Internal Revenue Code 1954:A Twelve-Part Analysis of the New Tax Law Reprinted from the Journal of Accountancy

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A Twelve-Part Analysis of the New Tax Law

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Editorial

The Accounting Profession and the New Code

This issue of The Journal is largely devoted to the 1954 Internal Revenue Code—the first thorough overhauling of the nation's tax laws in more than half a century.

The articles, covering nearly all of the major changes effected by the new law, have been prepared by members of the American Institute of Accountants' federal taxation committee and by the chairman of the AIA's special committee on accounting principles for income tax purposes.

The authors and reviewers have worked under heavy pressure in order that the magazine might be published only a few weeks after Congress completed action on the measure.

It is no exaggeration to say that probably no other group could have preformed so difficult a task in such a limited amount of time.

They were able to handle the assignment because they and their colleagues on the Institute's committees have lived with this legislation since it began its long journey through Congress. They helped to draft the Institute's recommendations for changes in the old Code when the job of revision started last summer. They presented oral and written testimony on each gigantic bill as it appeared—the original House bill, the Senate version, the final Conference bill. In order to perform this public service, they have been obliged to devote countless hours of study to the subject and to hold several round-the-clock sessions in both Washington and New York City.

This is not the first time, of course, that the accounting profession has rendered such service.

Back in 1909, when the present series of tax laws began with the enactment of the corporation excise tax, accountants urged the lawmakers to clarify some of its confusing definitions before the measure was adopted. The advice was ignored, and the law would have proved almost unworkable if the Treasury Department, calling upon the accountants for assistance, had not been able to frame some practical and convenient regulations. Ever since that unhappy incident, the accounting profession has had a part in the development of tax legislation—though its role has never been so spectacular as it has been during the creation of the 1954 Code.

In fact, Kenneth W. Gemmil, assistant to the Secretary of the Treasury, and other government technicians have lauded the assistance of the Institute as being highly useful and objective.

It is paradoxical that this commendation of Treasury and Congressional officials should coincide with the efforts of some lawyers to drive CPAs from tax practice.

This is not a fitting occasion to challenge the logic of those who would erect an exclusive "For Lawyers Only" sign on the tax field. But it *is* appropriate to observe that any conflict over tax practice will be ultimately resolved by the public on the basis of the most satisfactory service.

Of course, in assisting Congress with the new Code, the Institute's committees were not seeking recognition for the tax skills of accountants—though that might be an incidental result of their labors. Primarily, they were discharging the profession's obligation to make available its tax accounting knowledge to those who had the hard task of devising legislation which would best serve the nation.

The tax committee also recognizes that its own job has not ended with the enactment of the new Code. It must now help all other accountants to acquire a knowledge of the new Code—and this issue of THE JOURNAL is one of the projects designed to accomplish that purpose.

The issue, one need hardly add, is a mere beginning to the tax re-education required of every accounting practitioner. It spotlights some of the more significant changes; but it is certainly no substitute for a careful review of the Code itself.

The prospect of spending weeks in such study may not be exactly inviting. Yet there is no escape. It is part of the never-ending responsibility of a professional man to remain well informed in order to render proper service to his clients. It is particularly important today. For the whole defense of the accountants' right to practice in the tax field will depend in large measure on his continuing to demonstrate his competence and ability to handle tax-matters.

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A Brief Introduction to The New Internal Revenue Code

By J. S. Seidman

At the time of its birth, the 1954 tax law weighed in at over three pounds.

Although this makes it the undisputed all-time heavyweight champion, its wallop is nowhere near as punishing as the 1939 Code—in fact, it is over a billion dollars kinder on individuals.

It more than compensates for any fiscal loss, however, by its enhanced orderliness, scholarliness, and justness. Instead of the crazy-quilt patchwork that developed from annual tinkering, we now have a unified, logically arranged, and rather smoothly worded statute.

The Incubation

A birth of this sort required more than the usual care and number of attendants. About 500,000 man-hours went into the task.

In the summer of 1953, the House Ways and Means Committee (Daniel A. Reed, *Chairman*) sweltered through three months and 3,000 pages of hearings on what was wrong with the old law. A few of those pages recorded the testimony and the 52 recommendations presented by representatives of the American Institute of Accountants' federal taxation committee.

Then came the prodigious job of developing a bill.

The chief drafting agency was the staff of the Joint Committee on Internal Revenue Taxation (headed by Colin F. Stam). Working alongside of them were men from the Treasury Department (led by Kenneth W. Gemmill and Dan Throop Smith). They, in turn, drew heavily on the accumulated experience and ideas of the Internal Revenue Service (under the direction of T. Coleman Andrews).

In seven months—more precisely on March 9, 1954—H.R. 8300 was delivered by the Ways and Means Committee.

It was quite a baby. It took more than 800 over-size, closely printed pages to tell its story. If published in regular bill form, it would have required about 3,500 pages. Nearest to it in size was the Revenue Act of 1942, which, at its most bloated point, was less than 600 standard pages. Even the committee's report to explain the new bill ran that long. But more significant than the physical bulk was the sweeping character of the revision. Many new concepts were ushered in by the bill—including drastic and complex ones dealing with corporations and partnerships.

The House passed the bill on March 18, 1954, with four hours of debate. Obviously the Representatives could not hope to come to grips, at this stage, with the technical aspects of the measure.

Then the Senate Finance Committee (Eugene D. Millikin, *Chairman*) took over. It conducted hearings for more than two weeks and 2,500 pages. It heard plenty about the House bill—some of the testimony expressing particular unhappiness over the corporation provisions. Again, the Institute's federal taxation committee participated and recommended 213 amendments to the House version.

The hearings made their mark. On June 18, 1954, the Senate Finance Committee came up with over 500 amendments, set forth in 400 bill print pages. Its accompanying report ran over 600 pages. On the corporation front, the main drift of the Senate version was to continue the 1939 treatment (with some modernization), instead of going all-out for a new approach.

The Senate passed the bill on July 2, a. er several stormy days of debate that pivoted around the House proposal that stockholders' taxes be reduced by 5–10 per cent of the dividends they received.

That transferred custody of the child to the tender care of a conference committee. (Once more the AIA tax committee submitted recommendations—this time 137 in number.) On July 26 the conference group announced its conclusions in a 100-page report. It went along with most of the Senate changes and added a compromise on the dividend provision.

By July 29 the bill was passed by both houses of Congress; and on August 16, 1954, President Eisenhower signed the adoption papers—the final step in the child's legality.

All told, this pre-natal biography of the bill (technicians call it legislative history) encompasses this bit of literature:

	Pages
Ways and Means Committee	
Hearings	3,000
Bill	800
Report	600
Senate Finance Committee	
Hearings	2,500
Amendments	400
Report	600
Conference Committee	
Report	100
Total	8,000

Mind, this does not include the pages of debate in the *Congressional Record*. *Anthony Adverse* and *Gone With The Wind* are snappy short stories compared to the saga of the Revenue Code of 1954.

Those who have become skilled in reeling off section numbers—like 102, 23, 117, 112, etc.—must start all over again. Only Section 32 is the same in the 1954 Code as it was in the 1939 Code. Otherwise, there is a completely new numerology—with the sections running up to 8023 in the new law compared with 5012 in the old. In both Codes, many section numbers were ominously left blank for "future expansion."

But it is not just section numbers that have been reshaken. Over 3,000 technical changes have been made. They are so extensive that the old experts have had their tax knowledge pretty much repealed. Now all of us can start all over again from scratch.

The Evaluation

Here are some striking points about the personality of this latest addition to our tax-law population:

1. It brings closer the happy marriage of tax accounting and generally accepted accounting. There will be less of a gap between income in financial statements and income in tax returns. In the transition, the revenues will be reduced, but the goal is well worth the sacrifice.

2. It ameliorates some of the tax distortion and difference that in the past came about merely by the form of business organization utilized. The play between corporations and partnerships will be narrowed as a result of the dividend credit and the option to partnerships to be taxed as corporations. The right of one company to inherit the tax benefits and burdens of another will make business judgment, rather than tax factors, the controlling consideration in determining whether to wind up or continue a subsidiary, or

whether to organize a new company or reorganize an old.

3. Partnerships and estates for the first time get the "full treatment" in the law. The provisions are not easy reading, and the principles applied in them are somewhat fuzzy. But at least a courageous start has been made in letting the law speak for itself, instead of creating a vacuum that will have to be filled by administration or litigation.

4. Many areas of doubt have been clarified. Now we will soon know where we stand on stock dividends, stock redemptions, preferred stock "bail-outs," and company liquidations.

5. Individuals will be accorded more "liberal" treatment on retirement income, child-care and medical expenses, health and accident benefits, contributions, deduction for dependents, carrying charges on installment purchases, tax litigation expenses, and penalties for underestimating the year's tax.

6. In the business area more palatable treatment will prevail on depreciation, net losses, organization expenses, research and development expenses, acquisition or disposition of treasury stock, penalty for unreasonable accumulation of earnings, etc.

7. About 50 loopholes have been plugged—some effectively, some not so effectively. The pickings will not be so easy with things like trafficking in net loss companies, premium bonds, discount bonds, single premium annuities, and other erstwhile soft spots.

8. Some intriguing innovations on administration will be tested. For example, it will be interesting to see whether the shift of T-Day from March 15 to April 15 will reduce the burden on taxpayers and accountants, or whether procrastination will merely transfer the old deadline pressure to the new date. We will also get a chance to see just how "cents-less" income taxes can become now that pennies may be eliminated in compiling returns.

9. Company finances will need replanning and year-end balance sheets will look different because the larger corporations will have to shell out their tax money faster under the new pay-as-you-go arrangement.

10. In the estate and gift tax field, the new treatment for property taken in the name of husband and wife is bound to meet with acclaim. So also with the new principles for determining whether insurance policies are part of the taxable estate.

The list is woefully incomplete, even of the high-spots. The other articles in this issue will round out the picture.

The Destination

Lest anyone think that the Revenue Code of 1954 is a tax law to end all tax laws, I predict we're going to have a whopping Revenue Act, or Technical Changes Act, of 1955.

It will be recalled that the Senate drastically revised the House bill. The most significant of the 500 Senate amendments reinstated the old law. I suspect that the reinstatement is only temporary, and that we are going to renew our acquaintance with some of the new approaches introduced by the Ways and Means Committee. However, they will be revived in more polished and effective form to overcome the objections that were raised to them this year.

If I am right, these further changes will include: on the liquidation of a corporation, gain or loss to the stockholders will be based on the difference between the cost of the stock, and the cost of the assets to the liquidation company; deferred compensation contracts will be recognized without need for fancy contractual conditions; the effects of private annuities will be spelled out in detail; the whole treatment of foreign operations, foreign tax credit, and tax rates on foreign income will still undergo a thorough revision.

The new law permits partnerships to be taxed as corporations. A Senate provision to allow corporations to be taxed as partnerships did not survive the conference committee, but I believe the 1955 tax law will return to that subject, and in the process we will again hear of the distinction between publicly and privately held companies—a distinction made in the House bill.

Moreover, while the 1954 law closes many loopholes, I am sure that it also opens a few new ones. By next year some will have been revealed—and Congress will be anxious to eliminate them. Finally, the inevitable mistakes and unintended inequities will have to be corrected.

There is no doubt that the Internal Revenue Code of 1954 justifies the use of adjectives usually found only in Hollywood releases. It is indeed "stupendous," "colossal," and "momumental." Yet the old jingle still stands: "Who'er hopes for a perfect tax to see, hopes for what ne'er was, ne'er is, and ne'er shall be."

How the New Code Will Affect The Individual Taxpayer

By David Zack

RETURNS AND EXEMPTIONS

Heads of Household

Under the old Code, heads of household received tax benefits of approximately half those which a married couple received from income splitting. A taxpayer could not claim head-of-the-household exemption unless the qualified dependent relative actually lived in the household maintained by the taxpayer.

A widow or widower, maintaining a household for a dependent child now receives the full benefits of income splitting for the first two years after the spouse's death (Sec. 2).

A taxpayer otherwise qualified to claim head-of-the-household exemption may do so as long as he maintains a home anywhere for a dependent parent.

Dependency Credits

Under the old Code, a $600 exemption was permitted for a dependent only if the dependent had gross income of less than $600; received more than half his support from one taxpayer; was a specified close relation to that taxpayer; and was a citizen or resident of the United States or contiguous countries.

Income Limit. In the new law (Sec. 151, 152) the $600 gross-income limit does not apply to a taxpayer's child who is under 19, or a full-time student at an educational institution during five months of the year, or a full-time trainee in a course of institutional on-the-farm training under the supervision of an educational institution or state or local government bureau.

Nonqualifying Programs. Correspondence schools, employee-training courses, and similar institutions and programs are not considered educational institutions. Night school does not qualify as full-time attendance.

Scholarships. In applying the support test, the new code excludes any scholarships received by the dependent from an educational institution.

Exemption Claimed by Dependent. A dependent child earning more than $600 must still file his own tax return and pay any tax due, but he may nevertheless claim his own $600 exemption as long as he is not filing a joint return with his spouse. The parent may still get the additional $600 dependency deduction.

These provisions will probably encourage a greater division of family income among children. We may find some situations in which children employed in the family business and earning more than $600 may still receive more than half of their support from their parents.

Group Contributors. Where no single taxpayer contributes more than one half of the support of a dependent, the group of contributors may annually designate one of their members to claim the dependency exemption if all the following criteria are met:

1. No single person must contribute more than one half of the dependent's support, but the group must do so.

2. Each member of the group must have been entitled to the exemption except for the support requirement.

3. The member of the group claiming the dependency exemption must have contributed more than ten per cent to the dependent's support.

4. Each other person in the group who contributed more than ten per cent of the support of the dependent must file a written declaration that he will not claim the exemption for the dependent in the same calendar year.

Relationship Test. The meaning of the word "relative" has been extended to include a dependent irrespective of his relationship if he is a member of the taxpayer's household and if the home of the taxpayer is his principal place of abode.

Dependent cousins can also qualify for the exemption if they are receiving institutional care because of a physical or mental disability and were members of the taxpayer's household prior to being placed in the institution.

Contiguous Countries. For purposes of dependency credits, the Canal Zone, Panama, and, in certain cases, the Philippine Islands are now considered contiguous countries.

CHANGES AFFECTING INCOME

It would serve no useful purpose just to list all details of the new provisions affecting individual taxpayers. But it will be constructive to highlight new tax-saving opportunities and warn practitioners of potential pitfalls in some loophole-closing provisions of the new law.

Dividend Credit

This political hot potato represents the first inroad made by individual taxpayers against the unfair double taxation of corporate dividends. The compromise provision (Sec. 34) allows the double-barreled approach of a dividend exclusion from income plus a dividend credit against the final tax.

Fifty dollars a year of dividend income received in any taxable year ending after July 31, 1954, can be excluded from income. Married couples who are filing a joint return can exclude $100 a year if each spouse has at least $50 of dividend income.

Additional Credits. Although not nearly so favorable as the original House proposals, these provisions will undoubtedly stimulate a great deal of future tax planning.

Credit against the tax of four per cent will be allowed in full on any dividends received above the $50 exclusion after July 31, 1954. The credit is subject to the limitation of two per cent of total taxable income in 1954 and four per cent of taxable income in later years.

Dividends paid by stock, fire, casualty, title, and marine insurance companies also will now get the benefits of these provisions.

New capitalizations will undoubtedly give more favorable treatment to capital stock than heretofore, and the corporate form of doing business may even be encouraged.

Borrowing funds in order to purchase stocks has become advantageous because the interest paid is fully deductible, while the dividend income is entitled to the credit.

Long-term capital gains will lose some attractiveness, especially to the lower-bracket taxpayer, because of the narrowed gap between the tax on dividend income after the credit and the capital-gains tax.

Stock purchases prior to dividend-record-date, with immediate sale after the ex-dividend date will be encouraged to get the dividend credit and a short-term capital loss to offset against other short-term capital gain.

Declaring an ordinary dividend prior to a corporate liquidation may now be desirable if the dividend creates a capital loss on the liquidation of up to $1,000 that can be applied against ordinary income. This ostensibly simple, innocuous provision opens the way to potential tax savings.

Health and Accident Benefits

The new law removes the inequities previously existing between insured and uninsured health and accident plans. Now employees absent from work because of sickness or accidents may exclude wage-continuation benefits up to a weekly rate of $100 (Sec. 105). A seven-day waiting period is provided in the case of absence due to sickness.

However, if during the period of absence due to sickness the employee is hospitalized for at least one day, the exclusion applies even to amounts received during the first seven days.

For example, if an employee is sick for two full weeks, and receives benefits of $75 per week, the $75 for the second week is excluded. If during the absence the employee was hospitalized for at least one day, the full amount of all benefits up to $100 per week would be excluded.

Retirement Income

A new provision includes a special credit for retirement income which, in effect, extends the tax exclusion now granted social security benefits to other forms of retirement income (Sec. 37).

Beneficiaries. Individuals 65 years or over, and younger persons receiving pension-type payments from public retirement systems, are granted a credit against total tax liability equivalent to the tax at the first income-tax-bracket rate (currently 20 per cent) on the amount of retirement income up to $1,200. Each spouse may qualify for the credit, so there might be a maximum tax saving of $480 on a joint return.

Credited Income. Retirement income includes annuities, pensions, interest rents, and dividends. In order to avoid double tax benefits, the retirement income on which the exclusion is based is reduced by tax-exempt income such as social security benefits, railroad retirement pay and veterans' pensions.

Noncredited items—those not constituting income, such as a return of capital, tax-free proceeds of annuities or insurance and workmen's compensation or disability insurance—will not reduce the base for the retirement-income credit.

Eligibility. Retirement-income credit is intended solely for the benefit of persons retired from gainful employment. A qualifying taxpayer must have earned at least $600 a year in each of any ten years prior to the taxable year. Each spouse must qualify separately, but a surviving spouse qualifies whose deceased spouse would have been eligible.

Persons under 75 years of age may earn up to $900 a year without affecting their credit. Earnings above $900 reduce the $1,200 exclusion base, so $2,100 in earned income would eliminate the retirement credit. As in the case of social security, this limitation does not apply to individuals of 75 years or over.

A married couple without dependents, each of whom qualifies and possesses retirement income, may receive as much as $5,333 tax free.

The incentive to earn more than $900 a year is thus materially reduced for qualified retirees between the ages of 65 and 75. It is obviously worthwhile to advise older clients to arrange their affairs so as to qualify for the maximum benefits under this section.

Nonqualified Taxpayers. Retirement-income credit is not available to nonresident aliens or taxpayers using the short form where the tax is computed by the Secretary or his delegate.

Annuity Rule.

Under the old Code an annuitant paid tax annually on three per cent of the cost of his annuity until the total exempt payments above that three per cent equalled his cost. After recovery of his cost basis, the entire annuity payments were taxable. In most cases annuitants could not recover cost taxfree unless they survived their life expectancy.

Lifetime Cost Recovery. The new Code (Sec. 72) permits the annuitant to recover his costs evenly over his lifetime. The annual exclusion is computed by dividing the annuitant's cost by his life expectancy at the time the annuity payments commence. It remains static, notwithstanding the annuitant's actual life.

The actuarial data on which the exclusion is computed will be supplied by regulations and the insurance companies and thereafter the taxpayer can count on a given amount of taxfree income for the balance of his life.

An annuitant who lives beyond his life expectancy recovers, taxfree, more than the cost of his annuity.

If the annuity contract is sold after an excess above cost has been recovered taxfree, the seller pays tax on only the proceeds of the sale.

The life expectancies of taxpayers currently receiving annuities are determined as of January 1, 1954. For these taxpayers the cost basis, which is permitted to be recovered taxfree over their life expectancy, is reduced by any amount that already has been excluded from income under the old three-per-cent rule.

Proceeds of an insurance, endowment, or annuity contract paid by reason other than the death of the insured are also granted special treatment in the new law. The tax on lump-sum payments of this type cannot exceed the tax that would have been due if one third of the proceeds had been received in the current year and one third in each of the two preceding years. In effect, this provision provides for a three-year spreadback of income in accordance with the principles of the old Section 107.

Conversion of Proceeds. An important aid to tax planning permits a taxpayer to convert the lump-sum proceeds of an endowment contract into an annuity within 60 days of the maturity of the contract. These proceeds will be taxed under the new annuity rule whereby the beneficiary can be sure of a given amount of taxfree income for the rest of his life.

Coupled with the retirement-income credit previously discussed, this provision may exempt as much as $1,200 of income per taxpayer each year, permitting many elderly people to plan their economic security for the balance of their lives.

Detailed technical provisions abound in this section of the law, going beyond the scope of this discussion. For example, there are special provisions for joint and survivor annuities, refund annuities, certain employee annuities financed in part with employer contributions, installment payments on endowment contracts, and definitions of actuarial terms.

The election of settlement options on the surrender or maturity of life and endowment contracts becomes extremely important in light of these new rules regarding annuity and insurance payments.

A taxpayer faced with the choice of such options will do well to consult with his tax adviser before making a choice. The adviser, in turn, should make a detailed study of each specific contract in the light of the new law in order to make an intelligent decision.

Death Benefits

Life insurance proceeds payable by reason of death were generally exempt from income tax under the 1939 Code. However, where the insurance contract was transferred for a valuable consideration, only the actual value of the consideration, and the subsequent premiums paid were tax exempt. The balance was taxable as ordinary income. This rule did not apply where the transferee of the insurance policy had a basis determined by reference to the basis of the contract in the hands of the transferor.

The old law exempted the first $5,000 of death benefits received pursuant to a contract by an employee's estate or beneficiary from *each* employer to the extent the employee did not have a nonforfeitable right to payment before death.

The old Code excluded the proceeds of life insurance paid by reason of death, even though such proceeds were paid in installments and included interest earned after the death of the insured.

Extended Exclusions. The exclusion of life insurance proceeds payable as a result of death has been extended to contracts transferred to the insured, or a partner of the insured, or a partnership including the insured, or a corporation of which the insured was a shareholder or officer. This section will prove to be valuable for the planning of estate taxes.

The $5,000 exclusion is restricted to one for each employee, regardless of how many employers he had.

Payments need not be made pursuant to any contractual obligation. A voluntary payment qualifies for the exclusion.

Lump-sum distributions are eligible for the exclusion where they are payable by reason of death under a qualified employees profit-sharing, stock-bonus, or qualified pension plan, even though the employee had a nonforfeitable right to the amounts while living.

Interest on life insurance proceeds held by the insuror will now be includable in gross income. If the proceeds are received as an annuity (election may be made within 60 days after death) the annuity rules will prevail. If the proceeds are held by the insuror under an agreement to pay interest or to pay installments which include an interest element, gross income will result. The gross income will equal the amount received each year minus an annual "exclusion factor" based upon the amount held by the insuror.

A "*widow's exclusion*" of $1,000 per year is allowed to a surviving spouse.

Employment agreements or other contracts written under the old law to provide for the $5,000 employee benefit from one or more employers should be reviewed. Since the total exclusion is limited to $5,000, some old contracts, especially in multicorporate setups, may result in unnecessary pyramiding of income in the return of the estate. Consideration must be given to estate-tax implications as well as income-tax consequences.

Income from Long-Term Services

The old Code's provision on compensation for "personal services" gave rise to many problems when a taxpayer received in one year compensation earned over 36 months or more.

Employment. Under the new law (Sec. 1301, 1302) the term "an employment" is substituted for the phrase "compensation for personal services." The new term is intended to encompass a particular project on which the taxpayer has worked, such as a specific law case, but not a set of unrelated services the taxpayer may have performed for the same person.

This will preclude a separation of services relating to a particular project merely because the taxpayer may have received compensation for such services from different sources or at different times. Taxpayers will probably experience greater difficulty in qualifying under this revised provision.

Partnership Income. The new Code has made some modifications in the 36-months rule.

Qualification for back allocations. A partner cannot get full benefit of the back allocation of partnership income unless he was a member of the firm continuously during the period during which the services were rendered by the partnership. However, if the services were rendered over a period extending more than 36 months preceding the receipt or accrual of the income, the partner can still qualify if he was a member of the firm continuously during the 36 months.

Spreadback. If the partner was a member of the partnership during the entire period the services were rendered, he can spread back his share of such income of the partnership over that period. If he was not a member of the firm during that entire span, he can spread back his share of the income only if he qualifies under the 36-months rule—in which event he can spread his income back only over the 36 months.

All allocable income is now treated as belonging to the person who has to report it on a separate return when received or accrued. Therefore, income splitting applies only if income splitting was permitted in the year of the spreadback and a joint return was filed in that year.

Income from an invention can now be spread back as much as 60 months instead of the present 36 months, and the required work period has been shortened to 24 months.

CHANGES AFFECTING DEDUCTIONS

Expenses of Outside Salesmen

Old-law provisions have been modified with regard to deductible business-transportation expenses and the use of the standard deduction by outside salesmen.

Business-Transportation Expenses. Employees are permitted to deduct all business-transportation expenses for adjusted gross income purposes and still use the standard deduction (Sec. 62). Only expenses that are incurred for actual travel may be deducted.

Outside salesmen who solicit business full time away from the employer's place of business will be permitted to deduct business expenses in arriving at the adjusted gross income. These include split commissions and similar items.

Separate-Maintenance Payments

Alimony and separate-maintenance payments formerly were deductible by the husband and taxable to the wife only if they were imposed pursuant to a court decree or a written agreement incident to the court decree.

The same tax treatment is now accorded (Sec. 71) to payments under a written separation agreement executed after enactment of the new law when the husband and wife are living apart and have not filed a joint return.

A court decree is unnecessary for tax purposes if the payments are made pursuant to the terms of a written agreement or because of the marital or family relationship.

Periodic payments to a wife under a court decree for support are treated in the same way as alimony payments, provided they are under a decree entered after March 1, 1954. Some states have not considered such support payments to constitute alimony or separate-maintenance payments.

Theft and Embezzlement Losses

The old regulations provided that a loss from theft or embezzlement was ordinarily deductible for the year in which sustained. There has been considerable uncertainty and litigation about the application of this rule, and in some cases the loss has been held deductible in the year it was discovered.

The Year of Discovery. The new Code (Sec. 165) provides that the loss from theft or embezzlement will always be deductible only in the year in which the taxpayer discovers the loss.

If the loss is deducted under the new Code, no deduction under the 1939 Code for the same loss for a prior year is allowed. Let's hope that taxpayers can still use the deduction after discovery of the loss!

Charitable Contributions

The permissible maximum amount allowable as a deduction for charitable contributions by individuals is increased under the new Code (Sec. 170) from 20 to 30 per cent of adjusted gross income, provided that at least ten per cent of the gifts and contributions are made to churches, educational organizations, and hospitals. Gifts to non-profit-making cemeteries or burial companies will be permitted as charitable contributions.

No limit on charitable contributions is imposed when the combination of the taxpayer's contributions and income taxes in the current year and eight of the preceding ten years equals 90 per cent or more of his taxable income.

The net operating loss carry-back, under the old Code, could cause a loss or reduction of a charitable deduction in the prior year because of the consequent reduction in the adjusted gross income of the earlier year.

Under the new Code, the carry-back shall no longer be taken into consideration in computing adjusted gross income for the purpose of applying both the 20 per cent and the new additional 10 per cent limitation on contributions. Nor shall it be considered for the purpose of applying the 90 per cent rule of unlimited deduction for individuals specified above.

Transfers to charitable trusts will not be deductible where the grantor retains a reversionary interest of more than five per cent of the value of the property. No carry-over of excess contributions is permitted to individual taxpayers. (However, a two-year carry-over is now provided for corporations.)

Amortized Bond Premiums

The old Code permitted premiums paid on bonds to be amortized over the period between the purchase date and the redemption date or the earliest call date specified in the debenture—even if the call date was in the very near future. This permitted an almost immediate deduction for substantial bond premiums.

Three-Year Rule. The premium on callable bonds may now be amortized to the nearest call date only if that date is more than three years from the issue date (Sec. 171). If the call date is earlier, the premium has to be charged off over the period between the date of the purchase and the date of maturity. If the bonds are actually called prior to the maturity date, the deduction of the unamortized premium can be taken in that year. These rules do not apply to tax-exempt bonds or bonds issued before January 22, 1951, and acquired before January 22, 1954.

The loophole, of course, simply has been transferred from bonds callable on short notice to bonds callable three years and a day after original issue. An immediate tax windfall has been converted into a tool of longer-range tax planning.

Expenses for Production of Income

The old Code allowed an individual to deduct expenses connected with earning income or managing and maintaining income-producing property. The regulations, and some court cases, refused to allow deduction of the cost of contesting gift-tax liability.

A deduction for expenses incurred with the determination, collection, or refund of any tax liability is allowed in Section 212. This provision may encourage litigation of many nuisance-tax assessments.

Medical Expenses

Reduced Limitations. The limitation on nondeductible medical expenses for a taxpayer under 65 years of age has been reduced to three per cent of adjusted gross income (Sec. 213).

The maximum medical deduction has been raised to $2,500 per exemption, with an over-all $5,000 limit per separate return; and $10,000 on a joint return (or of a head of a household or surviving spouse). The three per cent of gross income limit does not apply where a taxpayer is 65 or over, but the separate limitation of one per cent of adjusted gross income for medicines does. This limit applies to all taxpayers in determining the total medical expense before the three per cent elimination.

Tax Implications. It should be noted that, although the carry-back of a net operating loss is disregarded in computing the charitable-contributions limitation, it still reduces adjusted gross income for computing the three-per-cent limitation on the medical-expense deduction and the one-per-cent limitation on medicines and drugs.

The change in the effect of the net operating loss carry-back therefore gives the taxpaper an advantage on both contributions and medical expenses.

Expenses of the last illness may be deducted on the final return of a decedent—even if paid after death—if the expense is actually paid by the decedent's estate within one year after death and if the item is not claimed as an estate-tax deduction.

Traveling expenses prescribed by a physician may qualify as a medical expense only to the extent of actual transportation costs. Meals and lodging while away from home cannot be included.

Child-Care Expenses

A new provision (Sec. 214) grants a maximum deduction of $600 to any working woman or working widower for expenses paid for the care of children under 12 years of age, or for the care of any dependent who is mentally or physically incapable of caring for himself. This special deduction is allowed in addition to the $600 dependency deduction.

A working wife may claim the child-care deduction only if she files a joint return with her husband and if the deduction is decreased by the amount by which the combined adjusted gross income of the spouses exceeds $4,500. No deduction will be allowed when the combined family adjusted gross income is $5,100 or more.

A divorced or separated mother may claim the child-care deduction even though the father supports the child and claims the $600 dependency deduction.

Payments to a relative for caring for the child qualify as long as the taxpayer is not permitted the dependency deduction for the relative.

Real Estate Taxes

Where real estate was sold, the property taxes for the year of sale were allowed either to the buyer or the seller, depending on the date liability accrued. This tax treatment in the prior law was not at all consistent with the usual practice of apprortioning such taxes.

The new law (Sec. 164) now permits both the buyer and the seller to deduct a portion of the taxes for the year of sales, based upon the time the property was held during the "property tax year." Corresponding changes have been made in the definitions of proceeds from such sales and in the rules for basis determination.

Single-Premium Annuity Loans

In the 1939 Code there was no provision denying interest deduction for indebtedness incurred to purchase single-premium annuity contracts. Nor did it cover a situation where a purchaser, borrowing approximately the single-premium cost of a life or endowment policy, did not purchase it but deposited the borrowed funds with the insurer for future premiums.

Interest Deduction Denied. Effective March 1, 1954, the new Code (Sec. 264) denies the interest deduction on indebtedness incurred to purchase deferred annuity as well as single-premium life insurance or endowment contracts.

If an amount is deposited with an insurer for the payment of a substantial number of future premiums on a policy, the contract will be treated as a single-premium contract, and no interest deduction will be allowed on the indebtedness incurred or continued in order to purchase or carry such a contract. The word "substantial" is not defined.

Carrying Charges as Interest

Under prior law it was impossible to deduct interest on installment purchases even though a carrying charge in the nature of interest was paid.

The new Code (Sec. 163) remedies this by providing that, where "carrying charges" are separately stated but "interest" cannot be ascertained, an amount equal to six per cent of the average unpaid balance will be treated as interest and be allowed as a deduction. The average balance will be computed by averaging the balances outstanding on the first of each month during the year. In no case may the amount treated as interest exceed the aggregate carrying charge.

Business Expenses and Deductions For Corporations and Individuals

By Charles N. Whitehead

SCOPE OF ARTICLE

It should be recognized that, while the new Code introduces many changes of extreme importance to corporations and individuals, some of its provisions are minor in character. For example, the new provision permitting an out-of-town allowance for police officials of any state or the District of Columbia is doubtless important to the people affected, but it does not fall within the scope of this article.

MAJOR PROVISIONS

Business Expenses

One minor change (Sec. 162) provides that, if an item is properly deductible as a contribution by an individual, it will not be allowable as a trade or business expense. In other words, the old rule for corporations has been extended to include individuals.

Deductible Taxes

The general provisions relating to deductible taxes (Sec. 164) are much the same as in the old Code, but the new law introduces certain different concepts.

Allocation of Taxes. The principal change relates to the allocation of taxes paid between a buyer and a seller of property. Under the old Code, taxes that were a lien were not deductible to a purchaser, but were considered capital items, so that they became a part of the purchase price. The new Code provides for the allocation of taxes on real property between sellers and purchasers whether on the cash or accrual basis.

One corollary to the application of these rules is that, if a taxpayer sells his property, the tax deduction claimed in a prior year in excess of his pro rata share must be reported as income in the year of sale.

Losses

Embezzlement and theft loss deductions are now (Sec. 165) definitely limited to the year of discovery—thus eliminating uncertainties possible under Section 23 of the old Code.

Affiliated Corporations. Some minor changes have been made regarding the deductibility of losses on worthless securities of an affiliated corporation. The qualifications for affiliation in the old Code provided that over 90 per cent of the aggregate of gross income for all taxable years was required to be from sources other than, in effect, personal holding company income. The new provision substitutes a test of gross receipts for gross income, eliminating the possibility of an affiliated corporation sustaining losses that would preclude any gross income within the meaning of the Code.

Both Committee reports specify that no change has been made in the rule of the *Hunter Manufacturing Company* (21 TC 52). That case held that what would have been a capital loss on worthless securities of an affiliate could not be converted into an ordinary loss merely by purchasing additional stock to qualify the stockholdings at the 95 per cent figure where the stock was worthless at the time of purchase.

Bad Debts

Nonbusiness Bad Debt Losses. Debts created or acquired in a trade or business are now (Sec. 166) to be treated as business bad debts when determined worthless, even though the taxpayer is no longer in the business that gave rise to the debt. This is a direct change from the provision in Section 23 of the old Code.

Guaranty or indemnity losses sustained by a taxpayer are no longer considered nonbusiness bad debts if; (*1*) the proceeds of the loan have been used by the borrower in his trade or business, and (*2*) the debt of the borrower was worthless to the person to whom the guarantor or endorser made the payment.

Depreciation

Extended Use of Varying Methods. Section 167 provides for the use of the straight line method, declining balance method, the sum of the years' digits method, and any other consistent method that will produce an annual allowance in which the deductions during the first two-thirds of the useful life of the property do not exceed the allowance under depreciation computed according to the declining balance method.

Rate Permitted. In former years the declining balance method of depreciation was a recognized one, but it was so limited that the rate could not exceed 150 per cent of the straight-line method. The new law permits a rate equal to 200 per cent of the straight-line method. The sum of the years' digits method has been given official approval and is likely to be widely used due to its simplicity and the high deductions obtained in the early years.

Limitations. It should be noted that the Code imposes certain limitations on the use of the declining balance and the sum of the years' digits methods.

1. The life of the asset must be at least three years.

2. The asset must be a new one, that is, an asset whose original use commences with the taxpayer.

3. The asset must have been acquired after December 31, 1953. In the event that an asset was in the process of manufacture or construction at the close of 1953, but completed and first used subsequent to December 31, 1953, the new methods will be permitted only for the portion constructed after December 31, 1953.

Right of change. The taxpayer has a right, in most cases, to change to the straight-line method of depreciation from the declining balance method at any time, so long as an agreement has not been made between the taxpayer and the Treasury. Limitations, if any, on this right of change will be set by regulations.

Treasury-Taxpayer Agreements. A new provision permits the Treasury and taxpayer to enter into an agreement specifically setting forth the useful life and depreciation rates of any property owned by the taxpayer. This rate will be binding unless facts not considered at the time of adoption compel a change. To change the agreed rates, written notification must be made, and such change that is made is effective beginning with the year in which notice is given.

Deductible Contributions

Under Section 170 of the new Code, the old 20 per cent of adjusted gross income limit on deductions for contributions by individuals has been modified to permit an additional 10 per cent for contributions made to specified types of organizations (churches, educational institutions, and hospitals). The new 30 per cent rule operates so as to permit contributions to these qualified organizations to utilize an additional 10 per cent after any qualified contributions have used up the first 20 per cent.

The limitation for corporations remains five per cent. However, the new law permits corporations to carry over to the two succeeding tax years contributions in excess of the five per cent limitation. Contributions of the current year must be deducted before the ones carried over.

Effect of Loss Carry-Backs. A net operating loss carry-back, under the new Code, will not affect the percentage limitations on either corporate or noncorporate taxpayers. The five per cent limitation on contributions deductible by corporations is now computed on taxable income without regard to contributions, special deductions for dividends, partially tax-exempt interest, special deductions for Western Hemisphere trading corporations, and the deduction allowed for net operating loss carry-backs.

Amortizable Bond Premiums

The major change in the treatment of amortization of bond premiums (Sec. 171) relates to the rule that bond premiums can be amortized to the earliest call date. The "earliest call date" recognized must now be more than three years from the date of original issue of the securities. If such call date is within three years, any premium must be amortized to maturity. This change should have the effect of limiting but not preventing tax avoidance, formerly rather widespread, which arose from the purchase of bonds at a substantial premium, with a fairly long life, but short call date.

The provision applies only to completely taxable bonds issued after January 22, 1951, and acquired by the taxpayer after January 22, 1954, and is, therefore, not retroactive.

Unamortized Premiums. In the event that bonds with a call date of three years or less are actually called prior to maturity and the bonds are subject to the limitations of the new Code, the loss on unamortized premiums will be treated as an ordinary loss rather than a capital loss.

Substantial justice would appear to have been done by this new rule.

Net Operating Loss Deductions

Section 172 of the new Code makes certain major and important changes in the computation of net operating loss deductions.

Carry-Back Extension. Probably the most important change in the net operating loss deduction is the opportunity to carry back two years and forward five, as compared with the old limitations of one year back and five forward. In the case of corporations, the revised carry-back provisions apply to income tax only and do not affect the excess-profits tax. In the case of fiscal-year taxpayers, only that portion of the loss for the fiscal year 1954 allocable to the number of days after December 31, 1953 may be carried back two years.

Computation. Under the new Code, tax-exempt interest and the excess of percentage depletion are no longer added back in computing the net operating loss deduction. Also, in the case of corporations, the dividends-received deduction is no longer, in effect, eliminated. This should be of material help to a taxpayer who has sustained net operating losses.

A technical change has also been made; not only are adjustments for tax-exempt interest, depletion, etc. no longer required, but no adjustment is made to the carry-over itself in determining the income for 1954 and later years to which net operating loss is carried back or forward. If a loss is carried back to 1952 or 1953, the adjustments to such loss are to be made as under the old Code.

Individual net operating losses have now been clarified regarding losses from the sale of a business or assets used in a business. Such losses are now definitely permitted as a part of a net operating loss deduction.

Research Expenditures

Section 174 of the new Code is an entirely new provision. It eliminates the confusion and adopts the established policy of the Revenue Service of permitting current deductions for research and development expenditures.

Elective Amortization. The new provisions give a taxpayer an election to expense or capitalize for subsequent amortization research and development expenditures. In order to expense such expenditures, a taxpayer must make his election in the first taxable year beginning after December 31, 1953, in which such expenditures are incurred or do so with consent in subsequent years. An election once made must be adhered to in subsequent years, unless the Secretary consents to a change in method.

The amortization of capitalized costs is subject to special provisions in the new Code. An election to amortize such capitalized expenditures may be made without consent in the return for any taxable year. If property capitalized has a determinable useful life, then that period should be used as the amortization period. If property capitalized has no determinable useful life, then the expenditure can be amortized over a period of not less than sixty months. It should be noted that land and depletable or depreciable property are not subject to the amortization or expense provisions in this section, but must be treated under either the depletion or depreciation sections.

Conservation Expenditures

Section 175 is a new addition to the Code, relating to deductibility of certain expenditures for farmers. It includes soil and water conservation, and general earth-moving projects such as land leveling, grading, construction of ditches, earthen dams and similar items. Under the old Code these items had to be capitalized by farmers.

Adoption of New Method. The taxpayer may adopt this method without consent for the first year of such expenditures beginning after December 31, 1953, and may adopt it later at any time with the consent of the Secretary. Once adopted, this method must continue until permission is granted to change.

The provision allows farmers to deduct all such expenditures subject only to the limitation that the total amount in any one year does not exceed 25 per cent of the gross income derived from farming during that year. If such expenditures exceed this limitation, the excess may be carried forward and deducted in subsequent taxable years. In determining the deductible amount of the carry-over, the year's conservation expenses should be figured first, after which a sufficient part of the carry-over can be used to fulfill the 25 per cent maximum allowed.

Deductibility of Carry-Over. A question may arise in a situation in which the farmer has a carry-over and then sells his property. After the sale, he may have no gross income from farming the property and therefore would not be entitled to deduct the carry-over. A clarifying provision was contained in the House bill, but eliminated by the Senate, so that the deductible status of the carry-over remains uncertain.

Expenses of Income Production

Provisions in the new Code (Sec. 212) remain substantially the same as in the old Code. One further allowance has been provided, however—a deduction for the expense of contesting any determination of a tax liability. This includes gift-tax litigation costs, which were nondeductible under the old Code.

Special Corporation Deductions

The adjustments for partially tax-exempt interest and dividends received are now deductions (Sec. 242, 243). Under the old Code these items were treated as credits. However, the deduction for partially tax-exempt interest is not allowed in computing the surtax. There is no change in the computations of the amounts of such items, but the conversion from credit to deduction requires adjustments in computations of items which are affected by amounts of net income; *e.g.*, contributions and net operating loss deductions.

Organization Expenses. Under the new Code (Sec. 248), a corporation may elect to amortize organization expenses over not less than sixty months beginning with the first month of business. The deduction applies only to expenses paid or incurred after the date of enactment and must be made in the return filed for the first year in which they occur. (Previously, such expenses were capital items, deductible only at liquidation.) Organization expenses are defined, and limited to the expenses of forming a corporation. This deduction constitutes a definite advance in that it permits the amortization of items which, in the past, were frequently written off for accounting purposes, but could not be amortized for tax purposes.

Items Not Deductible

Much of the new Code concerned with nondeductible items remains substantially the same as the old Code. However, some changes have been made.

Intangible drilling and development costs of oil and gas wells will be covered by a completely new set of regulations to be issued under the directive of Section 263. Until then, it is not clear whether a new election with respect to such items will be required for 1954. But for the first time the Code provides a statutory basis for the election to expense such costs.

Interest paid or accrued on indebtedness incurred to purchase single-premium annuity contracts will now be disallowed (Sec. 264). Also, where an amount is deposited to cover a substantial number of premiums on a life indurance, endowment, or annuity policy, interest will be disallowed.

Sales to Related Parties. The new law (Sec. 267) increases the classes of related taxpayers for loss-disallowance purposes. New additions to the group are: (*1*) a fiduciary dealing with the beneficiary of any other trust created by the same grantor; (*2*) a fiduciary dealing with a corporation controlled by the grantor or the trust; and (*3*) an exempt organization controlled by a person or his family. In cases where losses are disallowed on sales between related taxpayers, the new Code provides for the use of a seller's basis where a later sale to an unrelated taxpayer results in gain to the purchasing taxpayer, except that no loss can be taken by using the seller's basis. The basis for depreciation and similar types of deductions, however, is not affected by the new provisions.

Acquisition to Avoid Taxes. Section 269 of the new Code is substantially similar to the old Code in providing that deductions or credits arising from corporate acquisitions may be disallowed when the principal purpose is avoidance or evasion of taxes. The new Code's tightened rules provide that, when the amount paid to acquire corporate property or control of a corporation is substantially disproportionate to the sum of the tax benefits not otherwise available and the adjusted basis of the property acquired, additional proof is necessary to show that the acquisition is not within the scope of this section. The above factors are now considered prima facie evidence. Obviously, the purpose of this change is to make the old provisions more effective.

Hobby Loss Limitations. The new law provides (Sec. 270) a number of liberalizing changes. An individual who sustains in a business a loss of more than $50,000 for each of five consecutive years was considered to have a "hobby" and lost the deduction of annual losses in excess of $50,000.

In computing the annual loss, taxes and interest were not considered under the old Code. The new law adds a number of new types of deduction that can be eliminated in the computation of the loss. Casualty and abandonment losses in business, losses and expenses of farming that are attributable to the job, loss carry-overs and carry-backs, and expenditures for which taxpayers are given an option to expense or capitalize, are now eliminated from loss computation, subject to limitations. This rule applies to such items as intangible drilling and land conservation costs. The changes in this section are applicable to any period of five consecutive years, of which at least one begins after December 31, 1953.

Natural Resources

The new Code has combined the tax treatment of natural resources into one complete subchapter including exploration and development costs. (Subch. 1).

Rates of percentage depletion on a number of strategic metals have been moved to the 23 per cent rate, and other mineral rates are adjusted materially. In addition, certain new types of minerals are added to the percentage depletion category.

Terms used in connection with the computation of percentage depletion have been clarified. The term "the property" has been given a statutory definition, and the term "gross income from the property" has been more clearly defined.

Aggregation of mineral interests is now permitted under the new Code, if such a move is desired by the owners of the interest. An election is required in the return for 1954 or the first year of expenditures after the acquisition of the property.

Mine Tailings. Percentage depletion is allowed with respect to mine tailings when the recovery is made by the owner of the property or a successor in interest, but percentage depletion is not allowed to a purchaser of such tailings.

Exploration expenses. The new law continues the provisions of the old Code, except that the annual limit on deductible exploration expenses is now $100,000 instead of $75,000.

Capital Gain on Timber. The election to report as capital gain the gain on timber cutting is continued with a number of adjustments in the new Code. A new provision holds that the date of disposal of timber is the date the timber is cut, unless the timber is paid for prior to cutting. If timber is paid for prior to cutting, the taxpayer may elect the date of receipt of payment, or the actual cutting date as the disposal date. This provision, in effect, eliminates the *Springfield Plywood Company* case rule.

Timber and Coal. When these items are sold, the term "current owner" now includes both the original owner and sublessors. In the event that the seller elects a capital-gains treatment on coal, no percentage depletion is allowable.

Determining Basis, Gain or Loss; Capital Gains and Losses

By Gerhard Mayer

GAIN OR LOSS

General Rule

Section 1001 restates the rule that gains and losses generally equal the difference between proceeds and adjusted basis. A new provision, made necessary by the apportionment of real estate taxes between seller and purchaser under Section 164(d), allows an adjustment of proceeds for taxes paid by the seller and treated as if imposed on the purchaser or *vice versa.*

Two rules are established:

1. If the property is sold during the year, but after the taxes are paid by the seller, and he is reimbursed by the purchaser for the portion applicable to the period after the sale, under the old Code the amount thus added to the contract price was part of the proceeds, and the seller had a deduction for the entire tax. Under the new Code, that amount is merely an apportionment of taxes (a decrease of the seller's deduction for taxes, and a deduction to the purchaser). Consequently, it is no longer a part of the proceeds.

2. If the property is sold during the year, but before the taxes are due, and they are paid by the purchaser, and the purchaser is reimbursed by the seller for the portion applicable to the period before the sale, under prior law the amount thus deducted from the contract price was a diminution of proceeds, and the purchaser had a deduction for the entire tax. Under the 1954 Code, that amount is merely an apportionment of taxes (a decrease in the purchaser's deduction for taxes, and a deduction to the seller). Consequently, it is no longer a decrease in proceeds.

The operation of these rules may be illustrated by the following example:

A, an individual on the cash basis, sells in 1954 real estate to B, also an individual on the cash basis. The contract price is $24,000. Under local law, real estate taxes for the calendar year accrue on April 2, and are payable on August 1. Such taxes for 1954 are $730.

Suppose the closing takes place on April 1, so that Rule 1 applies. A must reimburse B for 90/365 of the taxes, or $180, which is deducted from the contract price, so that A (disregarding other possible adjustments) receives from B $23,820. In computing gain or loss on the transaction, A is deemed to have received $24,000 (Sec. 1001). A is allowed a deduction of $180 with respect to such taxes, although he actually paid no part of them (Sec. 164). B is allowed a deduction of only $540, although he actually paid all of such taxes (Sec. 164).

Suppose the closing takes place on October 1, so that Rule 2 applies. B must reimburse A for 92/365 of the taxes, or $184, which is added to the contract price, so that A (again disregarding other possible adjustments) receives from B $24,184. In computing gain or loss on the transaction, A is deemed to have received only $24,000 (Sec. 1001). A is allowed a deduction of only $546 with respect to such taxes, although he actually paid all of them (Sec. 164); B is allowed a deduction of $184, although he actually paid no part of such taxes (Sec. 164).

BASIS

General Rule

Section 1012 provides that, unless a specific exception applies, the basis of property is its cost to the taxpayer. The cost of real property does not include taxes the purchaser of real estate may deduct because they are considered imposed upon him—even if such taxes are paid by the vendor. Thus, in the foregoing example, where the property was sold on October 1, B may not add to his basis the $184, representing the portion of taxes for the portion of the tax year after September 30, for which he reimbursed A.

Property Acquired from a Decedent

Section 1014 continues the old provision for a date-of-death (or optional-valuation-date) value and extends the rule to all property includible in the gross estate of the decedent. For instance, property transferred in contemplation of death, or property passing to the survivor of joint tenants or of tenants by the entirety, is includible for estate-tax purposes in the gross estate at market value, but does not technically pass as inheritance.

Under the old Code, although the date-of-death value (or the optional-date value) was the amount upon which the estate tax was paid, the donee or survivor would pick up only the basis to the decedent.

Restrictions. This extension applies only to decedents dying after 1953 and does not apply in certain situations, such as joint and survivor annuities, shares in a foreign personal holding company, certain community property, rights to receive an item of income in respect of a decedent, and unexercised restricted stock options.

The extension is also restricted to property not disposed of by the transferee before the decedent's death, and requires the estate tax value to be reduced by depreciation and similar deductions allowed the taxpayer before the death of the decedent. The expression "allowed to the taxpayer" may prove the source of substantial trouble, especially in the case of property transferred in trust in contemplation of death.

Adjustments to Basis

Section 1016 enumerates certain specific adjustments to be made to the unadjusted basis, and makes several changes in the old provisions.

When none of the several methods available for computing depreciation under Section 167 have been adopted, the amount of depreciation allowable for basis adjustments shall be computed under the straight-line method.

The Finance Committee's report suggests that the use of any one of the methods provided for in Section 167 for any one year will be considered as the adoption of that method for all other years, regardless of the fact that the taxpayer may have omitted taking a deduction for other years.

This section also provides that basis shall be adjusted for exhaustion sustained while the property was held by a person or organization not subject to federal income tax. The provision is broad enough to include not only holdings by tax-exempt organizations, but also by a nonresident alient who becomes a resident or by a nonresident foreign corporation from which the property is acquired with a substituted basis.

Another basis adjustment, similar to that for depreciation, is required for deferred research and experimental expenses amortized under Section 174(b).

Disallowed Expenses. A new adjustment to basis must be made for deductions disallowed in connection with the disposal of coal entitled to capital-gain treatment. Such disallowed expenses are treated as part of the cost deductible from the proceeds of the coal removed. They are thus recovered in a manner similar to the depletion basis. This rule is patterned after the adjustment with respect to deductions disallowed as expenses applicable to the sale of land with unharvested crops, which are added to the basis. In connection with the disposal of coal, if the expenses, plus depletion, are covered by the proceeds, they apply as reduction of gain. If they are not so covered, the excess of expenses over proceeds is deductible as loss. If there are no proceeds, the expenses are deductible as such. In any case, the expenses are allowed.

Discharge of Indebtedness

Section 1017 requires a decrease of basis with respect to excluded income from discharge of indebtedness. It does not expressly state whether exclusion of such items from income under rules other than the express provision of Section 108, such as by virtue of the so-called insolvency rule, requires a basis adjustment.

Basis of Annuity Contract

Section 1021, which has no counterpart in the old Code, is needed as a result of the novel treatment of income from annuity contracts, under which taxfree recovery may exceed cost. Section 1021 makes it clear that this longevity gain does not result in a "negative basis."

Receipt of Property for Stock

Section 1032 provides that no gain or loss shall be recognized to a corporation as a result of an exchange of its own stock for money or other property, even if such stock is treasury stock. Since 1934, the regulations have contained a similar rule for the original issuance but, in the case of disposition of treasury stock, the result depended on whether the corporation was dealing in its own shares as in the shares of another corporation. Instead of this rather indefinite criterion, the new Code establishes a clear-cut rule. However, transactions consummated before the effective date of this provision must be dealt with under prior law.

It would appear that the issuance of stock (including treasury stock) in discharge of a corporate liability would come under the benefits of this section. For instance, if Corporation X owes Corporation Y $1,000 and, in full discharge of that liability, transfers to Y treasury stock of X with a cost of $100 and a fair market value at the time of $500, the $400 excess of fair market value over cost of the treasury stock does not represent recognized gain. Whether the $500 differential between principal amount of indebtedness and the fair market value of the property used in its satisfaction represents an item of income, is less certain. The language of Section 1032(a) seems broad enough to cover that item too. Yet, this element is certainly not within its purview, and it could be argued that this differential is not attributable to the exchange proper.

Involuntary Conversions

Section 1033 provides for nonrecognition of gain realized upon involuntary conversion. Three changes are worth noting:

1. The tax effects of an involuntary conversion of a residence are now covered within the framework of the provisions relating to involuntary conversions. Under the old Code this situation was treated under the rules relating to gain from sale or exchange of a residence. Although this change merely shifts the location of the rule, it has the effect that the replacement period becomes flexible rather than the rigid 12 or 18 months under Section 1034.

2. Sales under limitation orders of the Federal Reclamation Laws will be treated as involuntary conversions.

3. Involuntary conversion treatment is provided for livestock destroyed by or on account of disease. In view of difficulties that are likely to be connected with replacement of livestock, it is hoped that future regulations will provide for liberal treatment of the replacement period, the accounting method, and other circumstances attending a replacement.

Sale or Exchange of a Residence

Section 1034 provides for nonrecognition of gain realized upon sale or exchange of a residence. Two changes are worth noting.

1. Expenses for repairs on an old residence made to assist in its sale are deductible from the selling price. The work must have been performed within 90 days preceding the contract of sale *and* paid within 30 days after the date of the sale. To be deductible, the expenses must be for work performed for the purpose of facilitating the sale. If the work was performed for any other reason (such as the personal gratification of the seller), the expenses are not deductible, regardless of when incurred or paid or whether they in fact facilitated the sale.

If, in the contract to sell, the seller undertakes the obligation to perform certain work, the expenses incurred in connection with that obligation would seem to be deductible in calculating the amount realized upon the sale. It is clear that selling commissions are a deduction in computing the amount realized, and the same reasoning should apply to cost of work performed pursuant to the contract to sell and after it has been entered into.

Under the 1939 Code, the selling price was the starting point for computation of gain on sale of a residence. Under the new Code, the amount realized is the starting point. In some situations the difference may be important, as shown in Exhibit I.

Exhibit I

	1939 Code		1954 Code	
(1) Selling price of old residence	$20,000		$20,000	
(2) Less: Selling commissions	1,000		1,000	
(3) Amount realized on sale of old residence		$19,000		$19,000
(4) Cost of old residence		$12,000		$12,000
(5) Realized gain on sale of old residence		$ 7,000		$ 7,000
(6) Cost of new residence		$15,000		$15,000
Recognized gain:				
Under 1939 Code:				
Selling price of old residence (1)	$20,000			
Cost of new residence (6)	15,000			
		$ 5,000		
Under 1954 Code:				
Amount realized on sale of old residence (3)			$19,000	
Cost of new residence (6)			15,000	
				$ 4,000

2. Another change refers to the time limitations for replacement of residence sold by members of the armed forces. The old Code's limitations (four years, not to extend beyond January 1, 1954) has been changed to the four-year period only.

Exchange of Insurance Policies

Section 1035, providing for nonrecognition of gain or loss upon certain exchanges of insurance policies, has no previous counterpart. Under prior law, an exchange of a life-insurance, an endowment, or an annuity contract for any other such forms of insurance was usually a taxable event. Under the new law, any such contract may be exchanged without recognition of gain for the same or a "more expensive" form of contract. Thus, a life-insurance contract may be exchanged for another life-insurance contract, an endowment, or an annuity; an endowment contract may be exchanged for another endowment or an annuity contract; an annuity contract may be exchanged for another annuity contract. But an exchange for a cheaper form of insurance, such as an exchange of an annuity contract for a life-insurance or an endowment contract, remains taxable.

The definitions of these terms follow the meaning generally connected with them. A remote endowment feature, such as that of an ordinary life policy payable at age 80 does not deprive such a contract of characterization as a contract of life-insurance, and does not make it an endowment contract. To that extent, the Finance Committee's report implements the somewhat general terms of the statute. It is hoped that the regulations will provide a more precise guide.

The exchange may be for a contract of a lesser value but at least of the same, and not of a lesser, quality.

For example, a life-insurance contract with a cash value of $10,000 may be exchanged for a

$8,000 single-premium annuity plus $2,000 cash and the recognized gain, if any, would be limited to the $2,000 cash. On the other hand, an annuity contract with a cash value of $6,000 plus $2,000 cash may not be exchanged for a life-insurance contract with a single premium of $8,000 without recognition of the full gain, if any.

In any event, the cost of the contract surrendered is the sum total of all premiums and other consideration paid, less dividends received, but undiminished by the cost of current protection enjoyed for the period before the exchange. The amount realized is the fair market value of the contract received; *i.e.*, what it would then cost to buy it, regardless of its cash-surrender value.

The Code does not require the insured to be the same person on both contracts.

The effect of loans existing against the contract exchanged is covered by a reference to exchanges not solely in kind. There is ordinarily no personal liability under standard life insurance loans. It would seem, however, that they should be considered as other property. This observation seems to be borne out by the Ways and Means Committee's report.

It would appear that both ordinary life insurance and term insurance are included in the term "life insurance" and that the exchange of the former for the latter is taxfree. (A conversion of term insurance into ordinary life insurance has always been considered as not resulting in realization of income.) Under the language of the new Code, only one contract may apparently be involved on either side of the bargain. For example a contract of life insurance may not be exchanged for two contracts of life insurance.

Basis Established by Prior Law

Section 1052 provides for continued use of bases established under prior revenue acts. This is necessary because the amount of gain or loss recognized and the basis of the property disposed of is generally computed under the law applicable to the year in which the property is disposed of.

For example, if property disposed of in 1955 was acquired after 1935 and before 1954 in connection with a reorganization as defined in the 1939 Code, the basis remains as provided for in the 1939 Code, even though the transaction might not qualify as a reorganization under the 1954 Code. If the property is disposed of in 1955 and was acquired after 1921 and before the effective date of the 1954 Code by a corporation as a contribution to capital by a nonstockholder, it would retain the basis provided for by the 1939 Code, although under the 1954 Code the basis of such property would be zero.

CAPITAL GAINS AND LOSSES

Section 1221, defining capital assets, corresponds to old Section 117(a). Now excluded from capital-asset treatment are accounts or notes receivable acquired in the ordinary course of trade or business, for services rendered, or from the sale of stock in trade or inventory, or other property held primarily for sale to customers, as defined in that section.

For gain or loss from disposition of accounts or notes receivable to be treated as ordinary income or loss, the disposition need not be in the ordinary course of business. It is necessary only that the acquisition was thus made. An occasional sale of such items acquired in the ordinary course of trade or business will result in ordinary income or loss. It appears necessary that it was the vendor himself who rendered the services or sold the property from which such accounts or notes originate. For instance, rediscounting by a finance company of accounts or notes receivable acquired from a dealer would not seem to qualify for treatment as ordinary income or loss, unless the finance company is a dealer in such items.

Section 1223 provides for "tacking" of holding periods in a number of situations:

1. Tacking is permitted only between capital assets or business property as defined in Section 117(j) of the 1939 Code and Section 1231(a) of the 1954 Code. In other words, to the period for which a capital asset was held may not be added the prior period in which a non-capital asset or non-business property was owned by the taxpayer, even though it was exchanged for the capital asset in a taxfree exchange.

2. Another change refers to stock or securities received in a divisive reorganization (i.e., a spin-off). The old Code failed to extend the tacking benefit to property received under a taxfree distribution where no property was surrendered in exchange. The 1954 Code corrects this oversight.

For spin-offs that occurred under the old law, tacking is apparently provided for by a parenthetical reference to the 1939 Code. Thus, in dispositions of spin-off securities under the new Code, tacking is provided for, regardless of whether the spin-off itself was governed by the 1939 or by the 1954 Code. In dispositions governed by the 1939 Code, the holding periods are apparently still not tacked.

3. Tacking is also provided for stock or stock rights received on a taxfree distribution if the basis is determined by reference to stock or rights to stock in the issuing corporation. Note that tacking is provided for in the case of stock rights whose basis may be zero because their value is less than 15 per cent of the stock upon which they are issued.

4. Tacking is provided for in the case of commodities acquired in satisfaction of a futures contract.

Property Used in Trade or Business. Section 1231 restates the provisions of Section 117 (j) of the 1939 Code.

Sale, Exchange, Retirement of Bonds

Section 1232 provides for the tax treatment of gain or loss upon sale, exchange, and retirement of bonds. Several important changes have been made.

Whereas the provision is still restricted to corporate and governmental bonds, it is no longer necessary that the bonds be with interest coupons or in registered form in order to entitle the holder to capital gain or loss treatment. But this applies only to bonds issued after 1954 or converted into such form before March 1, 1954.

Discount Bonds. Another important change denies capital-gain treatment, wholly or in part, with respect to so-called discount bonds. The purpose of this provision is to tax as ordinary income the discount on noninterest-bearing bonds issued at a discount roughly comparable to the aggregate interest that would accrue over their life.

Discount (called "original issue discount") is defined to mean excess of the redemption price at maturity over the issue price. If that difference is small, (less than one-fourth of one per cent of the redemption price at maturity, multiplied by the number of complete years to maturity), it is ignored and no computation need be made. The terms "stated redemption price at maturity," "issue price," and "issue date" are defined in the Code.

The new provision requires ordinary income treatment for any gain up to the amount of *original issue discount* proportionate to the time the bond is held by the taxpayer. The time-period calculations are made in terms of full months.

For example, an individual purchases a 10-year bond with coupon interest at 3% from an investment banker at a price of 90 on Feb. 1, 1955. The redemption price is 100. It is sold February 20, 1960.

Assume that it is sold at 94. In this case the bond has been held for 60 months of its life of

120. The fraction 60 over 120 multiplied by the discount of 10 yields 5. Any part of the gain up to 5 would be taxed as ordinary income, and, therefore, in this case the entire gain of 4 is taxable as ordinary income.

Assume that it was sold at 97. In this case only 5 of the gain is ordinary income and the balance of 2 is capital gain.

Assume that it was sold at 80. In this case the seller realizes a capital loss of 10.

If the same bond is purchased at 80 on Feb. 1, 1960, by a second holder, who keeps it to redemption at 100, he also will have held it 60 months, so he will, on redemption, have 5 of ordinary income and 15 of capital gain.

This provision is applicable only to bonds issued after 1954 at a discount and does not apply to tax exempts or to any bond acquired at a premium by the particular holder. It applies only to sales or exchanges, whether made at retirement or upon other disposition. This provision applies even to a holder who is on the accrual basis and accrues the discount under Section 454, referring to non-interest bearing obligations redeemable at periodically increasing amounts. In this case, there would have been an inequitable duplication of income for accrual-basis taxpayers. One unfortunate result of these provisions is that (for bonds issued after 1954) each purchaser must determine any original issue discount.

Bonds issued before 1955 will be treated under the provisions of the old law.

Detached Coupons. A somewhat similar rule is provided when the seller detaches and retains coupons maturing more than twelve months after the date of the sale. To the extent that the diminution in value at the time of the purchase is attributable to the detached coupons, any gain will be treated as ordinary income upon the subsequent disposition of the bonds by the purchaser.

An important exception from the provisions of Section 1232 is made with respect to face amount certificates as defined in the Investment Company Act of 1950. Tax on gains from them will be computed on a three-year average under Section 72(e)(3) of the 1954 Code.

Short Sales

Section 1233 provides for capital gain and loss treatment of gain or loss from certain short sales, and covers the same area as Sections 117(g)(1) and 117(l) of the 1939 Code. Again, important changes have been made.

Hedging transactions are now expressly excluded from the capital gain and loss treatment. Moreover, if a dealer enters into a short sale and closes it by delivery of assets that are not capital assets in his hands, the gain or loss from the short sale will not be treated as capital gain or loss.

A modification of prior law excepts from the usual short-sale treatment "puts" acquired on the same day as the property put, if that property is identified as intended to be used in exercising the put, and if the put (if exercised) is exercised through the sale of the property so intended. If the put is not exercised, the last-mentioned requirement is, of course, ineffective.

The effect of this provision may be illustrated as follows:

A, not a dealer in stock, acquires 100 shares of X stock on February 1 and another 100 on May 10, 1955, and on the latter date also a three-months put on 100 shares of X stock. He identifies the last 100 shares with the put. The put is not exercised. On August 15, 1955, A sells at a gain the 100 shares acquired on February 1, 1955. Ordinarily, A would be deemed to have short-term gain. The new rule sets aside this treatment and allows a long-term gain. The cost of the put is added to the basis of the shares acquired on May 10.

If the put was exercised on August 9 by delivery of the shares acquired on May 10, their actual holding period—including any "tacked" —would govern. In that event, the holding period of the shares acquired on February 1 would be that otherwise determined.

If the put is exercised by A by delivery of the shares acquired on February 1—which then will have been held for him for more than six months—this exception to the usual short-sale treatment does not apply, since the put was exercised by delivery of other than the identified property. Any gain or loss is short-term. In this event, the holding period of the shares retained begins on May 10. No "tacking" of prior holding periods would take place.

Sale or Exchange of Patents

Section 1235 provides for limited capital gain treatment with respect to the sale of patents by certain individuals. It has no counterpart in the old Code, although it reflects in a substantial degree the preponderance of judicial authority. Within limits, its effect is to make long-term capital gain treatment available to the holder of the patent disposed of by him regardless of the period or mode of payment. It requires a disposition of "all substantial rights" in the patent (or an undivided fraction of interest therein). It excludes, for instance, a geographical limitation, or a grant of less than substantially all rights. The form of the assignment and the language used is immaterial as long as the transfer includes substantially the entire interest.

This treatment does not appear to be limited to amateur inventors. It is restricted in its application to transfers by the "inventor," as that term is known in the patent law, or by certain individuals backing the inventor financially. These include individuals (other than the inventor's employer and certain close relatives of the inventor) who have acquired an interest in the property for cash (or its equivalent) paid to the inventor before the invention is actually reduced to practice. This treatment is not available to a transferee.

This section applies to any amounts received pursuant to such a transfer if they are received in a taxable year to which the 1954 Code applies, regardless of when the transfer was made. It does not apply to transfers by a corporation, by a partnership, by individuals who do not qualify as holders within the stipulated definition, or to payments received in taxable years before the effective date of the 1954 Code. The provision does not cover the situation where a patent is owned in community property. Equity would seem to require that in such a situation the term "holder" should include the spouse of the holder.

Options to Buy or Sell

Gains or losses arising from sales or exchanges of options are subject to capital gain or loss treatment only if the property underlying the option is a capital asset. Dealers in securities may, under Section 1236, by proper earmarking, qualify securities as capital assets. Rights, and probably calls, are included in the Section 1236(c) definition of securities.

Subdivided Real Property

Section 1237, which provides in certain situations for capital gain or loss treatment of subdivided real estate, has no counterpart in the 1939 Code. It represents an unsatisfactory, detailed, and tricky compromise. Under prior law, activities commonly known as "subdividing" were usually considered as indicating conclusively that the property was held for sale to customers in the ordinary course of business and, therefore, was not eligible for capital-gain treatment. In addition, the personal participation of the taxpayer tended to have a similar effect. These interpretations generally applied even if the owner was not otherwise a dealer in real estate. In other words, under prior law subdividing activity made the owner taxable as if he were a dealer.

The new law eliminates such activities as decisive criteria.

Subdividing, or any activity incident to such subdivision or sale (such as advertising, being on the property to wait on prospects, and similar work), will not in itself prevent capital-gain treatment, provided such activity is limited to the particular property.

If the taxpayer is otherwise a dealer, he is not entitled to the benefits of this section. Nor is a corporate taxpayer entitled to it. In deciding the question whether the taxpayer is otherwise a dealer in real estate, subdivisions of other properties undertaken by him, or his work in connection with parceling out other properties, may well be taken into consideration. But this new provision would not seem to impair the rule that a dealer in real estate may hold certain real property as an investment and receive capital-gain treatment on it.

Certain limitations apply to this section. The tract of property, or any part thereof, must not have been held for sale to customers at any previous time by the owner, and the owner must not be otherwise engaged in activities as a real estate dealer during the year. The taxpayer (or certain people closely associated to him or, under certain conditions, a lessee or a government) must not have made substantial improvements on the tract that substantially increase the value of the particular parcel sold. Except for real estate acquired by inheritance or devise, the tract must have been held for at least five years. "Tract" is defined to mean a single piece of property or pieces that are contiguous except for a road, railroad, stream, or similar property.

Improvements endanger the capital-gain treatment only if they are made by the taxpayer (or the related persons referred to above), if they are made while the taxpayer owns the property, if they are substantial, and if they substantially increase the value of the particular parcel sold. All four conditions must be present in order for the improvement to be detrimental to the capital-gain treatment. Improvements are considered made by the taxpayer if they are made "pursuant to a contract of sale entered into between the taxpayer and the buyer."

Certain minimum improvements are deemed not to be substantial if the lot or parcel "is held by the taxpayer" for at least ten years. Since Section 1223, which provides for "tacking" of holding periods and is discussed above, applies by its terms to all income tax provisions, it would seem that, despite the language quoted above, the period during which the property was held (*e.g.*, by taxpayer's donor) or during which the taxpayer held property exchanged under Section 1031(a) for the property sold, may be "tacked" on. The statute is not explicit as to when the ten years must have elapsed. Since the rule cannot "apply" unless a gain is realized, it would seem to be sufficient if the time requirement is met at the time of the sale. If this is correct the rule would apply if property was acquired in 1943, improved in 1952, and sold in 1954.

The minimum improvements which may be put in with impunity are those water and sewer facilities and roads without which the benefited lot would not be marketable at the prevailing local price for similar building sites. But to come under capital-gain treatment, the owner appears to be denied any deduction for the cost of such improvements. If the necessary improvement rule is fair, the restrictions provided for in the statute appear to be excessive. This penalty will be further considered (*Cong.Rec.*, p. 9099).

If all of the stipulations of this section are met, gains will be treated as capital gains until the taxable year in which the sixth parcel or lot is sold from the track. All sales in that and subsequent years will result in ordinary income equal to five per cent of the selling price (but not exceeding the gain). If, for example, only five lots are sold in 1954, all gain will be capital gain. If the sixth lot is sold in 1955, gain up to five per cent of its selling price will be ordinary income, and the remainder capital gain. If six or more lots were sold in 1954, the five per cent ordinary income treatment would apply to all sales.

Expenses of sale apply first against any ordinary income. Any excess over the ordinary income reduces any capital gain by reducing the amount realized.

Ordinarily these new provisions apply to sales after December 31, 1953. However, in determining when the sale of the sixth lot or parcel occurs, sales in the five years preceding 1954 are considered. However, if no sales occur for a period of five years following a sale, a new tract is deemed created from the remainder so that counting of sales begins anew.

Lease or Franchise Cancellation

Section 1241, which has no counterpart in the 1939 Code, provides for treatment as an exchange two kinds of settlements: (*1*) amounts received by a lessee for the cancellation of a lease; and (*2*) amounts received by a distributor of goods for the cancellation of his distributors' agreement, provided he has a substantial investment in the distributorship. The mode of payment is apparently immaterial, whether lump-sum, fixed amount, or depending on some variables.

Few questions should arise regarding lease cancellations. A surrender ought to be included, and it seems to make no difference whether the cancellation arises out of exercise of an option in the lease, or out of a superceding agreement. Nor should it make any difference whether the recipient is the original lessee, an assignee, or a sublessee. Finally, identity of the payer also appears to be immaterial.

As to the cancellation of a distributor's agreement, it appears that the required investment need not be in the contractual relationship itself but may consist of inventories or facilities. However, will intangibles, such as advertising, or costs of training help, qualify? In a proper situation, they ought to, since they may make up the entire going concern value of a distributorship.

No particular requirement is established as to the nature of the distributors' agreement. Apparently it need not be exclusive or in any particular form. But it must refer to "goods." Distributorships of real property, or intangibles would not qualify. Incidental services, such as installation, should be harmless. But situations where the profit from installation, maintenance, or other services is substantial in relation to the value of the "goods" are more doubtful. Yet, the language of the statute does not seem to exclude that situation or to make a distinction. That goods are technically fixtures, or become permanently attached to, and an inseparable part of, real property, such as prefrabricated houses, or swimming pools, should make no difference.

Accounting Procedures & Methods Under the New Revenue Code

By Walter L. Schaffer

GENERALLY ACCEPTED PRINCIPLES

The new Code gives added recognition to generally accepted accounting principles as the proper standard for computation of business income for tax purposes. Congress has at last taken notice that many needless divergences between income for tax purposes and income for business purposes have developed from court decisions and rulings.

The Profession's Role

Enactment of the new legislation climaxes a long and unrelenting campaign of public education by the accounting profession. Many articles criticizing the divergences were written and for many years the committee on federal taxation of the American Institute of Accountants urged the adoption of corrective legislation. The American Institute's committee on accounting principles for income tax purposes made a thorough study of the problem, and submitted a report to the chairman of the Ways and Means Committee in 1953. This report discussed the general nature and extent of the problem and pointed out specific areas where divergences existed. The new legislation attempts to remedy the divergences in each of the major areas considered in the report.

Changing the tax-accounting habits of American business that have grown up over a long period of years presents serious administrative and educational problems. Congress wisely recognized that a mandatory shift to generally accepted accounting principles could bring harsh transition problems, difficult to foresee and even more difficult to deal with equitably by statutory formula. Therefore, the law does not require every accrual-basis taxpayer to follow all of the new methods. Instead, elections are provided in the areas of widest applicability (prepaid income, estimated expenses, and real property tax accruals).

Taxpayers' Books. Although the new methods will generally result in taxable income being more nearly in accord with net income for financial purposes, taxpayers' books need not be kept on the basis elected for tax purposes.

Effective Dates. Like most provisions of the new Code, the rules on accounting methods are first applicable for the calendar year 1954 or fiscal years beginning in 1954.

Prepaid Income

Under the old law, amounts received for services to be rendered or facilities to be provided in the future were taxable on the accrual basis (1) upon receipt of cash without restriction as to its use or (2) when all the events had occurred to fix the taxpayer's right to the revenue, whichever was earlier. Actual earning of the revenue by performance of the services was ignored. Thus, advance rentals were taxable when received, regardless of the period to which they applied; and sale of transportation tickets gave rise to income immediately, even though the services had not been performed. That rule remains in effect for the calendar year 1953 and all other taxable years beginning before January 1, 1954. It also remains in effect for subsequent years unless the taxpayer makes the election to have the new rules apply.

Period of Deferral. A taxpayer who elects to have the new provisions apply will, in general, defer the recognition of prepaid income until it is earned, in accordance with good accounting practice. The law limits the period of deferral, however, if (*1*) the period within which the income is to be earned extends more than five years from the end of the taxable year in which it is received or (*2*) the income is to be earned over an indefinite period (as in the case of transportation tickets or tokens without a definite expiration date).

Where the period over which the income is to be earned is definitely known to extend longer than five years after the year of receipt, one-sixth of the income must be reported in the year of receipt and in each of the five succeeding taxable years. With the Treasury's consent, the income may be reported in any taxable year or years (including those more than five years distant) in such proportions as may be provided in the consent. The Treasury may impose such conditions together with its consent as it deems advisable.

Indefinite Earning Period. Where the revenue from a prepaid income contract is to be earned over an indefinite period, the total amount received must be allocated between (*a*) the part expected, on the basis of experience, to be earned by the end of the fifth taxable year after the year of receipt, and (*b*) the part not expected to be earned within that period. Part (*b*) apparently includes all receipts from coupons, tokens, etc., expected never to be presented. Part (*a*) is reported as income as earned, in accordance with good accounting practice. Part (*b*) is reported one-sixth in the year of receipt and one-sixth in the five succeeding taxable years. Apparently, the allocation between parts (*a*) and (*b*) can be adjusted in subsequent years on the basis of later experience.

End of Liability. When the taxpayer's liability to perform services, etc., ends without actual performance (as, for example, when a lessee surrenders or loses his rights to occupy a property before the end of the period for which rent has been paid), the prepaid income must be included in income in the year the liability ends. Likewise, all prepaid income previously deferred must be reported in the year of an individual taxpayer's death or the cessation of existence of a corporate taxpayer.

Exceptions to Rule. This rule does not apply in the case of (*1*) taxfree liquidations of subsidiaries, if the basis of the assets in the hands of the subsidiary carries over to the parent; or (*2*) certain taxfree corporate reorganizations, if in either case the transferee corporation assumes the liability to perform services, etc. The transferee corporation then reports the income on the same basis as it would have been reported by the transferor if the transferor had continued in existence.

Customers' Deposits. In addition to amounts received for services to be rendered or facilities to be provided in the future, the statutory definition of prepaid income includes amounts received subject to a liability to furnish goods or other property in the future. It is not believed, however, that Congress intended to change the old rule that customers' deposits on sales of merchandise were not taken up as income until the sale was made (*Veenstra & De Haan Coal Co.*, 11 T.C. 964 (1948)).

Rules Governing Elections. An election to have the special provisions regarding prepaid income apply may be made without Treasury consent in the tax return for the calendar year 1954 or fiscal years beginning in 1954, or for the first year in which prepaid income is received. Later elections require consent. A separate election may be made with respect to each trade or business in which the taxpayer is engaged. Any prepaid income that will be earned within 12 months from the date of receipt of such income may be excluded from the election.

The prepaid-income provisions do not apply to cash-basis taxpayers, who must continue to report all income in the year of receipt.

Estimated Expenses

The tax treatment of estimated expenses has been a major irritant to taxpayers under the old Code.

Costs and expenses related to the income of a given period have been disallowed as deductions in that period merely because their amount had to be estimated.

Reserves Now Permitted. Under the new Code (Sec. 462) taxpayers may establish and claim deductions for reserves for estimated expenses. Such reserves may cover cash discounts, costs of product guarantees, sales returns and allowances, freight allowances, quantity discounts, vacation pay, liabilities for self-insured injury and damage claims, and any other expenses attributable to income of the year (or prior years to which the election is applicable) and which the Treasury is satisfied can be estimated with reasonable accuracy. A reserve is considered reasonably estimated when it is based on reliable data or statistical experience of the taxpayer or others in similar circumstances.

Reserves may not be provided for costs and expenses of a contingent or contested nature and as to which there is no reasonable certainty of their amount. Thus, reserves for general contingencies, possible future losses, and contested claims in general would not provide the basis for deductions.

Bad debts continue to be provided for by a separate reserve, if the taxpayer has elected that method; the reserve for estimated expenses may not cover them. Expenses attributable to prepaid income that has not yet been taken into account are also excluded.

The new treatment may be elected without Treasury consent in the tax return for the calendar year 1954 or fiscal years beginning in 1954, or for the first year in which there are any expenses to be provided for by reserve. Later elections require the Treasury's consent. A separate election is made for each trade or business in which the taxpayer is engaged, but one election covers all types of estimated expenses of one trade or business. If no election is made, the rule effective prior to 1954 continues to apply.

The discretion of the Treasury governs allowance of any deduction for an addition to a reserve for estimated expenses. This limitation, which apparently is intended as a safeguard against extravagant claims, is the same as that applicable to the adoption of the reserve method of deducting bad debts. In the latter connection, the courts have held that the Treasury's discretion may not be exercised in an arbitrary or capricious manner.

Time of Charge Against Reserve. Expenses for which a reserve is provided are to be charged against the reserve when they are actually incurred. If such expenses include depreciation (for example, on equipment to be used in fulfilling guarantees), it is not considered as having occurred for purposes of determining the adjusted basis of the property until the period for which it is computed.

If the balance in the reserve is found to be excessive at the end of any taxable year, the excess must be taken up as income for that year.

Expenses attributable to 1953 and prior years (or to any year prior to the first year to which the election to provide reserves for estimated expenses applies) remain deductible when actually incurred, even though incurred in a year for which a reserve is provided.

Cash-basis taxpayers may not provide reserves for estimated expenses, but must continue to deduct expenses only when paid.

Property Taxes

Elaborate and conflicting rules governed the accrual of taxes under the old Code. State statutes imposing taxes were minutely examined and some date mentioned in the statute or some action by local officials was selected as determining when the tax was imposed. In general, the tax was deductible in full by an accrual-basis taxpayer on that critical date. When property was transferred, the tax was deductible only by the party owning the property on the critical date, regardless of any agreements the parties might make for dividing the tax between themselves on the basis of the period of ownership by each.

Real Estate Taxes. Although the old rules applied equally to the accrual of all types of taxes, most of the confusion and the controversies involving substantial amounts related to real estate taxes. The changes in the new law affect only real estate taxes, leaving all the existing rules in effect for other taxes.

New Method of Accrual. Under the new law (Sec. 461), an accrual-basis taxpayer making the necessary election will deduct real property taxes ratably over the period for which they are imposed. The new rule may be elected without Treasury consent in the tax return for the calendar year 1954 or fiscal years beginning in 1954, or for the first year in which the taxpayer incurs any real property taxes after 1954. Subsequent elections require permission.

Real property taxes deductible in 1953 or fiscal years beginning in 1953 under the old rules remain deductible in such years and do not give rise to another deduction later. Real property taxes which under the old rules would not have become deductible until 1954 or a fiscal year beginning in 1954 are deductible under the elective method in that year to the extent they relate to that year or to prior periods.

The apportionment of taxes between the buyer and seller of the real property is also provided for (Sec. 164). That part of the real property tax which is properly allocable to the period ending on the day befor the sale is allocated to the seller and the balance to the purchaser.

The rule is applicable to all taxpayers, regardless of the method of accounting employed, and is effective for all sales on January 1, 1954, and subsequently, except that no real property tax is apportioned if it was deductible by the seller in a taxable year ended before January 1, 1954.

Cash-basis buyers or sellers cannot, under the general rule, deduct taxes unless paid. A special provision is that real property taxes apportioned to such taxpayers on a sale are deductible in the taxable year of the sale without regard to actual payment of the taxes. The rule applies, however, only if the cash-basis taxpayer (either buyer or seller) did not own the property at the time personal liability for the tax arose, or (if there is no personal liability for the tax) at the time the tax imposed became a lien on the property. In other cases, the tax must be paid.

A special rule is also provided for accrual-basis taxpayers who, for the taxable year in which real property is sold, do not accrue real property taxes ratably over the period to which they apply, because they have not made the necessary election. In general, such taxpayers continue to deduct real property taxes on the critical date selected under the old rules discussed above. Upon a sale of the property, the part of the real property tax allocated to such a taxpayer is deductible on the appropriate critical date, if he owns the property on that date. If he does not own the property on that date, the allocated tax is deductible on the date of the sale.

Where a real property tax that is subject to apportionment between buyer and seller has been deducted by the seller in a prior taxable year (because it was paid by a cash-basis taxpayer or accrued on a specific date by an accrual-basis taxpayer who has not elected to adopt the new method), that part of such tax apportioned to the buyer is treated as a recovery of the tax by the seller. The recovery is fully taxable as income to the extent that the earlier deduction resulted in a federal income tax reduction.

Apportionment of real property taxes between two taxpayers is provided for only where the property is sold. A notable shortcoming of the statute is the failure to provide for apportionment on transfers other than sales.

Permissible Accounting Methods

The basic accounting rules of the old Code are continued without any substantial change except for the elective methods discussed above.

However, the new law gives greater recognition to hybrid accounting methods. It specifically recognizes (Sec. 446) the taxpayer's right to use different methods for different trades or businesses and to use one method for business transactions and another one for purely personal items. In addition the Treasury may by regulations permit the use of a combination of methods in a single business.

The Committee reports give as an example a small retail store that reports sales, purchases, inventories, accounts receivable, and merchandise accounts payable on the accrual basis; but which deducts rent, interest, salaries, insurance, and similar expenses on a cash basis. It is possible that the new law may also permit the Treasury to give greater recognition to trade practices deviating from strict accrual accounting. (See *Pacific Grape Products Co.*, 17 T. C. 1097 (1952, on appeal).)

The old provisions respecting inventories are continued without any change of substance. The special treatment of involuntary liquidations of LIFO inventories at the taxpayer's election is, however, extended one year (Sec. 1321), so that liquidations in any taxable year ending in 1954 are covered. Replacement must still be made not later than the taxable year ending in 1955.

52- or 53-Week Year. The term "fiscal year" has been enlarged to include a 52- or 53-week period. Special rules are provided for effective dates when such periods are used. In general, the effect of these rules is to regard 52- or 53-week taxable years as beginning on the nearest first day of a whole calendar month.

Installment Sales. Under the installment method, the gross profit on sales of property is reported proportionately as the sales price is collected. The new Code continues to permit use of the installment method (*a*) by dealers in personal property who adopt the method for all installment sales; and (*b*) by any taxpayer making a sale of real property or a casual sale of personal property for a price of $1,000 or more—with a separate election available for each such sale.

The old law limited the sales of real property and casual sales of personal property which could be reported on the installment basis to cases where the payments in the year of sale did not exceed 30 per cent of the selling price. This was interpreted to mean that if there were no payments in the year of the sale the installment basis could not be used. The new Code (Sec. 453) permits use of that basis either where there are no payments in the year of sale or where the payments do not exceed 30 per cent. The new rule applies to sales in taxable years beginning on or after January 1, 1954.

Sales or other dispositions of an installment obligation generally result in recognition of gain or loss measured by the difference between the selling price or the fair market value of the obligation and its basis, the latter being the equivalent of the basis of property initially sold less that part of subsequent collections which did not represent income. Such other dispositions include gifts and distributions to stockholders by corporations, except that certain taxfree intercorporate transfers and distributions are excluded. The new law, effective for taxable years beginning after December 31, 1953, eliminates the need for a bond upon a transmission at death to the decedent's estate or heirs and requires that in all cases the heirs or others receiving payments report income therefrom in the same manner as the decedent would have (Sec. 453, 691).

Changes in Accounting Methods. Where a taxpayer voluntarily changes accounting methods, the Treasury's approval is ordinarily required before the new method can be used for tax purposes. As a condition for granting such approval, the Treasury in the past has generally required that adjustments be made in the year of change to insure that no item, either of income or deductions, would be duplicated or completely omitted as a result of the change. For example, if the taxpayer changed from the cash basis to the accrual basis, an amount equivalent to the trade accounts receivable at the beginning of the year of change, representing sales which were never reported on the cash basis, would have to be added to the year's sales on the accrual basis; also, an amount equivalent to the trade accounts payable at the beginning of the year of change, representing unpaid expenses of the prior year, would be deductible in addition to expenses which accrued during the year.

If, however, the Treasury required a change from an incorrect basis on which returns had been filed and accepted in prior years, the courts held under prior law that the Treasury could not require adjustments of the type described above, but could merely compute income correctly for the year in issue considered by itself. In such cases, if the change required was from the cash basis to the accrual basis, sales proceeds represented by opening accounts receivable would go untaxed, and the taxpayer would have a double benefit of purchases represented in opening inventory less opening accounts payable.

The new Code (Sec. 481) specifically adopts the rule that adjustments will be required on all changes of accounting methods, voluntary or involuntary. An exception is made, however, for adjustments with respect to taxable years beginning before January 1, 1954. A change of accounting methods may be made in 1954 or later without taking into account any items respecting years beginning prior to 1954. Thus, the rule for Treasury-imposed changes prior to 1954 is apparently applied to all changes in 1954, whether voluntary or involuntary and whether from an improper method of accounting to a proper one or from one proper method to another. However, whether the Treasury will grant approval for a change of accounting method resulting in large amounts of income escaping taxation is questionable.

Presumably the general provisions relating to changes in accounting methods do not apply if they are in conflict with transitional rules in particular sections.

Changes in 1955 or Later. Where a change of accounting method occurs in 1955 or later, transitional adjustments in respect of years subject to the new Code are taken into account in the year of change but not those in respect of years beginning before January 1, 1954. The rule applies whether the change is initiated by the taxpayer or the Treasury. Where adjustment is required in a particular year for inventory built up over a period of prior years by a cash-basis taxpayer, the Finance Committee's report indicates that the amount of inventory at the end of the taxable year beginning in 1953 can be excluded from the inventory adjustment, apparently without any regard for the identity of the items comprising the inventory. There is no reason why the same principle should not apply to other items requiring adjustment, so that only the increase since the end of the taxable year beginning in 1953 would be taken into account.

Tax Limitations During Change. Where the increase in taxable income resulting from the adjustments which must be taken into account on a change of accounting methods exceeds $3,000, the law provides two limitations on the tax for the year of change. These limitations are intended to give the taxpayer relief from the "bunching" of income.

Under the first limitation, if the taxpayer had used the old accounting method for two years prior to the year of change, the tax attributable to the increase in taxable income resulting from the change cannot exceed the aggregate of income and excess profits taxes that would result if one-third of the increase were included in year of change and one-third in each of the two preceding taxable years.

The second limitation applies only where the taxpayer can establish what his taxable income for one or more consecutive years prior to the year of change (but beginning after December 31, 1953) would have been if the new accounting method had been used in such years. Where this can be done, the tax attributable to the increase in taxable income resulting from the adjustments cannot exceed the net increase in taxes that would result if the adjustments were allocated to the taxable years to which they applied under the new method of accounting and the balance, if any, to the taxable year of change. It would appear that there would be a balance to allocate to the year of change only where the taxpayer could not establish the taxable income under the new accounting method of some year beginning after December 31, 1953. If allocation of any of the adjustments affects a net operating loss carry-over or carry-back or a capital loss carry-over, the effect on the year to which the loss is carried is taken into account.

Apparently, the tax attributable to the

increase in taxable income resulting from the adjustments should be determined by computing the tax with and without the inclusion of the adjustments in taxable income. This is the method prescribed in the regulations covering long-term compensation under Section 107 of the old Code.

In lieu of including the transitional adjustments in taxable income for the year of change, the law permits the Treasury to prescribe regulations under which the adjustments would be taken into account for other taxable years agreed upon by the taxpayer and the Treasury. The Code and Committee reports contain no clues as to how the Treasury should administer this provision. If the taxpayer could select future years, he could thereby defer payment of the tax on the adjustments.

Change to Installment Basis

The foregoing general provision does not apply to dealers in personal property who change from the accrual basis to the installment basis of reporting income from installment sales. Under prior law, the gross profit on installment sales made prior to the change and collected in the year of change and thereafter was included in income twice—on the accrual basis when the sale was made and on the installment basis when it was collected.

For changes of method occurring in taxable years beginning after December 31, 1953, the new law (Sec. 453) provides a measure of relief. Although the double inclusion in income is continued, the tax for the year of change and any subsequent year in which there are collections of installment sales previously reported on the accrual basis is reduced by the lesser of (*a*) the portion of the tax for the year of original sale which is attributable to the gross profit on such year's sales collected in the taxable year; or (*b*) the portion of the tax for the taxable year which is attributable to the inclusion of such gross profit. The law, however, provides that the portion of the tax attributable to the gross profit is the same proportion of the total income tax (not including excess profit tax) which the gross profit in question is to the total gross income for the appropriate year. This latter provision introduces an extraneous factor (total gross income) into the computation and substantially reduces the relief afforded. A more equitable method of determining the adjustment should have been provided. The tax attributable to the double inclusion of gross profit could be determined by making two tax computations—one with and one without the inclusion of the duplicated amount.

If such a computation had been provided for, the adjustment would be treated more nearly like other adjustments resulting from changes in accounting methods and more adequate relief provided. As the matter stands, accrual-basis taxpayers might do well to await another change in the law before changing to the installment basis.

The provisions of the new law respecting accounting methods reflect an earnest attempt on the part of Congress to make it possible for taxpayers to adhere more closely to generally accepted accounting principles for tax purposes. The new rules for prepaid income, estimated expenses, and real property tax accruals represent tremendous strides in that direction.

Exactly how successful the new provisions will be in achieving their goal has still to be demonstrated in practice. It is to be hoped that their administration, like their original conception by Congress, will find its inspiration and guidance in sound accounting principles, and that the Treasury will not try to whittle them down by narrow technical interpretations of their language or by restrictive regulations.

Tax Effects of Corporate Distributions and Adjustments

By T. T. Shaw

The provisions of the new tax law on corporate distributions and adjustments are contained in Subchapter C of Chapter 1, Subtitle A, of the new Revenue Code.

These provisions represent a serious and meritorious attempt to state the tax consequences of corporate distributions, liquidations and reorganizations in logical form and to eliminate the defects, inequities and areas of uncertainty which previously existed and which have been highlighted by court decisions over many years. Not all defects have been eradicated and possibly some new loopholes have been opened. Yet, commendable progress has been made.

Such decisions as *Groman and Bashford*, *Court Holding* and *Cumberland Public Service*, *Bazley* and *Adams*, *Kimbell-Diamond Milling*, *Stanton Brewery*, *Chamberlin*, and many others have been considered in drafting the new provisions, and many problems, uncertainties and, inequities arising out of those decisions will now be eliminated.

An important addition of widespread interest is a new section permitting successor corporations, subject to certain limitations, to stand in the tax shoes of their predecessors with respect to loss carry-overs, earnings and profits, and 17 other specified items. The operation of prior law in this area was uncertain at best and depended upon continuance of the corporate legal identity. The new Code emphasizes economic identity rather than mere legal identity.

Progress has also been made in the reorganization and organization areas of corporate-stockholder relationships. Several of the controversial tests of prior law, such as the proportionate interest test in Section 112(b)(5), have been eliminated.

Rules as to taxability of corporate distributions have been simplified, and several types of transactions that will not run afoul of the "essentially equivalent to a dividend" rule have been specified.

In liquidations the rules of prior law have been substantially retained, but there is a new provision which eliminates the double tax danger where corporate property is sold during the course of liquidation and another provision which permits, under prescribed conditions, the cost of the stock of a purchased corporation, subsequently liquidated, to be treated as the cost of the underlying assets. In the collapsible corporation area, a new presumption designed to aid enforcement is added.

Business purpose requirements in the case of corporate reorganizations will continue to exist under the new law. The situations in which continuity of interest is necessary are less uncertain than before.

CORPORATE DISTRIBUTIONS

General Rule

Section 301 provides that a distribution of money or other property will be includible in income by the recipient to the extent it represents a dividend (as defined in Sec. 316). Any portion which is not a dividend will be applied against the basis of the stock, and will, in so far as it exceeds the basis of the stock, be taxed as capital gain, except to the extent it is out of increase in value accrued before March 1, 1913, to which extent it will be exempt from tax. Distributions out of pre-March 1913 earnings will be applied against basis, any excess being capital gain.

The amount of the distribution to noncorporate stockholders will be the sum of the money plus the fair market value of other property distributed. The amount to corporate stockholders will be the sum of the money plus the other property distributed, such other property valued at the lesser of fair market value, or adjusted basis in the hands of the distributor increased by any gain to the distributor recognized under Section 311(b) (distributions of LIFO inventory) or Section 311(c) (distributions of property subject to a liability in excess of its adjusted basis). The amount of any property distribution will be reduced, but not below zero, by any liability assumed by the shareholder or by any liability to which the property is subject.

The basis of property to the distributee will be the same as the amount treated as a distibution not reduced by any liability.

Special rules covering distributions in redemption of stock, distributions in partial or complete liquidation, and distributions in reorganization are treated in other sections of the Code.

Redemption of Stock

While substantially restating prior law, Section 302 provides special rules where there is a "substantially disproportionate" redemption or a termination of a shareholder's interest.

If a corporation redeems its stock (including acquisitions for treasury), the redemption will be treated as a distribution in part or full payment for the stock (subject to capital-gain treatment) if the redemption is either: (*1*) not essentially equivalent to a dividend; or (*2*) substantially disproportionate; or (*3*) in termination of the shareholder's interest in the corporation; or (*4*) is of stock issued by a railroad corporation pursuant to a plan of reorganization under Section 77 of the Bankruptcy Act.

Whether or not a redemption is essentially equivalent to a dividend is to be determined from all the facts as under prior law. Failure to meet the requirements of (*2*) and (*3*) will not be taken into account. In general, the rules of constructive ownership (Sec. 318) apply in determining ownership of stock for purposes of this section.

If a corporation's redemption of its stock does not fall within the above rules, it will ordinarily be treated as a distribution under Section 301.

A substantially disproportionate redemption occurs only if immediately afterwards the shareholder owns less than 50 per cent of the total combined voting power of all classes of voting stock and the percentage of the outstanding voting stock and all common stock (voting or nonvoting) owned is less than 80 per cent of the percentage owned before. Again, constructive ownership rules will apply.

If there is more than one class of common stock, the determination of the percentage of stock owned before and after the distribution will be made by reference to fair market value. The 80 per cent rule will be applied on a shareholder-by-shareholder basis, and its application to one shareholder will not affect its application to any other shareholder.

The "substantially disproportionate" rule will not apply to any redemption made pursuant to a plan, the purpose or effect of which is a series of redemptions resulting in a distribution (in the aggregate) not substantially disproportionate with respect to the shareholder.

For example, X Corporation has outstanding 100 shares of common stock. A owns 60 shares and B owns 40. A and B are unrelated. In 1955, pursuant to a plan of redemption of stock, the corporation redeems 25 shares from A. Standing alone, this qualifies as a disproportionate redemption, since A owned 60% of the stock before the redemption and now owns less than 48% (80% of 60%). In 1956, pursuant to the plan, the corporation redeems 15 shares from B. This redemption, standing alone, would also have qualified as a disproportionate redemption. However, when the two are considered together, A and B have not sufficiently changed their respective proportionate interests in the corporation, and both redemptions fail to qualify as substantially disproportionate.

Termination of Interest. A special provision waives constructive ownership under the family rule where a distribution terminates a shareholder's interest. Stock owned by members of the family of a distributee will not be attributed to him if the distributee retains no interest in the corporation (including an interest as officer, director, or employee, but not one as a creditor) and does not acquire such interest (other than stock acquired by bequest or inheritance) within ten years after the date of distribution. The distributee must undertake to notify the Treasury if and when he acquires a prohibited interest during this period, and the limitation period on assessment and collection of any deficiency resulting from the acquisition will include one year following the date such notice is given. The year of distribution will be held open for this purpose. In determining the deficiency, credit will be allowed for any capital gain tax paid upon the prior redemption.

This rule waiving the constructive ownership test will not apply if within the ten years preceding the redemption, and with a principal purpose of avoiding tax, (*1*) any portion of the stock redeemed was acquired by the distributee from a person whose ownership would be attributable to the distributee, or (*2*) if any person had acquired from the distributee (and still owns after the redemption otherwise in termination of the transferor's interest) stock in the corporation attributable to the distributee under the constructive ownership rules.

For example, X owns all of the stock of Corporation A. X gives half to his wife in 1955, and in 1960 the corporation redeems all of her shares. The special rule would not apply if tax avoidance were a principal purpose. The wife's interest would not be considered terminated and the redemption would be taxed under Section 301. If the husband's shares were entirely redeemed, the same result would follow. If there was a concurrent redemption of both spouses' shares, the interest of both would be deemed terminated.

Redemptions to Pay Death Taxes

Important liberalizations have been made in the rule permitting capital gain treatment on such redemptions (Sec. 303). However, the amount of such redemption that is assured capital gain treatment may not exceed the sum of death taxes (including interest) and funeral and administration expenses allowable for federal estate-tax purposes.

This treatment applies only if the value, for federal estate tax purposes, of all of the stock of the corporation included in the decedent's gross estate is more than either 35 per cent of the gross estate or 50 per cent of the taxable estate. Stock of two or more corporations will be treated as the stock of a single corporation if more than 75 per cent in value of the outstanding stock of each is included in determining the value of the estate.

For example, decedent owned more than 75% of the stock of each of Corporations X, Y, and Z. The value of the X stock is 10%, Y 20%, and Z 30% of the gross estate. Since the total of all three is more than 35%, redemption of any could qualify. If the total value of the stock in all three was less than 35% of the gross, but more than 50% of the taxable estate, the redemption could also qualify.

Stock representing a surviving spouse's interest in community property will be treated as having been included in determining the value of the gross estate for the purpose of the 75 per cent requirement.

These rules will apply only to redemptions after death and within the period of limitations for assessment of federal estate tax plus 90 days or, if a petition is filed with the Tax Court, at any time within 60 days after the decision of the Tax Court becomes final.

If the estate receives stock whose basis is determined by reference to the basis of stock included in the gross estate (*e.g.*, in a reorganization exchange), the new stock will qualify for this treatment in the same manner as the old. For this purpose it is immaterial that the new stock may be Section 306 stock (discussed below).

Related Corporations

If one or more persons are in control of each of two or more corporations (brother-sister corporations) and one of the corporations purchases stock in the other from the person or persons in control, the purchase will be treated as a redemption of the stock of the purchaser and will be taxed as a dividend unless Sections 302 or 303 provide otherwise (Sec. 304). The amount to be treated as a dividend will be determined solely by reference to the earnings and profits of the purchaser. The stock acquired will be treated as a contribution to its capital and will take as its basis the basis in the hands of the shareholder. This provision had no counterpart in prior law.

For example, A owns all of the stock of Corporations X and Y. X buys all of the stock of Y for $100,000. X has more than $100,000 of accumulated earnings. The $100,000 received by A would be taxed as a dividend and the stock of Y would be treated as a contribution to the capital of X. Its basis would be the same as in the hands of A. A's basis for his X stock would be increased by his basis for the Y stock.

If a subsidiary purchases stock of its parent from a shareholder the purchase will be treated as a redemption of the parent's stock (subject to Section 302, 303). This provision is a restatement of prior law. The determination of the amount, if any, to be treated as a dividend will be made as if the purchase price was distributed by the subsidiary to the parent and immediately thereafter distributed by the parent in redemption of its stock.

Control (and parent-subsidiary relationship) for this purpose means ownership of stock possessing at least 50 per cent of the total voting power or of the total value of all classes of stock. Moreover, a person in control of a corporation owning at least 50 per cent of the voting stock of another corporation will be treated as in control of such other corporation. The constructive ownership rules apply in determining control.

Distributions of Stock and Rights

Virtually all stock dividends will be taxfree at time of receipt (Sec. 305), though Section 306 may give rise to ordinary income upon sale or redemption. The only taxable distributions of stock or stock rights are those in discharge of preferred dividends for the current or the preceding year, or where the shareholder may elect to take either cash or property in lieu of stock (or stock rights).

Disposition of Certain Stock

Section 306 is an attempt to prevent the type of "preferred stock bail-out" illustrated in *Chamberlin* v. *Commissioner* (207 F(2d) 462).

This section coins a new term, "Section 306 stock." Specifically, it comprises:

A. Stock (other than common on common) distributed to a shareholder if, by reason of Section 305(a), any part of the distribution was not includible in the gross income of the shareholder. Note that common issued on preferred can be Section 306 stock.

B. Stock, other than common, distributed to a shareholder in pursuance of a plan of reorganization, or in a divisive transaction such as a spin-off (see Sec. 355 and 356), if upon receipt gain or loss was to any extent not recognized, but only to the extent that the effect was substantially the same as a stock dividend, or the stock was received in exchange for Section 306 stock.

C. Stock whose basis to the disposing shareholder is determined by reference to the basis of Section 306 stock. This, however, is limited to cases other than those to which (B) above is applicable. Here, too, common may be Section 306 stock.

Stock is not Section 306 stock if a distribution of money in lieu of the stock would not have been to any extent a dividend. Thus, preferred stock issued upon incorporation and stock issued when the corporation had no current or accumulated earnings and profits would not be Section 306 stock.

Sale. If a shareholder sells or otherwise disposes of Section 306 stock, but not in a redemption within the meaning of Section 317(b), the entire proceeds will be treated as gain from the sale of a non-capital asset to the extent there would have been a dividend if the corporation, at the time of distribution, had distributed money instead of Section 306 stock. If the proceeds do not exceed this amount, the basis of the stock may be lost, as under former Section 115(g)(1). Proceeds in excess of this amount are treated as payments for the stock and are applied against basis before additional gain results to the shareholder.

For example, a shareholder owns all of the outstanding common of a corporation. The shareholder receives 1,000 shares of preferred stock with a fair market value of $100 per share as a dividend on his common when the corporation has $100,000 in accumulated and/or current earnings and profits. Assume the basis allocable to the preferred is $30,000. The preferred is Section 306 stock. If it is sold for $100,000 the entire proceeds (not just $70,000) will be taxed as ordinary income.

If the corporation had only $60,000 of accumulated (and current) earnings and profits at the time of the distribution of the preferred stock, $60,000 would be taxed as ordinary income. To the extent that the remaining $40,000 exceeded the basis allocated to the Section 306 stock ($30,000), there would be capital gain (long-term or short-term as the case may be) from the sale of such stock.

The ratable share of earnings and profits of Section 306 stock at distribution will be determined in accordance with its fair market value at that time. It would be immaterial that a cash dividend reducing earnings and profits to zero might be distributed subsequent to the distribution of the Section 306 stock. The stock would be Section 306 stock because of corporate earnings in existence at the time of its distribution. Ordinary income may be avoided only through redemption when there are no earnings and profits.

In no event will any loss be allowed with respect to the sale of Section 306 stock.

Redemption. A redemption (rather than a sale) will be treated as a distribution to which Section 301 applies, giving rise to a dividends received credit or deduction. However, if Section 306 stock is redeemed when there are no accumulated or current earnings and profits, the redemption will be treated under Section 301 as a return of capital.

Exceptions. The disposition of Section 306 stock will not give rise to ordinary income under Section 306, and the rules of Section 302 or other appropriate sections will apply (*1*) if the entire interest of the stockholder is terminated in a redemption under Section 302, or in a disposition to a person other than one whose ownership would be constructively that of the stockholder; (*2*) in a complete or partial liquidation (as defined in Section 346); (*3*) to the extent that gain or loss is not recognized on disposition of the stock (*e.g.*, in a reorganization exchange); (*4*) if the distribution, and the disposition or redemption, were not part of a plan having tax avoidance as a principal purpose. Participation in a tax-avoidance plan will be determined on an individual basis.

These new rules apply only to stock issued on or after June 22, 1954. Disposition of stock previously issued will be treated under prior law.

Basis of Stock and Stock Rights

If a shareholder receives stock or rights to acquire stock in a nontaxable distribution under Section 305, the basis will be an allocated portion of the basis of the stock on which the distribution was made (Sec. 307). However, if the fair market value of stock rights is less than 15 per cent of the fair market value of the stock on which the distribution was based, no allocation need be made. The rights will take a zero basis unless the recipient elects to make an allocation. It is not clear whether the 15 per cent is determined by reference to the value of the stock before or after the distribution.

Taxability of Distributor Corporation

Section 311 incorporates the rule of *General Utilities & Operating Co.* (296 U.S. 200) that a corporation does not realize taxable income in a distribution of its property whose value exceeds its basis. In the reverse situation, no loss will be realized (but the corporation can realize a loss by selling the property and distributing the proceeds—subject to exceptions in Section 337). The rule is extended to distributions of stock and stock rights.

This general rule does not apply to distributions of goods inventoried under LIFO, or property subject to a liability (or if the stockholder assumes a liability) greater than the adjusted basis of the property distributed.

On the distribution of such "inventory assets" the corporation realizes gain equal to the excess of the "inventory amount" under a method other than LIFO over the "inventory amount" under LIFO.

"Inventory assets" means stock in trade or other property that would be included in inventory. "Inventory amount" means the value of such inventory assets determined as if the taxable year closed at the time of such distribution. The "inventory amount" other than under the LIFO method will be determined under the retail method if the corporation uses that method, or under the lower of cost or market method if the corporation does not use the retail method.

Where the property distributed is either subject to a liability or the shareholder assumes a liability of the corporation, and the liability exceeds the adjusted basis to the corporation, gain will be recognized to the corporation equal to the excess. However, if there is no assumption of the liability, gain will be limited to the excess of fair market value over adjusted basis.

For example, property having an adjusted basis of $100 and a fair market value of $1,000 (but subject to a liability of $900) is distributed. Such distribution is taxable to the corporation to the extent of $800.

If the liability was $1,200 and was not

assumed, the gain would be $900. The gain will be capital or non-capital, depending upon the nature of the property distributed.

Effect on Earnings and Profits

For the first time a statutory rule (Sec. 312) states the appropriate adjustments to earnings and profits when appreciated or depreciated property is distributed.

In general, upon a distribution by a corporation in respect to its stock, the earnings and profits of the corporation will be decreased by the sum of (*a*) the amount of money; (*b*) the principal amount of the obligations of such a corporation; and (*c*) the adjusted basis of other property so distributed. Earnings and profits may not be reduced below zero, however.

For example, property with a cost of $80 and a value of $100 is distributed. If earnings and profits are only $75, they will be reduced to zero. If the property costs the corporation $50, its earnings and profits will be reduced by only $50, and $25 will remain in earnings and profits.

For the purpose of taxing shareholders on the appreciation in inventory assets, earnings and profits will be increased by the excess of value over basis and decreased by the fair value of the assets distributed, but not below zero.

For example, Corporation X distributes inventory assets with a basis of $80 and a fair market value of $100 when its earnings and profits are $50. Earnings and profits will be increased to $70, and will be reduced to zero.

"Inventory assets," for this section, means those items normally included in inventory or held primarily for sale to customers and unrealized receivables or fees. Unrealized receivables or fees means, to the extent not previously includible in income, rights to payment for goods delivered or to be delivered (other than capital assets), or rights to payment for services rendered or to be rendered. Apparently all contracts must be valued at the date of distribution for this purpose. Note that this differs from the definition in Section 311.

Provision is made for proper adjustments where property distributed is subject to a liability; or where the distributee assumes a liability in connection with the distribution; or where gain is recognized to a corporation upon the distribution of Lifo inventory or property subject to indebtedness in excess of basis. These adjustments are to be detailed in regulations.

A distribution of stock or securities will not reduce earnings and profits if no gain to the distributee is recognized. However, a distribution of stock in lieu of preferred dividends for the current or the prior year would reduce earnings and profits since the distributee recognizes income under Section 305.

Section 312 also provides for taxing as a dividend "windfall profits" from government insured loans to construction projects. If a corporation makes a distribution when there is outstanding a loan made, guaranteed, or insured by the United States (or by any agency or instrumentality thereof) exceeding the adjusted basis (without regard to adjustments for depreciation) of the property constituting security for such loan, the earnings and profits of the corporation will be increased by the excess. It is intended that as long as such loan is outstanding any distribution shall be treated as a dividend to the extent that it does not exceed such excess. An accumulated deficit may not be used to reduce the increase in earnings and profits to be made under this section. To the extent that any distribution exceeds such excess, earnings and profits not arising out of the increase here provided are decreased, and if there are insufficient earnings and profits, capital may be decreased.

For example, a corporation has earnings and profits of zero before applying this section. It has outstanding such a loan of $100,000 on property with a basis of $80,000. Earnings and profits are therefore increased to $20,000. A distribution of $30,000 would be treated as a dividend to the extent of $20,000, and a return of capital of $10,000.

Definitions

The term "dividend" generally means (as in prior law) a corporate distribution to shareholders out of earnings and profits accumulated after February 28, 1913, or out of earnings and profits of the taxable year.

The term "property," for purposes relating to corporate distributions, means money, securities, and any other property except stock in the distributing corporation (or rights to acquire such stock). Thus, treasury stock is not "property."

The term "redemption of stock" means the acquisition by the corporation of its stock from a shareholder in exchange for property—whether the stock is cancelled, retired, or held in treasury.

Constructive Ownership

Section 318 describes the area in which ownership of stock is attributable to a person other than the person actually owing such stock. This includes members of the family; persons having interests in partnerships, estates, trusts, and corporations; and stock with respect to which an option exists.

CORPORATE LIQUIDATIONS

Gain or Loss to Shareholders

Section 331 substantially restates prior law by providing that corporate distributions in complete or partial liquidation shall be treated as payment in exchange for the stock. However, the transactions treated as a partial liquidation are limited by Section 346. The general rule relating to distributions (Sec. 301) will not apply to any distribution of property in partial or complete liquidation.

Liquidations of Subsidiaries

Section 332 substantially restates Section 112(*b*)(6) of the old law. The provisions will now apply even though the parent corporation decreases its stockholdings in the subsidiary after the time of the adoption of the plan of liquidation and before receipt of the subsidiary's property. Furthermore, if the subsidiary was indebted to its parent when the plan of liquidation was adopted, the subsidiary will recognize no gain or loss on the transfer of property to the parent in satisfaction of indebtedness. Evidently the rule of prior law remains that a parent can realize income upon the receipt of property exchanged in liquidation for bonds of the subsidiary purchased at a discount. Under Section 334 the property so received retains the same basis as in the hands of the subsidiary.

Election in Certain Liquidations

Section 333 incorporates and makes old Section 112(*b*)(7) a permanent part of the law. It will apply only to plans of liquidation adopted on or after June 22, 1954, and it is not necessary that the month of completion fall within the taxable or calendar year in which the plan is adopted.

This provision permits qualified electing stockholders to receive appreciated property without the recognition of gain on such appreciation. In the case of individuals, any gain is treated as a dividend to the extent of earnings and profits and as capital gain to the extent realized in cash (or stock or securities acquired after December 31, 1953). Corporate distributees are taxed on any gain at capital-gain rates measured by the greater of their share of the earnings and profits or the cash (and stock and securities acquired after December 31, 1953) received. Any other gain will not be recognized; in general, such part will represent unrealized appreciation in property distributed.

Basis of Property Received

The general rules of prior law that, if property is received in a liquidating distribution and gain or loss is recognized, the basis of property shall be its fair market value, and that the basis of property received by a parent corporation in the taxfree complete liquidation of its controlled subsidiary is the same as in the hands of the subsidiary, are retained in Section 334. It is also made clear that no increase or decrease in the basis of property will result from its transfer in liquidation by a subsidiary to the parent in satisfaction of indebtedness.

However, where a corporation acquires stock to acquire the underlying assets, the basis of the property to the distributee will be the basis of the stock on which the distribution was made. Adjustments must be made for any distribution to the distributee with respect to the stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

For these rules to apply, the distributee must acquire by purchase (generally any taxable transaction not between related parties), during a period of not more than 12 months, stock possessing at least 80 per cent of the total combined voting power and at least 80 per cent of the total number of shares of all other classes of stock (except nonvoting stock that is limited and preferred as to dividends). The distribution must be made pursuant to a plan of liquidation adopted on or after June 22, 1954, and not more than two years after the date of the acquisition of the requisite amount of stock. If a straight liquidation were not practicable, a statutory merger would probably produce the same effect.

The new law thus codifies the rule of the *Kimbell-Diamond Milling Company* decision (187 F.(2d)718) and similar cases. It is somewhat more liberal than the court-made rules and lends certainty to this type of transaction. If a stepped-down basis were involved, the taxpayer would probably seek to avoid it; *e.g.*, by postponing the liquidation for more than two years. The new Code does not cover such acquisitions by individuals.

Section 334 also prescribes rules for the basis of property received in a transaction to which Section 333 applies (old 112(*b*)(7)). The basis is the same as the basis of the stock cancelled or redeemed in the liquidation, decreased by any money received and increased by any gain recognized. Adjustments for corporate liabilities (if any) taken over by the shareholders will be prescribed by regulations.

Effects on Corporation

Section 336 provides that no gain or loss will generally be recognized by the distributor of property in kind in partial or complete liquidation. However, in a taxable liquidation the profit on installment obligations will become taxable in the year of liquidation. In a taxfree liquidation, installment obligations can still be taken over by the parent without realization of income to the subsidiary.

Although somewhat similar to Section 311 (recognition of gain or loss to a corporation making a distribution with respect to its stock), this section contains an important difference. No gain or loss is recognized to the corporation in complete or partial liquidation in case of distributions of LIFO inventory or assets subject to (or where the shareholder assumes) a liability in excess of basis. If a taxpayer has his stock redeemed under Section 302 in exchange for LIFO inventory of the corporation, the corporation can there realize gain under Section 311. However, if the redemption is effected in connection with a partial liquidation as defined in Section 346, the corporation will realize no gain.

Sales or Exchanges in Liquidations

Section 337 attempts to overcome the hardship of the *Court Holding Company* (324 U.S. 331) rule and to eliminate the uncertainty injected by the *Cumberland Public Service Co.* (338 U.S. 451) decision and similar cases. In general, the tax on any gain derived during liquidation is limited to a single tax imposed on the shareholder.

If a corporation adopts a plan of complete liquidation on or after June 22, 1954, and within 12 months thereafter distributes all of its assets (less assets retained to meet claims), no gain or loss will be recognized to the corporation from any sales or exchanges of property by it within such 12-month period. This provision does not apply to inventory, other property held primarily for sale to customers, or certain installment obligations. However, where substantially all of the inventory and like property is sold to one person in one transaction, and no replacement thereof is made, the rule of nonrecognition of gain or loss will apply. A corporation may dispose of some property before adopting a plan of liquidation and any losses thereon would be decuctible by the corporation. If the 12-month distribution requirement is not met, losses (and gains) will be recognized.

This section will not apply to any sale made by a collapsible corporation, a corporation being liquidated in a taxfree liquidation under Section 332, or a corporation being liquidated under the partially taxfree provisions of Section 333.

This section will apply if the basis of property in the hands of the distributee is determined under Section 334(b)(2) (*Kimball-Diamond Milling Co.* type of transaction), but only to that portion of the gain arising from the sale of any asset which is not greater than the excess of that portion of the basis of the stock of the liquidating corporation in the hands of the distributee, allocable to the property sold or exchanged, over the adjusted basis of such property.

For example, in 1955 Corporation X purchased all of the stock of Corporation Y for $10,000. The sole asset of Y is a building with a basis of $6,000. In 1956, X causes the taxfree liquidation of Y under Section 332. The building is sold during liquidation for $11,000. Of the $5,000 gain to Y, Section 337 permits nonrecognition of $4,000. No gain or loss will be recognized to X, even though it receives $10,750 in cash (proceeds of the sale less 25% tax on $1,000). The $1,000 excess of proceeds of sale of the building over the $10,000 purchase price of stock paid by X is taxed to Y, but not again to X.

Collapsible Corporations

Section 341 follows the pattern of old Section 117(m). provides that a distribution in excess of basis of stock, which would ordinarily be capital gain, shall be ordinary income if made by a collapsible corporation.

The term, "Section 341 assets," is introduced to define a collapsible corporation and to provide for a rebuttable presumption of collapsible corporation status under certain conditions. It means property similar to "inventory assets" in Section 312, the held less than three years.

In addition, Section 341 assets include property described in Section 1231(b) (formerly 117(j)), held for less than three years unless it is or has been used in connection with the manufacture, construction, production, or sale of certain other Section 341 assets, such as inventory or property held primarily for sale. The holding period includes the time of holding property transferred in nontaxable exchanges. However, the period will not be deemed to begin before the completion of the manufacture, construction, production or purchase of the property.

There will be a presumption that a corporation is a collapsible one if the fair market value of its Section 341 assets is 50 per cent or more of the fair market value of its total assets (not including cash, stock and certain obligations) and 120 per cent or more of the adjusted basis of such Section 341 assets. However, absence of these conditions will not justify the presumption that the corporation is not a collapsible corporation.

These provisions will not apply to any shareholder owning less than five per cent in value of the outstanding stock of the corporation. Before it was ten per cent.

Partial Liquidation Defined

The definition of partial liquidation (Sec. 346) is considerably narrower than under prior law. Redemptions which do not qualify as partial or complete liquidations are treated under Section 302 or other applicable sections. In general, therefore, only a liquidation that has the effect of contracting the business will qualify as a partial liquidation.

A distribution will be treated as in partial liquidation if it is one of a series in redemption of all of the stock pursuant to a plan, or if the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock pursuant to a plan of partial liquidation, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

Section 346(b) describes as an illustration only one kind of a distribution which will be considered as being in partial liquidation. If a distributing corporation engages in the active conduct of at least two businesses which have been actively conducted (whether by it or not) for five years immediately before the distribution, the assets of one of the active businesses may be distributed in partial liquidation (or the proceeds of sale of such a business may be distributed) if the corporation continues in the active conduct of the other. None of such businesses may have been acquired within the five-year period in a transaction in which gain or loss was recognized in whole or in part, as for example by a purchase or in a reorganization where "boot" was present. Whether or not the distribution is pro rata among the shareholders of the corporation will be ignored in this situation.

If a distribution to a shareholder qualifies for capital gain treatment under both this and Section 302(a), any restriction imposed by Section 302 will not apply to such shareholder.

For example, if a shareholder terminates his interest in a corporation pursuant to a partial liquidation in which he and his son each owned half the stock, there would be no sanction under Section 302(c)(2)(A) if he reacquires an interest within 10 years after the date of the distribution.

CORPORATE ORGANIZATIONS AND REORGANIZATIONS

Transfer to Controlled Corporation

Although Section 351 is similar to old Section 112(b)(5), the "proportionate interest" requirement has been eliminated and the new provision states specifically that stock or securities issued for services shall not be considered as issued in return for property.

Under prior law, it was not clear whether a distribution of the stock received by corporate transferors would destroy the taxfree characteristics because of the requirement that the transferor be in 80 per cent or more control immediately after the exchange. Now the fact that any corporate transferor distributes part or all of the stock it receives to its shareholders will not be taken into account for the purpose of determining control. If the transferor corporation did not itself have the necessary control after the transfer (because of other transferors), any distribution of the stock of the transferee to the stockholders of the transferor would be taxable to the distributees.

The "boot" provision and the provision that no loss will be recognized are brought within the section with no substantive change from prior law.

While the "proportionate interest" requirement has been eliminated, the Finance Committee's report states that, if stock and securities received are not in proportion, the transaction will be treated as if the stock and securities had first been received in proportion and then some stock and securities had been used to make gifts, pay compensation, or satisfy obligations. A disproportion may thus give rise to income-tax or gift-tax liability.

Exchanges of Stock and Securities

Section 354 is derived from Section 112(b)(3) of prior law and provides rules for exchanges by shareholders and security holders in various reorganizations. Unlike Section 112(b)(3), however, this section specifies that securities (as distinct from stock) may be received taxfree only in an amount not in excess of the principal amount of securities surrendered. If any greater principal amount is received, the fair market value of the excess principal is treated as "boot." If securities are received and none are surrendered, all are treated as "boot."

The new law does not define the term "securities." On the basis of court decisions, bonds, debentures and notes should probably have a term of at least ten years to be certain of qualifying as securities.

Where a corporation transfers substantially all of its assets to another corporation then controlled by it or its stockholders, Section 354 applies only if the transferor distributes all of the stock and securities received in pursuance of the plan of reorganization and all of its other property. Cash or other property distributed in connection with the reorganization is treated as "boot." If all of the property of the transferor is not distributed (*i.e.*, the transferor continues in operation), the distribution of stock and securities will be governed by the provisions of Section 355 (assuming all of the requirements of that section have been met). Here again, the "boot" rules are applicable.

Distribution of Stock and Securities

If a corporation distributes to a shareholder, with respect to its stock, or to a security holder in exchange for its securities, solely stock or securities of a controlled corporation, no gain or loss will be recognized to the distributees, subject to certain limitations as to "boot" distributions (Sec. 355).

In order to qualify for this treatment, the transaction must not be used principally as a device for the distribution of earnings and profits of either the distributing or the controlled corporation, and the distributing corporation must distribute all of the stock and securities of the controlled corporation held by it immediately before the distribution, or an amount of stock constituting 80 per cent control. It must be established that any retention of stock and securities was not for purposes of tax avoidance.

Distributions of the following items will be treated as distributions of "boot": securities (as distinct from stock) of a controlled corporation to the extent that their principal amount exceeds the principal amount of securities surrendered; securities of a controlled corporation where no securities are surrendered; other property; and stock of a controlled corporation acquired by the distributing corporation in a transaction in which gain or loss was recognized to any extent within five years prior to the distribution of such stock.

Superimposed on these provisions is the requirement that both the distributing corporation and the controlled corporation or corporations must be engaged immediately after the distribution in the active conduct of a trade or business. However, a corporation will meet this requirement where substantially all of its assets are stock or securities in controlled corporations, each of which is engaged immediately after the distribution in the active conduct of a trade or business (*e.g.*, split-up of a holding company).

There is no definition of "active conduct of a trade or business," but presumably the intent is to prevent such transactions as the spin-off of an active business and the retention of only investment assets in the distributing corporation with the intention of subsequently liquidating the distributing corporation at capital gain rates (a sort of bail-out).

This requirement cannot be met by purchasing an active business immediately before the distribution. Each business, whether retained or distributed, must have been actively conducted for a period of at least five years preceding the date of distribution. In general, the active business of the corporation whose stock is distributed must have been conducted by the distributing corporation or a controlled corporation for a period of five years.

The distribution need not be pro rata with respect to all the shareholders. An example of a non-pro-rata distribution would be the distribution of stock of a spun-off controlled corporation to one of several stockholders of the distributing corporation. Similarly, individuals jointly owning a corporation may split up into independent separate corporations.

The shareholder is not required to surrender stock in the distributing corporation, and distribution of both common and preferred stock is permitted, although the preferred may be Section 306 stock.

There need be no plan of reorganization. Because of the elimination of this requirement, it is no longer necessary to form a new corporation to effect the distribution. The requirement that a transaction not be a device for the distribution of earnings and profits, by inference, requires a showing of an adequate business purpose. The mere sale of stock received in such a distribution is not in itself to be treated as a device for the distribution of earnings and profits, if the sale is not part of a plan.

Receipt of Additional Consideration

If Section 354 or 355 would apply except that other property or money ("boot") is also received, gain, if any, will be recognized to the extent of the money and the fair market value of other property received, but no loss will be recognized (Sec. 356). The term "other property" includes the principal amount of securities received minus the principal amount of securities, if any, surrendered.

Where the receipt of "boot" has the effect of a dividend, the gain recognized will be treated as a dividend to the extent of each stockholder's ratable share of the earnings and profits of the corporation accumulated after February 28, 1913. The remainder of the recognized gain will be treated as a gain from the exchange of property.

To the extent that money or other property is received in exchange for Section 306 stock, it will be treated as a distribution under Section 301. Ordinarily, money or other property received will first be applied to Section 306 stock.

Since the new Code limits the taxfree aspects of a distribution of securities to the principal amount of securities surrendered, if debentures are issued in exchange for preferred stock, gain or loss will be recognized (and taxed as capital gain or dividend as the facts warrant).

Assumption of Liability

In general, if the taxpayer receives property permitted to be received under Sections 351, 361, or 371 without the recognition of gain and, in consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, the amount of the liability will not be treated as money or other property received. However, if the principal purpose with respect to the assumption or acquisition of the liability was tax avoidance or not a bona fide business purpose, the total liability will be considered as money received by the taxpayer on the exchange.

There is one situation in which taxable gain will result from assumption or acquisition by another of a liability of the taxpayer, even if no tax avoidance motive is present and even if there are good business reasons for the transaction. In the case of an exchange to which Section 351 applies, or to which Section 361 applies by reason of a plan of reorganization within the meaning of Section 368(a)(1)(D), if the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceed the adjusted basis of the property transferred, the excess will be considered as a gain (capital or noncapital, depending on the nature of the property transferred).

For example, A, an individual, transfers to Corporation X property with a basis of $20,000. It had a fair market value of $60,000 and was subject to a mortgage of $50,000. In exchange X issues to A all of its stock. A will have gain equal to the $30,000 excess of the mortgage over the basis.

Basis to Distributees

Section 358 provides that the basis of property (including stock or securities) permitted to be received without the recognition of gain or loss (pursuant to Sections 351, 354, 355, 356, 361, or 371(b)) will be the same as that of the property exchanged, decreased by the "boot" received by the taxpayer and increased by the amount treated as a dividend or gain (other than a dividend) recognized. The basis of "other property" received will be its fair market value. Allocation of basis between properties received will be made under regulations. This is substantially the same as under old Section 113(a)(6).

Gain or Loss to Corporations

Section 361 substantially restates the rules on nonrecognition of gain or loss and "boot" as old Sections 112 (b)(4,) 112(d), and 112(e).

Basis to Corporations

Section 362 provides that the basis of the property acquired by a corporation in connection with an organization, reorganization, as paid-in surplus, or as a contribution to capital, will be the same as the basis to the transferor, increased by any gain recognized to the transferor. However, this rule will not apply to property acquired in a reorganization if the property consists of stock or securities in a corporation which is a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

For example, in pursuance of a plan of reorganization Corporation X acquires the stock of Corporation Y. Section 362 would apply if the acquisition is accomplished by the issuance of X's own stock or securities. If X acquired the stock of Y in exchange for substantially all of its properties, the stock of Y would have, under Section 358, the same basis in the hands of X as the properties exchanged. The properties acquired by Y would retain, under Section 362, the same basis as in the hands of X.

The section also provides special rules with respect to contributions to capital by nonstockholders. If property other than money is acquired by a corporation on or after June 22, 1954, as a contribution to capital and is not contributed by a shareholder as such, the basis of the property will be zero. If money is received under these conditions, the basis of any property acquired with such money during the 12-month period beginning on the day of the contribution will be reduced by the amount of the contribution. The excess (if any) of the amount of such contribution over the amount of such reduction will be applied to reduce, as of the last day of the 12-month period, the basis of any other property held by the taxpayer. The method of allocation among properties will be covered by regulations.

Foreign Corporations

Section 376 provides that, in determining the extent to which gain (but not loss) will be recognized in the case of any of the exchanges described in Section 332, 351, 354, 355, 356, or 361, a foreign corporation will not be considered a corporation unless, before such exchange, it has been established that tax avoidance was not a principal purpose for it.

Any distribution described in Sections 355 and 356 will be treated as exchange.

Definitions in Reorganizations

Section 368 restates, with some modifications, the six different ways in which a "reorganization" can be accomplished so that the exchanges involved are taxfree. The familiar symbols (A, B, C, D, E and F) of old Section 112(g)(1), by which these six types were commonly known, are retained.

To summarize briefly, the six types are:

A. Statutory merger or consolidation.

B. Acquisition of stock of another corporation solely for voting stock, provided the acquiring corporation then has control of the acquired corporation.

C. Acquisition of substantially all the properties of another corporation solely for voting stock.

D. Transfer of property to a controlled corporation followed by distribution to shareholders of the stock or securities of the corporation to which the property is transferred.

E. Recapitalization.

F. Change in identity, form, or place of organization.

Because it must be followed precisely, the statutory language should be referred to. (For a reproduction of these definitions from Section 368, see Appendix I on p. 396.) Changes from prior law are summarized below:

1. Under prior law there was doubt as to whether the statute permitted a type (B) acquisition taxfree when the acquiring corporation already owned some of the voting stock of the other corporation. This doubt has now been removed.

For example, Corporation A bought for cash 20 per cent of the stock of Corporation B in 1940. In 1955 it buys an additional 60 per cent of the stock of B in exchange for its voting stock. This exchange is taxfree since A controls B immediately after the exchange. Any subsequent acquisition of B stock by A in exchange for its voting stock would be taxfree.

2. Under the (C) definition, as modified, a corporation may acquire substantially all the properties of another corporation solely in exchange for the voting stock of the parent of the acquiring corporation.

For example, Corporation P owns all the stock of Corporation S. All the assets of Corporation W are transferred to S solely in exchange for the voting stock of P. This now constitutes a (C) type reorganization. Previously, it was a taxable transaction.

3. A type (D) reorganization has been changed so that, if the control of the transferee is in the transferor or in shareholders of the transferor, or any combination thereof, the transfer will qualify, even if the control is not in the same proportions as before the transfer.

For example, Corporation X has two divisions carrying on unrelated types of businesses. It transfers all of the assets (subject to the liabilities) of one division to Corporation Y in exchange for all the stock of Y and transfers the assets of the other division to Corporation Z in exchange for all the stock of Z. Immediately thereafter, X distributes all the stock in Y to A, one of the two shareholders in X, in exchange for all of A's stock, and distributes all the stock in Z to B, the other shareholder, in exchange for all his stock. The distributions qualify under Section 355. This transaction now qualifies as a (D) type reorganization. In the event the values of the net assets transferred to Corporations Y and Z are disproportionate to the value of the stock in X held by shareholders A and B, the transaction at the shareholder level may have the effect of a gift, compensation, or satisfaction of an obligation.

4. Another change in the (D) type definition is the requirement that the stock and securities of the transferee corporation or corporations be distributed by the transferor in a transaction qualifying under Section 354, 355, or 356. However, where there is no such distribution, the transaction may, nevertheless, result in nonrecognition of gain or loss to the transferor corporation under Section 351.

In addition to these changes in definition, three special rules are provided:

1. If a transaction falls within both the (C) type and the (D) type definitions, it will be treated as a (D) type reorganization. It appears that this treatment is in order to insure that distributions in divisive reorganizations will be governed by the requirements of Section 355.

2. If in a (C) type reorganization at least 80 per cent of the fair market value of all the property (not just that acquired) of another corporation is acquired solely for voting stock, the remainder of the property may be acquired for cash or other property without disqualifying the transaction as a reorganization. For this purpose only, a liability assumed or to which the property is subject, is considered other property.

For example, Corporation A has assets worth $100,000 and $10,000 in liabilities. Corporation Y acquired $98,000 worth of the assets (subject to the liabilities of $10,000) in exchange for voting stock and $8,000 in cash. This transaction is a (C) type reorganization even though a part of the assets of A is acquired for cash. If the assets of A were subject to $50,000 in liabilities, an acquisition of all the assets subject to the liabilities could only be in exchange for voting stock because the liabilities alone are in excess of 20% of the fair market value of the property.

3. If one corporation acquires all, or substantially all, of the assets of another corporation in an (A) or (C) type reorganization, the acquisition will not fail to be a reorganization merely because the acquiring corporation transfers some or all of these assets to a corporation controlled by it.

Section 368 also defines a "party to a reorganization," restating Section 112 (g)(2) of prior law and providing that the corporation controlling the acquiring corporation is also a party to the reorganization when the stock of such controlling corporation is used to acquire assets. It also provides that a corporations remains a party to the reorganization although it transfers all or part of the assets to a subsidiary.

Section 368 defines "control" in the same manner as Section 112(h) of law the old Internal Revenue Code.

CARRY-OVERS TO SUCCESSOR CORPORATIONS

Section 381 has no counterpart in prior law. Its purpose is to place successor corporations in qualifying transactions in substantially the same position as predecessors with respect to numerous items listed below. The new section puts an end to most of the uncertainties created by conflicting court decisions and questions of form of transaction and lays down definite rules.

The qualifying transactions are the complete liquidation of a subsidiary under Section 332 (except in the *Kimbell-Diamond Milling Co.* type of liquidation —Section 334(b)(2)) and a taxfree reorganization pursuant to Section 361, in connection with a reorganization described in subparagraphs (A), (C), (D) and (F) of Section 368(a)(1). A type (D) reorganization will qualify only if certain additional requirements are met.

Subject to various limitations (discussed below), the following items must be carried over from a distributor or transferor corporation to an acquiring corporation:

1. Net operating losses
2. Earnings and profits (or deficits)
3. Capital losses
4. Accounting methods
5. Inventory methods
6. Depreciation methods
7. Prepaid income
8. Installment method
9. Amortization of bond discount or premium
10. Deferred exploration and development expenses
11. Contributions to pension plans, etc.
12. Recovery exclusions re bad debts, taxes, etc.
13. Involuntary conversions
14. Dividend carry-over for personal holding companies
15. Indebtedness deduction for personal holding companies
16. Certain obligations of transferor
17. Deficiency dividends for personal holding companies
18. Percentage depletion of mine tailings
19. Charitable contributions in excess of prior years' limitation

Net Operating Losses

Operating loss carry-overs of a transferor are first carried to the first taxable year of the acquiring corporation ending after the date of the transaction. However, in the first year, the amount of loss carry-over is limited to a pro rata part of the income for such year of the acquiring corporation based on the ratio of the days in the year after the transaction to the total days in the year.

For purposes of determining the net operating loss carry-over for subsequent years, the general rules of Section 172 (b)(2) are applicable, except that if the transaction takes place on other than the last day of the acquiring corporation's taxable year, the taxable income of the year is divided on a daily basis between the pre-acquisition part and the post-acquisition part. Then any loss carry-over of the acquiring corporation is first carried to the pre-acquisition part of the year and the remainder is carried to the post-acquisition part of the year.

For example, assume Corporation Y transfers its properties to Corporation X on July 4, 1955 in a transaction which qualifies. Assume further—

	Income (loss)	
	Y	*X*
1952	$(7,000)	$ —
1953	(10,000)	(10,000)
1954	(25,000)	(15,000)
1955	1,000	36,500

The net operation loss deduction for X in 1955 is:

X's 1953	$ 10,000
X's 1954	$ 15,000
	25,000
Y's 1952 (less $1,000 1955 income)	6,000
Y's 1953	10,000
Y's 1954	2,000*
	18,000
Total net operating loss carry-over to 1955	$ 43,000

* Total of X's 1955 carry-overs attributable to Y are limited to 180/365 of $36,500 or $18,000.

The excess of X's allowable net operating loss carry-over for 1955 ($43,000) over its net income for that year ($36,500) or $6,500 apparently may be carried over as far as 1959. The portion of Y's 1954 loss ($25,000) in excess of the amount allowable to X in 1955 ($2,000) or $23,000 may be carried forward as far as 1958 by X. Although the splitting of the first year by the transaction operates to limit Y's losses to a carry-over of four full taxable years, X may still carry forward five full years.

The rules with respect to carry-over of net operating losses do not have the effect of reducing the amount of a transferor's loss which can be carried over to a transferee. They merely prescribe how, and in what years, it shall be deducted and, in some cases, limit the period of carry-over of the transferor's loss.

A corporation acquiring property in a distribution or transfer under this section will not be permitted to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

Earnings and Profits (or Deficits)

The earnings and profits (or deficit) of the transferor will be deemed to have been acquired by the acquiring corporation on the date of completion of the transfer. However, a deficit of the transferor or transferee corporation may offset only earnings of the surviving corporation accumulated after the date of the transaction. The earnings of the year of the transaction are divided into pre-acquisition earnings and post-acquisition earnings on a daily basis. No part of the earnings of the transferor, whether or not earned during the year of the transaction, will be considered earnings of the acquiring corporation for the year of the transaction.

This subsection codifies the *Sansome* rule and, in part, overrules the *Phipps* case (336U.S.410).

Capital Loss Carry-Over

An acquiring corporation may claim a net short-term capital loss with respect to a capital loss carry-over of the transferor. In the first year ending after the acquisition, the transferor's loss carry-over available to the acquiring corporation is limited to a pro rata part of any capital gain realized by the acquiring corporation based on the ratio of the days in the year after the transaction to the total days in the year. The remainder may be carried forward to future years.

For example, Corporation X acquires all of the assets of Corporation Y on September 30, 1954, in a transaction qualifying under Section 381(a). Both corporations are on a calendar-year basis. Y has a capital loss carry-over of $3,000 from 1953. X has a $10,000 capital gain in 1954. The portion of Y's 1953 capital loss that may be used against X's 1954 capital gain is limited to $2,520.55 (92/365 of $10,000). The balance may be carried forward to subsequent years.

Depreciation Methods

If the transferor had elected to compute depreciation under the declining balance method or the sum of the years' digits method, or some other permitted accelerated depreciation method, the acquiring corporation is required to continue the same method. However, where the basis of the property is greater to the acquiring corporation than to the transferor corporation, the rule applies only to an amount not in excess of the basis to the transferor corporation. The method used by the transferee will apply to the remainder.

Certain Obligations of Transferor

If the acquiring corporation assumes an obligation of the distributor or transferor not reflected in the consideration for the property and which, after the date of the distribution or transfer, gives rise to a liability that would have been deductible in computing the distributor's or transferor's taxable income, the acquiring corporation will be entitled to deduct such item. For example, if the acquiring corporation assumed an obligation to make monthly pension payments to the transferor's retired employees, the acquiring corporation could deduct such payments.

Acquisition of Loss Companies

To limit traffic in loss companies, Section 382 disallows net operating loss carry-overs to a corporation 50 per cent or more of whose outstanding stock has changed ownership and been acquired by ten or fewer persons as a result of purchases or redemptions during a period of two years or less if such corporation has not continued to carry on a business substantially the same as before the change in ownership.

This section also limits the net operating loss carry-overs of either the transferor or acquiring corporation in a reorganization specified in Section 381 unless, as a result of the reorganization, there is a 20 per cent or more continuity of interest in the resulting corporation retained by the stockholders of the corporation with the net operating loss carry-overs.

The Finance Committee report states that if the limitations of this section apply, Section 269 (relating to acquisitions made to avoid income tax) is not applicable to such carry-over. However, the fact that a limitation under this section does not apply has no effect upon determining whether Section 269 applies.

Purchase. The net operating loss carry-over is entirely disallowed if all of the following three conditions exist:

1. One or more of the ten persons owning the greatest percentage of market value of the outstanding stock of the loss corporation owns, at the end of a taxable year, a percentage of the market value of the outstanding stock (except nonvoting stock which is limited and preferred as to dividends) which is at least 50 percentage points more than such person or persons owned at the beginning of either such taxable year or the prior taxable year.
2. The increase is due to purchase of the corporation's stock (directly or indirectly) or a decrease in the loss corporation's outstanding stock, or the outstanding stock of another corporation owning stock in the loss corporation, unless resulting from a redemption to pay death taxes to which Section 303 applies.
3. The loss corporation has changed its business to some extent (how much is not clear) so that it is not substantially the same as that conducted before the change in ownership referred to above.

The constructive ownership rules apply in selecting the ten persons owning the greatest percentage of stock, related persons being considered as one person. But in determining the percentage of increase in ownership in the two-year period, apparently each person is considered separately.

An increase of "50 percentage points" does not mean the same as a "50 per cent increase." A stockholder who increases his ownership from 4 per cent of the value of the outstanding stock to 6 per cent has had an increase of 50 per cent in ownership, but an increase of only 2 percentage points.

Reorganization. In the case of a change in ownership in a reorganization as specified in Section 381(a)(2), the stockholders of the loss corporation must own immediately after and as a result of the reorganization at least 20 per cent of the value of the outstanding stock (except nonvoting stock limited and preferred as to dividends) of the acquiring corporation if 100 per cent of the operating loss carry-over is to be allowed to the acquiring corporation. If less is owned, the carry-over is reduced proportionately.

For example, assume Corporation X has a net operating loss carry-over from 1954 to 1955 of $100,000. Y merges into X in a statutory merger on January 1, 1955. X's former stockholders then own only 5% of the fair market value of total outstanding stock. The 1955 net operating loss deduction will be computed as follows:

Net operating loss carry-over	$100,000
Percentage of stock of surviving corporation owned immediately after the merger by the stockholders of the loss corporation	5%
Percentage that 5% is of 20%	25%
Net operating loss deduction limited to 25% of $100,000 or	$ 25,000

This limitation on loss carry-overs does not apply if the transferor and acquiring corporations are owned substantially by the same persons in the same proportions.

Provision is also made for an appropriate reduction in a net operating loss carry-over not completely absorbed in the year in which the limitation is applicable. In computing the net operating loss carry-over to subsequent taxable years, the income in the year of acquisition is increased by the amount of the reduction computed under Subsection (b). The effect of this provision is to apply the reduction against the oldest net operating loss first and then, if necessary, against subsequent net operating losses in order.

For example, using the facts above, assume Corporation X has a net income in 1955 of only $15,000 before applying the net operating loss deduction of $25,000. Assume also that the net income for 1956 before any net operating loss deduction is $60,000. This net income is adjusted as follows:

Net income before net operating loss deduction—1956			$60,000
Deduct:			
Net operating loss carry-over from 1954		$100,000	
Less:			
Net income—1955	$15,000		
Increased by amount of reduction under Section 382(b)(2)	75,000	90,000	10,000
Net income after net operating loss decution—1956			$50,000

Special provision is made for parent–subsidiary relationships where the parent owns less than 80 per cent of the stock of the subsidiary (and therefore is not within the taxfree liquidation provisions). If one of the corporate stockholders of a loss corporation is also a party to a reorganization, and either disappears in the reorganization or becomes the acquiring corporation (and, hence, does not own stock in the acquiring corporation immediately after the reorganization), it will be considered to own such percentage of the stock of the acquiring corporation as is determined by the following formula:

$$\frac{\textit{Value of outstanding stock of loss corporation immediately before reorganization}}{\textit{Value of outstanding stock of acquiring corporation immediately after reorganization}} \times \textit{Per cent of stock of loss corporation owned by acquiring corporation immediately before reorganization.}$$

For example, loss Corporation Y is merged into acquiring Corporation X which immediately prior to the merger owned 70% of the outstanding stock of Y. The value of the entire outstanding stock of Y immediately before the merger was $10,000 and the value of the entire outstanding stock of X immediately after the merger is $50,000. The percentage of Y's stock deemed to be owned by X is 14% determined as follows: $10,000/$50,000 × 70% = 14%

A special rule permits stockholders of the loss corporation who own, as a result of the reorganization, stock of a corporation controlling the acquiring corporation to treat such stock as if it were an equivalent amount (measured by value) of stock of the acquiring corporation.

EFFECTIVE DATE OF SUBCHAPTER C

Generally, the new law will apply to corporate distributions, liquidations, organizations, and reorganizations made on or after June 22, 1954. Exceptions are as follows:

1. Section 306 applies only to stock issued and disposed of or redeemed on or after June 22, 1954. Prior law will apply to sales and redemptions of stock issued before that date.

2. Sections 331–338, relating to liquidations, apply only if the first distribution in pursuance of the plan occurs on or after June 22, 1954.

3. Section 341, relating to collapsible corporations, applies only with respect to sales, exchanges and distributions on or after June 22, 1954.

4. A special provision contained in Section 392(b) makes the nonrecognition of gain or loss provisions of Section 337 available to a corporation that adopted a plan of liquidation after December 31, 1953, and before June 22, 1954, if the corporation so elects, and if the liquidation is completed within 12 months after adoption of the plan. If liquidation is completed in 1954, a corporation can elect nonrecognition of gain or loss on 1954 sales or exchanges in the course of liquidation (subject to some limitations), regardless of when the plan of liquidation was adopted.

5. Sections 351 to 368 are effective with respect to plans of reorganization adopted on or after June 22, 1954. Plans to make a transfer to a controlled corporation pursuant to Section 351, or to make a distribution pursuant to Section 355, are covered by the new Code if adopted on or after June 22, 1954. However, if a corporation had submitted a plan of reorganization to the Secretary before June 22, 1954, but did not adopt the plan before such date, and if the Commissioner issues a ruling with respect to such plan, the corporations that are parties to the reorganization may elect to have the tax treatment determined under prior law. In the case of a plan of reorganization adopted after March 1, 1954, and before June 22, 1954, the corporations that are parties to the reorganization may elect to have the provisions of the new Code apply.

6. Section 381 applies to liquidations and reorganizations, the tax treatment of which is determined under the new Code.

7. In applying the special limitation of Section 382(a) on net operating loss carry-overs as a result of change of ownership, the beginning of the taxable years as specified in clauses (i) and (ii) shall be considered to be the beginning of such taxable years or June 22, 1954, whichever occurs later.

8. Section 382(b) (the limitation on loss carry-overs) applies only to re-

organizations taxed under the new Code.

9. Provisions stated in terms of a specific date apply to taxable years ending after that date.

10. The provisions of prior law which are superseded by the new provisions remain in effect until the effective date of the new provisions.

Deferred Compensation Plans; Employee Stock Options

By Matthew F. Blake

DEFERRED COMPENSATION

Under the new Code, government supervision in this field has been strengthened so that trusts engaging in prohibited transactions may forfeit their exempt status; taxation of unrelated business income has been extended to include employee-benefit trusts; and taxation of benefits has been revised on a comparatively broad scale.

QUALIFICATION

The legislative criteria for qualification of plans (which are retained with little change) may be found in Section 401 of the new Code, although Section 501 actually accords the exemption from tax. For the first time (Sec. 401), exemption is limited to plans created or organized in the U.S. However, if the foreign situs of the trust is the only bar to qualification, beneficiaries will be taxed as if the trust were qualified and contributions to the trust by resident employers are deductible.

Denial of Exemption

Machinery has been made available to the Commissioner to take away the exempt status of an employee-benefit trust that engages in a "prohibited transaction" after March 1, 1954 (Sec. 503). (This is an extension of Section 3813 of the 1939 Code to employee-benefit trusts.)

Two prohibited transactions by employee-benefit trusts that seem to have a high potential for loss of exemption are:

Lending of money to the employer with inadequate security or at an unreasonable rate of interest;

Purchase by trusts of securities or property from the employer at an amount in excess of fair market value.

Loans made by trusts prior to March 1, 1954, may continue to maturity without loss of exemption if payable on a definite date. Special rules provide for no penalty on the renewal of notes outstanding at March 1, 1954, and maturing prior to December 31, 1955; and for the continuation up to December 31, 1955, of demand notes outstanding at March 1, 1954.

Tax on Unrelated Business Income

Even an employee trust exempt by reason of full compliance with the conditions of Section 401 of the 1954 Code may find that it is subject to tax on income designated as unrelated trade or business income for the taxable years beginning after June 30, 1954 (Sec. 511–514). "Unrelated trade or business income" includes, in the case of exempt employee-benefit plans, operating income from "any trade or business regularly carried on by such trust or by a partnership of which it is a member." (Sec. 513)

Income from certain leases with terms in excess of five years may come under the unrelated-income category, depending upon the amount of business-lease indebtedness incurred in connection with such leases (Sec. 514). The purpose of Section 514 is to tax only rental income that stems from borrowed funds. However, indebtedness incurred prior to March 1, 1954, is not business-lease indebtedness; nor is an obligation entered into after March 1, 1954, that is necessary to carry out the terms of a lease made prior to March 1, 1954.

DEDUCTION OF CONTRIBUTIONS

Extension of Payment Period. For accrual-basis taxpayers, the period for payment of contributions to pension, profit-sharing, and stock-bonus plans (Sec. 404) is lengthened from 60 days after the close of the taxable year to the last day prescribed by law for filing the return, including extensions of time for filing such a return. This extension should result in a decrease in the pressure of meeting deadlines, but of course it is helpful only where the terms of the plan permit payment after 60 days.

Profit-Sharing Plans. If one or more of the member corporations of an affiliated group (a group qualified to file consolidated returns) is prevented from making a contribution, or is limited in its contribution by a lack of current or accumulated earnings, the other members of the group now are permitted to pay their allocated share of the total intended contribution and to claim deductions for such contributions (Sec. 404).

Allocation among the contributors is based upon the relationship of the net current or accumulated earnings of each to the total earnings—except that when a consolidated return is filed no allocation is necessary. This permits eligible employees of a relatively unprofitable or loss corporation in a group plan to share in consolidated profits when their performance merits recognition.

Pension and Welfare Funds. A new provision (Sec. 404) represents an effort to assist employers to obtain deductions, as business expenses, for contributions to union pension, health, and welfare funds (such as the United Mine Workers'). Since such plans may not qualify for exemption, this is a departure from the general rule that pension contributions are deductible only if made under exempt plans. It is restricted to plans established prior to January 1, 1954, as a result of an agreement between a union and the government during a period of governmental seizure and operation of a major part of the productive facilities of an industry. Membership in an industry wherein such circumstances were present is sufficient; actual seizure of a given company's facilities is not a prerequisite.

Integration of Codes. Section 404 integrates deductions under the 1939 and 1954 Codes, so that rights to carry-over benefits are not lost in the transition.

Corporate Reorganization. In the past, conflicting rulings created the hazard of the potential loss of the right to carry forward such items as the balance of past service costs and unused profit-sharing deductions in the process of corporate liquidations and reorganization. Section 381 provides that, where a specified degree of continuity exists, the transferee corporation may assume such deductions, incurring at the same time the responsibility of fulfilling the prerequisites to these deductions.

TAXATION OF BENEFITS

Beneficiaries of approved pension, profit-sharing, and stock-bonus plans continue to be free from tax until their rights ripen into benefits upon some such event as retirement or death or separation from service. This deferral of taxation applies alike to trusts (Sec. 402) and to annuity plans (Sec. 403). On the other hand, beneficiaries of nonexempt trusts and nonqualified annuities are taxable currently on the employer's contribution, provided their interests are nonforfeitable, or they will be taxable in the year when their interests do become nonforfeitable.

Pension Payments

For plans that do not require contributions by the employee, pensions are taxed to the employee as received or made available (Sec. 72). Contributory plans continue to present complications, as they did under the 1939 Code.

Three-Year Recovery. In the case of contributory plans, where the total amount of the employee's contributions will be recovered in full by him within three years after his pension starts, there is no tax to pay until his receipts exceed the total of his contributions.

For instance, if his cost basis totals $9,600 and his pension, commencing January 1, 1955, is $300 per month, he will not include any part of his pension in taxable income until 1957, when he will report a total of $1,200. Thereafter he will include the full $3,600 per year in gross income.

Life-Expectancy Return. If the employee's contributions are not recoverable within three years, he must compute an exclusion ratio based upon his expected return under the contract. Under this method, which supplants the old three-per-cent rule, his expected return is based upon life expectancy, just as in the case of commercial annuities.

Thus, if his contributions total $20,000, his pension arrangement upon retirement calls for $5,000 per year for life, and his life expectancy is ten years, then $2,000 ($20,000/10) of the $5,000 annual receipts would be excluded from gross income. This annual exclusion would continue to apply throughout his life, whether he dies before or after the completion of the ten-year period.

Profit-Sharing Plans

Benefits under profit-sharing plans generally follow the pattern of pension payments, although relatively few include the problem of amortizing the cost of employee contributions.

Capital Gain on Separation

If the balance to the credit of an employee is paid by an exempt trust or a qualified annuity plan within one taxable year on account of the employee's death, or other separation from the service of the employer (such as retirement), or death after separation, the amount of the distribution in excess of the employee's unrecovered contributions shall be considered a long-term capital gain.

This represents an extension of the capital-gain break in the 1939 Code in two respects—previously it did not apply to death after retirement or to qualified nontrusteed or insured plans.

The old law permitted nonrecognition of unrealized appreciation in securities of the employer corporation, its parent or subsidiary, included in lump-sum distributions to employees. The new law extends this somewhat by defining parent as a corporation owning 50 per cent or more of the combined voting stock of another corporation rather than more than 50 per cent.

Reorganizations and Capital Gain

Long-term capital gain can be obtained only in certain cases where the lump-sum distributions have been made during 1954 as a result of the termination of a plan pursuant to the complete liquidation of a corporation (whether or not incident to a tax-free reorganization) prior to the enactment of the new Code (Sec. 402). Otherwise, the implication is that, when a reorganization occurs, employees who continue in the employ of the surviving company will not obtain capital-gain treatment.

Exclusion of Death Payment

Up to $5,000 of the total distributions paid in a lump sum by an exempt pension or profit-sharing trust or annuity plan to the beneficiaries of a deceased member of the plan may be excluded from gross income, even though the interest of the deceased had become vested prior to death (Sec. 101). This enlarges the possible methods of payment of benefits, but it does not modify the limitation of $5,000 per employee.

Estate Tax

In cases of decedents dying after December 31, 1953, that part of the value of an annuity attributable to the employer's contribution under an approved pension, stock bonus, or profit-sharing trust or annuity plan is now excludable from the gross estate (Sec. 2039). No exclusion is allowed for the portion attributable to the employee's unrecovered contributions under the plan.

Nonexempt Plans

The law continues to provide that when the rights of an employee to deferred compensation under a nonexempt plan are nonforfeitable, he is deemed to receive gross income in the year in which his rights become nonforfeitable—the same year in which the employer obtains his deduction. Obviously, nonforfeitable interests will be no more attractive to the employee than heretofore; so it may be anticipated that carefully calculated measures of forfeitability will continue to be pivots around which nonqualified deferred compensation contracts will resolve.

EMPLOYEE STOCK OPTIONS

The new Code (Sec. 421) retains the basic provisions of the 1939 Code relating to stock options, and makes a number of changes to eliminate ambiguities and provide more definite rules. The more important of these are described below.

Qualification

In order for options granted after June 18, 1954, to qualify as "restricted stock options" they must be exercisable only within a ten-year period. However, a "variable-price option" may now definitely qualify if the option price is at least 85 per cent of the value of the stock at the time the option was granted, and the other qualifications are met. The definition of a variable-price option stipulates that the value of the stock is to be the only variable. Value may be determined at any time during a six-month period which includes the time of exercise.

Options granted to employee-stockholders could not qualify if the employee owned more than ten per cent of the stock of the employer. The new Code permits qualification even under these circumstances if the option price is at least 110 per cent of the value of the stock at the time the option is granted *and* if the option is exercisable during a period not exceeding 5 years. This latter requirement is waived if the option is exercised within one year following the date of enactment of the new law.

Exercise

An estate or beneficiary of a deceased employee may now exercise an option and be treated in substantially the same manner as the employee. The estate tax attributable to the inclusion of the option in the decedent's estate will be allowed as a deduction for income-tax purposes in the year the estate or beneficiary has income from the disposition of stock acquired under option.

For income tax purposes the transfer of stock from an estate to a beneficiary will be treated as a disposition.

Modifications in Options

Under the new law a modification will not be deemed to result from certain corporate reorganizations or liquidations if the old option is assumed by the new employer (or cancelled and a new one granted). The new option must not be of greater value than the old and must not give additional benefits not available under the old. Changes in option terms to comply with a reorganization are not to be considered modifications.

The option price under present law must be at least 85 per cent of the higher of the value of the stock at the time the option is granted or modified. This "higher value" test has been removed where there has been a "prolonged" decline in the stock value. A prolonged decline is defined as one of at least 20 per cent in value for a year or more.

Other Changes

Under the old law tax returns of the employee and the employer had to be reopened for the year of exercise where stock acquired was disposed of before two years from the date the option was granted or before six months had elapsed following acquisition. Now any adjustments will be made in the returns for the year the stock is sold.

A parent-subsidiary relationship will now be based upon ownership of at least 50 per cent rather than more than 50 per cent of the voting rights in another corporation.

Corporations Used to Avoid Income Tax on Shareholders

By Waymon G. Peavy

ARRANGEMENT

Subchapter G of the new Code includes the provisions relating to corporations improperly accumulating surplus, to personal holding companies, and to foreign personal holding companies. Because these provisions were widely scattered in the 1939 Code, the new arrangement is a considerable improvement.

Subchapter G ("Corporations Used to Avoid Income Tax on Shareholders") consists of four parts: (I) corporations improperly accumulating surplus; (II) personal holding companies; (III) foreign personal holding companies; and (IV) deduction for dividends paid.

Part IV contains the rules for computing the "dividends paid deduction" for the types of corporations dealt with in parts I, II, and III. This deduction is actually based only on dividends paid, dividends carried over, and consent dividends, and should not be confused with the "dividends paid credit" under the 1939 Code, which took into account several items not included in the "dividends paid deduction." Provision for most of these items has been made in the other parts of Subchapter G.

This subchapter applies to all taxable years beginning after December 31, 1953, and ending after the date of enactment. Material exceptions to this rule are mentioned below.

IMPROPER SURPLUS ACCUMULATION

Determination of Status

One important detail of the rules for determining whether a corporation is improperly accumulating earnings and profits has been changed. As under the 1939 Code (Sec. 102), an accumulation "beyond the reasonable needs of the business" is evidence of a purpose to avoid income tax on the shareholders. However, the term "reasonable needs of the business" now specifically (Sec. 537) includes "reasonably anticipated needs." This provision is intended to protect corporations with definite plans for future (but not immediate) investment or expansion. Previously, corporations could be penalized if the investment was delayed.

The Finance Committee's report states: "It is contemplated that this amendment will cover the case where the taxpayer has specific and definite plans for acquisition of buildings or equipment for use in the business. It would not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely.

"Your committee agrees with the House that only the facts as of the close of the taxable year should be taken into account in determining whether an accumulation is reasonable. If the retention of earnings is justified as of the close of the taxable year, subsequent events should not be used for the purpose of showing that the retention was unreasonable in such year. However, subsequent events may be considered to determine whether the corporation actually intended to consummate the plans for which the earnings were accumulated."

Burden of Proof

Whenever, under the 1939 Code, the Commissioner asserted that a corporation had improperly accumulated surplus, it was up to the corporation to prove the contrary—which usually involved considerable effort and expense. Section 534 of the new Code puts the burden of proof on the government under the following circumstances:

Tax Court. The proceeding must be before the Tax Court. If the corporation pays the deficiency and then sues for a refund, the burden of proof will still be on the corporation.

Taxable Year. The proceeding must relate to a taxable year beginning after December 31, 1953, and ending after the date of enactment, and the deficiency notice must have been mailed more than 90 days after the date of enactment.

Absence of Notification. If, before mailing the notice of deficiency, the Commissioner has *not* notified the taxpayer by registered mail that the proposed notice of deficiency will include an amount attributable to the accumulated-earnings tax, then the burden of proof will be on the government.

Corporation's Statement. If the Commissioner does send the registered notice referred to above, the corporation may submit, within a period to be specified in the regulations, which will be at least 30 days, a statement of the grounds on which it relies to establish that there was no unreasonable accumulation of surplus. Sufficient facts to show the basis of the taxpayer's grounds must also be furnished. If the taxpayer submits such a statement adequately supported by facts, the burden of proof is shifted to the government as far as these grounds are concerned.

If the taxpayer does not submit a statement or does not support its grounds with sufficient facts, the burden of proof will still be on the taxpayer.

A jeopardy assessment, followed by a 90-day letter informing the corporation that the deficiency includes a tax on accumulated earnings, shall be regarded as a notification by the Commissioner, and the corporation's statement may be included in its petition to the Tax Court.

Status of Subsidiary Investments

The Ways and Means and the Finance Committees made substantially identical statements on the use of retained earnings to acquire other business enterprises. While these statements are not embodied in the Code, they may nevertheless be given weight by the courts and are therefore noteworthy:

"...Under existing interpretations, retained earnings may be invested in a business enterprise operated directly by the taxpayer, but doubt exists as to the operation of such a business through a subsidiary corporation.... Your committee again agrees with the House that where the taxpayer has 80 per cent or more of the voting stock of another corporation, the taxpayer should be viewed as though it engaged directly in the business of such other corporation. If the taxpayer's ownership of stock is less than 80 per cent..., a factual determination should be made as to whether the funds are employed in a business operated by the taxpayer. However, the operation, through stock ownership of a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business, should not provide a basis for the exclusion of the funds from possible application of the accumulated earnings tax."

Computation of the Tax

The tax on corporations improperly accumulating surplus is termed "accumulated earnings tax." The present tax rate (Sec. 531) is the same as under the 1939 Code (Sec. 102): $27^1/_2$ per cent of the first $100,000 of accumulated taxable income and $38^1/_2$ per cent of the excess over $100,000. The "accumulated taxable income" computation is similar to that of "undistributed Section 102 net income" under the 1939 Code. The two computations differ in the following respects:

Taxes. If the corporation applies income and similar taxes of foreign countries and of U.S. possessions as credits against the federal income tax rather than as deductions, it may nevertheless, under the 1954 Code (Sec. 535), deduct such taxes in computing its "accumulated taxable income." Under the 1939 Code, if a corporation chose to take such taxes as a credit against its federal income tax, it could not use them either as a deduction or as a credit in computing its Section 102 tax. A further change in the treatment of federal, United States possessions, and foreign income and excess-profits taxes has been made (Sec. 535) by providing for the deduction of such taxes *accrued* during the taxable year. Section 102 of the 1939 Code permitted the deduction of federal income and excess-profits taxes *paid or accrued* during the taxable year. A similar wording (Sec. 505) in the personal holding company provisions was held to allow the taxpayer (regardless of the method of accounting) the deduction of taxes either in the year paid or in the year accrued. The new Code has eliminated this choice and allows the deduction only in the year during which the respective tax accrues.

Net-Operating-Loss Carry-Over. A corporation can no longer deduct any net operating loss in computing its accumulated taxable income (Sec. 535). Sections 102, 27 and 26 of the 1939 Code allowed a corporation to deduct the net operating loss of the preceding taxable year in computing its "undistributed Section 102 net income." However, the "accumulated earnings credit" discussed below now indirectly enables a corporation to reduce its future accumulated-earnings tax by making a reduction in its earnings and profits.

The dividends-paid deduction for purposes of the accumulated-earnings tax is to be computed so that dividends paid after the close of a taxable year, but on or before the 15th day of the third month of the next year, are considered as having been paid on the last day of the prior taxable year. This treatment is mandatory as far as the computation of the accumulated-earnings tax is concerned (Sec. 563). The 1939 Code contained a similar but elective provision (Sec. 504) for personal holding companies (which has been continued in Section 563 of the 1954 Code), but none for corporations accumulating surplus unreasonably. The new provision is intended to benefit corporations paying dividends shortly after the close of their year on the basis of their financial position at the end of the year. In effect, this provision gives corporations vulnerable to the tax at least $2^1/_2$ months in which to compute and pay the dividend necessary to eliminate their "accumulated taxable income." However, dividends so used will not be available for computing the tax for the year actually paid.

The specific provisions of the 1939 Code relating to dividends in kind, dividends in obligations of the corporation, taxable stock dividends, and nontaxable distributions have been omitted.

The Finance Committee's report states: "The requirements of Sections 27(d), (e), (f), and (i) of existing [1939] law are incorporated in the definition of 'dividend' in Section 316, and accordingly are not restated in Section 562."

Accumulated Earnings Credit. This credit (Sec. 535) is entirely new. It eases the impact of the accumulated earnings tax in two important ways:

1. *The exemption* of the reasonably accumulated part of the earnings from the accumulated-earnings tax limits the tax to the unreasonable part. Previously, if only part of the earnings was unreasonably accumulated, the Section 102 surtax was nevertheless based on all of the year's retained income.

The credit (Sec. 535) is the amount of that part of the earnings and profits for the taxable year which is reasonably retained; reduced, however, by the deduction for long-term capital gains under Section 535 (b)(6) of the 1954 Code. The reduction will prevent long-term capital gains from being deducted twice in computing accumulated taxable income. Because no statutory formula is given for computing the amount reasonably retained, every corporation that might be subject to the accumulated earnings tax should carefully preserve all possibly needed evidence.

Although this credit is not allowed to mere holding or investment companies, such corporations can nevertheless claim the minimum credit described below.

2. *Minimum credit.* The accumulated-earnings credit shall never be less than $60,000 minus the accumulated earnings and profits at the end of the preceding taxable year (Sec. 535). Such earnings and profits are to be reduced by dividends paid during the present taxable year but treated as paid on the last day of the preceding year under Section 563(a), 1954 Code. This minimum credit has the result that any corporation can accumulate—reasonably or unreasonably—up to $60,000 of earnings and profits without becoming subject to the penalty tax. To prevent the securing of several minimum credits through the device of multiple corporations, Section 1551 of the new Code allows in effect but one minimum credit in such cases unless the taxpayer establishes, by the clear preponderance of the evidence, that the securing of such minimum credits (or $25,000 surtax exemptions) was *not a major purpose* of the transaction.

PERSONAL HOLDING COMPANIES

Although the same basic tests of gross income and stock ownership are still applied to determine whether a corporation is a personal holding company or not, several important changes have been made:

Gross Income Test. At least 80 per cent of a corporation's gross income for the taxable year must now (Sec. 542) be personal-holding-company income before that corporation is taxed as a personal holding company. Section 501 of the 1939 Code provided that, if a corporation was a personal holding company in a prior year, 70 per cent personal-holding-company income was sufficient for personal-holding-company status, unless during each of three consecutive years the personal-holding-company income was less than 70 per cent of gross income. The abolition of this dual test makes it easier to determine a corporation's status. Moreover, under the new rule a corporation can avoid being taxed as a personal holding company by keeping its personal-holding-company income below 80 per cent of its gross income, even if it had been a personal holding company in a prior year.

Stock Ownership Test. Entirely new (Sec. 542, 503, 642) is the provision that, for the purpose of determining whether more than 50 per cent of the outstanding stock is owned by or for not more than five individuals, exempt organizations (with certain exceptions) and charitable trusts are counted as individuals.

Consolidated Returns. Under the 1939 Code, every corporation was considered separately to determine whether it was a personal holding company. Consolidated returns were not permitted for personal-holding-company-tax purposes, except to certain railroad corporations (Sec. 501). As a result, dividends from a subsidiary could cause a parent corporation to be taxed as a personal holding company, even though the group, on a consolidated basis, had little or no personal-holding-company income. To correct this inequity, the new Code (Sec. 542) provides that, in the case of affiliated corporations filing consolidated returns, the gross-income test shall be applied to the consolidated gross income and the consolidated personal-holding-company income. If the group does not meet the gross-income test, no member of the group is a personal holding company.

The group will be ineligible for the benefit of this provision if:

1. Any member of the group (including the common parent) is a corporation excluded from the definition of personal holding company (Sec. 542); or if

2. Any member of the group (including the common parent) derives 10 per cent or more of its gross income from sources outside the group, and 80 per cent or more of this gross income from outside the group is personal-holding-company income. However, if the parent owns, directly or indirectly, more than 50 per cent of the voting stock of another corporation that is not a personal holding company, then dividends received by the common parent from such a corporation are not treated as gross income from outside the group (Sec. 542). An affiliated group of railroad corporations that could have filed consolidated returns for personal-holding-company-tax purposes under the 1939 Code (Sec. 501) cannot be disqualified by this provision in the new Code.

Income Definition. Three changes in favor of the taxpayer have been made in the definition of personal-holding-company income:

1. Compensation for the use of corporation property by a shareholder is personal-holding-company income only if the corporation has, in addition, other personal-holding-company income (excluding rents) in excess of 10 per cent of its gross income (Sec. 543).

2. Under the 1939 Code (Sec. 502), the entire gain from stock and securities transactions by nondealers or from commodities transactions other than bona fide hedges was treated as personal-holding-company income, undiminished by losses from such transactions. The new provision (Sec. 543) is that, in determining whether a corporation meets the gross-income test of a personal holding company, only the excess of gains over losses from such transactions shall be included in gross income and in personal-holding-company income. A comparatively small amount of nonpersonal-holding-company income may be sufficient to protect the corporation from being taxed as a holding company.

3. Interest on amounts set aside in a reserve fund under Section 511 or 607 of the Merchant Marine Act, 1936, is excluded from the definition of personal-holding-company income under the 1954 Code's provisions.

Statute of Limitations

Under the 1939 Code, the personal-holding-company tax was imposed under Chapter 2 (Subch. A), and the regular corporation income tax under Chapter 1 (Subch. B). Personal holding companies were therefore required to file a personal-holding-company return (Form 1120-H) in addition to the regular corporation income tax return (Form 1120). Failure to file Form 1120-H was treated as failure to file a return, so that in such a case the period of limitations remained open indefinitely for the personal-holding-company-tax liability, even where the failure to file was due to the belief—erroneous but in good faith—that the corporation was not a personal holding company.

Chapter 1 of the new Code remedies this situation by imposing the personal-holding-company tax as well as the regular corporation income tax, so that a single return will be sufficient for both taxes and will start the running of the period of limitations on both the regular income tax and the personal-holding-company tax. However, unless the corporation attaches to its return a schedule showing its personal-holding-company income and the ownership of its stock, the period of limitations for the personal-holding-company tax will be six years rather than the three years provided for under the general rule (Sec. 6501).

Computation of the Tax

The "personal holding company tax" is still (Sec. 541) assessed at the same rates as the "surtax on personal holding companies" under the 1939 Code (Sec.

500); namely, 75 per cent of the first $2,000 of undistributed personal holding company income and 85 per cent of the excess over $2,000. Although the computation of "undistributed personal holding company income" under the new Code is similar to that of "undistributed Subchapter A net income" under the 1939 Code, some changes have been made:

Taxes. The 1939 Code permitted the deduction of federal income and excess-profits taxes *paid or accrued* during the taxable year (Sec. 505). This provision was held to allow such taxes to be deducted either in the year they accrued or in the year they were paid, regardless of the taxpayer's method of accounting. The new provision (Sec. 545) permits the deduction of federal, United States possessions, and foreign income and excess-profits taxes *accrued* during the taxable year if elected by a cash-basis taxpayer.

Charitable Contributions. The new Code (Sec. 545, 170) allows to personal holding companies the same maximum deduction allowed to individuals; namely, 20 per cent under the general limitation plus an extra 10 per cent under the special rule for certain religious and educational organizations and for hospitals.

Long-Term Capital Gains. Because, under the old Code (Sec. 505), the capital-gains tax was not only in lieu of the holding-company surtax but was, itself, deductible in the computation of the undistributed income subject to the surtax, the taxpayer received a double benefit. The new Code continues the exemption of long-term capital gains from the personal-holding-company tax, but removes this double benefit. Under Section 545, the alternative capital-gains tax can be deducted as a tax as under the old Code. In addition, the taxpayer can deduct the excess of net long-term capital gain over net short-term capital loss reduced, however, by the federal income taxes attributable to such excess.

Dividends Paid. The following changes have been made:

Complete Liquidation. In addition to continuing the old (Sec. 27) provisions relating to liquidating dividends, the new Code (Sec. 562) provides that, in the case of a complete liquidation within 24 months after adopting the liquidation plan, all distributions may be deducted as dividends paid to the extent of earnings and profits for the year of distribution.

Personal-Holding-Company Dividends. A new provision (Sec. 562) is that, if a member of a group filing a consolidated return is a personal holding company, then distributions by such company to another member of the group will qualify for the dividends-paid deduction—provided they would so qualify if made to a recipient not a member of the group.

The dividend carry-over provisions (Sec. 564) have been simplified. The carry-over will be based only on income and dividends in the two preceding years. However, if either of the two preceding taxable years was subject to the old rather than the new Code, the carry-over is to be computed under the old provisions.

Deficiency Dividends. A deficiency (but not interest or penalties) in personal-holding-company surtax established by a court decision or a closing agreement could previously (Sec. 506) be wiped out by the payment of "deficiency dividends." The new Code (Sec. 547) permits deficiency dividends not only after a court decision or a closing agreement, but also after an informal agreement relating to the taxpayer's personal holding company tax liability. Deficiency dividends may, under certain conditions, be paid (Sec. 381) not only by the corporation against which the deficiency was assessed but also by a transferee corporation.

Foreign Personal Holding Companies

Changes corresponding to those above have been made for foreign personal holding companies. In addition, if business is done under the banking and credit laws of a foreign country, and the Secretary certifies that the corporation is not used to avoid United States income tax, it may be exempt (Sec. 551–557).

The Income-Tax Treatment Of Partners and Partnerships

By Everett C. Johnson

NEW CONSISTENCY

The new Code provides a set of detailed rules to replace the incomplete and frequently contradictory regulations, rulings, and court decisions that have developed under the 1939 Code. Many of the new provisions substantially adopt existing practice, but duplications and contradictions have been avoided.

Partnership Theories in Code

These new rules, however, do not follow any single partnership theory. For purposes of imposition of tax liability on partnership income, a partnership is regarded as nothing other than an *aggregate* of individuals who are individually liable for tax on their respective shares of partnership income (Sec. 701). When a partner contributes property to a partnership, the new Code generally views the partnership as a separate *entity* but recognizes no gain or loss on the transaction. The situation here would be analogous to a transaction under Section 112(b)(5) of the 1939 Code. If the partnership agreement so provides, however, a *credited value* theory may be applied to take into account any variation between the contributing partner's basis in the property and its fair market value at the time of contribution. Under this theory, the above relation of the fair market value to the contributing partner's basis determines the allocation among all the partners of any deductions attributable to the property and any gain or loss on its disposition.

In this fashion the authors of the new Code have made use of a variety of theories—have even provided optional theories—in an attempt to arrive at a practical and workable set of rules to govern the tax problems of partners and partnerships.

INCOME DISTRIBUTION

In accordance with present practice, partners in their individual capacities rather than the partnership are liable for tax. The partnership as such is merely an income-reporting agency—a conduit through which income passes to the individual partners. Both partners and partnerships are defined in substantially the same terms as in the 1939 Code (Sec. 761).

Segregated Items

Each partner will continue (Sec. 702) to report, separately from his share of ordinary partnership income or loss, his distributive share of partnership capital gains and losses; gains and losses from the sale or exchange of property used in the trade or business; charitable contributions; foreign taxes paid or accrued; partially tax-exempt interest; and dividends received. A catch-all provision allows the Secretary to require the segregation of other items.

Partnership income is, for tax purposes, computed (Sec. 703) in the same manner as that of an individual, except that (*1*) the segregated items mentioned above are stated separately and (*2*) the partnership is allowed neither the standard deduction, the deduction for personal exemptions, the foreign-tax credit, the charitable deduction nor the net-operating-loss deduction.

A partner's distributive share of any of the segregated items is determined (Sec. 704) under the terms of the partnership agreement. In the absence of specific provisions, the segregated items shall be distributed in accordance with each partner's distributive share of ordinary taxable income or loss.

If evasion or avoidance of income taxes is the purpose of the agreement's provisions, the segregated items shall be distributed in the same ratio as ordinary taxable partnership income or loss. For example, if one partner were to receive the entire partnership's foreign-tax credit, the Commissioner could normally be expected to contend that this arrangement was a device to evade or avoid income taxes.

The entity theory shall, as a general rule (Sec. 704,) be followed in determining a partner's distributive share of the segregated items or of depreciation, depletion, or gain or loss regarding to property contributed to the partnership by a partner.

For example, assume A and B form a partnership with A contributing $1,000 in cash and B contributing property having an adjusted basis in his hands of $400 and current market value of $1,000 with a 10-year depreciable life. The annual deduction for depreciation determined by reference to the contributing partner's adjusted basis would be $40. Since each partner has a one-half interest in the partnership, each would be entitled to a $20 deduction for depreciation on the contributed property. This deduction would, of course, be reflected in the ordinary net income or net loss of the partnership distributable to each partner.

Credited-Value Theory. If the partnership agreement so provides, however, the items mentioned in the general rule may be treated under a credited-value theory, so that they would be shared among the partners, so as to take into account the variation between the basis of the property to the partnership (representing cost to the contributing partner) and its fair market value at the time of contribution.

In the previous example, partner A (who contributed $1,000 in cash) would be entitled to the entire $40 depreciation deduction. The theory here is that partner A has in effect purchased an undivided half interest in the property for $500 and, since the property depreciates at an annual rate of 10 per cent, A should be entitled to a deduction of $50 per year. But since the partnership is allowed only $40 per year, no more than that amount may be allocated to A.

Undivided Interests

Section 704 sets forth a rule that, unless the partnership agreement provides otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This provision applies only if all the partners had undivided interests in such property prior to the contribution, and their interests in the capital and profits of the partnership correspond with such undivided interests.

Guaranteed Interest or Salary

Guaranteed interest on a partner's capital contribution or a guaranteed salary for his services becomes deductible by the partnership and includable in the partner's income (Sec. 707). The interest and salary are included in the taxable year of the partner within which the partnership fiscal year ends rather than when received.

Payments to Retiring Partner

The uncertain status of payments made by a continuing partnership to a retiring partner or to the estate or heir of a deceased partner has been clarified. To the extent that such payments are not made in liquidation of his partnership capital interest or are determined with regard to the income of the partnership, they are deductible to the remaining partners and are taxable to the with drawing partner irrespective of the period over which they may be paid. Amounts paid for unrealized receivables and for good will (unless the partnership agreement provides otherwise) are similarly treated (Sec. 736).

Deductibility of Losses

If a partner's distributive share of partnership losses exceeds his adjusted basis for his interest, the excess is deductible only at the time the partner makes an additional contribution of capital in the amount of the excess. Thus, if a partner has a basis of $50 for his interest, and if his distributive share of partnership losses is $100, his deductible loss for the current taxable year is limited to $50. If he makes an additional $50 capital contribution to cover such loss the remaining $50 loss is deductible at the end of the partnership year in which repayment is made.

TAXABLE YEARS

A set of detailed rules (Sec. 706) provides that in computing income for his taxable year, a partner shall include all items of income, gain, loss, deduction, or credit received in respect of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner. A partnership may not change to or adopt a taxable year other than that of all its principal partners (one having an interest of 5 per cent or more in partnership profits or capital) unless it establishes to the satisfaction of the Secretary a business purpose for so doing. A principal partner may not change to a taxable year other than that of the partnership unless he establishes to the satisfaction of the Secretary or his delegates a business purpose for so doing.

Closing of Taxable Year. A specific, new provision is (Sec. 706) that a partnership taxable year shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership. This rule, however, does not apply if the partnership agreement provides to the contrary. The partnership year does close with respect to a partner who sells or exchanges his entire interest in a partnership or whose interest is liquidated during the partnership year. It does not close, however, with respect to a partner who dies prior to the end of the taxable year. The decedent's share of distributable income from the partnership for the taxable year in which death occurred is thus included in the taxable income of the deceased partner's estate.

Continuing Partnership

An existing partnership shall be considered as continuing unless no part of its business is carried on by any of its partners or, if within a 12-month period, 50 per cent or more of the total interest in partnership capital and profits is disposed of other than by gift or at death. This provision, however, will not apply if the partnership elects under regulations prescribed by the Secretary to be considered as a continuing partnership.

Mergers and Consolidations. A partnership formed by merger or consolidation shall be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 per cent in the capital and profits of the resultant partnership.

Division of a Partnership. Any resulting partnerships, the members of which have had an interest of more than 50 per cent in the capital and profits of the prior partnership, shall be considered to be continuations of that prior partnership.

PARTNER-PARTNERSHIP TRANSACTIONS

The adjusted basis of a partner's interest in a partnership is computed (Sec. 705) in a substantially unaltered fashion. Briefly, it is his basis for his contribution or the cost of his interest if purchased, increased by his distributive share of partnership income, less actual distributions of income to him and his share of partnership losses and nondeductible, noncapital partnership expenses.

If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction generally shall be considered (Sec. 707) as occurring between the partnership and one who is not a partner. If, however, a partner owns more than a 50 per cent interest in the capital or profits of a partnership, no deduction is allowed because of losses from such transactions.

This is also the case if the transaction takes place between two partnerships in which the same persons have, directly or indirectly, more than a 50 per cent interest in the capital or profits of the partnerships. In the case of a subsequent sale or exchange of the property by either of the above transferees, the basis for computing gain will be the transferor's basis.

If a partner owns more than an 80 per cent interest in the capital or profits of a partnership, any gain from the sale or exchange between the partner and the partnership of assets other than capital assets shall be ordinary income.

Contributions to Partnerships

There is no change in the method of handling capital contributions to partnerships. No gain or loss is to be recognized either to the contributing partner or to the partnership. Any property contributed to the partnership is to have the same basis in the hands of the partnership for tax purposes as it had in the hands of the contributing partner (Sec. 721–723). While the contributing partner's basis for his interest in the partnership is to be increased by the basis of the contributed property, it is to be reduced by that portion of any indebtedness assumed by the partnership (Sec. 752).

Distributions to Partners

If partnership property is distributed to a partner other than in liquidation of that partner's interest, his basis for the property shall be the partnership's adjusted basis in the property immediately prior to such distribution (Sec. 732). If the adjusted basis of the partner's interest, reduced by any money distributed in the same transaction, is less than the partnership's adjusted basis in the property, then the partner's basis in the distributed property is limited to his adjusted basis in the partnership reduced by any money received in the same transaction (Sec. 732).

Liquidation of Partner's Interest

When property is distributed by a partnership to a partner in complete liquidation of his interest, his basis in the property shall then be an amount equal to the adjusted basis of his interest in the partnership reduced by any money received in the same transaction.

The adjusted basis for the partnership interest is allocated to the property received by a partner in liquidation of his interest in the following order:

1. Unrealized receivables and inventory items receive a basis of an amount equal to the partnership's basis for each of such assets received.
2. Any remaining basis (after deducting the amount so allocated to receivables and inventories) shall be allocated to other properties received in proportion to their adjusted bases to the partnership.

Optional Allocation of Basis. If the distribution is made to a partner who acquired all or a part of his interest in the partnership within two years prior to the distribution, that partner may take advantage of an optional allocation of basis. This permits a partner to allocate to the distributed property so much of the adjusted basis of his partnership interest acquired by transfer as is attributable to the distributed property and to any other property in which he had relinquished an interest. This privilege, however, does not apply to the extent that the distribution consists of unrealized receivables and inventory items. Basis must still be allocated to these two items first.

Recognition of Gain or Loss

No gain or loss is recognized (Sec. 731) to a partnership on a distribution of property (including money) to a partner unless it concerns either payments to a retiring partner (Sec. 736) or unrealized receivables and appreciated inventory (Sec. 751).

Gain shall not be recognized by a partner on a distribution by a partnership except to the extent that any money received exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.

Loss shall likewise not be recognized to a partner unless the distribution is in liquidation of his interest and consists only of money, inventory, and unrealized receivables. In this case the loss shall be recognized to the extent that the partner's adjusted basis for his interest exceeds the sum of the money, and the partnership's basis of receivables and inventory distributed. In the event of a distribution by a partnership to a partner other than in liquidation of the partner's interest, the partner's adjusted basis for his interest is to be reduced by the amount of money distributed to him and the basis to him of property distributed other than money. In no case, however, shall his basis be reduced below zero,

Unrealized Receivables. If a partner receives a distribution of unrealized receivables, any gain or loss on their disposition by him shall be considered gain or loss from the sale or exchange of property other than a capital asset (Sec. 735).

Inventory Items. If a partner receives inventory items in a distribution, any gain or loss on their disposition, if within five years of the date of distribution, shall be considered gain or loss from the sale or exchange of property other than a capital asset (Sec. 734).

Basis of Remaining Assets

As a general rule no adjustment will be made to the basis of remaining assets of a partnership as the result of a distribution of property to a partner (Sec. 734).

Elected Adjustments. A partnership can, however, elect to have the basis of its remaining assets adjusted when distributions are made (Sec. 754,) but such an election, once made, is binding for all subsequent taxable years unless revoked in accordance with regulations to be published. The election permits the partnership to increase the basis of its remaining assets by the amount of any gain recognized to the distributee, or reduce the basis by any loss.

Gain. As previously indicated, gain to the distributee on distribution of property is recognized only if the amount of cash distributed exceeds the distributee partner's basis for his partnership interest.

Loss. Similarly, a loss on liquidation is allowed only if the entire distribution is cash, receivables, and inventory, and such distribution is less than the basis of the interest of the distributee.

An adjustment of the basis of remaining assets also occurs when an election under Section 754 has been made and if the basis of distributed property in the hands of a distributee partner is different from the basis of such asset to the partnership before distribution. For example, if a partner had a basis for his partnership interest of $600 and received property with a basis to the partnership of $1,000, in liquidation of his interest, he would have a basis for such distributed property of $600. The difference of $400 can be added to the basis of remaining partnership assets.

Allocation of Increase or Decrease

As a general rule (Sec. 755) the increase or decrease is to be allocated so that the difference between the fair market value and the adjusted basis of the partnership properties is reduced. In making the above allocation, the differences should first be allocated to like property except that in no case shall the basis of any property be reduced below zero. If the partnership has no property similar to that distributed, the adjustment may be applied in the future to similar property when acquired.

TRANSFER OF INTEREST

Gain or Loss

Gain or loss from the sale or exchange of a partnership interest will continue to be recognized to the transferor partner (Sec. 741). Such gain or loss is to be considered as capital gain or loss, except that gain or loss relating to unrealized receivables and inventory shall be considered as ordinary gain or loss (Sec. 751). Generally, the basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner.

Readjustment of Basis. After the transfer of partnership interest, however, the partnership may elect under Section 754 to adjust the basis of partnership property by the amount of the difference between the basis for the interest in the partnership of the transferee and his proportionate share of the adjusted basis of all partnership property (Sec. 743).

This adjustment shall normally be made to the basis of partnership property with respect to the transferee partner only. However, an agreement among partners as to the basis of contributed property is to be taken into account. In the case of property previously contributed to the partnership by a partner however, the adjustment shall be allocated among the partners to the extent that the increase ar decrease is attributable to the difference between the adjusted basis of the property in the hands of the transferor immediately prior to its contribution to the partnership and the fair market value of the property at such time.

Assume that A and B form a partnership AB to which A contributes X, a depreciable asset worth $1,000, with an adjusted basis to him of $400. B contributes $1,000 in cash. During the partnership's first taxable year, X appreciates in value to $1,200, and A sells his half interest in the partnership to C for $1,100. Under the rule stated in Subsection (b)(1), the adjusted basis of the partnership property, $400, will be increased by the excess of the transferee's basis for his partnership interest, $1,100, over the transferor's basis for his interest immediately prior to the transfer, $400. The amount of the increase is $700. Of this amount, only $100 is attributable to the post-contribution appreciation of X. $600 is attributable to the difference between the basis and the value of X at the time it was contributed. Thus, there is a $100 basis adjustment with respect to the transferee only. The remaining $600 is to be allocated among the partners.

EFFECTIVE DATE

Generally, the new provisions take effect for any partnership taxable year beginning after December 31, 1954, and for any part of a partner's taxable year falling within such partnership taxable year (Sec. 771). The provisions of Section 706 relating to the adoption of a taxable year by a partner or a partnership apply after April 1, 1954. The provisions relating to the character of gain or loss on disposition of property distributed by a partnership (Sec. 735) and the unrealized receivables and inventory rules (Sec. 751) apply after March 9, 1954. In view of the fact that the general provisions are not effective until 1955, it is entirely possible that further changes may be made by Congress before that time. Certain other provisions have optional effective dates.

ALTERNATE TAXABLE STATUS

Section 1361 provides that certain partnerships may elect to be treated as domestic corporations for income-tax purposes. The partnership may not have more than 50 members. No partner having a 10 per cent interest in the profits or capital of the partnership may have more than a 10 per cent interest in any other partnership making a similar election. No partner may be a nonresident alien or a foreign partnership. The partnership must be one in which capital is a material income-producing factor, or 50 per cent or more of the gross income of the partnership consists of gains, profits, or income derived from trading as a principal, or from buying and selling real property, stock, securities, or commodities for the account of others.

The election must be made within 60 days after the close of the taxable year to which it is to apply. Once made, the election is irrevocable unless there is more than a 20 per cent change of ownership in the capital or profits.

Income of Estates, Trusts And Their Beneficiaries

By Maxwell A. H. Wakely

SCOPE OF SUBCHAPTER J

Subchapter J covers the taxation of income of estates, trusts and their beneficiaries; and the taxation of income received in respect of decedents. It corresponds, in the main, to the old Code's

Supplement E ("Estates and Trusts") and Section 126 ("Income in Respect of Decedents").

ESTATES AND TRUSTS

Imposition of Tax

Whereas the conduit theory of taxation of income of estates and trusts has been continued, numerous changes have been made, principally: (*1*) detailed rules for allocating classes of income between the fiduciary and beneficiary, (*2*) a new formula for taxing distributions in excess of current income, and (*3*) inclusion in the Code of the so-called *Clifford* regulations.

Credits, Deductions and Exclusions

A fiduciary is allowed the credits for partially tax-exempt interest, foreign taxes, and dividends allowed to an individual, but only with respect to income taxable to the trust after applying the deduction for distribution to beneficiaries.

Credits applicable to income taxable to beneficiaries are allowed to them. The dividend credit is allowed only with respect to dividends received by the fiduciary after July 31, 1954, as determined on a pro rata allocation, regardless of the date of distribution. The fiduciary may exclude $50 of dividends after applying the credit for distributions to beneficiaries.

Estates receive a deduction for personal exception of $600; trusts required to distribute their entire income currently, $300; and other trusts, $100.

Depreciation, depletion, and amortization are allowed to the trustee if used to reduce accounting income of a trust, or on the basis of distribution of the income from the property in the case of a trust, and the entire income in the case of an estate.

The old limitation on charitable deductions has been carried into the new Code with certain additional limitations relating to trusts created under a will of a decedent dying after January 1, 1951.

A new provision makes available to beneficiaries succeeding to the property from an estate or trust, on termination, any unused capital loss, or net operating loss carry-over, or any deductions in excess of gross income for the last taxable year of the estate or trust. The deductions in excess of gross income for the last taxable year of the estate or trust made available to the beneficiary, are limited to the deductions allowable in the final taxable year of the estate or trust. In computing such excess deductions, the deductions for personal exemption and for amounts paid or set aside permanently for charitable purposes are nct taken into account.

Distributable Net Income

In making specific rules for allocation of taxable income between the fiduciary and beneficiary, the term "distributable net income" (DNI) introduced is the sum of tax-exempt income, net of applicable expenses, and taxable income, adjusted as follows:

1. Deductions for personal exemptions and distributions to beneficiaries other than charity are not made.
2. The $50 dividend exclusion is not allowed.
3. Capital gains allocated to corpus are excluded unless they become distributable or are the subject of a charitable deduction for the year.
4. Capital losses are excluded unless they offset included capital gains.
5. In the case of a simple trust, as defined later, taxable stock dividends and extraordinary dividends are excluded if they are allocated to corpus.

Simple Trusts

"Simple trust" usually refers to a trust meeting the requirements of Subpart B. The requirements are met if the trust instrument requires all accounting income to be distributed currently to beneficiaries other than charities. However, a trust distributing corpus will be taxed as a complex trust for the year of the distribution.

Ordinarily a simple trust is allowed a deduction equal to the taxable portion of DNI. If, however, the income required to be distributed currently should be less than DNI, the deduction is the product of the amount distributable and the ratio of taxable DNI to total DNI.

The beneficiaries as a group must include in taxable income an amount equal to the deduction allowed to the fiduciary. In determining the character of the amounts distributed to beneficiaries so as to compute their capital gains, dividend exclusions, and credits, the law, in Section 652(b) is contradictory. It first says that amounts distributed to beneficiaries shall have the same character in their hands as in the hands of the fiduciary, and then goes on that deductions shall be allocated against income. Does this mean that if a fiduciary receives $1,000 of dividends, incurs $100 of deductible expenses and distributes $900 to the beneficiary, the beneficiary's dividend credit is four per cent of only $900? Although this example is discussed in the Finance Committee report (p. 351) an answer to the problem must await the issuance of regulations.

The allocation of classes of income among various beneficiaries is made in proportion to the amount distributable to each, unless the terms of the trust specifically allocate different classes of income to different beneficiaries.

Complex Trusts and Estates

Trusts not qualifying as simple trusts and all estates are taxed under a more complicated formula, which necessitates determining whether the trust is to be treated as a single entity or as a group of separate trusts, for each of which a separate computation is to be made. The determination is to be in accordance with regulations to be prescribed under Section 663(c).

Determination of the deduction for distributions and the income taxable to beneficiaries, and the type of income taxable to each requires three steps: (*1*) determination of the amount considered distributed, (*2*) allocation of such amounts between taxable and nontaxable income, and (*3*) division of taxable income into classes which may be taxed in different manners.

The amount considered distributed is the lower of (*1*) DNI or (*2*) income required to be distributed currently, including annuities to the extent paid out of income (mandatory distributions) and other amounts properly paid, credited, or to be distributed for such year (discretionary distributions). The latter does not include gifts payable out of corpus in not more than three installments, or distributions deductible in a preceding year. A distribution made during the first 65 days of a year can be considered made on the last day of the preceding year.

Each beneficiary entitled to a mandatory distribution is considered to have received the amount distributable to him, unless the total of such amounts exceeds DNI, in which event the DNI is allocated to the beneficiaries in proportion to the mandatory distributions to each. Where DNI exceeds mandatory distributions, such excess if considered distributed in proportion to discretionary distributions for the year.

In allocating the amounts considered distributed between taxable and nontaxable income to determine the amount deductible by the fiduciary and taxable to the beneficiaries, and in allocating classes of income between them to determine credits and deductions, the allocations are based on the proportions of the various items included in DNI to the total DNI, unless the governing instrument specifically provides otherwise.

The law provides for offsetting expenses in the same manner as in the case of simple trusts and creates the same question.

Accumulation Distributions of Trusts

Where discretionary distributions exceed DNI less mandatory distributions, there may be an accumulation distribution. Such excess is reduced by (*1*) distributions of income accumulated before birth or before age 21; (*2*) payments to meet emergency needs of a beneficiary; (*3*) amounts distributed upon the beneficiary's attaining a certain age, if specifically required as of January 1, 1954, (there can be no more than four such distributions at intervals of four years or more); and (*4*) final distributions made more than nine years after the last transfer to the trust. The balance is known as the accumulation distribution if it exceeds $2,000.

The accumulation distribution is considered to have been distributed on the last day of the preceding year to the extent of undistributed net income for such year, and if in excess thereof is so considered for the second preceding year, etc., but it cannot be carried back for more than five years or to a year of the trust covered by the 1939 Code. The undistributed net income for any year equals DNI less the sum of distributions and applicable taxes.

Applicable taxes imposed on the trust represent the amount of taxes for the prior year properly allocable to the undistributed portion of distributable net income; but if not all the undistributed income is included in the accumulation distribution, only a pro rata portion of such taxes is taken into account. A detailed illustration reproduced from the Finance Committee report appears on page 394.

The beneficiary receiving an accumulation distribution allocated under the above rules to a prior year is considered to have received such amount plus the applicable taxes imposed on the trust.

The beneficiary may compute his tax either by including such amount in income of the current year, or by computing the additional tax which would have resulted had the accumulation distribution been included in the beneficiary's income in the years to which it is allocated and adding it to the current year's tax computed without the accumulation distribution. Applicable taxes paid by the fiduciary are not refunded but are credited against the tax liability of the beneficiary.

INCOME ATTRIBUTED TO GRANTOR

The new Code generally incorporates the present regulations taxing the grantor on the income of short-term trusts under the *Clifford* rule. The trust income may be taxable to the grantor because (*1*) the trust property will revert to the grantor within a short period of time after the creation of the trust; (*2*) there is a reversion of the power to determine who should enjoy the corpus or income; or (*3*) there is a reservation of important administrative controls in a nonfiduciary capacity.

Reversionary Interests. A grantor is taxable on the income of a trust in which he has a reversionary interest either in the corpus or the income which will reasonably be expected to take effect in possession or enjoyment within ten years. If the income of a short-term trust is irrevocably payable to a designated school, hospital, or church, the grantor would be taxable on the income only if the term of the trust is less than two years. A grantor will not be treated as the owner of a trust by reason of a reversionary interest if such interest takes effect only on the death of the beneficiary of the income, even though the reversionary interest may be expected to take effect within ten years because of a short life expectancy of the beneficiary.

Power to Control Beneficial Enjoyment. Under the regulations in effect under the old Code a power to allocate income or corpus among a class of beneficiaries made the grantor taxable if the power was held by a spouse of the grantor or by any related trustee, unless the trustee was an adverse party. Under the new Code the grantor is taxable only if the related or subordinate trustee is subservient to the grantor. It will be presumed that the trustee is subservient unless the grantor can overcome the presumption.

Administrative Powers. Under the regulations in effect under the old Code the grantor was taxable on income of a trust where the administrative control of the trust was exercisable primarily for the benefit of the grantor. So, for example, if a grantor, directly or indirectly, had borrowed from the corpus or income of a trust and had not completely repaid the loan before the beginning of the taxable year, he was taxable on the income. Under the new Code the grantor will not be taxable if the loan provides for adequate interest and security and is made by a trustee other than the grantor or a related or subordinate trustee who is subservient to the grantor.

Effective Date

The effective date of the provisions of Part I of Subchapter J is for any taxable year "beginning after December 31, 1953, and ending after date of the enactment of this title."

Note particularly, however, that:

1. The provisions of Part I do not apply in the case of any beneficiary of an estate or trust with respect to any amounts paid, etc., in any taxable year of the estate or trust to which this part does not apply.
2. Any distribution made within the first 65 days of the *first* taxable year of a trust or estate to which this part applies will be deemed to have been paid or credited by such trust or estate in the preceding taxable year, if Section 162 of the 1939 Code so provides.

INCOME IN RESPECT OF DECEDENTS

Successive Decedents. Although the old Code had remedied the "bunching" of income in a decedent's final return, the old provisions did not apply to cases involving successive decedents.

For example, if the widow of a life insurance agent acquires on his death the right to receive renewal commissions on insurance sold by him in his lifetime and payable over a period of years, but the widow dies prior to receiving the commissions, and leaves the right to receive them to her son, no income in respect of the commissions is required to be included in the final return of the husband. However, upon the widow's death, the old Code provided that the fair market value of the right to receive the commissions must be included in her final return.

Extensions of Application. This principle now applies to successive decedents as well, so that an item of gross income in respect of a subsequent decedent includes any item of gross income to a prior decedent, provided that the right to receive such amount (commissions, in the example above) is acquired by the subsequent decedent by reason of the death of the prior decedent or by bequest, devise, or inheritance from prior decedent. Thus, all successive decedents in the example would include in gross income only the actual commissions received in the years receved, so long as the prior decedent bequeathed such right to receive.

Installment Obligations A major change has been made with respect to installment obligations held by a decedent.

The old requirement of a bond has been eliminated and, in general, the recipients of payments of installment obligations or proceeds derived from their sale or satisfaction, *at other than face value*, will be taxed on the excess over face value.

Deductions for Estate Tax. Several substantive changes have been made in the provisions for deductions for estate tax. The principle of taxation of successive decedents has been adopted as well as the revised rules on the taxation of the income of estates, trusts and beneficiaries.

For example, (*1*) the allocation between the estate and the beneficiary of a deduction for the applicable estate tax from gross income of a decedent's estate in the case where an estate or trust has items of income required to be paid to beneficiaries during the tax year; and (2) the elimination of the provision that income in respect of a decedent, distributable by an estate or trust, is not ordinarily includible in the beneficiary's gross income, because such items represent "corpus" as distinguished from "income" in the hands of the estate or trust.

Computation of Net Value. The method of computing the net value for estate-tax purposes is outlined in Section 691. A special computation is required in the case of annuity payments. This will have the effect of spreading the estate tax attributable to the net value of the annuity for estate-tax purposes over the life of the survivor in such a way that it will be fully allowed as a deduction against income if the survivor reaches his life expectancy. No deduction will be allowed if the survivor receives any annuity payment after reaching his life expectancy. If he dies before reaching his life expectancy, there is no compensating adjustment for the unused deduction.

Estate and Gift Taxes Under the New Code

By Walter M. Bury

ESTATE TAX

A number of substantive changes have been made in the estate tax, although the basic structure and the rates in effect under former law have been retained.

Gross Estate

Certain important changes have been made in the basic definition of the gross estate (Sec. 2031). The value of the gross estate of the decedent shall be determined by including the value at the time of death of all property—real or personal, tangible or intangible—except real property situated outside the United States.

Valuation of Property. In all cases, the executor may still value property included in the gross estate as of a date one year after the decedent's death or, in the case of such property disposed of at an earlier date, the value at such date of disposition.

Property in Gross Estate. The general provisions for inclusion in the gross estate of transfers in contemplation of death, transfers with retained life estate, revocable transfers, joint interests, powers of appointment, transfers for insufficient consideration, and prior interests remain unaltered.

Transfers at Death. Property previously transferred by a decedent (Sec. 2037) will be includable in his estate only if, immediately before his death, he still had a reversionary interest in it—either express or by operation of law—exceeding five per cent of its value. Except for this modification the new provision is similar to the pre-October 8, 1949, ruling.

Annuities and Death Benefits. Section 2039 requires the inclusion in the gross estate of a joint survivor annuity to the extent that the decedent contributed to its cost. Payments made by the employer under an unqualified pension plan must be taken into account, but not those made under an approved trust, pension, or retirement plan.

If an annuity is attributable partially to contributions by the employer, the exclusion of its value from the gross estate is proportionate to the part of the policy cost contributed by the employer. These provisions apply to all decedents dying after December 31, 1953.

Life Insurance. Under the new Code (Sec. 2042), life insurance proceeds payable to the executor continue to be includable in the gross estate and subject to the estate tax. Proceeds receivable by beneficiaries other than the executor are also includable in the decedent's estate, but only if the decedent at death possessed any of the incidents of ownership exercisable either alone or in conjunction with any other person.

A reversionary interest previously was not treated as an incident of ownership, but Section 2042 provides that if the value of a reversionary interest—whether express or by operation of law—exceeds five per cent of the value of the policy immediately before the death of the decedent, such interest shall constitute an incident of ownership.

Payment of premiums thus is no longer a factor in determining taxability under this section of insurance proceeds. It should be noted, however, that pursuant to Section 2035 certain transfers by the decedent within three years of his death would be includable in the gross estate as transfers in contemplation of death.

Deductions

Loss of Property. Only one deduction from the gross estate in computing the taxable estate has been continued without change. This is the deduction provided by Section 2054 for losses incurred during the settlement of estates and caused by fires, storms, shipwrecks, or other casualties, or from theft, when such losses are not compensated for by insurance or otherwise.

Property Previously Taxed. The provision of the 1939 Code for property previously taxed has been replaced with a credit against the estate tax for the tax on prior transfers. (This new credit is described later in this article.)

Expenses, Debts, and Taxes. Section 2053 is similar to old law in that it allows funeral expenses, administration expenses, claims against the estate, and unpaid mortgages to be taken as deductions from the gross estate in computing the taxable estate.

Two important changes eliminate inequities under the former law.

Limitations on Deductions. Previously, the total allowance in respect to the above items could not exceed the value of the property included in the gross estate subject to claims—that is, the probate estate. Thus, if the decedent's estate included only property held by him and his spouse as tenants by the entirety, no deduction would have been allowed for these items, since there would have been no probate estate.

Section 2053 removes this arbitrary limitation by providing that such items, where the total thereof exceeds property subject to claims, are deductible from the gross estate providing they are paid prior to the time prescribed for the filing of the estate-tax return.

Other Administration Expenses. Expenses incurred in administering property not subject to claims included in the gross estate are allowed as deductions from gross estate—providing such expenses would be allowable if the property were subject to claims, and providing such expenses are paid within the period provided for the assessment of the estate tax.

Principal commissions paid in respect to trust property included in the gross estate and attorney's fees incurred to contest the inclusion of the trust property in the gross estate are among the expenses deductible under this section.

Philanthropic Transfers. Bequests to veterans' organizations organized under an act of Congress are now included (Sec. 2055) among those transfers for public, charitable, and religious uses which are deductible from the gross estate.

Complete termination of a power to consume, invade, or appropriate property for the benefit of an individual, before the exercise of the power and before the due date of the estate tax return, is now deemed an irrevocable disclaimer sufficient to qualify the property for the charitable deduction if it passes to or for the use of charitable, etc. institutions as a result of such termination.

Marital Deduction. Although the 1939 Code allowed a deduction up to 50 per cent for property included in the gross estate that passed to the surviving spouse, it was not clear under the varying state laws whether a legal life estate qualified as a trust or whether the survivor spouse's interest in only part of the trust property constituted a transfer in trust qualifying for the marital deduction.

Property in a legal life estate, as well as property in trust, now clearly qualifies (Sec. 2056) for the marital deduction. Moreover, a right to income plus a general power of appointment over only an undivided part of the property will qualify that part of the property for the marital deduction.

Payments under Contracts. Similar clarifications have been made with respect to payments under life insurance, endowment, or annuity contracts under which a surviving spouse is entitled to installment payments of proceeds or interest and has a power of appointment exercisable by her alone. Reference is now to "all amounts, or a specific portion of all such amounts," payable under such contracts.

Community Property. Property converted by the decedent and his surviving spouse from community property to separate property at any time after 1941 shall, for the purposes of the marital deduction, be considered as community property (Sec. 2056). Previously, only conversions during 1942 or after April 2, 1948, were affected by this provision.

Taxable Estate

The new Code (Sec. 2051) replaces the term "net estate" with a new term, "taxable estate," the value of which is determined by deducting from the value of the gross estate the allowable exemption and deductions.

Change of Exemption. In lieu of the former $100,000 exemption for basic estate tax and $60,000 exemption for the additional estate tax, there is only one $60,000 exemption. In the new Code (Sec. 2001) the basic and additional estate taxes are combined into one rate table, which is applied to the taxable estate after allowing the $60,000 exemption.

Estate Tax Credits

State Death Taxes. The maximum credit is computed as a percentage of the taxable estate (Sec. 2011). This simplified method does not change the tax liability or credit allowed for state death taxes of any citizen or resident of the United States.

Since some states base their inheritance taxes on the federal estate tax, and since estates of certain members of the Armed Forces are exempt from the additional estate tax, Section 2011 provides that the basic estate tax shall be 125 per cent of the maximum credit for state death taxes, and that the additional estate tax shall be the difference between the estate tax imposed by Section 2001 and the basic estate tax.

Gift Tax. Credit is still allowed against the estate tax for gift tax paid on any gift made by the decedent during his lifetime that is required to be included in his gross estate for estate-tax purposes (Sec. 2012). Credit previously allowed for gift tax paid on the transfer of property to the decedent has been eliminated.

Tax on Prior Transfers. Section 2013 of the 1954 Code makes substantive changes in this relief provision.

The previous law allowed a deduction from the decedent's gross estate of the value of property included in the estate that was previously subjected to gift tax or estate tax. This deduction applied only to property received within five years of the current decedent's death, or to property that could be identified as having been acquired in exchange for property so received. Since the value of such property was deducted from the gross estate, the benefits were measured by the tax rate applicable to the current decedent's estate.

The following modifications have been incorporated into the new law:

Credit is now allowed against the estate tax for all or part of the estate tax paid, with respect to the transfer of property to the present decedent, by or from a person who died within ten years before, or two years after, the present decedent's death.

Such credit is now allowed for estate tax paid on all property transferred to the decedent within the prescribed time limits. Transferred property no longer need be identified in the gross estate either as transferred property or property received in exchange therefor.

"*Transfer of property*," according to the Finance Committee's report, is a term broad enough to cover the transmission of any property included in the transferor's gross estate.

This includes property passing to the decedent as a result of the exercise or nonexercise of a power of appointment exercisable when the property is included in the gross estate of the donee of the power. It also includes property transferred between spouses to the extent that no marital deduction was available—whereas the 1939 Code permitted no deduction if the property was received from the current decedent's spouse.

Limitation on Credit. A method is provided for computing the portion of estate tax paid by the prior decedent applicable to the property transferred to the current decedent. The credit for such tax on the transferred property cannot exceed the decrease in estate tax (computed after deducting the credits for state and foreign death taxes and gift tax) that would result if the value of the transferred property were excluded from the present decedent's estate.

If a charitable deduction is allowable to the estate of the present decedent it has to be decreased for purposes of computing this limitation.

The credit thus computed is allowed in full unless the transferor did not die within two years of the death of the decedent. In that case the credit is to be computed in the following percentages: 80% if the transferor died within the third and fourth years preceding the decedent's death; 60% if within the fifth and sixth years; 40% if within the seventh and eighth years; and 20% if within the ninth and tenth years.

Refund of Foreign Death Tax. The old provisions with respect to the redetermination of the estate tax if taxes claimed as a credit are recovered are retained in Sections 2014–2016. One minor change in Section 2016 provides that no interest shall be assessed on any deficiency in estate tax resulting from the refund of a foreign death tax for which a credit had been claimed for any period before the receipt of such refund, except to the extent interest was paid by the foreign country on such refund.

Estates of Nonresident Aliens. Section 2101 provides for the determination of the taxable estate in generally the same manner as the net estate was determined under Section 861 of the old Code after allowing a $2,000 exemption. However, the old deduction for certain property previously taxed has been replaced by a credit for estate tax paid by the transferor's estate on the transferred property.

A change has also been made with respect to determining situs of shares of corporate stock. Section 2104 brings the law in accord with treaty provisions by providing that shares of stock owned and held by estates of nonresident aliens are deemed within the United States only if issued by a domestic corporation. Thus, even if shares in a Canadian company are physically located in the United States at the decedent's death, such shares would not be deemed to be property within the United States.

The combined tax provided by the table in Section 2001 is imposed on the taxable estate of a nonresident alien and this tax is subject to the credits for state death taxes, gift tax, and tax on prior transfers allowed estates of citizens and residents. Nonresident aliens (like citizens and residents) now receive a credit for state death taxes on their taxable estates in excess of $40,000, previously they were allowed such credit on their entire net estate.

Miscellaneous

Sections 2202 through 2207 continue without change various miscellaneous provisions of the 1939 Code as to missionaries in foreign service, definition of executor, discharge of executor as to liability for estate tax, reimbursement out of the estate of beneficiaries for estate tax, liability of life insurance beneficiaries, and liability of recipient of property over which the decedent had the power of appointment.

Estates of Armed Forces' members dying in a combat zone, or dying from wounds or disease incurred while in a combat zone during any period in which persons generally are subject to induction under the Universal Military Training and Service Act, are now (Sec. 2201) exempt from the additional estate tax. The old exemption applied only to those dying before January 1, 1955.

Returns and Administration. Copies of the estate tax return are no longer required in duplicate. An executor has to file whenever the gross estate of a citizen or U.S. resident exceeds $60,000 (Sec. 6018). In the case of nonresident aliens, a return is required if more than $2,000 of the gross estate is situated in the U.S. The requirement for filing notice of qualification as executor is continued, but the Secretary is permitted to waive the requirement in instances where no tax liability is involved.

Filing Deadline. Estate tax returns are still due 15 months after the decedent's death (Sec. 6075) and are to be filed in the Internal Revenue District where the decedent was domiciled at death (Sec. 6091). An extension of up to six months for filing may be granted (Sec. 6081). The 10-year extension period for payment of estate taxes in cases of undue hardship to the estate is retained in the new Code (Sec. 6161).

An early return or early payment shall be considered made as of the due date for purposes of the stature of limitations. A new provision (Sec 6501) extends the assessment period to six years after the return was filed if the taxpayer omits from the gross estate more than 25 per cent of the gross estate stated in the return.

GIFT TAX

The rate of the gift tax has been continued, but several substantive changes have been made in gift-tax provisions. Section 2501, applying to gifts made during, and subsequent to, the calendar year 1955, imposes a gift tax on all gifts made by citizens or residents of the U.S., wherever the property is situated.

Gifts by Nonresident Aliens

With respect to nonresident aliens engaged in business in the United States (Sec. 2502), the tax is imposed on gifts of property situated in the United States. With respect to all other nonresident aliens, the tax is imposed only on gifts of tangible property situated in the United States. Accordingly, after December 31, 1954, gifts of intangible property like stocks and bonds by nonresident aliens not engaged in business in the United States will not be subject to the gift tax.

Foreign Stock Issues. Shares of stock owned and held by a nonresident not a citizen shall be deemed situated within the United States only if issued by a domestic corporation (Sec. 2511). Thus, shares of stock issued by a foreign corporation and so held will no longer be deemed situated within the United States, even if the stock certificates are located within the U. S.

Taxable Gifts

The term "net gifts" has been replaced (Sec. 2503) with "taxable gifts," which are defined as the total amount of gifts made during the year, less the allowable deductions. In the case of gifts other than gifts of future interests in property to each donee, the $3,000 annual exclusion has been continued.

Future Interests. *Gifts to minors* will not be considered gifts of future interest after 1954 if the income and property may be spent by or for the child prior to his attaining age 21 and, if not so spent, will pass to the child when he reaches 21, or to his estate if he dies prior to age 21, or as he may appoint under a general power of appointment. Such gifts are entitled to the $3,000 annual exclusion.

Diminishing Interest. Another change with respect to future interest provides that, where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in determining whether this is a gift of a future interest, if no part of such interest at any time will pass to any other person.

Thus, if trust income is payable to A for life, with the remainder payable to B upon A's death, and the trustee has uncontrolled power to pay over the trust principal to A in whole or in part at any time, A's present right to income will not be treated as a gift of a future interest. This is so because, although A's present right to receive the trust income may be terminated, no other person has the right to such income interest.

Gifts for Preceding Years. For purposes of computing the current year's tax, the amount of taxable gifts in preceding years will be computed on the basis of the law in effect at the time the earlier gifts were made.

Under former law, the value of gifts made in a prior year could be adjusted for the purpose of computing the tax for the current year, even though the statutory period for the assessment of additional tax for the prior year had expired. This will no longer be possible (Sec. 2504) in cases where a tax was paid for the prior year in question. This change will not prevent an adjustment if no tax was paid for the prior year, or when issues other than valuation of property are involved.

Tenancies by the Entirety. Under the former law, when a husband purchased real property and conveyed it to himself and his wife as tenants by the entireties, he made a gift of the value of the property less the present worth of his retained rights therein.

The new law (Sec. 2515) eliminates this by providing that the creation of a tenancy by the entirety in real property by one or both spouses, and additions in the value thereof in the form of improvements, reductions in the indebtedness thereon, or otherwise, shall not be deemed to constitute a taxable transfer unless the donor so elects.

Termination of Tenancy. If a tenancy, the creation of which has not been treated as a gift, is terminated other than by death of a spouse, a gift is deemed to have resulted unless the property is divided in the same proportion as were the contributions to the purchase price.

For example, a husband furnished $30,000 and the wife $10,000 for the purchase of real property held as tenants by the entirety. The property was sold for $60,000, and $35,000 was received by the husband and $25,000 by the wife. The value of the husband's interest equals $60,000 × $30,000/$40,000 = $45,000. The value of the gift equals the value of the interest minus the value of the proceeds received. Therefore, the gift equals $45,000 minus $35,000 or $10,000. The gift of $10,000 results because the wife received $25,000, rather than $15,000, which would be proportionate to her contribution to the purchase price.

Election. If a donor wishes to elect to treat the creation of a tenancy as a gift, such election must be made by him in a timely gift-tax return for the year in which such tenancy was created. Moreover, for this purpose the return is required, regardless of whether the gift's value exceeds the $3,000 annual exclusion.

Certain Property Settlements. Section 2516 provides that transfers of property by husband and wife under a written agreement relating to their marital and property rights, or to provision of a reasonable allowance for support of children during minority, will be exempt from gift tax if divorce occurs within two years after the agreement.

Exemptions and Deductions

The lifetime exemption of $30,000 for citizens or residents continues (Sec. 2051).

The marital deduction, equal to one half of the value of the interest transferred by a citizen or resident to his spouse, continues with certain changes (Sec. 2523).

The 1939 Code qualified for the marital deduction a transfer to a trust where the donee spouse is entitled to all of the income from the transferred property for life and has a power of appointment over the entire property. The new Code (Sec. 2523) enlarges this exception to the terminal trust by eliminating the requirement that the transfer be in trust and by making it possible for a part of the transferred property to qualify for the marital deduction.

Community Property. If property held as community property was converted into separate property by the donor and the donee spouse during 1942 or after, such property, for purposes of the marital deduction shall be considered as "held as such community property." Previously, this provision applied only to such conversions during the calendar year 1942 or after April 2, 1948.

Returns and Administration

A gift tax return is due April 15, following a calendar year in which any gift over $3,000 has been made (Sec. 6019). Filing and payment dates may be extended up to six months.

An assessment can be made within three years after due date or filing (Sec. 6501). If gifts in excess of 25 per cent of the total stated in the return are omitted, the tax may be assessed within six years after the filing date.

Claims for refund or credit must be filed within three years from the time the return was filed or within two years from the time the tax was paid.

The Administrative Provisions For Returns and Payments

By James F. Pitt

REARRANGEMENT

One of the most important accomplishments of the new Code is the rearrangement and consolidation of existing administrative provisions under Subtitle F, which is applicable to most internal revenue taxes. For this simplification, the harried tax practitioner will be forever grateful.

CHANGED PROVISIONS

In addition to the rearrangement and consolidation of existing provisions, many important substantive changes have been made in the area of administration.

Returns

In the case of individuals who are 65 or over at the end of the taxable year, the gross-income requirement for filing an income-tax return was changed from $600 to $1,200.

Returns are required *(1)* from every estate or trust with a nonresident alien beneficiary, (2) every estate or trust with gross income for the year of $600 or more, and *(3)* every trust with any taxable income for the year (Sec. 6012). Taxable income reflects allowance of the deduction allowed by Section 642 in lieu of the personal exemption of $300 for certain trusts required to distribute income currently and $100 for all other trusts.

Declarations of Estimated Tax. Requirements for filing have been liberalized in several respects (Sec. 6015). If the total gross income is from wages subject to withholding, a declaration will not be required unless the total gross income exceeds $5,000 in the case of a single individual, $10,000 in the case of a head of household or a surviving spouse, and $10,000 in the case of a married couple. If, however, the gross income includes more than $100 of income other than wages, a declaration will be required if the total gross income exceeds the amount of allowable exemptions for the year, plus $400. Another change permits a final income tax return to be considered as a timely amendment of the declaration if filed within one month from the close of the taxable year.

In the case of taxable years ending on or after December 31, 1955, corporations will be required to file declarations of estimated tax on or before September 15 (or the corresponding date for fiscal years) if the tax liability is expected to exceed $100,000 for the year (Sec. 6016, 6074).

Authorized Signatures. Corporation income tax returns will be acceptable (Sec. 6062) if signed by "the president, vice-president, treasurer, assistant-treasurer, chief accounting officer, or any other officer duly authorized so to act." For prior years, signatures were required by two specified corporate officers.

New Filing Date. One of the most important administrative changes, from the standpoint of the tax practitioner, is the change in the filing date for individual and partnership income tax returns, gift tax returns, and declarations of estimated tax. These returns will become due for the calendar year 1954 (1955 for gift tax) and later years on April 15 instead of March 15 as at present. Corporation returns will continue to become due on March 15. However, the automatic extension for corporation returns has been incorporated in the Code in substantially the same form as the prior administrative ruling. Furthermore, the Commissioner will now have authority to grant an extension of time, up to six months, for filing *any* "return, declaration, statement, or other document" (Sec. 6072, 6073, 6075, 6081). These dates and the ones cited throughout, of course, apply only to calendar-year taxpayers. The corresponding dates would apply to fiscal-year taxpayers.

Payments

Although declarations of estimated tax by individuals will be due on or before April 15 (instead of March 15), subsequent installment payments will become due as before on June 15, September 15, and January 15 (Sec. 6153).

Payments on corporation declarations of estimated tax will be required on September 15 and on December 15 to the extent of 5 per cent of the estimated tax in excess of $100,000. For each year after 1955 the required payment is increased by 5 per cent until finally a maximum payment of 25 per cent is required on each of September 15 and December 15, 1959 (Sec. 6154).

Statute of Limitations

The old Code provided various limitation periods for the various taxes. The new Code (Sec. 6501) provides for general application (with exceptions) of the rules that formerly applied to income, gift, estate, and payroll taxes. That is, a uniform three-year assessment period has now been provided for all taxes, beginning with the due date of the taxes or of the return, or the date of filing of the return if after the due date.

The limitation period where 25 per cent of income is omitted has been extended one year and now expires six years after the return was filed. However, the new test for application of the rule is an omission of 25 per cent of gross receipts (or accrual equivalent) instead of 25 per cent of gross income. The difference is substantial in the case of a merchandising operation. Furthermore, the new Code provides that full disclosure of income omitted from the return in good faith and a statement of the reason for the omission will preclude that omitted income from being taken into account in determining a 25 per cent omission.

Estate and Gift Taxes. The omission of property valued at 25 per cent or more of the value of property reported will cause the statute of limitations to be extended to six years instead of three. The undervaluation of listed property will not be considered as an omission for this purpose. However, the full-disclosure rule is applicable here.

The personal holding company tax was formerly imposed as an entirely separate and distinct tax. Failure to file the personal-holding-company return (Form 1120H) prolonged the limitation period indefinitely. The personal holding company tax is now simply an element of the income tax, so that the filing of an income-tax return starts the running of the limitation period. In view of the above, a special limitation period of six years after the return is filed has been provided for the assessment of the personal holding company tax (only) in those cases where the personal holding company schedule (formerly return) is not filed with the tax return.

Interest on Deficiencies

Under the old Code certain tax deficiencies were not subject to interest at all. Now, six per cent interest is provided (Sec. 6601) for all taxes, with one exception. If the special extension of time for paying estate tax is granted pursuant to Section 6161, interest is charged at the rate of four instead of six per cent.

Interest runs from the due date of the tax (without regard to extensions or installment dates) to the date of payment. In cases of income, gift, and estate taxes, interest will not be charged beyond thirty days after filing a waiver of restrictions on assessment (Form 870). However, if the deficiency is paid within ten days after notice and demand for payment, interest will not be charged after the date of the notice and demand.

Elimination by Carry-back. The effect of the *Seely Tube and Box Co.* decision (338 U.S. 561) is adopted with a minor modification. Interest on deficiencies eliminated by carry-back will run from the due date of the tax to the last day of the loss year. Interest was formerly charged to the date of filing a claim for refund, or to the due date of filing the return for this carry-back year if no tax had been paid for the year of the potential deficiency.

Interest on Refunds

No interest will be allowed (Sec. 6611) on refunds made within 45 days after the due date for filing a return. Interest was formerly allowed in all cases up to 30 days preceding the date of the refund check.

Refunds Arising from Carry-Backs. Interest was formerly denied for any period prior to the filing of a claim for refund. The new Code (Sec. 6611) denies interest for any period prior to the last day of the loss year—irrespective of when or whether a claim for refund is filed.

Penalties

Penalties for failure to file a tax return (Sec. 6651) now follow a uniform rule. The old provision requiring the taxpayer to file a return before the possibility of abatement of certain taxes could be considered, has been superseded by the old rule applicable to income taxes.

The delinquency penalty will be measured by the net amount of tax due with the return rather than the total amount of tax shown by the return.

Failure to file certain information returns—such as Forms W-2 and 1099—will now (Sec. 6652), for the first time, be subject to a penalty of $1 for each information return not filed. The maximum penalty for any one calendar year, however, is limited to $1,000. It does not appear that this penalty will be assessed if the information returns are ultimately filed, even though not filed within the prescribed time.

Fraud Penalty. In the case of taxes other than income, estate, and gift taxes, the fraud penalty was previously measured by the entire amount of the tax liability. In the case of income, estate, and gift taxes, however, the penalty was measured by the amount of the tax deficiency. The new Code (Sec. 6653) provides for uniform measurement of the penalty by the amount of the deficiency.

Under the old Code, a taxpayer who, with intent to evade tax, failed to file a return was subject to both the 25 per cent delinquency penalty and the 50 per cent fraud penalty. The new Code provides that the delinquency penalty is not to be asserted with respect to any underpayment that is subject to the 50 per cent fraud penalty.

Declarations of Estimated Taxes. Penalties have been drastically modified (Sec. 6654) for years beginning on or after January 1, 1955. The penalty for failure to file a declaration has been eliminated. The penalty for substantially underestimating the tax, however, has been extended to compensate therefor.

Token Declaration. Under the old Code a taxpayer could legally defeat the spirit of the prepayment provisions by filing a token declaration on March 15 and amending that declaration (and paying 80 per cent or more of his actual tax) on or before January 15 of the following year. Under the new Code, however, a penalty will be imposed under those circumstances.

Computation of Penalty. The first step will be to determine the tax liability for the year shown by the return filed, before deducting the credit for payments by way of withholding and estimated tax. Then, one-fourth of 70 per cent ($66^2/_3$ per cent for farmers) of that reported tax liability is scheduled backward to each of the quarterly payment dates. Next, the actual prepayments by way of withholding and declaration are also scheduled backward to those same dates. Payments of estimated tax are scheduled backward on the basis of payment. Unless the taxpayer establishes otherwise, however, the withholding tax is scheduled equally to each installment date. A penalty of six per cent, computed like interest, is then imposed upon the difference between the amount of the tax scheduled backward to each installment date, and the prepayments scheduled backward to those dates. The penalty is computed from the installment date to the date of payment, or to the due date for filing the final return, whichever is earlier. Although this penalty closely resembles interest, the Finance Committee has pointed out specifically that an interest deduction is not allowable on account thereof.

It should be noted that penalties are determined by the amount of tax shown by the return filed for the year. If no return is filed, penalties will be based on the correct tax for the year determined after examination.

Exceptions to Penalty. The penalty for underestimation will not always be imposed, even though 70 per cent of the final tax has not been prepaid. The penalty will not be imposed with respect to any installment date on which the taxpayer pays a ratable portion or a larger amount of the tax shown on his return for the preceding year on or before that installment date. However, this exception will not apply unless the preceding year was a period of twelve months and a return *showing a tax liability* was filed for that year. Nor will the penalty be imposed if the taxpayer pays a ratable portion of a tax computed on the basis of rates and exemptions applicable to the taxable year, but otherwise on the basis of his return for the preceding year. This exception applies even if the preceding year has been a loss year.

Certain taxpayers receive the bulk of their income during the last few months of the taxable year. The penalty will not be imposed with respect to an installment date if, on or before that date, the taxpayer has paid at least 70 per cent of a tax computed on the basis of his annualized actual income for the period ending on the last day of the month preceding the installment date. Nor will the penalty apply if the payment is at least 90 per cent of the tax on the actual income of the full months prior to the declaration date without annualization.

While the new Code contains no specific provision covering the timing of income from partnerships for this purpose, the Finance Committee's report states:

"For purposes of applying this section in any case in which the taxable year of a partnership ends with or within the taxable year of a partner, the facts as to the partnership income for the months of the partnership year prior to the partner's installment date and as to the partner's distributive share of such income shall be taken into account in determining the partner's income for the months before such installment date."

Provisions for Corporations. Although the preceding discussion of penalties for underestimation pertains specifically to individuals, the same provisions are also applicable in principle to corporations (except for the 90 per cent provision noted immediately above) (Sec. 6655). In the case of corporations, "the tax" is reduced by $100,000 for purposes of deductions, and annualization may be made optionally on the basis of the first six or first nine months of the year rather than the full months prior to declaration dates.

Depositary Receipts. The old Code provided no penalty for failure of a taxpayer to comply with regulations for paying payroll and other excise taxes by way of depositary receipts. The new Code provides a penalty of one per cent for each month (or fraction thereof) during which any payment is unpaid. This penalty may not exceed six per cent in the aggregate (Sec. 6656).

MISCELLANEOUS

Departing aliens may be required to file a final income tax return for the period prior to the date of departure. The old Code made no provision for reopening the taxable year in the event of a temporary departure, so that an alien could be required to file two returns for one calendar year. The new provision (Sec. 6851) permits the consolidation of income and deductions of the taxable year (before and after departure) into one tax return.

Suit for Refunds. The new Code (Sec. 7422) provides that, if the Commissioner issues a notice of deficiency where a refund suit had been filed, but before a case is heard in the District Court (or Court of Claims), the proceedings there must be stayed for the 90-day period of the notice and for 60 days thereafter. If the taxpayer appeals the deficiency to the Tax Court, then the District Court (or Court of Claims) loses jurisdiction over the refund. If the taxpayer does not appeal to the Tax Court, the Government may then enter a counter-claim in the taxpayer's suit.

Official Filing Date. The new Code (Sec. 7502) provides that any claim or other document (except a tax return) will be considered to have been filed on the date it was mailed. This new rule will apply to documents filed with the Tax Court but not to those filed with any other court. This provision is exactly contrary to the old rule, under which tax returns were generally accepted on the basis of the postmarked date.

Extension of Due Date. Section 7503 provides for an extension of the time for the performance of any act required by the new Code, whenever the due date falls on a Saturday, Sunday, or legal holiday, to the next following "business" day.

APPENDIX I

EXAMPLE OF THE APPLICATION OF SUBPART D

Assume that a trust is required to distribute currently one-half of its income to beneficiary A and that the trustee has full discretionary power to distribute the remaining income to beneficiaries B or C in whatever amounts he sees fit. Assume further that the trust had the following amounts of income during its taxable years, 1954, 1955, and 1956.

	Royalties	Interest (taxable)	Interest (exempt)
1954	$20,000	$10,000	$5,000
1955	15,000	10,000	5,000
1956	25,000	15,000	5,000

1954.—Assume that the trustee in 1954 only distributed the one-half of the trust income for that year. The beneficiary A would receive $17,500 and would be taxed on $15,000. He would be exempt from tax on $2,500 as his portion of the tax-exempt interest. Under section 661 the trust would be entitled to a deduction of $15,000, and thus its taxable income would be $15,000. Taking into account the deduction under section 642 (b) of $100, the tax imposed on the trust as of the close of 1954 is $4,683. The undistributed net income of the trust as of the close of 1954 is ($17,500 *minus* $4,683) $12,817.

1955.—Assume that the trustee in 1955 distributed the one-half of the trust income to beneficiary A and $6,000 to beneficiary B. Beneficiary A would receive $15,000 and would be taxed on $12,500. Beneficiary B would be taxed on $5,000. Each beneficiary would be exempt from tax on $2,500 and $1,000 of tax-exempt interest, respectively. Under section 661 the trust would be entitled to a deduction of $17,500, and thus its taxable income would be $7,500. Taking into account the deduction under section 642 (b) of $100, the tax imposed on the trust for 1955 at the close is $1,780. The undistributed net income as of the close of 1955 is ($9,000 minus $1,780) $7,220.

1956.—Assume (1) that the trustee in 1956 distributed one-half of the trust income to beneficiary A, (2) that the trustee distributed to beneficiary B $20,000 and (3) that the trustee distributed to beneficiary C $10,000.

Beneficiary A would receive $22,500 and would be taxed on $20,000. He would be exempt from tax on $2,500 of tax-exempt interest.

Beneficiary B would, without regard to subpart D, be subject under section 662 to tax on $13,333.33 and would be exempt on $1,666.66 as tax-exempt interest.

Beneficiary C would, without regard to subpart D, be subject under section 662 to tax on $6,666.67 and would be exempt on $833.33 as tax-exempt interest.

For 1956, there would be no tax on the trust since the taxable income of the trust is $40,000 minus $20,000 taxable income distributed to beneficiary A, plus $13,333.33 as taxable income distributed to beneficiary B, plus $6,666.67 as taxable income distributed to beneficiary C.

Under subpart D, beneficiaries B and C would be subject to tax in their 1956 returns on amounts deemed distributed under section 666 on the last day of each of the two preceding taxable years, 1955 and 1954.

Under section 665 (b) the trust has for 1956 an accumulation distribution in the amount of $7,500. This amount is computed by subtracting $22,500 (distributable net income reduced by amounts falling within section 661 (a) (1) from the total of all amounts for 1956 falling within section 661 (a) (2); i.e., $30,000. Under section 666 (a) the accumulation distribution of $7,500 is deemed to have been distributed as an amount specified in section 661 (a) (2) on the last day of each of the years 1954 and 1955. However, the amount of the $7,500 accumulation distribution deemed distributed in 1954 is the excess of such amount over the undistributed net income for 1955; i.e., the excess of $7,500 over $7,220, or $280. The amount of the $7,500 accumulation distribution deemed distributed in 1955 cannot exceed the undistributed net income for 1955 (computed without regard to such accumulation distribution). Thus, under section 666(a), $7,220 is deemed distributed on the last day of 1955.

Since the portion of the accumulation distribution for 1956 which is deemed distributed in 1955 is not less than the undistributed net income for 1955, the trust is deemed under section 666 (b) to have distributed on the last day of 1955 an amount in addition to the $7,220. This additional amount is equal to the taxes imposed on the trust for 1955, i.e., $1,780.

Since the portion of the accumulation distribution for 1956 which is deemed distributed in 1954 is less than the undistributed net income for such year of $12,817, the trust is deemed under section 666 (c) to have distributed an amount in addition to the $280. This additional amount is the amount which is equal to the taxes imposed on the trust for 1954 ($4,683) multiplied by a fraction the numerator of which is $280 and the denominator of which is $12,817. This additional amount is $102.30.

As the result of the application of subpart D to the accumulation distribution of $7,500 for 1956, the trust is deemed to have distributed the following amounts:

(1) On the last day of 1955, the total amount of $9,000.

(2) On the last day of 1954, the total amount of $382.30.

Under section 668 (a) the total of the amounts which are treated under section 666 as having been distributed by the trust on the last day of any of the 5 preceding taxable years must, subject to sections 662 (a) (2) and 662 (b), be included in the income of the beneficiaries when in fact paid, credited, or required to be distributed.

Beneficiary B is deemed to receive $6,000 on the last day of 1955. He includes in his income for 1956, resulting from the application of subpart D to 1955, $5,000 and is exempt with respect to $1,000. Beneficiary B is deemed to receive $254.86 on the last day of 1954. He also includes in his income for 1956 resulting from the application of subpart D to 1954, $218.46, and is exempt with respect to $36.40.

Beneficiary C is deemed to receive $3,000 on the last day of 1955. He includes in his income for 1956, resulting from the application of subpart D, $2,500 and is exempt with respect to $500. Beneficiary C is deemed to receive $127.44 on the last day of 1954. He also includes in his income for 1956, resulting from the application of subpart D, $109.24, and is exempt with respect to $18.20.

The trust is not permitted any refund or credit for the amount of taxes imposed on the trust which would not have been payable by the trust had the trust in fact made the distributions deemed to have been made on the last days of 1954 and 1955 resulting from the application of this subpart to the $7,500 accumulation distribution for 1956.

Beneficiaries B and C are entitled to a credit under section 668 (b) against each of their tax for 1956 for a pro rata portion of the taxes imposed on the trust prior to the application of this subpart to the accumulation distribution for 1956 which would not have been payable in 1954 and 1955 had the trust in fact made the distributions to such beneficiaries resulting therefrom.

Since for 1955 the amount deemed under section 666 (a) to have been distributed was equal to the entire undistributed net income for that year, the entire amount of taxes imposed on the trust ($1,780) is allowed as a credit against the taxes imposed on the beneficiaries. In this case beneficiary B is permitted to credit against his tax the amount of $1,086.67 which is two-thirds of $1,780. Beneficiary C is permitted to credit against his tax for 1956 the amount of $593.33 which is one-third of $1,780.

With respect to 1954, prior to the application of this subpart to the accumulation distribution of $7,500 for 1956, the trust had undistributed net income of $12,817 and the tax was $4,683. After the application of subpart D, the undistributed portion of distributable net income for 1954 is $17,117.70 and the tax applicable to such portion is $4,528.99. Since the tax imposed on the trust prior to the application of this subpart to 1954 was $4,683, $154.01 is the amount of the taxes imposed on the trust under this chapter for 1954 which would not have been payable by the trust for 1954 had the trust in fact made distributions to beneficiaries B and C at the times and in the amounts specified in section 666.

Beneficiary B will be allowed an additional credit against his 1956 tax of $102.67, and beneficiary C, $51.34.

The undistributed net income for the year 1954 as of the close of 1956 is $12,588.71.

Tax Effects of Corporate Distributions and Adjustments

APPENDIX I

STATUTORY DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS (FROM SEC. 368)

Additions to prior law in the way of new matter are shown in italics; deletions are shown in brackets.

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, [of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes] of stock of another corporation *if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);*

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock *(or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation)*, of substantially all of the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, [or its shareholders or both or] *or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is* in control of the corporation to which the assets are transferred; *but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under Section* 354, 355, *or* 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.