sec. 642(c) was not entitled to its full tax benefits prior to January 1, 1970 due to a prohibited transaction, it need not comply with the provisions requiring an affirmative statement that it will not again engage in a prohibited transaction since the statutory basis for such demand has been repealed.

Moreover, the limitations imposed under prior law allowing exempt status only with respect to the taxable year after the year in which the claim of exempt status is refiled will no longer operate to inadvertently deny an organization's tax exempt status for an untimely filing.[96] This filing requirement meant that an organization had to file its exemption application in the first year after the year it received its IRS notice denying exemption (its first taxable year, prospectively applied) in order to assure that any subsequent year would not be adversely affected. An untimely application—that is, one filed in a year after the year in which the organization was taxable—used to cost the Sec. 501(c)(3) organization an extra year out of tax exempt status.[97] Thus, Sec. 501(c)(3) organizations which were not exempt in 1969 due to a prohibited transaction (after notice issued in 1968) will not lose exemption for 1970 for failing to reapply for exemption in 1969.

Disqualified persons as self-dealers—Sec. 4946(a)(1)

The tax on self-dealing is imposed upon any person who is a disqualified person in relation to the private foundation within the meaning of Sec. 4946. The term "disqualified person" includes

[94] Martha H. Davis, 22 TC 1091.
[95] Sec. 503(d); Regs. Sec. 1.503(d)-1(a).
[96] Regs. Sec. 1.503(d)-1(b).
[97] Rev. Proc. 69-3, 1969-1 CB 389 (Sec. 9.03).

the following individuals and organizations. (The listing is keyed in to subparagraphs (A) to (I) of Sec. 4946(a)(1).)

(A) Substantial contributor. For a full discussion of a substantial contributor to a private foundation, see "Composition and Concepts," page 363.

(B) Foundation manager. Under Sec. 4946(b), the term "foundation manager" means:

- With respect to the private foundation, an officer, director, or trustee of the foundation (or an individual having the powers or responsibilities similar to those of officers, directors, or trustees), and
- With respect to any self-dealing transaction, the employees of the foundation who have authority or responsibility with respect to such act or failure to act.

Unlike the considerations involved in the definition of "substantial contributor," a person who is a disqualified person by reason of being a foundation manager does not keep that characterization once he leaves office.[98] While the individual is a foundation manager, the attribution rules involving his spouse and descendents and antecedents apply.[99] In the case of those organizations which are trustees of private foundations (e.g., a bank or trust company acting as trustee of a charitable trust), a person who owns more than 20% of the trustee organization would not be treated as a disqualified person in relation to the private foundation of which his bank is a trustee. The downstream attribution of Sec. 4946(a)(1)(D), *infra,* applies only to the owner of a corporation where the corporation was a disqualified person by reason of substantial contributor status and not because of foundation manager status.

(C) Owner of substantial contributor. If a person owns more than 20% of

- The total combined voting power of a corporation,
- The profits interest of a partnership, or
- The beneficial interest of a trust or an unincorporated enterprise,

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[98] *Cf.* Sec. 507(d)(2)(B)(iv).
[99] Sec. 4946(d).

which corporation, etc., is a substantial contributor to the private foundation, such owner is treated as a disqualified person. Under Sec. 503(c) before its 1969 amendment, there was no correlative to this "downstream" attribution for purposes of disqualifying a person connected with another person with a substantial nexus to the private foundation.

(D) Certain relatives. A member of the family of any individual described in (A), (B) or (C) above is a disqualified person. For this purpose, "family" is defined by Sec. 4946(d) to include only an individual's spouse, ancestors, lineal descendants and spouses of lineal descendants.[100] Thus, a brother or sister of a substantial contributor or a foundation manager is not treated as a disqualified person by reason of the family attribution rule. Because the status of a substantial contributor applies retrospectively, an individual who had such status because of a gift or bequest made many years prior to the enactment of Chapter 42 (but computed as if made on October 9, 1969 under Sec. 507(d)(2)(B)(ii) would have the effect of "tainting" the status of his children, grandchildren and great-grandchildren.

> *Example.* In 1910, John Doe made a bequest of $25,000 to begin the activities of the John Doe Foundation. His gift met the $5,000 and 2% tests (Sec. 507(d)(2)) on October 9, 1969, so that he is treated as a substantial contributor and disqualified person. All of John Doe's children and their children (his grandchildren) and their

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[100] The Senate liberalized the original House version of the attribution rules to make them "reasonable." The reason for the change in the House bill was stated as follows:

> The [Senate Finance] committee accepted the House bill as to family and other attribution, with two changes: (1) the term "family" still includes ancestors, lineal descendents, and spouses of the above but the committee decided not to include brothers and sisters (and their descendents and spouses) and (2) it decided that relationship through a partnership should take into account another partner only if the other partner held at least 20 percent interest in partnership profits.
>
> The committee was especially concerned that the rules be reasonable as to who are substantial contributors and related persons because the foundation will need to keep the records to identify those who are disqualified from dealing with it. The committee concluded that the 2 percent minimum for substantial contributors, the elimination of the brother-sister attribution, and the 20 percent minimum for partnerships would make the rules practical and enforceable. [S. Rep. No. 91-552 (11/21/69), p. 30.]

spouses are "disqualified persons" because they are members of the family of a substantial contributor. Because of the inter-spouse attribution of Sec. 507(d)(2)(B)(iii), if Mrs. Doe remarried in 1915, children by her subsequent marriage, or marriages, (and their children) and their spouses would also be treated as disqualified persons in relation to the John Doe Foundation.

If, in the preceding example, Mrs. Doe again marries, allegro, and produces offspring who do likewise, the circumstance is pregnant with the possibilities for bizarre results unless regulations somehow act as a prophylactic against such attribution. The way this could be done would be to interpret the family member rule of Sec. 4946(d) to include only those antecedents and lineal descendents (and their spouses) who are the product of the marriage(s) of the substantial contributor from the time of his initial substantial contribution. Thus, the children of the second (or third, etc.) marriage of John Doe himself would be disqualified persons but the children of the second (or third, etc.) husband of John Doe's first wife would not be disqualified persons.

(E) Related corporations. A corporation of which persons described in (A) through (D) above own, directly or through attribution, more than 35% of its total combined voting power will be treated as a disqualified person.[101] For this purpose (as well as for (C) above relating to 20% ownership of a substantial contributor), Sec. 4946(a)(3) requires that there be taken into account indirect stockholdings which would be taken into account under Sec. 267 (c) except that "members of a family" is limited to only those members listed in (C) above, thereby excluding brothers and sisters. Compare Secs. 4946(d) and 267(c)(4).

Example. John Doe is a substantial contributor to the Doe Family Foundation. John owns 6% of the stock of the *X* corporation. The S corporation, wholly owned by John, owns 5% of the stock of *X*. *P*, John's only partner in a joint venture, owns (individually) 5%

[101] Under prior law, Sec. 503(c), there were no specified attribution rules either in the statute or regulations similar to that prescribed in Sec.4946 (a)(3). A substantial contributor had to own (directly or indirectly, but with no reference to Sec. 267) more than 50% of the total combined voting power of all classes of stock entitled to vote or 50% or more of the total value of shares of all classes of stock of a corporation to be an object of the prohibited transaction rules.

of the *X* stock. (See (F) below.) *T*, a split interest (charitable income) trust with John's grandchild as the remainderman, owns 20% of *X* stock. *X* corporation is considered a disqualified person in relation to the Doe Family Foundation, although *X* made no contributions to such foundation. By applying Sec. 4946(a)(3) to John's ownership of *X* stock, and through attribution, he is deemed to own more than 35% of the stock of *X*—i.e., 6% directly owned, 5% owned by *S*, 5% owned by *P*, and 20% owned by the trust.

(F) Partnerships. A partnership in which persons described in (A) through (D) own more than 35% of the profits interest (regardless of capital interest) will be treated as a disqualified person.

(G) Trusts and estates. A trust or estate in which persons described in (A) through (D) hold more than a 35% interest in the beneficial interests.

(H) Private foundations. Only for purposes of Sec. 4943 (dealing with excess business holdings of foundations), a foundation will be treated as a disqualified person where:

- It is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or
- Substantially all the contributions to which were made (directly or indirectly) by the same person or persons described in Sec. 4946(a)(1)(A), (B) or (C) or members of their families (as limited by Sec. 4946(d)) who made (directly or indirectly) substantially all of the contributions to the private foundation in question.

If three brothers each have a private foundation, but no brother sits on the board of any other foundation nor has made a contribution to another foundation, the three foundations are not disqualified persons in relation to each other for purposes of Sec. 4946(a)(1)(H) and Sec. 4943. If all three brothers furnished substantially all the funds of each foundation, then the three foundations are disqualified persons in relation to each other for purposes of Sec. 4946(a)(1)(H) and Sec. 4943. If all three foundations have the same individuals in control, regardless of funding considerations, all three foundations are considered disqualified persons in relation to one another for purposes of Sec. 4943.

A private foundation, for purposes of the self-dealing provisions, may be a disqualified person in relation to another private founda-

tion by reason of substantial contributions to such other foundation. This particular provision (Sec. 4946(a)(1)(H)) does not affect transactions between two foundations where one foundation has its characterization solely by reason of Sec. 4946(a)(1)(H) rather than by reason of Sec. 4946(a)(1)(A) (substantial contributor).

A private foundation controlled by a family would not be an entity whose business holdings could be attributed to the family under Sec. 318. The statutory rules governing attribution of stock out of the foundation to an individual or business corporation is ineffective since the family (or any person in control) does not have a proprietary interest in the foundation.[102]

Example. John Doe and a foundation controlled by him each own 50% of the stock of the John Doe Corporation. The foundation sells its 50% interest back to the corporation (to satisfy, for example, the excess business holdings provisions). John Doe would not be deemed to have received a dividend, as would probably be the case were the foundation a proprietary corporation controlled by him.[103]

(I) Government officials. It should be noted that a government official is treated as a disqualified person only for the purposes of the tax on self-dealing transactions. Under Sec. 4946(c), "government official" means an individual who, at the time of a self-dealing act, holds any of the following offices or positions:

- An elective "public office" in the executive or legislative branch of the government of the United States;
- An "office" in the executive or judicial branch of the government of the United States, appointment to which was made by the President;
- A "position" in the executive, legislative, or judicial branch of the government of the United States (i) which is listed in Schedule C of Rule VI of the Civil Service Rules, or (ii) a compensation for which is equal to or greater than the lowest rate of compen-

[102] Rev. Rul. 58-556, 1958-2 CB 355; Stevens Brothers Foundation, CA-3, 324 F2d 633, 643-646 (12 AFTR2d 5952, 63-2 USTC ¶9820).

[103] *Cf.* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (Hamden, Conn.: Federal Tax Press, 1966), pp. 287-291. The redemption would be a self-dealing transaction except that Act Sec. 101(l)(2)(B) permits such sales if the stock sold by the foundation was "held" by it on May 26, 1969.

sation prescribed for GS-16 of the general schedule under Sec. 5332 of Title 5, U.S. Code (now $25,044);

- A position under the House of Representatives or the Senate of the United States held by an individual receiving gross compensation at an annual rate of $15,000 or more;
- An elective or appointive "public office" in the executive, legislative, or judicial branch of the government of a state, possession of the United States, or political subdivision or other area of the foregoing, or the District of Columbia, held by an individual receiving gross compensation at an annual rate of $15,000 or more; or
- A position as personal or executive assistant or secretary to any of the foregoing.

An individual is not considered a government official if he holds any of the foregoing offices or positions as a "special government employee," as defined in Sec. 202(a) of Title 18, U.S. Code. This means that a temporary federal employee (less than 120 days per year), a part-time U.S. Commissioner, a local representative for a member of Congress or a reserve or national guard officer on active duty is not a "government employee." The characterization as a disqualified person does not apply to employees of foreign governments.

In a temporary regulation,[104] the Treasury Department constricted the scope of the definition "government official" in new Sec. 4946(c)(5), dealing with state officers as "government officials." This relieved those foundation officials who were concerned that the definition relating to state government officials could directly (and adversely) affect studies and research projects where foundations were funding studies by faculty members of state colleges and universities.

The regulation also provides that there is a distinction between the term "public office" used in Sec. 4946(c)(5) and mere public employment.[105] A determination of whether a public employee holds a public office is based upon the facts and circumstances of the particular case, with the essential element being

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[104] Temp. Regs. Sec. 143.3, TD 7035.

[105] It is unclear from the legislative history as to the real distinctions involved, but Sec. 4946 categorizes employment in terms of (i) public office, (ii) office, or (iii) position, evidently to the exclusion of each other.

whether or not a significant part of the activities of the public employee includes the performance of policy-making functions. The regulation further provides that the policy-making function would also apply when determining whether or not an employee of the federal government held a "public office" for purposes of Sec. 4946(c). Other factors to be considered, according to the regulation, are (1) whether the office was one created by the Congress, a state constitution or state legislature, or by a municipality or other governmental body pursuant to authority conferred by Congress, a state constitution or legislation, and (2) if the powers conferred on the office and the duties to be acknowledged by such office are defined either directly or indirectly by the Congress, a state constitution or legislature or through legislative authority. If the Congress creates the office and delegates the powers to the person who holds such office, it would appear that such public employee is holding a "public office" within the meaning of Sec. 4946(c)(5).

The regulation excludes, by illustration, the following positions of public employment since, *ipse dixit,* they do not involve policy-making functions:

- The chancellor, president, provost, etc., or other officers of a state university who are appointed, elected, or otherwise hired by a state board of regents or equivalent body and who are subject to the direction and supervision of such body;
- Professors, instructors and other members of the faculty of a state institution who are appointed, elected or otherwise hired by the officers of the institution or by the state board of regents or equivalent public body;
- The superintendent of public schools and other public school officials who are appointed, elected or otherwise hired by a board of education or other equivalent public body and who are subject to the direct supervision of such body;
- Public school teachers who are appointed, elected, or otherwise hired by the superintendent of public schools or by a board of education or by an equivalent public body;
- Physicians, nurses and other professional persons associated with public hospitals and state boards of health who are appointed, elected, or otherwise hired by a governing board or officers of such hospitals or agencies; and
- Members of police and fire departments, except for those

department heads who, under the facts and circumstances of the case, independently perform policy-making functions as a significant part of their activity.

Shortly before the issuance of this significant regulation by the IRS, another temporary regulation[106] was adopted. It provided that a government official who was otherwise described in Sec. 4946 (c) but was on leave of absence without pay on December 31, 1969 from his position or office pursuant to a commitment entered into on or before such date to engage in certain activities for which he would be paid by one or more private foundations, would not be treated as holding a position or office within the meaning of Sec. 4946(c) for any continuous period after December 31, 1969 and prior to January 1, 1971. This would be the case where the individual remains on leave of absence to engage in the same or similar activities for which he will be paid by the foundation. The regulation specified that a commitment would be considered entered into on or before December 31, 1969 if, on or before such date, the amount and nature of the payment to be made and the name of the individual receiving such payment were entered on the records of the payor foundation or otherwise were adequately evidenced, or the notice of payment to be received had been communicated to the payee either orally or in writing.[107]

Overview on disqualified persons

If a contribution by one private foundation to another meets the $5,000 and 2% test of Sec. 507(d)(2), the grantor foundation will be treated as a disqualified person in relation to its grantee foundation. Accordingly, the grantor private foundation may not engage in any of the self-dealing acts specified in Sec. 4941(d)(1) unless such acts are clearly covered by the exceptions contained in Sec. 4941(d)(2). It may be necessary for the Treasury Department to provide in regulations that certain transactions between a disqualified grantor foundation and its grantee foundation will not be treated as self-dealing acts, although the literal language of Sec.

[106] Temp. Regs. Sec. 143.4, TD 7035.

[107] Compare, as to the necessary records, the original evidence for pre-December 31, 1969 acts having Chapter 42 overtones contained in Temp. Regs. Sec. 143.1, TD 7022 and the more relaxed standard contained later in Temp. Regs. Sec. 143.8, TD 7042.

4941 would treat certain transactions as acts of self-dealing. While there doesn't seem to be an explicit basis in the statute for any such regulation, the likelihood of its promulgation is substantial because of the absurd results which could occur where two foundations are attempting to carry forward their charitable program and inadvertently violate one of the substantive provisions.

Also of concern is the fact that there is no limitation on the extent to which attribution can be applied to reach persons two or more times removed from the actual substantial contributor to the private foundation.[108]

> *Example.* The ABC Corporation owned by three brothers *A*, *B*, and *C* makes a substantial contribution to the ABC Private Foundation. Since ABC Corporation is a substantial contributor, individuals *A*, *B*, and *C* are treated as disqualified persons under Sec. 4946(a)(1)(C)(i). By reason of the family attribution rules (see (D) above), the spouses and children of *A*, *B*, and *C* are treated as disqualified persons. If *A*'s son, *AA*, owns 100% of the XYZ Corporation, the corporation is also a disqualified person in relation to the ABC Private Foundation.

The care with which one must proceed in dealing with a family-connected private foundation is underscored by the fact that self-dealing transactions can be taxed where they inadvertently occur without the knowledge of the disqualified person.

Acts of self-dealing—Sec. 4941(d)(1)

Anything which was a prohibited transaction with a "debarred party" under prior law would be treated as an act of self-dealing with a disqualified person under Sec. 4941(d). The Sec. 4941(d) acts of self-dealing go much further because they do not deal with the extent of preferences, adequacy of security, rate of return, or other arm's-length aspects of prior law. These provisions simply tax a number of specified transactions without regard to any mitigating circumstances and with no concept of fault. "Self-dealing" means any one of the transactions, whether directly or indirectly affected. (The listing is keyed to subparagraphs (A) to (F) of Sec. 4941(d)(1).)

[108] However, Sec. 4946 has no equivalent of Sec. 318(a)(15) dealing with re-attribution.

(A) Sales, exchanges or leases. Any direct or indirect sale, exchange or leasing of property between a private foundation and a disqualified person is generally regarded as self-dealing. Prohibiting all sales, exchanges or leases between a private foundation and a disqualified person has the effect, *inter alia,* of eliminating the bargain sale transaction as a means of financing contributions to the private foundation.[109] It makes no difference whether or not the amount of the purchase or sales price represents the fair value of the property.

Sec. 4941(d)(2)(A) specifies that the transfer, including gift, of any real or personal property (including securities) by a disqualified person to a private foundation shall be treated as a sale or exchange:

- If the property is subject to a mortgage or similar lien which the foundation assumes, or
- If the property is subject to a mortgage or similar lien which a disqualified person placed on the property within the ten-year period ending on the date of the transfer.

Thus, in the case of any transfer by a disqualified person, including a bequest, care must be exercised to ascertain when a mortgage was placed on the transferred property. If, under the will of a decedent, recently mortgaged property is given outright to a private foundation, it would be an act of self-dealing for the foundation to accept the burdened property. The executors of the estate would be required to ascertain whether or not a probate court will permit substitution of an equivalent value of property in order to satisfy the charitable bequest. If the law of the jurisdiction provides that real property immediately vests, without waiting for close of the estate, regulations will be needed to forestall application of tax.

Other transitional rules for sales have been provided for under savings provisions of Act Sec. 101(l). In the case of a transaction between a private foundation and a disqualified corporation pursuant to the terms of the securities of such corporation in existence at the time acquired by the foundation, the sale or exchange of such securities between the foundation and the disqualified corporation is not an act of self-dealing if the securities were acquired by the private foundation before May 27, 1969.[110] This permits, for example, convertible bonds, under the terms stated in the bonds, to

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[109] William Waller, 39 TC 765, acq. 1963-2 CB 5.
[110] Act Sec. 101(l)(2)(A).

be redeemed or exchanged for stock without causing the self-dealing rules to be operative. It only applies, however, to securities which were acquired by the foundation before May 27, 1969 and not to the identical securities, however acquired, after such date.

The sale, exchange or other disposition of property owned by a private foundation on May 26, 1969, will not be treated as an act of self-dealing if the foundation is required to dispose of the property in order to avoid the Sec. 4943 taxes on excess business holdings, applied only in the case of dispositions before January 1, 1975, without regard to the percentage-of-holding rules of Sec. 4943 (c)(4).[111] The private foundation must receive, in return, an amount which equals or exceeds the fair market value of the property either at the time of the disposition or at the time a contract for such disposition was previously executed, and the transaction would not have constituted a prohibited transaction within the meaning of Sec. 503(d). While it is generally recognized that a private foundation may sell *excess* business holdings to a disqualified person without engaging in an act of self-dealing, this provision has the effect of treating certain permitted holdings as excess holdings, thereby allowing the sale or other disposition to occur without imposition of the self-dealing tax.[112]

One omission in the statute which may be rectified in future legislation concerns the redemptions of holdings in an entity which is not a "business enterprise" within the meaning of Sec. 4943. Although these holdings would not be treated as excess holdings at the time, there may be instances where redemption (or sale) is appropriate to avoid "excess holding" classification in the future.

Examples. The ABC Foundation owns 50% of the stock of a corporation whose assets produce more than 95% "passive" investment income (as described in Sec. 4943(d)(4)(B)) and the remaining 50% of the stock is owned by a disqualified person. In the future, it is expected that the income from passive sources will decline below

[111] Act Sec. 101(1)(2)(B).

[112] Under Sec. 4943(c)(4), holdings of a private foundation in a business enterprise in excess of 20% (or 35%, if applicable) are treated as excess holdings unless held on May 26, 1969. If so held, they are treated as permitted holdings during a first (or, if applicable, a second) phase disposition period, subject to specified percentages. Without this provision, a foundation would be unable to sell back "permitted" holdings, which could later become excess holdings, until the excess holdings tax was imposed.

the 95% figure allowed. These holdings are presently treated as permitted holdings.[113]

The XYZ Foundation owns 100% of the preferred stock (non-voting) of the Cannabis Corporation, a corporation which was a substantial contributor to it within the meaning of Sec. 507(d)(2). Disqualified persons own 19% of the voting stock so that, under Sec. 4943(c)(2), the preferred stock is presently a permitted holding. Because of the size and wealth of the family, it is expected that they will acquire additional voting stock.

In both instances, the foundation may not have its securities redeemed until the holdings become excess business holdings under Sec. 4943. If the foundations sell their stock to disqualified persons before such time, the sale is treated as a self-dealing transaction and the purchaser is taxed on the amount involved. A little foresight by the drafters of the legislation could have avoided this frustration of sound tax planning.

Finally, under Sec. 4941 (d)(2)(F), a sale, exchange or other disposition of securities between a foundation and a corporation which is a disqualified person, pursuant to a merger, liquidation, etc., is not treated as a self-dealing transaction if all the securities of the same class as that held by the foundation are subject to the same terms and these terms provide for receipt by the foundation of no less than fair value for the securities involved. With respect to this exception (as to which there is no legislative history), it is unclear whether the securities themselves must contain the terms for the transaction or whether the merger, liquidation, reorganization, etc., agreement must include the terms for the transaction fully stated. This exception may be construed to permit redemption of permitted holdings of a business enterprise where the foundation owns 100% of the class of stock (see example above) or where all the holdings (if less than 100%) are being redeemed pursuant to the same terms.

The leasing of property between the private foundation and a disqualified person is an act of self-dealing. If the lease is in effect on January 1, 1970, continuing the lease thereafter may be an act of self-dealing unless the lease arrangement conforms to the transitional rules. If a lease represents a binding contract in effect on October 9, 1969 (or continued thereafter pursuant to renewals of

[113] Sec. 4943(c)(6) will allow a five-year period to dispose of the holdings of the corporation when it enters into the status of a business enterprise and the stock is deemed excess holdings.

a contract), such lease of property may be maintained until taxable years beginning after December 31, 1979[114]—provided (1) the leasing remains at least as favorable as an arm's-length transaction with an unrelated party and (2) the execution of the contract (prior to the October 9, 1969 cut-off date) was not at the time of such execution a prohibited transaction within the meaning of Sec. 503(b).

The Senate Finance Committee Report states: "If a substantial donor owns an office building, the foundation should look elsewhere for its office space."[115] Furnishing office space is regarded as the furnishing of a "facility" unless the arrangement is pursuant to a "lease."[116] Unless the Treasury Department overrides the statute of frauds, an informal, oral arrangement for a foundation to use office space free of charge in a donor's building will not be considered a self-dealing act.[117] It would appear somewhat illogical, but Sec. 4941 (d)(1)(A) (barring leases of properties) and Sec. 4941 (d)(2)(C) (barring furnishing of facilities unless without charge), taken together, suggest that a private foundation's mere use of donor-controlled office space (even if it is only for bookkeeping and related purposes) is an act of self-dealing if any amount, regardless of whether it is treated as a payment under a "lease" or a cost-sharing arrangement, flows back to the disqualified person. Thus, if the private foundation reimburses the disqualified person for overhead, such as sharing of the heat, light and power costs, this will be treated as a self-dealing act regardless of whether the practice was recorded in writing. Regulations should clarify all of this.

(B) Loans and credit. Any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person is generally treated as an act of self-dealing. Under Sec. 4941(d)(2)(B), however, the lending of money (but not extension of credit) by a disqualified person to a private foundation shall not be an act of self-dealing if the loan to the private foundation is without interest or other charge and if the proceeds of the

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[114] See Act Sec. (101(1)(2)(c).

[115] S. Rep. No. 91-552 (11/21/69), p. 30.

[116] See Note 115, p. 31. The Finance Committee treats a foundation providing its managers with office space as furnishing facilities, subject to Sec. 4941(d)(1)(C) and (d)(2)(D).

[117] H. Rep. No. 91-413, Part 2 (8/4/69), p. 8.

loan are used exclusively for purposes specified in Sec. 501(c)(3). The exclusive use of the proceeds of the loan for charitable purposes seems to preclude the use of such proceeds for investment purposes. Thus, a disqualified person cannot assist his private foundation to take advantage of an attractive investment opportunity by making a short-term, non-interest bearing loan for such purpose.[118]

Under prior law, the deposit of funds in a checking account or savings account with a "debarred" person by an organization subject to Sec. 503 was not treated as the type of "loan" or other prohibited transaction between the subject organization and debarred person at which Sec. 503 was directed.[119] With the addition of the limitation upon "extensions of credit," an acute problem exists for a bank acting as trustee of a charitable trust ("foundation manager") where it places trust income or assets in its own account facilities or otherwise has the trust taking advantage of its services. The checking account may be treated as a "loan" or extension of credit or the furnishing of a "service" within the meaning of (E) below. Furnishing banking services or facilities may be self-dealing unless, under Sec. 4941(d)(2)(C), the furnishing is without charge (e.g., no $.10 check charge) and the services or facilities are used for the purposes described in Sec. 501(c)(3).

In a recent speech before the University of Pennsylvania Tax Conference (October 14, 1970), the Honorable John S. Nolan, Deputy Assistant Secretary for Tax Policy, U.S. Treasury Department, made the following observations on banks and private foundations:

> A difficult issue in the private foundation provisions is whether the self-dealing provisions (Sec. 4941(d)(1)(E)) prevent a bank acting as trustee of a charitable trust subject to these provisions, or as a trustee or manager of a private foundation, from maintaining a custodial account with its investment branch or a savings account or checking account with its banking department. The thought of competing banks causing each of their trust departments to maintain custodial accounts and bank accounts with the other—'cross-fertilization'—boggles the mind!
>
> In the case of a custodial account, the charitable trust or private foundation retains full legal and beneficial interest in the assets placed in the custody account. The assets have not been transferred to the bank; nor is there any lease, loan, or other similar transaction

[118] *Cf.* Samuel Friedland Foundation, 144 F. Supp. 74 (50 AFTR 316, 56-2 USTC ¶9896).

[119] Rev. Rul. 59-29, 1959-1 CB 123.

of the type described in the self-dealing rules. Our tentative view is that these rules would not apply in such a case. We also feel that the fees paid for maintenance of such a custodial account could be treated as within the exception in Sec. 4941(d)(2)(E) for reasonable compensation paid for certain personal services.

The savings and checking account cases are more difficult. The bank acquires the use of the funds subject only to federal or state reserve and regulatory requirements. There is a transfer of the foundation's assets to the bank. At the same time, bank deposits are not commonly viewed as any of the type of transactions described in the self-dealing provisions, and such a deposit would not violate the highest fiduciary standards. The question is whether we can justify a special exception for this situation in the regulations in view of the broad language of the statute.

There are special transitional rules where a private foundation and a disqualified person have an outstanding loan or other extension of credit in effect on January 1, 1970 such as a portion of a deferred mortgage note. If such loan or extension of credit was made pursuant to a binding contract in effect on October 9, 1969 or pursuant to any renewal, Act Sec. 101(l)(2)(C) provides that it shall not be treated as an act of self-dealing until taxable years beginning after December 31, 1979—unless the contract for the lending of money or other extension of credit constituted a prohibited transaction at the time executed. The lending of money or other extension of credit must remain at least as favorable as an arm's-length transaction with an unrelated party in order to continue to secure the benefits of this transitional rule. This means, for example, that in an era of rising interest rates, the private foundation must ascertain whether or not the interest rate being charged a disqualified person (though reasonable under Sec. 503(c)(1)) can be increased under the terms of the loan, and, in any event, must arrange for an increase in order to reflect the inflationary cycle.

(C) Goods, services or facilities. Generally, any direct or indirect furnishing of goods, services, or facilities between a private foundation and a disqualified person is self-dealing. Under Sec. 4941(d)(2)(C), however, there is no self-dealing if goods, services or facilities are furnished *by* a disqualified person to a foundation *without charge* and such goods, services or facilities are used exclusively for exempt functions. Similarly, under Sec. 4941(d)(2)(D), where the foundation furnishes goods, services or facilities to a disqualified person (e.g., a foundation manager) on a basis *no more favorable*

than that on which goods or services or facilities are made available to the general public, there is no self-dealing. If office space is provided a foundation manager for his use in carrying on his administrative duties, there is no self-dealing.[120] Likewise, we may assume a foundation can pay its employees for their services although this area, for directors and trustees, has been the object of criticism.

As far as transactions under this prohibition which constitute acts of self-dealing in an indirect manner, very little guidance is available at the present time; but the personal use by a private foundation manager of an automobile, plane or painting belonging to the foundation seems clearly to be self-dealing.

Beyond that, there are some hard questions regarding professional services furnished by a part-time trustee or director. May a lawyer or accountant or stock broker provide services for a fee? And if so, what are the limits? Under Sec. 4942(d)(2)(E), a disqualified person (except a government official described in Sec. 4946(c)) may receive compensation, and amounts for expenses for rendition of *personal* services which are reasonable and necessary to carry out the exempt purposes of the foundation. Thus,

> . . . a private foundation could pay compensation to a disqualified person who is an accountant for bookkeeping services if such compensation is reasonable and necessary to carry out the exempt purposes of the private foundation.[121]

The purport of this statement is that the rendition of the services by the accountant is allowable, although Sec. 4941(d)(2)(C) only exempts services rendered without charge. It can be suggested that a lawyer can render legal advice or a stock broker investment counseling and brokerage services, and receive compensation for such services without engaging in a self-dealing transaction, provided, of course, that the compensation is not excessive; but the statute does not literally allow it. Since taxable corporations are frequently second-guessed by the IRS on the reasonableness of compensation,[122] much care is needed in planning for services within this exception

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120 See Note 115, p. 31.

121 See Note 117.

122 See, e.g., Equipment Rental Co., DC, Ky., 1970 (25 AFTR2d 70-1077, 1970-1, USTC ¶9542).

provided by the legislative history. Clearly necessary are regulations defining and delimiting the furnishing of services which may be performed for compensation.

(D) Excessive compensation. As a general rule, the payment of compensation (or payment or reimbursement of expenses) to a disqualified person (including government officials) is an act of self-dealing. A foundation is allowed, however, to make such payments (except to government officials) for personal services when they are reasonable and necessary to carry out the exempt purpose of the foundation and the payments are not excessive. This means employees may be paid their salaries but it doesn't give carte blanche to director's fees not correlated to the services rendered.

Among the foundation activities which outraged Rep. Patman were the payments of large fees to directors[123] for services which he believed nonexistent. The practice of flat fees as honoraria to board members should be curbed until counsel can determine whether or not the fee is excessive. It is not unlikely that $15,000 paid for attending three meetings of a foundation's board would be deemed excessive compensation and cause the board member to be taxed.[124] Where a relative of a donor, such as a son or daughter, sits on the board and receives honoraria, special scrutiny may be given these transactions. Under Sec. 4941(e)(2), in excessive compensation situations, the excise tax is imposed on the "amount involved" which (except where a government official is involved) is only the amount of excess compensation.

The payment of compensation to a government official on or after January 1, 1970 is not self-dealing if the payment was made pursuant to a commitment made before that date.[125] The commitment must have been made in accordance with the foundation's usual practices and must involve a reasonable amount of compensation in light of the services to be rendered. Further tests require that prior to January 1, 1970, the amount and nature of the payments to be made and the name of the payee must have been entered on

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[123] Hearings Before Subcommittee No. 1 on Foundations, Select Committee on Small Business, House of Representatives, 88 Cong., 2d Sess. (1964), pp. 135-139.

[124] See Note 123, p. 274(". . . Benson Ford received $15,000 for attending three meetings of the Ford Foundation").

[125] Temp. Regs. Sec. 143.8, TD 7042.

the records of the foundation or that notice of payment to be received has been communicated to the payee in writing.[126]

(E) Catch-all provision. This provision, in general, catches as a self-dealing transaction any direct or indirect transfer to, or use by or for the benefit of, the income or assets of a private foundation by a disqualified person. Even though this provision somewhat parallels prior law (now Sec. 503(b)(6)), there are few examples available to suggest its application to particular facts and circumstances. Prior law rulings have suggested that depositing of funds with a bank which is a disqualified person would not represent an instance of a prohibited transaction,[127] but whether this rule will carry over to self-dealing is a matter of conjecture. It is clear that a disqualified person may be liable for tax even though there was no actual transfer of property to him.

> *Example 1.* The XYZ Foundation purchases a block of stock in the Cannabis Corporation to assist John Doe, a disqualified person, to obtain control in a proxy contest or to obtain an advantage from the manipulation of the price of the stock. This would be regarded as a self-dealing transaction.[128]
>
> *Example 2.* Jane Doe, the spouse of a grandchild of a director of the XYZ Foundation, inadvertently sold some property to the foundation (for fair value). The foundation pays her 5% self-dealing tax to the IRS. The payment of the tax would be considered another act of self-dealing.[129]

On the other hand, a scholarship or fellowship grant made by a private foundation to children of nonstockholder-employees of a corporation which is a disqualified person would not be treated as a self-dealing transaction under this catch-all provision if the IRS approved tax exempt status for the foundation after disclosure of such a program.[130]

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[126] A similar, but somewhat broader, exception is provided for payments during 1970 to a government official who was on a leave of absence without pay on December 31, 1969 pursuant to a commitment to engage in certain activities for which he was to be paid by a foundation. See Temp. Regs. Sec. 143.4, TD 7034, which is covered in the portion of the text relating to note 32.

[127] See Note 119.

[128] See Note 115, p. 29.

[129] H. Rep. (Conf.) No. 91-782 (12/21/69), p. 279.

[130] Temp. Regs. Sec. 143.2, TD 7030.

It may be that the reserved annuity or the reserved life interest in a house[131] would be treated as a self-dealing "use" by a disqualified person of the "assets of the foundation," despite the existence of the reservation when the foundation acquired the assets.

(F) Payments to government officials. In general, this provision regards as self-dealing any direct or indirect *agreement* to make payments in money or property to a government official. Except to the extent indicated in (D) above, a government official cannot be paid any compensation for services rendered while in such status. Thus, a military officer[132] could not be paid (or reimbursed for expenses) to give a speech before a group of citizens about topics of interest to the public. Likewise, a judge or other government officer could not sit on the board of directors of a foundation and receive honoraria or reimbursement for expenses (but his wife may receive the payments).

An agreement by a private foundation to make any payment of money or other property to a government official is an act of self-dealing unless the agreement is to employ the individual after termination of his government service and within 90 days from the making of the agreement. If a public charity (or a college) makes payments to government officials as a result of receiving a grant from a private foundation, there may be an act of self-dealing involved if the foundation earmarks the grant for a named official and controls or retains veto power over the selection of particular officials by the grantee.[133] The "direct or indirect" general rule of Sec. 4941(d)(1) precludes grants to officials by the making of a grant to another organization, where it is quite clear that no grant would be made unless the particular official was the ultimate beneficiary. The cosmetics of a conduit situation will not foreclose the prospect of taxation for such grant.. Unlike the intended predecessor of this provision,[134] payments may be made to members

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[131] See Note 4; *cf.* Rev. Rul. 70-155, IRB 1970-14, 25.

[132] H. Rep. No. 91-413, Part I (8/2/69), p. 22. Note 2 provides "military officers . . . who receive Presidential appointments are government officials regardless of the amount of their compensation."

[133] Temp. Regs. Sec. 143.5, TD 7036.

[134] See S. 2075, (5/8/69) as reported by the Finance Committee as part of H.R. 9951. See S. Rep. No. 91-281, 90th Cong., 2d Sess., pp. 7-22. The provision was deleted on the floor of the Senate and reappeared in H.R. 13270 on August 6, 1969.

of the family of a government official since the attribution rules of Sec. 4946 do not apply to such officials.

Permissible payments to government officials. The prohibitions on self-dealing which could cover a government official *qua* official do not apply to the following payments, under Sec. 4941(d)(2)(G):

- Prizes and awards, within the meaning of Sec. 74(b), if recipients are selected from the general public;
- Scholarships and fellowships, within the scope of Sec. 117(a), used for study at an educational institution;
- Annuity or other payment by a trust exempt under Sec. 401;
- Annuity or other payment under a plan which meets Sec. 404(a)(2);
- Minor gifts (other than money) of merchandise, services or facilities—i.e., where the aggregate value thereof during the year does not exceed $25;
- Any payment made under 5 U.S. Code Chapter 41 (government employees training programs); or
- Domestic travel expenses not in excess of 125% of the per diem allowed officials under 5 U.S. Code 5702(a).

Under Sec. 4941(a)(1), a government official is not taxed as a self-dealer unless he *knowingly* participated in an act of self-dealing. Thus, inadvertent acts by an official *qua* official will not cause him to be taxed with respect to any act or failure to act listed in Sec. 4941(d)(1)(A) through (F).

The tax and returns

Initial tax on self-dealers. Sec. 4941(a)(1) subjects the self-dealer to an excise tax equal to 5% of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period. Under Sec. 4941(e)(1), the term "taxable period" means the period beginning with the date on which the act of self-dealing occurs and ending on whichever of the following dates is the earlier:

- The date of mailing of the notice deficiency with respect to the initial tax imposed under Sec. 4941(a)(1), or
- The date on which the correction of the act of self-dealing is completed.

The use of the taxable period concept means that an initial tax can be imposed for each year or part thereof within the taxable period even though the lapsed time involved in the self-dealing transaction is less than one year.

> *Example.* A foundation and a disqualified person engaged in a self-dealing transaction on December 1, 1970; the act was corrected on January 30, 1971. Both parties were on a calendar year basis. The initial tax would be imposed on the self-dealer in an amount equal to 10% of the amount involved in the self-dealing act. Note that if the self-dealer was on a fiscal year ended January 31, the tax would be only 5%. The tax is presumably determined in the light of the accounting period of the party subject to the tax, although the statute is not specific. Thus, the taxable period of the foundation, which is never subject to the self-dealing tax, seems to be immaterial here.

Regulations will have to clarify the computation of tax when several disqualified persons, with varying taxable years, participate in a self-dealing transaction.

The consideration of when the taxable period begins to run will need to be clarified by regulations, especially in the area of sales where an option is being arranged or exercised or an executory contract is outstanding. In general, the date on which the act of self-dealing occurs presumably means the date on which all terms and conditions of the sale, the lease or the like are satisfied and the interests of the party in the property have been shifted in accordance with the agreement. In order to conclude the taxable period, it may be necessary for the self-dealer to beneficially reverse as completely as possible under the circumstances the transaction which led to the imposition of the tax. In other words, to prove that the "correction of the act of self-dealing is completed," the self-dealer must repay the tangible benefits; an executory contract to do so would probably not end the taxable period.

The initial tax is imposed upon a *disqualified person* acting as a self-dealer solely because he has such status and not because he may be a foundation manager. As explained *infra,* there is a separate 2½% initial tax imposed on foundation managers acting in a representative capacity. Consequently, a foundation manager acting as a self-dealer in the purchase of property from the foundation (i.e., he's on both sides of the transaction) will pay the 5% initial tax on self-dealers under Sec. 4941(a)(1) and the 2½% initial tax on foundation managers under Sec. 4941(a)(2).

When several disqualified persons share in a self-dealing act—it is not entirely clear whether each one pays a tax on the "amount involved" or each one pays a ratable proportion of the tax on the "amount involved."

Example. Three disqualified persons sell jointly owned property to a private foundation for $5,000. The statute imposes a tax on "each act of self-dealing between a disqualified person and a private foundation." This may mean that an initial tax of $250 ($5,000 × 5%) is imposed on each disqualified person because of his individual participation; thus, the taxes on the single act would be $750 (or 15% of $5,000).

However, it is more likely that the statute will be read to apply a 5% tax to the amount involved, by treating the term "a disqualified person" under Sec. 4941(a)(1) to include its plural counterpart. Thus, in this example, there would be only one $250 tax imposed, for which the three self-dealers would be jointly and severally liable.

That each act, rather than each self-dealer, is an object of the tax seems to be the proper construction is suggested by Sec. 4941(c). This provides that if more than one person is liable in respect to any one act of self-dealing, then all such persons are *jointly and severally liable with respect to such act* and, accordingly, as to the amount involved as to such act.

Another considerable problem deals with the base of the initial self-dealing tax. The tax is imposed upon the "amount involved" and this means, according to Sec. 4941(e), the *greater* of the amount of money and fair market value of the property *given* or the amount of money and the fair market value of the property *received*—with one exception. The basic value is determined as of the date on which the act of self-dealing occurs with respect to the initial tax. In the case of payment of compensation for services, under Sec. 4941(e)(2) the amount involved is the *excessive* compensation.

Another aspect of the problem concerns the valuation of the amount involved where there is no classic exchange or utilization representing a completed transfer of services, facilities or property.

Example. Three disqualified persons borrow a foundation's airplane to fly to Las Vegas for a weekend. The airplane is worth $25,000. Is the amount involved $25,000 or is the amount involved the equivalent of commercial air fare from point to point because that was the "fair market value of the property" [service?] received?

The "amount involved" problem will be particularly acute where the foundation owns objects of art and a disqualified person permits these items to be hung in his own business office or residence while not on display at the foundation's office (if any). Indeed, since the foundation must have a principal office under the annual report provisions (Sec. 6056), the donor's home may be regarded as the foundation's office and paintings hung there for the benefit of citizens whom the disqualified person expects to welcome when such persons come to review the annual report of the foundation. If the disqualified person opens his home three days a month to the public so they may view the objects of art, this may give the foundation sufficient indicia of museum status to minimize any potential tax.[135]

With respect to a painting whose value for sale purposes may be extremely high, its value through a loan to a disqualified person where it is not seen by the public may be extremely small since art has no real value unless being viewed and accepted by the public. The issue becomes more complicated when it is realized that the disqualified person's family also resides in the house. Whether or not such persons are parties to the transaction and are therefore liable for tax as soon as they view the art is an open question.

When dealing with transactions between the foundation and husbands and wives in community property states, there is a statutory gap. Where a husband purchases a piece of property from his foundation with community funds, the law of the state deems the wife an owner of an interest in the property. Does this mean that the wife is jointly liable to tax on the amount of the sale price or will the husband simply be charged as the taxable party throughout the transaction?

In the case of purchases of property not under the community property rules, a variation of this innocent spouse problem arises where the husband puts the property jointly in his name and that of his wife (or other relative) without notice to the other joint owner. Does that mean that the other joint owner participated in the transaction and is liable for the inital tax? The tax is imposed upon a disqualified person even though he did not (1) "know" the "act" was one of self-dealing or (2) had no willfulness with

[135] Compare Weigand v. Barnes Foundation, 374 Pa. 149, 97 A2d 81 (1953), with Commonwealth v. Barnes Foundation, 398 Pa. 458, 159 A2d 500 (1960).

respect to participation. Thus, passive participation can lead to the imposition of tax.[136] The instances described above could be resolved in favor of the innocent party only by regulations, since the statute clearly provides the authority to impose a tax because of an individual's legal rather than personal involvement in the act of self-dealing.

Initial tax on foundation managers. In any case in which a tax is imposed on a self-dealer under Sec. 4941(a)(1), a tax is imposed on the participation in such act of any foundation manager knowing that the transaction was an act of self-dealing, unless the manager's participation was not willful and was due to reasonable cause. The tax imposed by Sec. 4941(a)(2) is equal to 2½% of the amount involved with respect to the act of self-dealing for each year, or part thereof, of the foundation manager in the taxable period.

The resulting tax imposed under Sec. 4941(a)(2) must be paid by the foundation manager who participated in the act of self-dealing. If a foundation pays the tax on behalf of the foundation manager, the foundation management who participated in making the payment on behalf of the other foundation manager will be deemed to have engaged in an act of self-dealing.[137] If a foundation manager did not know that a person he was dealing with was a disqualified person in relation to a private foundation, then the transaction would not lead to a tax on his participation.

Under Sec. 7454(b), the IRS has the burden of proving, to the same extent as in civil fraud, that a foundation manager knowingly participated in an act of self-dealing.[138]

Although there may be a conflict among the circuits, it seems that the better view of the term "willful and without reasonable cause" is that "reasonable cause" is part of the test (rather than a separate test) in determining whether or not actions of an individual were willful. "Willful" does not require criminal or other bad motive on the part of the responsible individual, but simply a conscious, voluntary and intentional action (or failure to act) described within the operative provision. "Reasonable cause," the

[136] See Note 132, p. 23. It is provided: "In the case of the self-dealer, the tax is to be imposed automatically, without regard to whether the violation was inadvertent."

[137] See Note 129.

[138] See Note 129, p. 280.

other key phrase, means the failure to exercise ordinary care and prudence in connection with actions of a man in the position of one charged and under the facts and circumstances of the situation. In some instances, negligence may be evidence of failure of reasonable cause but it does not coincide with willfulness. Something more than mere negligence is necessary for the presence of willfulness. Thus, it appears that if a foundation manager engaged in a self-dealing act without knowledge of its proscribed character, without willfulness, and without gross negligence, he should not be liable for tax under Sec. 4941(a)(2).[139]

As a minor mitigation of the tax on foundation managers, Sec. 4941(c)(2) places a $10,000 limit on the amount of initial tax with respect to any one act of self-dealing. Under Sec. 4941(c)(1), there is joint and several liability among the foundation managers liable for the tax.

Additional tax on self-dealers. In any case where an initial tax is imposed and the act of self-dealing is not corrected within the correction period, Sec. 4941(b)(1) imposes an additional tax of 200% of the amount involved upon the self-dealer. Under a special rule, provided in Sec. 4941(e)(2)(B), the amount involved for the additional tax means the highest fair value of the property (services or facilities) involved in the transaction during the correction period. The tax must be paid by the disqualified person (other than a foundation manager acting only in his management capacity). Under Sec. 4941(e)(4), the term "correction period" means the period beginning on the date the self-dealing act occurs (the same date as the beginning of the taxable period) and ending 90 days after the mailing of a notice of deficiency with respect to the additional tax (not the initial tax) as extended by:

- Any period in which a deficiency cannot be assessed under Sec. 6213(a) (restrictions applicable to deficiencies), and
- Any other period which the Secretary or his delegate determines is reasonable and necessary to bring about correction of the act of self-dealing.

[139] *Cf.* Dudley, CA-9, 1970 (25 AFTR2d 70-5035, 1970-2 USTC ¶9520).

Correction of an act of self-dealing means undoing the transaction to the extent possible but in any case, placing the foundation in a position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[140] The fact that the correction period remains open after the notice of deficiency is issued for the additional tax means that an opportunity is continually available to voluntarily correct the act so that application of the sanction may be rare. The sanction would only operate after the court has entered its final judgment on the case and appeal rights have been fully exercised or expired.

Additional tax on foundation managers. In any case in which an additional tax was imposed upon a self-dealer by Sec. 4941(b)(1), an additional tax is imposed upon a foundation manager who refused to agree to part or all of the correction.[141] Such refusal would, of course, be a direct cause for the imposition of tax on the self-dealer since the self-dealer would not have been able to correct the act unless management permitted it. By imposing the tax on the manager for the refusal, there is the incentive for management to seek correction regardless of other considerations involved. If the manager is willing to participate in the correction but the self-dealer is not, no additional tax on management is imposed. The tax is equal to 50% of the "amount involved," which is the highest fair market value during the correction period. [142] As is the case with the initial tax on managers, there is a $10,000 limit on any one act, and there is joint and several liability for the managers liable for the tax.[143]

The return. Congress expects that the exempt organization information return will become an excise tax return for purposes of paying on Chapter 42 tax due and applying the statute of limitations.[144] This will be done by having the form contain questions which relate to Chapter 42 transactions so that reporting a transaction (but not paying the tax) will start the running of the statute of limitations. The equivalent of the 1969 IRS Form 990-A will be

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[140] Sec. 4941(e)(3). See Note 117, p. 9.
[141] Sec. 4941(b)(2).
[142] Sec. 4941(e)(2)(B).
[143] Sec. 4941(c).
[144] See Note 132, p. 23, note 3.

the return for the foundation as well as the foundation manager and any other disqualified person who is liable for tax.[145]

The defect here is that a person involved in a taxable transaction is dependent upon a third party for the filing of a return which will start the running of the statute of limitations. If the foundation fails to respond to a Chapter 42 question (either through ignorance or negligence), no protection is accorded the individual involved under Sec. 6501. It seems incumbent upon the IRS to issue a separate, personal return for use of disqualified persons and foundation managers to enable them to report the transaction and pay the tax, when, as, and if appropriate.

May, July, August, October, November 1970

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[145] See Note 117, p. 20.

Debt-financed corporate acquisitions and related problems

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In addition to correcting some inequities in our tax structure, the Tax Reform Act of 1969 was designed to limit some corporate activities which could have undesirable effects on the U.S. economy if they were allowed to go unchecked. In attempting to achieve these results Congress has introduced some new sections in the Code and has added more detailed rules in existing Code sections.[1] As rules become more specific it often becomes easier to avoid their application. This situation can be contrasted with a broadly written Code section which allows great latitude to the courts in interpreting the intent of Congress. The Tax Reform Act certainly provides a new challenge for tax planning as we try to insulate our clients from adverse tax consequences.

Interest on acquisition indebtedness

The "urge to merge" has been aided and abetted in recent years by the wide variety of convertible debt and other obligations which give the holder the right to acquire stock of the issuing corporation at some future time. Various bills were introduced into Congress which attempted to limit this trend toward economic concentration

[1] Provisions of the Internal Revenue Code will be simply cited as "Sec."; provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" means pre-Tax Reform Act law.

and to make it less advantageous to issue these new forms of corporate securities. New Code Sec. 279 can limit the interest deduction of corporations with acquisition programs which involve the use of "corporate acquisition indebtedness."

Definition. The new term "corporate acquisition indebtedness" is defined as any obligation which was issued after October 9, 1969 (whether issued directly or acquired as guarantor or by assumption) by a corporation and which has all of the following attributes:

1. *Consideration for acquisition.* The obligation is issued to provide consideration for the acquisition of (a) stock of another (acquired) corporation or (b) at least two-thirds in value of all the assets (except money) used in the acquired corporation's trades or businesses.

2. *Subordination.* The obligation is *either:*

• Generally subordinated to the claims of trade creditors of the issuing corporation *or*

• Expressly subordinated to any substantial amount of unsecured indebtedness of the issuing corporation. (The unsecured indebtedness need not be outstanding at the time the corporate acquisition indebtedness is issued. Apparently an issuing corporation can initially avoid, but in later years run afoul of, this provision.)

3. *Convertible obligation or investment unit.* The bond or other evidence of indebtedness is *either:*

• Convertible directly or indirectly into stock of the issuing corporation, *or*

• Part of an investment unit or other arrangement which includes an option (warrants) to acquire stock in the issuing corporation.

4. *Thin capitalization.* As of the last day of the taxable year of the corporation issuing the obligations, *either:*

• The ratio of debt to equity of the issuing corporation exceeds 2 to 1 *or*

• The average annual earnings (computed with certain adjustments) for the three-year period ending on the last day of the acquisition year do not exceed three times the annual interest to

be paid or incurred. The earnings and interest costs of the acquiring and acquired corporations are combined where the issuing corporation acquired either 80% control (as defined in Sec. 368(c)), or substantially all the properties of the acquired corporation. Special rules apply to banks and lending or finance companies.

Limitation on interest deduction. The interest on corporate acquisition indebtedness is deductible only to the maximum extent of $5 million. The maximum is subject to reduction for interest paid or incurred on obligations issued after December 31, 1967 for acquisitions described in attribute (1) above but which are not corporate acquisition indebtedness. Although future debt issued for acquisitions described in attribute (1) above can be structured so as to avoid the designation of corporate acquisition indebtedness, the interest paid or incurred on this debt will reduce the $5 million annual exemption. This can indirectly serve to limit the deductibility of interest on debt which is classified as corporate acquisition indebtedness. For purposes of Sec. 279 the term "interest" includes not only cash payments of interest but also unstated interest such as original issue discount.[2] The operation of Sec. 279 can be illustrated by the following example.

Example. In 1970 *R* corporation incurred $11 million of interest expense which included:

- $2 million on convertible debentures issued in 1968 to acquire all of the stock of *T* corporation,
- $1 million on bonds with stock purchase warrants issued on December 1, 1969 to acquire one-third of the operating assets of S corporation,
- $6 million on corporate acquisition indebtedness, and
- $2 million of other interest.

R may deduct only $8 million interest expense for 1970. Of the $6 million interest on corporate acquisition indebtedness, $3 million ($5 million annual exemption less $2 million on debt which is not corporate acquisition indebtedness since it was issued prior to October 10, 1969) is disallowed. Thus, of the $11 million of interest, $8 million will be deductible, consisting of:

- $2 million on debentures issued for *T*'s stock,
- $1 million on bonds issued for *S*'s assets,

[2] S. Rep. No. 91-552 (11/21/69), p. 139.

- $3 million on corporate acquisition indebtedness, and
- $2 million other interest.

Special Rules. As previously stated, unless all four tests described above are met, no interest will be lost as a deduction since an obligation will not be classified as corporate acquisition indebtedness. In making the various tests, the members of an affiliated group will generally be treated as if they were a single corporation.

There are, however, many situations in which Sec. 279 will not apply, namely:

1. *Certain acquisitions of foreign corporations.* The term "corporate acquisition indebtedness" does not include any indebtedness issued to acquire the stock or assets of a foreign corporation if substantially all the income of the foreign corporation for the three-year period ending with the date of the acquisition is from sources without the United States.
2. *Five percent stock rule.* The new rules do not apply to indebtedness issued to acquire stock which represents less than 5% of the total combined voting power of all classes of the acquired corporation's stock which is entitled to vote.
3. *Binding written contracts.* Obligations issued to acquire stock or assets pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before the acquisition, will not be corporate acquisition indebtedness.
4. *Controlled corporations.* If the acquired corporation was already at least 50% controlled by the issuing corporation, Sec. 279 does not apply to indebtedness issued to acquire additional stock.
5. *Extension, renewal, refinancing.* Any extension, renewal, or refinancing of an obligation which itself was not corporate acquisition indebtedness will not be deemed to be the issuance of a new obligation.
6. *Nontaxable acquisitions.* If the acquiring corporation gains control (as defined in Sec. 368(c)) of the acquired corporation in a nontaxable transaction, the provisions of Sec. 279 will not be applicable if immediately before the transaction (i) the acquired corporation was in existence and (ii) the acquiring corporation was not in control of the acquired corporation.

Removing the taint. Once an obligation is classified as corporate acquisition indebtedness, the interest paid or incurred on it will

continue to be disallowed as a deduction in all future years to the extent that the $5 million annual exemption is exceeded. This taint is removed in a subsequent year if 80% control or substantially all the properties are acquired by the issuing corporation and the earnings test (described above) is met on a combined basis. If a corporation passes the debt/equity and projected earnings tests for three consecutive taxable years after the year in which the corporate acquisition indebtedness was issued, thereafter the obligations will no longer be classified as corporate acquisition indebtedness.

Installment sales

Under old Sec. 453(b), a sale of real estate or casual sale of personal property (where the selling price exceeds $1,000) could qualify as an installment sale at the election of the taxpayer. This election is available only when the payments in the year of sale do not exceed 30% of the selling price. Debt obligations of the purchaser did not constitute payments in the year of sale.

New rules. Under new Sec. 453(b), the following obligations received in a sale made after May 27, 1969 will not be treated as evidence of indebtedness of the purchaser and, therefore, will be includable as payments in year of sale:

1. An obligation payable on demand.
2. An obligation issued by a corporation, government, or political subdivision:

- With interest coupons attached or in registered form, or
- In any other form designed to render the obligation readily tradable in an established securities market.

1. *Demand notes.* The new rules apply to "a bond or other evidence of indebtedness which is payable on demand." This includes demand notes issued by individuals and partnerships as well as corporations and governments.

2. *Registered, readily marketable, etc.* The new rules will not apply to obligations in registered form which the taxpayer establishes will not be readily tradable in an established securities mar-

[3] S. Rep. No. 91-552 (11/21/69), p. 146.

ket. A readily marketable security does not include a promissory note, even though these notes may be made freely assignable.[3] In addition, only those obligations in registered form or with coupons attached which are issued by corporations or a government (or political subdivision thereof) are subject to the new rules.

Obligations received after year of sale. Sec. 453(b), as amended, provides that evidences of indebtedness will not be treated as payments *in the year of sale.* It may be possible for the seller to elect the installment method even though the buyer issues obligations payable on demand, in registered form, or with coupons attached, provided that the obligations are issued in the taxable year following the year of sale. In the year the obligation is received, the IRS would probably treat the seller as having received a payment equal to the fair market value of the obligation. However, since the obligation was not issued in the year of sale, the transaction may still qualify for installment reporting. Conceivably, the IRS could even take the position, under the step transaction theory, that in substance the obligations were received in the year of sale, and the sale does not qualify for installment reporting.

Effective dates. Act Sec. 412(b) specifies that the new rules apply only to sales of realty and casual sales of personal property occurring after May 27, 1969. Sales made pursuant to a binding written contract entered into prior to May 28, 1969 remain subject to the prior law.

Accrual of original issue discount

Prior law. Under prior law, upon the sale or exchange of an obligation issued by any corporation, government or political subdivision, which had been held for more than six months by the taxpayer, and which was a capital asset in the hands of the taxpayer, any gain realized would be ordinary income to the extent of:

1. The original issue discount on the obligation, or
2. If at the time of original issue, there was no intention to call the obligation before maturity, the original issue discount is multiplied by:

$$\frac{\text{No. of complete months obligation held by taxpayer}}{\text{No. of complete months between original issue and maturity date}}$$

Any gain realized in excess of the ordinary income which must be reported under (1) or (2) would be recognized as capital gain if the indebtedness qualified as a capital asset in the hands of the holder.

The term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. However, the discount is considered to be zero if it was less than one-fourth of 1% of the redemption price at maturity multiplied by the number of complete years to maturity.

The original issue discount rules do not apply to:

- Governmental obligations on which the interest is not taxable under Sec. 103.
- Any holder who has purchased the obligation at a premium.

In addition, the prior law did not require the inclusion of any amount previously includable in gross income.

There was no requirement under the prior law for a holder of an obligation to report the original issue discount ratably as income over the life of the obligation. Ordinary income, as well as capital gain, was recognized only on the sale, exchange, or retirement of the obligation.

New rules. Essentially, the new law[4] restates the prior law with respect to the computation of original issue discount on obligations issued for money. However, new Sec. 1232(a)(3) requires the accrual of original issue discount (even by cash basis taxpayers) with respect to any corporate obligation or evidence of indebtedness issued after May 27, 1969. More specifically, the holders of such obligations must include in gross income each year the ratable monthly portion of original issue discount multiplied by the complete and fractional months that the obligation was held by the taxpayer during the taxable year. The ratable monthly portion is computed by dividing the amount of original issue discount by the number of complete months from the date of original issue to the stated maturity date.

If the obligation is sold during a month, the ratable monthly portion of the original issue discount for the month will be allocated

[4] Sec. 1232(a)(2), as amended by Act Sec. 413(a).

between the transferor and transferee in accordance with the number of days in the month that each held the obligation. A complete month commences with the date of original issue and the corresponding day of each succeeding month. The holder of an obligation will increase his tax basis in the obligation by the amount of original issue discount included in his income.

If the debt is purchased, a subsequent holder will reduce the amount of ratable monthly portion of original issue discount (defined above) by a sum computed as follows: the price paid for the bond, less the issue price, plus the portion of original issue discount includable in the gross income of any previous holder is divided by the number of complete and fractional months from the date of purchase to the stated maturity date. In terms of a fraction, the reduction in monthly premium is computed as follows:

$$\frac{\text{Cost}-(\text{issue price} + \text{previously taxed original issue discount})}{\text{Months remaining to maturity}}$$

In effect, the second holder is not required to report as original issue discount the amount by which his purchase price exceeds what will generally be the original purchaser's cost basis (issue price plus accrued original issue discount). If the subsequent holder were to purchase the obligation for less than the sum of the issue price and the accrued original issue discount, there would be no adjustment to the amount of original issue discount.

The new requirement for including the original issue discount in income on a ratable basis does not apply to any holder:

- Which had purchased the debt at a premium or
- Which is a life insurance company subject to Sec. 818(b).

The term "purchase" does not include any acquisition where the basis of the debt is determined in whole or in part by reference to the adjusted basis of the debt in the hands of the person from whom it was acquired, or to debt acquired from a decedent where basis is determined under Sec. 1014(a).

The operation of the new requirements to accrue original issue discount are illustrated by the following examples.

Example 1. On October 1, 1969, *D*, an individual, purchased at original issue for $8,800 *R* corporation's 10-year, 6% bonds with a stated redemption price of $10,000. Interest is payable on October 1 and April 1. There was no intention to call the bonds before maturity. The ratable amount of the original issue discount that *D* must in-

clude in his gross income each month until the bond is sold, exchanged, or redeemed will be \$10 (1/120 months × \$1,200 (\$10,000 stated redemption price less \$8,800 issue price)).

D must include \$30 of original issue discount in 1969 income, and \$120 in 1970 income.

On April 1, 1971, *D* sells the *R* bonds to *S* for \$9,592. The ratable amount of the original issue discount that S must include in his gross income each month will be \$4 (\$10 original issue discount less \$6 reduction); that is, 1/102 × \$612 (\$9,592 purchase price less the sum of the \$8,800 original issue price plus \$180 discount previously includable in *D*'s gross income).

Example 2. Assuming the same facts, except that the bonds had been issued on April 1, 1969 before the effective date of the new rules, *D* would not include any original issue discount in his taxable income for 1969 and 1970. Of the \$792 gain realized in 1971 on the sale of the bonds, \$240 (\$10 × 24 months) will be treated as ordinary original issue discount income and \$552 as capital gain.

Investment unit. The definition of issue price was amended to specifically provide for the computation of original issue discount where debt and option or other security (warrants) are issued together as an investment unit.[5] In such case, the issue price will be allocated to each element of the investment in proportion to their relative fair market values. The amount allocated to the debt will be considered to be its issue price.

The portion of the pre-existing regulations issued relating to warrants were codified by the Tax Reform Act. Regs. Sec. 1.1232-3(b)(2)(i), issued under the old law, states that there is no original issue discount as to convertible debentures. Since this regulation has not been codified by the Tax Reform Act of 1969, it is possible that an argument may be made that the existing regulation is invalid.

Issued for property. In the case where an obligation or investment unit is issued for property, rather than money, amended Sec. 1232(b) provides that the original discount rules will apply only where either the obligation or investment unit is a part of an issue which is traded on an established securities market or the property for which the obligation is issued consists of stock or securities which are so

[5] Sec. 1232(b)(2), as amended by Act Sec. 413(b).

traded.[6] The issue price of the obligation in these cases will be the fair market value of such property for which the obligation was issued. If both the obligation or investment unit and the property (stock or security) acquired are not traded on an established securities market, the issue price of the obligation will be its stated redemption price at maturity. These rules relating to issuance for property do not apply where there is a tax-free reorganization within the meaning of Sec. 368(a)(1) or an insolvency reorganization within the meaning of Secs. 371, 373, or 374.

Information reporting on Form 1099. Under amended Sec. 6049 (a)(1), the present reporting requirements for Form 1099 as to cash interest payments will also apply to original issue discount if the bonds are in registered form. Holders of coupon bonds will have to make their own computation of original issue discount to be included ratably in income.

When a registered bond is sold by the original holder, the issuing corporation will continue to report the original issue discount on the Form 1099 issued to the new holder. The issuing corporation has no way of knowing the amount paid by the subsequent holder for the bond. As indicated in the example given above, this original issue discount may not be includable in full in the income of a subsequent holder. He must first determine if there was an original issue discount and then compute his ratable share based on the cost of the bonds to him.

Effective dates. As previously indicated, the new original issue discount provisions apply only to bonds, etc., issued after May 27, 1969. Moreover, the new rules do not apply to subsequently issued debt which is issued pursuant to a written commitment which was binding at all times on or after May 27, 1969.[7]

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[6] There was nothing in prior law specifically dealing with original issue discount where the debt is issued for property. The conclusions reached in this area by the various courts are not consistent. See American Smelting and Refining Co., CA-3, 130 F2d 883 (30 AFTR 7, 42-2 USTC ¶9670); and Paine, CA-8, 236 F2d 398 (50 AFTR 10, 56-2 USTC ¶9749). Compare Montana Power Co., Ct. Cls., 159 F. Supp. 593 (1 AFTR2d 1031, 58-1 USTC ¶9332); and Southern Natural Gas Co., Ct. Cls., 412 F2d 1222 (23 AFTR2d 69-1714, 69-2 USTC ¶9473).

[7] Act Sec. 413(e).

Limitation on deduction of premium on repurchase of convertible bonds

Prior law. The prior law did not specifically deal with this subject. However, Regs. Sec. 1.163-3(c)(2) states that in the case of the repurchase of a convertible bond (other than a bond which the corporation, before September 5, 1968, was obligated to repurchase at a specific price), the deduction is limited to an amount equal to one year's interest at the rate specified in the bond. However, the allowable deduction may be greater if the corporation can show that an amount in excess of one year's interest does not include any amount attributable to the conversion feature.

In *Roberts & Porter, Inc.*,[8] it was held that the premiums paid by the taxpayer on the purchase of its callable convertible notes, in excess of the amounts which it was legally bound to pay upon calling the notes, were deductible as ordinary and necessary business expenses. The position of the IRS has been that a deduction for premiums paid by a corporation on the redemption or repurchase of its own bonds is limited to an amount which relates to the cost of borrowing money; thus any excess amounts are not deductible. The IRS will not follow the *Roberts & Porter* decision.[9]

New rules. The deduction allowed the issuing corporation by new Sec. 249 for any premium paid on the repurchase of convertible debt will usually be limited to the excess of:

- The repurchase price over
- The sum of the adjusted issue price plus a normal call premium on debt which is not convertible.

However, to the extent the corporation can show that the excess of the actual call premium over the normal call premium on nonconvertible debt is attributable to the cost of borrowing and is not attributable to the conversion feature, the deduction allowable will be correspondingly increased. This exception is designed to allow for changes in interest rates and to permit market and credit conditions to be taken into account.[10]

The adjusted issue price is the issue price as defined by Sec.

[8] CA-7, 307 F2d 745 (10 AFTR2d 5686, 62-2 USTC ¶9378).

[9] Rev. Rul. 67-409, 1967-2 CB 62.

[10] S. Rep. No. 91-552 (11/26/69), p. 149.

1232(b) increased by any amount of discount deducted before repurchase or, in the case of debt issued after February 28, 1913, decreased by any amount of premium included in gross income before repurchase.

Effective date. Act Sec. 414(c) provides that the new rules apply to repurchases of convertible debt after April 22, 1969 except for repurchases made at a specified call premium under a binding obligation entered into before April 23, 1969.

Act Sec. 414(c) specifies that no inference shall be drawn as to the deductibility of a call premium on convertible debt repurchases prior to April 23, 1969. In other words, whether *Roberts & Porter, Inc.*, is a correct interpretation of the law applicable to prior repurchases of convertible debt will have to be resolved in the courts.

Guidelines for resolving debt vs. equity questions

No guidelines have been established under the prior law or regulations as to what constitutes a thin corporation. Cases have provided the only guides as to what is a proper debt-equity ratio. However, the results have varied and it seems that each case must be decided upon its own particular set of facts. Professors Bittker and Eustice[11] comment that it is usually assumed that a ratio of debt to equity that does not exceed 3 to 1 will likely withstand attack.

The Commissioner is authorized by new Sec. 385 to prescribe regulations which will establish guidelines as to whether an interest in a corporation is to be treated as stock or debt. The regulations may give weight to the following factors:

- Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
- Whether there is subordination to or preference over any indebtedness of the corporation;
- The ratio of debt to equity of the corporation;
- Whether there is convertibility into the stock of the corporation; and

[11] Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (Hamden, Conn.: Federal Tax Press, 1966), p. 126.

• The relationship between holdings of stock in the corporation and holdings of the interest in question.

This section will have direct effects on other new and old sections of the Code such as installment reporting (Sec. 453) and interest on indebtedness incurred by a corporation to acquire stock or assets of another corporation (Sec. 279). If an obligation is not treated as debt under Sec. 385, it cannot qualify as indebtedness in an installment sale. Also, the issuing corporation will not be entitled to any interest deduction which might otherwise come under the provisions of Sec. 279.

Import of new rules

The "related problems" discussed in this article will undoubtedly have more widespread effects than the "corporate acquisitions" problems. Sec. 279 will be of concern only to the largest corporations because of the $5 million annual exemption. In addition, it should not be too difficult to avoid or minimize the adverse consequences of Sec. 279. The new requirements for installment reporting can affect any business, large or small, in corporate form or otherwise, and many individuals.

The provisions for currently reporting original discount will have direct effects for thousands of individuals and will surely cause problems for practitioners in the preparation of individual income tax returns. Although some uncertainty remains as to how much of a call premium may be deducted when a corporation purchases its own convertible debt, the problems in this area have been narrowed by Sec. 249. As is the case with many provisions of the Reform Act, we must await the promulgation of regulations before we can adequately assess the opportunities and pitfalls of Sec. 385 relating to debt-equity problems.

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Unrelated business income tax

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Approximately one-fourth of the Tax Reform Act of 1969, one of the broadest pieces of tax legislation ever enacted, contains provisions that materially affect tax-exempt organizations. The major changes made in the area of exempt organizations, other than changes specifically applicable to private foundations, are covered herein. They are as follows:

1. The unrelated business income tax (UBIT) is now extended to churches and other exempt organizations to which it did not previously apply.
2. A charitable organization is barred from borrowing to purchase investment assets and avoiding income tax through the use of its tax-exempt privilege.
3. Investment income and nonmember income of social, fraternal and similar organizations will be taxed.
4. Interest, annuities, rents and royalties from a controlled corporation will be taxed as unrelated business income in certain situations.
5. Advertising activity is treated as a separate trade or business and thus subject to the unrelated business income tax. (Recent regulations are codified.)
6. Restrictions are imposed on deductions for services by taxable social, fraternal and similar organizations.

These major changes will be surveyed in this article.

Extension of UBIT to all exempt organizations

Secs. 511-515[1] now provide for the taxation of a (1) trade or business (2) regularly carried on by an exempt organization (3) where the conduct of the trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt function. Before these sections were amended by the 1969 Tax Reform Act, the UBIT was not applicable to a number of exempt organizations. Generally, under the amended law, *all* exempt organizations (except United States instrumentalities) will be taxed at corporate rates on their unrelated business income. Under amended Sec. 511(a)(2)(A), for the first time, the provisions of the UBIT will apply to churches, civic leagues, social clubs and fraternal benefit societies, etc.

Unrelated business income. The term "unrelated business income" still does not include income from:

1. An activity which is not "regularly" carried on—for example, an annual athletic exhibition, or
2. An activity substantially related to the organization's performance of its exempt function—for example, sale of drugs to patients of an exempt hospital.

In effect, the amended law taxes all income earned by an organization other than passive income and income earned within the purview of the organization's exempt function. Exempt passive income will include rents, royalties, capital gains and dividends. In the case of social clubs and employees' beneficiary associations, even passive income is no longer exempt. Also income from debt-financed acquisitions of property will generally be taxable unless the property is used by an organization for its exempt purposes.

Specific deduction. A $1,000 specific deduction is still allowed in computing the unrelated business income tax. However, in the case of churches, amended Sec. 512(b)(12) entitles each parish, district,

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[1] For convenience and clarity, provisions of the Internal Revenue Code will be simply cited as "Sec.", while provisions of the 1969 Tax Reform Act will be referred to as "Act Sec." "Prior law" will represent references to Code sections prior to their amendment by the Tax Reform Act, while "amended law" or "amended Sec." will refer to sections of the Code after such amendments.

individual church or other local unit to a separate $1,000 deduction (or, if less, the amount of the unit's income).

Also, new Sec. 512(b)(17) specifies that the unrelated business income tax is not to apply to a federally licensed business (e.g., television station) maintained since May 27, 1959 by a religious order or by a religious order's educational institution provided that more than 90% of the net income is used for exempt purposes.

Effective dates.[2] The extension of the unrelated business income tax to *all* organizations is effective for years beginning after December 31, 1969, except that new Sec. 512(b)(16) grants churches a six-year grace period in which to dispose of an unrelated business.

The unrelated business income tax will not apply to churches until a taxable year beginning after December 31, 1975, except in the cases of (a) debt-financed income and (b) an unrelated business acquired after May 27, 1969.

Income from debt-financed properties

Under prior law, an exempt organization could be subject to tax on rental income earned from real property acquired with borrowed funds. This provision was limited to rents derived under business leases—that is, those with terms of more than five years. Also, many exempt organizations, such as churches, were not covered by this provision.

Bootstrap sale and leaseback. Due to the restricted nature of the provision, some exempt organizations allegedly have been able to compete "unfairly" in the acquisition of commercially competitive businesses. In effect, these organizations were able to purchase businesses with rental income derived from a leaseback of the acquired assets, while contributing little or nothing to the transaction other than an exempt status. In a typical "bootstrap sale and leaseback,"[3] the stockholders of a closely held corporation sell all their stock to an exempt organization, receiving only a nominal down payment and promissory notes for the balance of the purchase price. The

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[2] The effective dates for all amendments to the Code within the scope of this article are prescribed in Sec. 121(g) of the Tax Reform Act.

[3] For example, see Clay Brown, 380 US 563, (15 AFTR2d 790, 65-1 USTC ¶9375); and University Hill Foundation, 51 TC 548.

notes are payable only from the earnings on the corporation's assets. The exempt organization liquidates the corporation and leases the assets to a company newly formed to operate the business. The newly formed company, with the same management as the old entity, pays a substantial portion of its profits as "rent" to the exempt organization. In turn, the latter remits a substantial portion of such rental income to the original stockholders as an installment payment on the promissory notes. The installment payments to the stockholders received (and still do) capital gain treatment. Under prior law, the income paid to the exempt organization was tax free.

Taxation of "debt-financed income." Sec. 514 has been radically revised so as to provide that income earned by *all* exempt organizations from "debt-financed" property will be taxed as unrelated business income. The taxable portion of this income is measured by the ratio of "acquisition indebtedness" to the adjusted basis of the acquired property. For example, if the acquisition is entirely debt financed, 100% of the income as well as 100% of the deductions will be taken into account for tax purposes. As the "acquisition indebtedness" (i.e., installment obligation) is paid off, the percentage taken into account diminishes. Thus, if the acquisition indebtedness to be taken into account is equal to 50% of the tax basis of the property, then 50% of the net income would be taxed. The ratio is computed by reference to the average acquisition debt during the year and the average amount of the tax basis of the property during the portion of the year it is held by the corporation. Where property is sold during the year, any gain or loss to be taken into account is computed by using the highest amount of the related acquisition indebtedness during the 12-month period ending with the date of sale or other disposition.

Acquisition indebtedness. The term "acquisition indebtedness" means the unpaid amount of any indebtedness:

1. Incurred in acquiring or improving property.
2. Incurred prior to an acquisition or improvement of property as a result of such acquisition or improvement, or
3. Incurred after the acquisition or improvement of property where the incurrence of such indebtedness was reasonably foreseeable at the time of acquisition or improvement.

In taxable years beginning before January 1, 1972, any indebtedness described above will not be taken into account if incurred prior to June 28, 1966. However, in the case of an organization (other than a church or convention of churches), Sec. 514(c)(1) provides that such indebtedness incurred prior to June 28, 1966 shall be taken into account if such indebtedness constituted business lease indebtedness of a type that would have been subject to tax under prior law.

When property is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage will generally be considered "acquisition indebtedness" incurred in acquiring the property. Special rules apply, however, when the acquisition of property subject to a mortagage is by will or gift. Where mortgaged property is received under a will, the mortgage shall not be treated as "acquisition indebtedness" during the ten-year period following the date of acquisition. Where mortgaged property is acquired by gift, the mortgage is disregarded during the ten-year period following the date of such gift if the mortgage was placed on the property more than five years earlier and if the property had been held by the donor for more than five years. See Sec. 514(c)(2).

Act Sec. 121(g) provides that, where mortgaged property is acquired by "bargain purchase" prior to October 9, 1969, the mortgage will be disregarded for a ten-year period following the date of the transaction. However, such a mortgage must have been placed on the property more than five years earlier. Additionally, the purchase price must have been no greater than the amount of the seller's expenses (including attorneys' fees) directly related to the transfer of the property to the organization with a further limitation that the price must have been no greater than 10% of the value of the seller's equity in the property. Establishing the amount of the seller's equity as well as his selling expenses may be difficult in many cases.

Exemptions. Even though property is acquired with "acquisition indebtedness," Sec. 514(b)(1)(A) provides that no unrelated business income will result if the property is utilized for the exempt purposes of the organization. For example, rental income from a dormitory acquired with borrowed funds would not result in an exempt college having unrelated business income. Also excluded from the term "acquisition indebtedness" are obligations to the ex-

tent insured by the Federal Housing Administration to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons.

Unrelated business income will not include income earned from real property located in the neighborhood of other property owned by an exempt organization where the other property is utilized for exempt purposes. This rule is applicable only if the principal reason for acquiring the property was its use in exempt purposes within ten years from the date of acquisition. In the case of a church the period is 15 years and the property need not meet the neighborhood test. If the property is actually used for exempt purposes within ten years from the date of acquisition it will also be covered by this rule even though it is not located in the neighborhood of other property owned by the organization. In such a case, when an exempt use first occurs after a return has been filed, a claim for refund may be necessary. New Sec. 514(b)(3)(D) extends the time for filing a claim where the normal statute of limitation has expired.

Effective dates. This expansion of the unrelated business income tax is effective for years beginning after December 31, 1969, except that any indebtedness incurred before June 28, 1966 shall not be taken into account in the case of any taxable year beginning before January 1, 1972.

Tax on investment and nonmember income of social and similar organizations

In the past, income earned by exempt social and recreational clubs was not considered to be unrelated business taxable income. This exemption was designed to allow individuals to join together to provide recreational or social facilities without tax consequences. Similarly, voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to its members were not subject to the UBIT.

Congress apparently felt that the exemption operated properly only where it was limited to receipts from the membership. Otherwise, the exemption of investment income and income derived from sources outside the membership would allow the members to receive a benefit from the tax-exempt funds used to provide pleasure or recreational facilities. Therefore, new Sec. 512(a)(3)(A) pro-

vides for the taxation of gross investment income and nonmember income less allowable deductions for expenditures directly related to the production of the income.

Exemption function income and gains. Gross amounts paid by members in return for goods, facilities, or services to the members, their dependents, or guests are categorized as "exempt function income" under Sec. 512(a)(3)(B) and, accordingly, are not taxed as unrelated business income. In addition, income which is permanently set aside or committed to religious, charitable, scientific, testing for public safety, literary or educational purposes or for the prevention of cruelty to children or animals is classified as "exempt function income." Income permanently set aside or committed to be used for the exempt insurance function of fraternal beneficiary associations and employees' beneficiary associations is also treated as "exempt function income."

If property used directly in the performance of the exempt function of an organization is sold at a gain, Sec. 512(a)(3)(D) provides for nonrecognition of the gain if within a period beginning one year before and ending three years after the date of such sale similar property is purchased. The replacement property must be used by the organization directly in the performance of its exempt function. Destruction, theft, condemnation, etc., shall be treated as a sale of property for the purpose of this provision.

The basis for determining gain or loss in the case of a sale of property is not mentioned. Presumably, traditional rules for determining tax basis must be followed. These rules may be difficult, if not impossible, to apply in some cases.

Impact on exempt status guidelines. Under prior law, the IRS prescribed guidelines for determining when a social club had excessive amounts of unrelated business income. Thus, when nonmember receipts exceeded 5% of gross receipts, a social club was in danger of losing its qualification as an exempt organization. Under this test, which was set forth in Rev. Proc. 64-36 (1964-2 CB 962), when nonmember receipts were less than 5% of gross receipts, a social club neither lost its exempt status nor incurred tax on such receipts.

The new law authorizes the IRS to tax unrelated business income of a social club without disturbing its overall exemption. While the new law seems to effectively abrogate the 5% guideline set up under

Rev. Proc. 64-36, this is not clear, and hopefully the regulations will clear up this point. However, the danger of an organization losing its exempt status where its unrelated business income is excessive in relation to its exempt function is still present under the new law.

Effective date. The extension of the unrelated business income tax to investment and nonmember income of social clubs and voluntary employees' beneficiary associations is effective for taxable years beginning after December 31, 1969.

Income from controlled organizations

New Sec. 512(b)(15) provides for taxation of interest, annuity, rent and royalty income (but not dividends) received by an exempt organization from a controlled organization where this income is not otherwise taxed. Adopting the Sec. 368(c) definition, "control" means ownership of at least 80% of each class of stock of the subsidiary corporation.

Background. Under prior law, an exempt organization could receive interest, annuity, rent or royalty income from a controlled organization and the income would generally not be subject to tax. The rule was the same regardless of whether the controlled organization was a taxable or exempt entity. Apparently there were some abuses of this rule. For example, an exempt organization would "rent" its physical plant to a wholly owned taxable corporation for 80% to 90% of all net profits (before taxes and before the rent deduction). This arrangement enabled the taxable corporation to pay only minor income taxes because of the large "rent" deduction. Occasionally, the courts disallowed some or all of the rent deduction. Nevertheless, this issue was a difficult one for the IRS and the purpose of the new law is to close this tax-minimizing route.

Computation of taxable portion. Under the new provision, usually only a portion of any interest, annuity, rent or royalty income received from a controlled organization will be reportable by the exempt parent organization as an item of gross income for tax purposes. The proportion of reportable income will vary depending upon whether the controlled organization is exempt or taxable.

The reportable portion in the case of an exempt organization is measured by the ratio of its unrelated business income to its total income (computed as though the organization was taxable). The reportable portion in the case of a taxable organization is measured by the ratio of that organization's income from activities which are not functionally related to the parent's exempt function to the total taxable income of the controlled organization. No doubt, difficulty will be encountered from an accounting standpoint in establishing allocable portions of income and expense in computing the above ratios.

Effective date. These new rules are effective for taxable years beginning after December 31, 1969.

Income from sales of goods and services (including advertising)

Prior to 1967, although it was understood that an exempt organization could have unrelated business income from the sale of goods or performance of services, it was generally believed that the sale of advertising by an exempt organization would be exempt where the journal, magazine, etc., was related to the educational or other exempt purpose of the organization. Late in 1967, however, Regs. Sec. 1.513-1(d)(2) was amended to provide that profits from the sale of advertising for years beginning after December 13, 1967, would be treated as unrelated business income except in those cases where advertising activities "contributed importantly" to an organization's exempt purposes. The regulations were aimed at removing a purported "unfair competitive advantage" enjoyed by exempt publishing organizations over taxable publishing organizations. The statutory language upon which the regulations were based was not clear; consequently, substantial litigation from the regulations has been expected.

Codification of regulations. For the purposes of the tax on unrelated business income, amended Sec. 513(c) now defines the term "trade or business" as including any activity which is carried on for the production of income from the sale of goods or the performance of services. Thus, it is now clear that income from advertising will be treated as unrelated business income unless the degree of rela-

tionship of the advertising activity to the exempt purpose of the organization is substantial. The new law specifically states that

> . . . an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

"Contribute importantly." Although the new law does not refer to the term "contributed importantly," it is assumed that regulations to be issued will provide that an advertising activity is substantially related to an exempt function only where the activity "contributes importantly." In example (5) of present (old) Regs. Sec. 1.513-1(d)(4)(iv), advertising income from a university's campus newspaper was considered related income since the purpose of the paper was to train students enrolled in the school of journalism and thus, the advertising activities contributed importantly to the educational program. On the other hand, however, in example (6) of the same regulations advertising income of an artists' association was considered unrelated income even though it promoted products within the general area of the professional interest of its members. Although the continuing education of its members in artistic matters was one of the purposes of the association, the regulations decided that the publication of advertising, designed and selected in the manner of ordinary commercial advertising, did not contribute importantly to its exempt function.

Deductions. Expenses related to advertising will be deducted from advertising income in arriving at unrelated business income subject to the tax. Further, the House Committee Report (No. 91-413, Part 1, p. 50) indicates that expenses of editorial departments should be considered deductible, and that taxable income of multiple publications would be computed on a consolidated basis. In any event, it would appear that an accounting for expenses directly connected with advertising income (or any other type of income taxable under the new provision) should include an allocable portion of general and administrative overhead, such as salaries, rents, insurance, utilities and depreciation.

Spin-off of advertising activity. Where a tax-exempt organization is engaged in an unrelated trade or business involving advertising income, consideration might be given to placing the advertising activ-

ity in a separate, wholly owned taxable subsidiary. Dividend income paid by the subsidiary to the exempt parent organization would not constitute taxable income to the parent. Further, removal of the trade or business might be helpful in insuring the continued exempt status of the parent corporation.

Not retroactive? It is obvious that, in effect, Congress has approved the regulations despite many objections from those adversely affected. However, Act. Sec. 121(g) specifies that this amendment applies only to taxable years beginning after December 31, 1969. Consequently, there is still likelihood of litigation for prior taxable periods, for which there is no specific statutory support for the regulations.

Other changes in unrelated business income

Rents. Except where a business lease indebtedness existed, rents from real property, including rent from personal property leased with the real property, have not previously been subject to tax. Amended Sec. 512(b)(3)(A) provides that rents applicable to personal property, leased with real property, are subject to tax unless incidental in amount. Further, all rental income received from real property leased with personal property will be taxable if more than 50% of the rent is applicable to the personal property or if the rent is based on a percentage of the net income from the property. The new rules are effective for years beginning after December 31, 1969.

Title-holding corporations. Amended Sec. 511(c) provides that when a title-holding corporation and a related tax-exempt parent organization file a consolidated return, the holding company will be treated as organized and operated for the same purposes as the tax-exempt organization. Consequently, if the business activities of the title-holding corporation are related to the purpose of the exempt organization, then its income will be related business income and not subject to tax. A title-holding corporation is a corporation organized for the exclusive purpose of holding title, collecting income, and turning over the entire amount thereof, less expenses, to an exempt organization. This provision will be effective for years beginning after December 31, 1969.

Feeder organizations. Previously, an organization operated primarily to carry on a trade or business for profit was taxable even

though all its profits were payable to one or more exempt organizations. Now, some of the beneficial exceptions from the unrelated business income tax have been extended to these organizations.

Under amended Sec. 502, in general, the unrelated business income tax will not apply to the operation of a business which sells donated merchandise—for example, a bargain or thrift shop. Nor will the tax apply where substantially all work performed in carrying on a trade or business is performed for the organization without compensation.

These rules apply to taxable years beginning after December 31, 1969.

Foreign. Previously, the only income of a foreign exempt organization which was taxed was that income effectively connected with the conduct of a trade or business within the United States. Under amended Sec. 512(a)(2), unrelated business taxable income of a foreign organization will include all unrelated income earned within the United States *whether or not* the amount is effectively connected with the conduct of a trade or business. This provision is effective for taxable years beginning after December 31, 1969.

Deny losses for services to members by taxable organizations

Prior to this Act, *taxable* membership organizations sometimes supplied services to members at less than cost. These organizations treated the resultant losses as offsets against taxable income earned from investments or other activities. Under new Sec. 277(a) a taxable membership organization is permitted to deduct expenses incurred in supplying services, facilities and goods to its members only to the extent of membership income. If for a particular year deductions for these services exceed the amount of membership income, the excess shall be treated as a deduction in the succeeding taxable year. Membership income includes income received from institutes and trade shows operated primarily for membership education.

Under other provisions of the new law it is possible for an *exempt* membership organization to have taxable unrelated business income which is not offset by losses from membership activities. Had this section (restricting deductions of taxable organizations) not been enacted, it is probable that some exempt organizations would

have attempted to become taxable so that their membership activity losses could be treated as an offset against other income.

Exceptions. Sec. 277(b) specifies that this new restriction is not applicable to (1) banks, (2) insurance companies, and (3) securities and commodity exchanges. Further, a deduction limitation will not apply where there has been an election before October 9, 1969, under Sec. 456(c) which covers the timing for reporting prepaid dues. An example is the American Automobile Association, which receives prepaid dues income as consideration for services to be rendered in competition with the charges made by other automobile clubs.

Effective date. The deduction limitation becomes effective for taxable years beginning after December 31, 1970.

Administrative provisions

Information returns. New Sec. 6050 requires that an information return be filed after a transfer of income-producing property to an exempt organization, but only when:

1. The property has a fair market value in excess of $50,000, and
2. The transferor knows that the organization is subject to the unrelated business income tax.

The responsibility by the transferor for obtaining knowledge of the organization's tax status is not mentioned by the new Act.

The return requirement applies only to transfers made during taxable years beginning after December 31, 1969. The return is due no later than 90 days after the date of transfer.

Church audits. New Sec. 7605(c) authorizes the IRS to examine the books of churches only after advance notice stating that there is reason to believe such organizations may be engaged in an unrelated trade or business. An officer no lower than a principal officer for an internal revenue region is authorized to issue such notice.

Further, authority to examine the books is granted only to the extent necessary to determine the amount of the unrelated business income tax. Authority to examine the religious activities of an organization shall be limited to the extent necessary for a determination of whether such organization is a church or convention of churches.

The provisions for examination of church records are effective

for taxable years beginning after December 31, 1969, although they are not fully workable until after December 31, 1975.

Study and plan now

Since most of the new provisions are quite complex, their meanings may have to be clarified or resolved by regulations, rulings and even court decisions. However, immediate consideration and action by an exempt organization may be required in order to:

1. Determine the applicability and resulting effect,
2. Initiate planning to minimize or avoid the income taxes imposed, and
3. Establish adequate accounting records.

Because of the new provisions some exempt organizations may need to alter or modify their present operations and activities. Further, considerations for entering into a transaction or engaging in certain types of activities will no doubt be influenced by these changes. In short, a detailed review of the impact of the pertinent new rules should be started promptly by and for exempt organizations.

March 1970