# Preliminary Survey of the Revenue Act of 1954

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# PRELIMINARY SURVEY OF THE REVENUE ACT OF 1954

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Many people have been led to believe that the Revenue Code of 1954 represents, in some respects, a basic change in our tax policy. This is not the case. There has been no change in the concept of the realization of taxable income, who realized the income and when the income was realized. These are fundamental questions which, when applied to numerous situations, have been answered by the Supreme Court and lesser federal courts over a period of many, many years. For the most part Congress has not attempted to tamper with the rules which have evolved from these basic decisions.

In general, the 1954 Code incorporates the statutory provisions in the prior Code, as those provisions have been amended and interpreted by judicial decisions, and also, many of the former Treasury Regulations and rulings. The Ways and Means Committee of the House and the Finance Committee of the Senate have both stated that the new Code is "the first comprehensive revision of the Internal Revenue laws since before the turn of the century and the enactment of the income tax." The revision also represents years of work by the Joint Committee of Internal Revenue Taxation. Some of the foremost tax attorneys in the country, under the aegis of the American Law Institute, studied the problems of revision of the Code of Internal Revenue.[1] There were also many suggestions from the tax committees of the American Bar Association, the American Institute of Accountants, and other similar groups. Prolonged public hearings held by the staff of the joint committee were reported in October and November of last year.[2]

New substantive provisions have been added to almost every subject dealt with. These new provisions, were not merely reflective of previous practice, are primarily designed (1) to make the tax less burdensome to the average taxpayer (2) to remove inequities (3) to encourage business activities (4) to conform "tax accounting" as nearly as possible to "business accounting" and (5), above all, to make the administration of the law less difficult for the In-

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1. See Surrey and Warren, *The Income Tax Project of the American Law Institute*, 66 HARV. L. REV. 761, 1161 (1953).
2. See 31 TAXES 775, and following, and 867 (1953), and following.

ternal Revenue Service. Naturally the transition from the old Code to the new one imposes a complicated and troublesome task upon the Service. To ease this transition problem Congress has provided for some of the new provisions to become applicable only if the taxpayer so elects, in other cases (particularly as to partnerships) Congress has provided that the new law becomes effective only with years closing after December 31, 1954. However, most provisions of the new law, unless otherwise stated, are effective for the year 1954.

The 1954 Code recognizes that there are only two classes of taxpayers: individuals and corporations. The Constitutional requirement that income be realized before it is taxed and then taxed to the one who earns it, applies to both equally as do many of the statutory provisions, such as depletion and depreciation, accounting methods, carryovers and carrybacks, and the like. On the other hand, many of the new substantive provisions are applicable only to individuals, such as dividends credit, medical expense or child care deductions; and many will apply only to corporations, such as improperly accumulating surplus, etc. The first chapter of this article therefore will discuss those substantive provisions applicable only to individuals. The second chapter will discuss such provisions applicable only to corporations. The third chapter will discuss provisions applicable to both individuals and corporations. The fourth chapter will discuss accounting methods. The fifth chapter will discuss partners and partnerships. The sixth chapter will discuss corporate distributions, liquidations and reorganizations. The seventh chapter will discuss trusts and beneficiaries. The eighth chapter will discuss estate and gift taxes. The ninth and the last chapter will discuss administration and procedure.

## I. PROVISIONS APPLICABLE ONLY TO INDIVIDUALS

A. *Rates, returns, dependents and exemptions.* Of interest to all individual taxpayers is the substitution of April 15 for March 15 as the due date for filing income and gift tax returns and estimates. If returns are made on the basis of a fiscal year the return and the declaration must be filed on or before the 15th day of the fourth month following the close of the year. (Section 6072 (a) ).

The new Code does not change rates; it does, however, have slightly less rigid requirements than the prior Code for claiming the benefits of split income, dependents and "head of household". A taxpayer may claim to be the head of a household [and pay approximately three-quarters of the tax payable in a separate return,

otherwise] even though he maintains a separate establishment for a dependent parent whether or not he lives in that establishment. (Section 1 (b) (2) ). Under the prior law he could not claim to be the head of a household unless the dependent lived with him. A taxpayer may split his income even though his spouse has died so long as he has a dependent child living with him. This privilege, however, is permitted only for the two calendar years succeeding the calendar year of the death of the spouse (Section 2).

A dependent exemption is allowed for a child under nineteen regardless of the amount earned by the child (Section 151). Formerly if the child earned as much as $600.00 gross income per year no dependency credit was allowed. If the child is over nineteen and is a full time student in an educational institution, the limitation likewise does not apply (Section 151 (e) ). A taxpayer no longer has to contribute over half of the dependent's support if he is a member of a group which contributed over half of the dependent's support. If he individually contributed over 10% and all other persons in the group contributing over that amount file a written declaration that they will not claim a dependency credit for the same dependent for that taxable year (Section 152 (c) ). Of course the dependent must not have had as much as $600.00 gross income (Section 151 (e) ). A relationship between the dependent and the taxpayer is no longer required if the dependent is a member of the taxpayer's household (Section 152 (a) ).

The requirement that returns be filed has been changed slightly. Formerly all taxpayers having gross income of more than $600.00 were required to file. Now if the taxpayer is over 65 years of age he is required to file only if he has gross income of more than $1,200. (Section 6012 (a) ). Formerly information returns were required whenever $600.00 or more were paid to another individual (with certain exceptions) and the payor was not required to withhold income taxes on such payment. Now information returns are required only where the payments are made in a trade or business (Section 6041 (a) ).

B. *Retirement income.* For several years Congress has been considering various means of removing the discrimination between retirement income under State, local and private retirement plans as opposed to retirement income under Social Security or other federally sponsored plans. The 1954 Code attempts to remove this discrimination by providing (Section 37) a credit against the tax, for persons 65 years of age or older (the taxpayer can be less than 65

when he is retired under a State or local pension plan), to the extent that the retirement income does not exceed $1,200. The credit is against tax liability at the first bracket rate (presently 20%). Retirement income is defined to include pensions and annuities, interests, rents and dividends. This $1,200 must be reduced by all non-taxable pension payments received by the taxpayer, but is not reduced by disability benefits or workmen's compensation.

Since the credit for retirement income is intended primarily to place private retirement income on the same basis as Social Security, the statute adopts a work qualifying test in order to limit its application to persons who were actually engaged in gainful employment prior to age 65. Thus, to qualify for the credit an individual must have earned at least $600.00 a year in each of any ten years prior to the taxable year. The widow or widower of a spouse is qualified when the spouse would have qualified under this requirement. Where husband and wife both meet this requirement each can qualify for a retirement credit.

If the taxpayer is less than 75 years of age, all sums earned by him in excess of $900.00 per year serve to reduce the $1,200 retirement income figure. Thus, if a taxpayer who is less than 75 years of age earns as much as $2,100 per year he will receive no tax credit for any retirement income. If the taxpayer is 75 years of age or over there is no such limitation.

The retirement income credit cannot be used where the taxpayer elects to report his income for the Commissioner's computation of tax under Section 6014 (a).[3]

C. *Dividend credit.* It has often been charged that the income tax laws result in severe penalization of operating a business as a corporation because of the double tax on its earnings; a tax upon the corporation and an additional tax when the earnings, after the corporation pays the tax thereon, are distributed as dividends to the owners of the business. This apparent discrimination has troubled Congress and the Treasury Department for as many years as the income tax law has been in effect. At one time it was suggested that Congress tax the shareholders upon their proportionate share of the corporation's earnings. This, however, was thought to be unconstitutional, on the theory that inasmuch as the corporation was

3. For an excellent discussion of the retirement income credit, see Floyd, *Taxation of Retirement Income,* 32 TAXES, 721 (1954). See also Zack, *How the New Code Will Affect the Individual Taxpayer,* 92 J. ACCOUNTANCY 294 (1954).

regarded as a separate taxable entity its earnings were not "realized" by the shareholders until distributed to them.[4]

In the 1954 Code, Congress has made a gesture towards curing this apparent inequity. By Section 116 the amount of dividends received from a domestic corporation up to the sum of $50.00, may be excluded from taxable income by each taxpayer.[5]

In addition to this flat exclusion of dividend income, individuals are allowed as a credit against their tax an amount equal to 4% of the amount of dividends included in gross income and received by them subsequent to July 1, 1954. All dividends in excess of the exclusion must be included in gross taxable income and it is 4% of these dividends which is allowed as a credit against the tax (Section 34). However, while the credit is limited to 4% of the dividend income, it cannot exceed 2% prior to January 1, 1955, and 4% for any year thereafter of the taxpayers entire taxable income. Moreover, it may not in any event exceed the amount of the income tax, reduced by the foreign tax credit.

Since the purpose is solely to prevent double tax on corporate earnings, the statute, consistently, denies the credit [and deduction] in the case of dividends received from a corporation not subject to the usual corporate tax. Thus, dividends received from all life, non-mutual marine and fire insurance companies, China Trade Act Corporations, foreign corporations and certain banks and exempt organizations fail to qualify for the credit and the exclusion.

As in the case of the retirement income credit, the credit for dividends received is not allowed (when the taxpayer elects to have the Commissioner compute his tax) (Section 6014 (a) ).

D. *Child care expenses.* Probably the most publicized interpretations of the prior Code which were generally deemed unfair were those denying the parents of a child the deduction for the expenses of a nurse or baby sitter which were necessary to enable the parents (or the survivor) to work and produce taxable income.[6] These decisions evoked much criticism. The new Code specifically allows

4. See Eisner v. Macomber, 252 U.S. 189 (1920). See also MAGILL, TAXABLE INCOME 24-80 (Rev'd ed. 1945), and 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 9.01 (1942).

5. If a joint return is filed, and only one spouse has dividend income, only the amount received up to $50.00 may be excluded. However, if the other spouse also has dividend income, that income may likewise be excluded up to $50.00. Thus, if husband and wife each have as much as $50.00 dividend income, the exclusion may be $100.00. Dividends received by a trust or an estate may also be excluded, to the extent that they are not allowable to a beneficiary.

6. Smith v. Commissioner, 113 F. 2d 114 (2d Cir. 1940), *aff'g* 40 B.T.A. 1038 (1939); Hauser, 8 CCH TCM 384 (1949); O'Connor, 6 T.C. 323 (1946).

working parents (or the survivor) to deduct expenses of child care up to $600.00 per year when the child is under twelve, and a nurse maid, play school or other child care expense is necessary to enable the parents (or the survivor) to work. (Section 214). If both parents are living (unless the husband is disabled) a joint return must be filed, and if the joint income exceeds $4,500 per year the deduction will be reduced by the amount of the excess.

Where the taxpayer's husband is incapable of self-support because mentally or physically incompetent expenses [up to $600.00 per year] for his care to enable the taxpayer to be gainfully employed, without limitation on income, may be deducted (Section 214 (b) ).

E. *Medical expenses.* Formerly medical expenses were deductible (in the case of a taxpayer under 65 years of age) only to the extent that they exceeded 5% of the taxpayer's gross income. Moreover, the statute imposed a limitation of $1,250 per exemption with an over-all limitation of $2,500 on a separate return and $5,000 on a joint one.

Section 213 of the new Code allows the deduction of all medical expenses over 3% of the taxpayer's gross income and the over-all limitations have been increased to $2,500 per exemption with an over-all limitation of $10,000 in the case of a joint return or the return of a head of a household. However, under the new law medicines and drugs must be separately stated and are allowed to be included in medical expense computations only to the extent that they exceed 1% of the taxpayer's gross income.

The new Code expressly provides (Section 213 (e) ) that medical expenses include amounts paid for transportation "primarily for and essential to medical care". This provision should tend to diminish litigation over whether the expense of travel is a deductible medical expense. On the other hand, there will probably be much litigation over whether or not in a particular case an expense is "primarily for and essential to medical care". The Senate Finance Committee gives an illustration helpful on this question, as follows:

> For example, if a doctor prescribes that a patient must go to Florida in order to alleviate specific chronic ailments and to escape unfavorable climatic conditions which have proven injurious to the health of the taxpayer, and the travel is prescribed for reasons other than the general improvement of a patient's health, the cost of the patient's transportation to Florida would be deductible but not his living expenses while there. However, if a doctor prescribes an appendectomy and the taxpayer chose

to go to Florida for the operation not even his transportation costs would be deductible. (p. 220).

As in the case of the prior Code the percentage limitation upon the deduction of medical expenses will not apply in the case of a taxpayer 65 or over. However, the over-all limitation does apply, as well as the 1% restriction upon the deduction for drugs and medicines.

F. *Charitable contributions.* An individual taxpayer may deduct contributions to any charity up to 20% of his gross income. This limitation is now increased to 30%, however, if the additional 10% consists of contributions to a church, educational organization or hospital. Formerly a net operating loss carryback to the taxable year reduced the taxpayer's gross income and thus reduced the charitable deduction allowable for that year. This is apparently no longer true since the statute provides that the additional deduction shall be "computed without regard to any net operating loss carry back * * *." (Section 170).

Under the 1939 Code the Bureau had ruled that a present interest of a charitable gift in trust, with a reversion to the donor, was deductible if the trust was for more than a ten-year term. The statute now precludes this by denying a deduction in such cases where the value of the reversionary interest exceeds 5% of the value of the property (Section 170 (b) (1) (D) ).

G. *Deduction of legal expenses.* In general legal and accounting expenses may be deducted by a taxpayer unless they relate to some personal matter or capital item.[7] One of the minor inequities of the decisions under the 1939 Code was that legal and accounting expenses in connection with the determination, collection or refund of gift tax liabilities were not allowable deductions, whereas such expenses in connection with income or estate tax liabilities were allowable deductions. The Circuit Courts for the Fifth Circuit and the Sixth Circuit had reached different conclusions on this question.[8] The

7. See article on *The Deductibility of Legal Expenses in Computing Income Tax*, 3 S.C.L.Q. 107 (1950).

8. In United States v. Lykes, 188 F. 2d 964 (5th Cir. 1951), the Fifth Circuit Court of Appeals held that attorney and accounting fees were deductible from the donor's income when such fees were incurred in contesting and settling a gift tax deficiency. However, in Cobb v. Commissioner, 173 F. 2d 711 (6th Cir. 1949), on similar facts the Sixth Circuit Court of Appeals held that such fees were not ordinary and necessary in the management, conservation or maintenance of property held for the production of income. The *Lykes* case was appealed to the Supreme Court of the United States where the circuit court was reversed, 343 U.S. 118 (1952). This decision resulted in the inequity mentioned above; that is, fees in connection with income and estate tax liabilities were deductible but similar fees in connection with gift tax liabilities were not. The 1954 Code overrules this decision.

Supreme Court, however, decided that such expenses were not deductible. In Section 212 of the new Code Congress has provided that all expenses in connection with the determination, collection or refund of any tax are deductible. It makes no difference now whether such expenses are in connection with gift taxes, income taxes or estate taxes.

H. *Annuity income.* The new Code contains a special formula for taxing annuity payments. Heretofore annuity payments have been considered a return of cost of amounts received in excess of 3% (which, when this rule was adopted in 1942, was deemed a proper rate of interest). Under the old Code when the payments to the annuitant equaled the cost of the annuity, apart from the 3% per annum considered as income, all amounts received were reportable as ordinary income. This had the effect of throwing the entire payment into the taxable income of an annuitant who lived beyond his life expectancy.

Under the Code of 1954 the old 3% rule has been abandoned. Under the new rules (Section 72) where the expected recovery exceeds the investment of the taxpayer in the annuity, the excess is taxable income proportionately as it is received. Where the annuity is for the life of the taxpayer, the "life expectancy rule" applies and the ratio of investment to expected recovery over the life expectancy of the annuitant is determined. This ratio is called the "exclusion ratio" and this percentage of each payment is excluded from taxable income (Section 72 (a)-(c) ). If the payments are not to be for the life of the annuitant but are for a fixed number of years, the exclusion ratio is determined in the same manner but the expected recovery is determined by totaling the amounts to be received under the contract, rather than using the life expectancy of the annuitant.

Where payments are received which were not included in the expected return under the contract in determining the "exclusion ratio", such payments are includable as ordinary income. There are several problems that are specifically dealt with in the new Code. For example, there is a problem of annuities that began before 1954 under the 1939 Code. Installment payments for a fixed period were not taxed at all until the cost of the contract had been recovered and thereafter all payments were fully taxable. This problem is met by subtracting all payments received tax free under the cost recovery rule as deductible in determining the taxpayer's investment in the contract. Refund annuities on which payments had been received present a special problem which is dealt with in some detail (Sec-

tion 72 (c) and (e) ). Joint and survivor annuities also present a special problem which can be determined only upon consideration of special joint survivor annuity bases which are to be set forth in regulations to be issued (Section 72 (i) and 691 (d) ).

I. *Subdivision of real estate.* Under the 1939 Code if real estate was subdivided by a taxpayer (whether a corporation or an individual) into lots, the taxpayer was generally held to be a real estate dealer — regardless of the fact that he was principally occupied in some other business — and the profit from the sale of the lots taxed as ordinary income. There were, however, certain exceptions to this rule, such as when the taxpayer was merely liquidating the property and did not hold the lots out for sale in the ordinary course of business.

Section 1237 of the 1954 Code purports to deal with this problem but does so in a rather unsatisfactory manner. If individual (not corporate) taxpayers who are not dealers in real estate (with respect to any other property) subdivide property which has been held by them for five years or more (unless acquired by inheritance) and do not directly or indirectly make any substantial improvements thereon, or engage in any substantial sales activities, the profit on the first five lots sold shall be considered capital gain in its entirety. Thereafter 5% of the sales price shall be deemed ordinary income and the balance capital gain. (Note that this is 5% of the sales price, not 5% of the profit.) Expenses of sale may be deducted proportionately (Section 1237 (b) (2) ).

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Other changes in the statute, applicable only to individuals, which are not discussed, include:

(1) Deduction of business expenses of an "outside salesman" Section 62 (2) (D) ).

(2) Deduction of transportation expenses (other than commuting) of an employee (Section 26 (2) (C) ).

(3) Deduction of medical expenses may include last illness and funeral expenses (Section 213 (d) ).

(4) Deduction by husband of alimony paid under private separation agreements (Section 215). Inclusion of such payments in wife's income (Section 71).

(5) The exclusion from gross income of death benefit payments up to $5,000 by an employer no longer have to be pursuant to a written contract or agreement (Section 101).

(6) The spreading of income attributable to several taxable years, including income from an invention or artistic or literary work (Sections 1301, 1302, 1303 and 1304).

(7) Inclusion in income of amounts received from prizes and awards (unless in recognition of religious, charitable, scientific, educational, literary or civic achievements) (Section 74).

(8) Exclusion from income of scholarship and fellowship grants (unless services are required) (Section 117).

(9) Exclusion, under certain circumstances, from an employee's income of meals and lodging furnished by an employer (Section 119).

(10) Exclusion from income of an allowance to a minister for rent in lieu of a parsonage (Section 107).

(11) Exclusion from income of policemen's subsistence allowances (Section 120).

(12) Exclusion from income of amounts resulting from cancellation of indebtedness (Section 108).

(13) Deferring taxable gain from the sale or exchange of residential property (Section 1034).

(14) Disposition of property used in the trade or business (Section 1231).

## II. Provisions Applicable Only to Corporations

A. *Estimates.* The "pay as you go" system has worked so well for individuals that Congress has now imposed, to a limited extent, this system on corporations. Here is the way it works: a corporation now pays its tax for the preceding taxable year in two installments — one with its return, due two and one-half months after the close of its fiscal year, and the other three months thereafter. This will still be the procedure for a corporation with a tax liability of not in excess of $100,000. Where, however, the income tax of the corporation (after credits) "can reasonably be expected to exceed $100,000" the corporation must file a declaration on the 15th day of the ninth month of the taxable year (Section 6016). A percentage (rising from 10% in 1956 to 50% in 1960) of the tax estimated, after deducting the $100,000 and credits, is then payable in full in one installment or by halves in two installments, one on the 15th day of the ninth month of the corporation's taxable year and one three months thereafter. The percentage of such estimated tax rises from 10% for corporate years beginning on or after December 31, 1955 to 50% for taxable years beginning on or after December

31, 1959 (Section 6154). Of course these estimated payments will diminish the amounts payable with the corporation's final return on the 15th of the third month following the close of the corporation's taxable year, and the final payment three months thereafter. When the system becomes fully effective in 1960, a corporation having a total tax liability, after credits, of more than $100,000, will pay the tax in four equal installments beginning the 15th day of the ninth month.

Several ways in which estimates may be made are provided in the statute. If the preceding year's income is used there will be no penalty (Section 6655 (d) ). The penalty of underestimation or for failing to file an estimate is similar to that of individuals — namely, 6% per annum on the amount of underpayment for the period of underpayments (Section 6555). There is no penalty for underestimation if the estimate is 70% of the actual tax. Apparently there is no specific penalty for failure to file an estimate though no doubt this will be considered as making an estimate of zero.

Where the corporation's tax liability cannot reasonably be expected to amount to $100,000 the provision requiring estimates is not applicable.

B. *Organizational expenses.* Heretofore organizational expenses incurred prior to the formation of the corporation (including accounting and legal fees, expenses of purchasing corporate seals, stock books and the like) were not deductible as expenses but were considered a capital expense — deductible only when the corporation was dissolved. The 1954 Code recognized the unfairness of this distinction between organizational expenses and regular expenses, and also recognized the administrative difficulties involved in its enforcement. Organizational expenses may therefore be amortized over a five-year period (Section 248).

While the right of a corporation to amortize its organizational expenditures is granted in the form of an election (Section 248 (c) ) it is unlikely that any corporation would fail to exercise the election; the alternative would be denial of the deduction unless the corporation has a limited life, in which case the expenses would be amortized.

C. *Unreasonable accumulation of surplus.* Here there has been no substantial alleviation for closely held corporations, but the sword of Damocles of Section 102 of the 1939 Code is now held by two strands of hair instead of one. One of the problems always confronting management of closely held corporations apprehending the imposition of the Section 102 penalty was that the taxpayer had the

burden of proving that the accumulation of surplus was reasonable. Under the new Code, if the taxpayer submits to the Commissioner (if the question is raised) an explanation of why the surplus needs to be accumulated, the burden of proving the surplus is not a reasonable one is imposed on the Commissioner (Section 534).

The Bill as introduced in the House drew a distinction between publicly held and closely held corporations. It provided that there could be no unreasonable accumulation of surplus in the case of a publicly held corporation. In so providing the House merely recognized reality. The unreasonable accumulation must be for the purpose of avoiding the tax upon shareholders of the corporation (Sections 532 and 533). The penalty is on the corporation. The Senate, however, felt that it was discriminatory to say that the provisions applied to closely held corporations but not to publicly held ones.

Be that as it may, however, the Bill as passed is to a limited extent helpful to taxpayers in shifting the burden of proof. It also is helpful in that it provides a cushion of sorts against the penalty tax by exempting a surplus of $60,000 (Section 535 (c) ). Small closely held corporations which pay most of their earnings out in salaries no longer need have any concern.

D. *Consolidated returns.* Heretofore consolidated returns by two or more corporations have been permitted only when one owned 95% of the stock of the other. The 1954 Code [Secs. 1501-1552] reduced this required percentage to 80%. However, the filing of consolidated returns is still regarded as a privilege for which the taxpayer should be willing to pay an additional tax of 2% which is imposed upon consolidated income (except in the case of certain regulated public utilities). Moreover, once the taxpayers elect to file a consolidated return, they may not shift to separate returns, unless (1) there is a change in the affiliated group, (2) there is a change in the law or regulations making the filing of a consolidated return less advantageous to the group or (3) the Commissioner grants permission. The Commissioner has recently ruled that the 1954 Code is a change in the law, freeing corporations previously electing to file consolidated returns.

E. *Acquisitions to evade or avoid income tax.* Section 129 of the 1939 Code prohibited the acquisition by one corporation of another where the principal purpose was the evasion or avoidance of income taxes. Where the company acquired had incurred a substantial operating loss which could be carried over, it was frequently of

great value to corporations with substantial earnings to acquire such loss companies, merge into them, change the corporate name and use the carryover loss as an offset to the large earnings.[9] Section 129 of the 1939 Code was designed to close this loophole and put a stop to the practice described. However, by making the section applicable only when the purpose was to evade or avoid the income tax the section became, administratively, very hard to enforce since its application was dependent on a subjective intent.

Congress has now provided in Section 269 that if the consideration paid for the acquisition is substantially disproportionate to the aggregate of the adjusted basis of the property of the corporation being acquired (to the extent of the interest acquired) and to the tax benefits (to the extent not reflected in the adjusted basis of the property) not available otherwise than as a result of the acquisition, the fact shall be *prima facie* evidence of the principal purpose of evasion or avoidance of income tax.

There are also restrictions on the use of loss carryovers which may prevent the acquisition even though the purchase price is "proportionate". Section 382 disallows the carryover when 50% or more of the outstanding stock of the company has been acquired by ten or fewer persons within a period of two years or less, unless the corporation has continued to carry on its business substantially the same as before the acquisition. If there is a reorganization, a portion of the loss may not be carried over unless the shareholders are substantially the same as before the reorganization.

The Senate Finance Committee report states that if the limitations of Section 382 apply Section 269 is not applicable. In other words, if the net operating loss cannot be carried over, then it is unimportant whether or not the purchase price was "proportionate" to what was acquired, apart from the carryover.

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Other provisions of the 1954 Code, applicable only to corporations, which are not discussed herein, include:

(1) No gain or loss from the sale of Treasury stock (Section 1032).

(2) Disregard of net operating loss carryback in computing charitable contributions (Section 170).

(3) Carryover of excess charitable contributions (Section 170).

9. See Commodores Paint Terminal Corp., 11 T.C. 411 (1948).

(4) Exclusion from gross income of capital contributions; definition of capital contributions (Sections 118 and 362).

(5) Liberalization of rules concerning personal holding companies (Sections 542 (a)-(c); 543 (a) and (b); 545 (b); 561 and 563 (b) ).

(6) Liberalization of taxable income from leases and exempt organizations (Sections 501, 514 and 7851 (a) ).

(7) Employee stock options (Section 421).

## III. PROVISIONS APPLICABLE TO INDIVIDUALS AND TO CORPORATIONS

A. *Taxability of insurance proceeds.* As under the 1939 Code the proceeds of life insurance which are received under a life insurance contract and are paid by reason of the death of the insured are not taxable income *unless* the recipient of the proceeds is a transferee for value (Section 101). Under the 1939 Code a transferee for value was anyone except the insured who paid a valuable consideration for the policy. Under the 1954 Code the transferee rule does not apply where the transferred contract of insurance (policy) has a basis for gain or loss in the hands of the transferee determined by reference to the transferor's basis. For example, a policy transferred in a tax-free reorganization is not a transfer for value. Neither will it apply if the transfer of the policy was to a partner of the insured, a partnership in which the insured is a member, or a corporation in which the insured was a shareholder or officer (Section 101 (a) ).

The proceeds of an insurance policy received for any reason other than the death of the insured are not exempt from tax. Thus, if an endowment policy matures or is surrendered and an amount is received which is in excess of the premiums paid plus the dividends, etc. received or accumulated, such excess is taxable income.[10] If the owner elects to receive the proceeds over a period of years, in fixed installment or annuity payments, the ratio of the owner's basis to the expected recovery will be applied to each installment payment and the amount determined by application of this ratio will be excluded from taxable income (Section 72). Under the 1939 Code an election by the owner to receive the proceeds in future installments had to be made prior to the maturity of the policy. Now, however, such election may be made at any time within 60 days after such maturity (Section 72 (h) ).

10. Parsons, 16 T.C. 256 (1951).

Under the 1939 Code insurance policies were not regarded as "like property" and to the extent that the value of one policy exceeded the premium paid for another policy was taxable in an exchange. This resulted in taxation where an owner of an insurance contract exchanged the contract for one better suited to his needs although no actual gain was realized. Section 1035 of the 1954 Code provides that no gain shall be realized on exchange of life insurance, endowment or annuity policies except in the case of the exchange of endowment for a life insurance policy or of an annuity for a life insurance or endowment policy.

One other change affecting insurance should be mentioned. Under the 1939 Code where an insurance contract contained an option to have the proceeds paid at a date later than death in installments rather than in a lump sum, the total installments paid were exempt even though a portion of the payments represented interest. Under Section 101 of the 1954 Code a surviving spouse who exercises such an option must include in taxable income the amount received by reason of the deferred payments which is in excess of the amount which would have been received at death. Such amount shall be included as received proportionately over the period of the installment payments. However, a widow is entitled to an annual exclusion of $1,000.

B. *Depreciation.* The 1939 Code provided merely that in computing taxable income a deduction was allowable on account of depreciation of property used in the trade or business, or held for the production of income. The statute provided that the allowance should be a "reasonable amount" representing wear and tear (including an allowance for obsolescence). While neither the statute nor the Commissioner's regulations or rulings thereunder limited the depreciation allowance to an amount determined under the straight-line method, in practice the straight-line method was generally adhered to. The straight-line method has the virtue of great simplicity. The cost less scrap value is divided by the years of its estimated life and the quotient represents the annual deduction. The computation can be by items or by a group of items consisting of all depreciable items of property, a classified group comprising all similar items or a composite group consisting of all items used in a particular activity or operation.

The statute has now been expanded (Section 167), and specifically provides that reasonable methods of computing depreciation for *new* property (completed in 1954, or in use for the first time after Janu-

ary 1, 1954) having a useful life of three or more years include, in addition to the straight-line method, the declining balance method when it is not in excess of 200% of straight-line and the sum of the years-digits method. These three methods are explained by the Senate Finance Committee as follows:

(1) The straight-line method —

Under this method, the cost or other basis of the property, less its estimated salvage value, is deducted in equal annual installments over the period of its estimated useful life. The depreciation deduction is obtained by dividing the amount to be depreciated by the estimated useful life. This may be expressed as a rate of depreciation computed by dividing the estimated life into 1. The deduction per taxable year may be arrived at by multiplying the cost or other basis (less salvage value) by the resulting rate.

(2) Declining balance method —

Under this method a uniform rate is applied to the unrecovered basis of the asset. Since the basis is always reduced by prior depreciation, the rate is applied to a constantly declining basis. The salvage value is not deducted from the basis prior to applying the rate, since under this method at the expiration of useful life there remains an undepreciated balance which represents salvage value. The rate to be used under this paragraph may never exceed twice the rate which would have been used had the deduction been computed under the method described in paragraph (1). Under section 23 (1) of the 1939 Code the declining balance method was allowed in certain instances but the rate was generally limited to 1½ times of the rate used under the straight-line method. If this method has been used for property acquired prior to December 31, 1953, it may continue to be used but the rate provided for in paragraph (2) will not be presumed to be reasonable with respect to such property.

(3) The sum of the years-digits method —

Your committee has added the sum of the years-digits method to those methods provided in the House Bill which will be deemed to produce a reasonable allowance. Under this method the annual allowance is computed by applying a changing fraction to the taxpayer's cost of the property reduced by the estimated salvage value. The denominator of the fraction is

the sum of the numbers representing the successive 12-month periods in the estimated life of the property and the numerator of which is the number of 12-month periods, including that for which the allowance is being computed, remaining in the estimated useful life of the property. This method of depreciation can best be illustrated by an example. A acquires new property in 1954 which costs $175, has an estimated useful life of 5 years and an estimated salvage value of $25. The depreciation schedule for the asset will be as follows:

| Year | Fraction of Cost Less Salvage ($175–25=150):* | Depreciation | Reserve Total | Reserve Adjusted Basis |
|---|---|---|---|---|
| 1 | 5/15 | $50 | $50 | $125 |
| 2 | 4/15 | 40 | 90 | 85 |
| 3 | 3/15 | 30 | 120 | 55 |
| 4 | 2/15 | 20 | 140 | 35 |
| 5 | 1/15 | 10 | 150 | 25 |
| | Total | $150 | ....... | ....... |

*The denominator of the fraction is determined by adding 1 plus 2 plus 3 plus 4 plus 5=15.

(4) Other consistent methods —

Any other method consistently applied which will not, during the first two-thirds of the useful life of the property, yield a greater depreciation reserve than would have accumulated had the method described in paragraph (2) been used. Your committee has added the qualification "during the first two-thirds of the useful life of the property" so as not to restrict unduly the use of multiple rate straight-line methods and other methods which because of a small salvage value accumulated a greater reserve for depreciation in the latter years of an asset's life than would have accumulated automatically under the declining balance method.

The statutory authority to use the sum of the years-digits method is attributable to the Senate Finance Committee. It was not included in the Bill as originally enacted by the House. However, the statutory allowance of the declining balance method was in the original House Bill. While it has no prior legislative sanction, it was, in some cases, permitted by the Commissioner of Internal Revenue dur-

ing the post-war adjustments, to encourage the construction of housing facilities.[11]

Under Section 167 (e) a taxpayer using the declining balance method may change at any time to the straight-line method. It should be noted, however, that there is no provision allowing a change from the sum of the years-digits method.

There is no particular treatment in the case of property owned by a life tenant or by a trust or an estate. However, Subsection (g) provides a life tenant shall compute depreciation as if he were the owner of the property and that in the case of a trust or an estate the depreciation deduction shall be apportioned to the beneficiaries or distributees.

A special provision (Section 167 (d) ) authorizes the Commissioner to enter into an agreement with the taxpayer as to the useful life of the property, for the purpose of the depreciation computation. The rate of depreciation computed on such useful life will be binding upon both the Commissioner and the taxpayer. This provision will be particularly useful. Heretofore it has been difficult to obtain commitments from the Service as to depreciation rates and many investors have for that reason alone been reluctant to acquire depreciable property. Even where such commitments were made there could be no assurance that they would not later be repudiated.[12]

11. Lasser, *Depreciation Under the 1954 Code*, 32 TAXES 695 (1954). In no case was it allowed by the Commissioner to exceed 150% of the straight-line depreciation rate.

12. Where there is no statutory authority for the Commissioner to enter into agreements as to rates of depreciation and the like, there is no question but that a successor Commissioner is not bound by an agreement between his predecessor and a taxpayer. This was the point at issue in the fascinating case of James Couzens v. Commissioner, 11 B.T.A. 1040 (1928). There it appeared that Henry Ford wished secretly to buy up the minority stock interests of the Ford Motor Company. The minority stockholders indicated to an undisclosed agent for Mr. Ford that they would be willing to sell their stock if they were able to get an advance ruling from the Commissioner as to the value of the stock on March 1, 1913. (The capital gains tax would apply only to the appreciation in the value of the stock from that date to the date of sale.). Mr. Daniel C. Roper, the then Commissioner of Internal Revenue, indicated to Mr. Arthur A. Ballentine, the attorney for the purchasing interest, that he would advise Mr. Ballentine of the valuation the Bureau would place on the stock of Ford Motor Company as of March 1, 1913. Mr. Roper then dispatched an acting deputy commissioner, together with a number of assistants, to determine the fair market value of the stock as of March 1, 1913. After several months study of the problem the deputy commissioner made a report to the Commissioner that the fair value of the stock of the Ford Motor Company on March 1, 1913, was $9,489.34 per share. On the basis of this advice the minority stockholders agreed to sell their stock. Some time after the sale, Mr. Roper having been succeeded, a deficiency of almost $30,000,000.00 was asserted by the Bureau against the selling stockholders on the ground that the value of the stock on March 1, 1913, was considerably less than that previously found by the Bureau. The Board of Tax Appeals held that in the absence of statutory authority the Commissioner had no power to enter into an agreement with the taxpayer and

No doubt the staff of the Bureau is swamped in attempting to meet the many and varied problems involved in a transition from the 1939 Code to the 1954 one. Nevertheless, as an indication of the importance of this subject early in October the Commissioner issued proposed new regulations under Section 167. These new proposed regulations are substantially the same as the ones under the 1939 Code. They cover (1) records to be maintained, (2) the requirement that depreciable property shall be accounted for by (a) items, (b) classified accounts, (c) group accounts or (d) composite accounts, (3) that item retirements where depreciation is computed under group, classified or composite accounts may not be charged off as a loss, (4) that the depreciation methods prescribed by the statute may be used but any method applied to particular accounts must be consistently applied, (5) that any change in method other than from declining balance to straight-line may be made only with the Commissioner's prior approval.[13]

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Other changes in the statute, applicable to both corporations and individuals, which are not discussed, include:

(1) Proration of real estate taxes between buyer and seller (Section 164).

(2) Election to accrue real estate taxes by an accrual basis taxpayer (Section 461).

(3) Deduction of taxes levied by a special taxing district (Section 164 (b) (5) (B) ).

(4) Deduction of a portion of carrying charges as interest on installment purchases (Section 163).

(5) Election to deduct soil and water conservation expenditures on land "used in farming" (Section 175).

(6) Allowance of depletion deductions (Sections 611-614).

(7) Election to deduct or defer the deduction of exploration expenditures (Section 615).

(8) Net operating loss deduction (the carryover period continues to be five years but the carryback period has now been extended to two years) (Section 172).

that the Bureau was not estopped from later repudiating any agreement made or advice rendered. While this decision would probably not be invoked in most situations, it is nevertheless established that the Commissioner cannot be bound by an agreement unless he is authorized by statute to enter into it. The story, however, has a good ending — the Board found no tax due.

13. Special Ruling, Aug. 30, 1946; I.T. 3818, 1946-2 C.B. 42, *modifying* I.T. 2369, VI-2 C.B. 63.

(9) Election to deduct, amortize or capitalize research and experimental expenditures (Section 174).

(10) The deduction for bad debts, or the creation of a reserve therefor, is similar to the provisions of the 1939 Code (Section 166) but the definition of a non-business bad debt has been made slightly less restrictive (Section 166 (d) ). A guarantor, endorser or indemnitor of a non-corporate debt may, under certain circumstances, claim a bad debt deduction (Section 166 (f) ).

(11) Bond premium may be amortized only over a three-year period, regardless of an earlier call date (Section 171).

(12) Category of "related taxpayers" on transactions with whom losses and expenses are not allowable deductions has been slightly enlarged (Section 267).

(13) Pension and profit-sharing plans for employees (Sections 401-404). In general the provisions of the 1954 Code are similar to the statute, the rulings, regulations and interpretative decisions under the 1939 Code. While the income of a qualified trust for employees will as heretofore normally be exempt from income tax, an exception is made in the case of "non-related business income" (Section 511-514).

(14) Sickness and disability benefit payments to employees (Sections 104-106). Heretofore amounts paid to employees on account of sickness or disability were excludable from the employees' income only when paid pursuant to a formal plan. This is no longer necessary.

## IV. ACCOUNTING METHODS

It has frequently been pointed out that the accounting requirements for tax purposes differ in many respects from business "good accounting practices".[14] The Revenue Code of 1954 shows that Congress has taken notice of the many divergences between income for tax purposes and income for business purposes. Congress also recognized that tax accounting practices which have become rooted because of the passage of time and which have become part of a taxpayer's *modus operandi* should not be arbitrarily discarded but there should be allowed a period of transition in which the new methods may be used and become established. Accordingly, in the case of most new provisions taxpayers may make elections as to whether they

14. See Reiling, *Practical Legal Aspects of Tax Accounting*, 30 TAXES 1028 (1952); Bruton, *Reserves and Deposits*, TAXES — The Tax Magazine, September 1953, p. 697.

wish to continue under the old practice, or to follow the new provisions.

While the new Code prescribes many changes in accounting methods, some of which are significant and others not, only three of the changes will be discussed in this article. However, these three are the principal changes and will apply to almost all, if not all business taxpayers. They are (A) reserve for estimated expenses (B) prepaid income and (C) payments under a "claim of right".

A. *Reserve for estimated expenses.* Section 462 allows an accrual basis taxpayer to establish a reserve for estimated future expenses. When the expenses are actually paid or incurred they must be charged to the reserve. Section 43 of the 1939 Code prohibited this procedure and allowed the deduction only when the expenses were actually paid or incurred. Both the Bureau and the courts had held that this did not include expenses which had not been "established" even though such expenses were certain to be incurred. For example: A paving contractor had received a certain sum for paving a sidewalk. He had also agreed to maintain the sidewalk for a period of five years and, out of the total sum received under his contract, he set up a reasonable reserve, based on experience, for the cost of the maintenance. This reserve was not allowed as a credit against the income received on the contract.[15] Reserves set up by a seller in anticipation of cash discounts on accounts receivable, were held to be non-deductible.[16] A reserve for anticipated shortages in scrap iron and steel, shipped under a contract which provided for liability of the seller in such cases, was held to be non-deductible.[17] A taxpayer engaged in the examination of title to real estate could not deduct an amount set up as a reserve to provide for liability in the event claims were made, even though the reserve was required by state law.[18] The fact that the

15. Uvalde Company, 1 B.T.A. 932 (1925); Chapin Construction Company, 3 B.T.A. 25 (1925); Consolidated Asphalt Company, 1 B.T.A. 79 (1924); Union Paving Company, 6 B.T.A. 527 (1927); Thomas Cronin Company v. Lewellyn, 9 F. 2d 974 (W.D. Pa. 1925); Vang v. Lewellyn, 35 F. 2d 283 (3rd Cir. 1929). The same is true of a roofing contract, Quality Roofing Company, 16 B.T.A. 1370 (1929); a heating ventilating contract, W. J. Sholl Company, 30 B.T.A. 993 (1934); neon display signs, Hamlin Neon Sign Company, Inc., 1 CCH TCM 126 (1942).

16. Shapleigh Hardware Company v. United States, 81 F. 2d 697 (8th Cir. 1936); Ederheimer-Stein Company, 2 B.T.A. 711 (1925); M. I. Stewart & Company, 2 B.T.A. 737 (1925); Jackson Casket & Manufacturing Company, 7 B.T.A. 1190 (1927); Landesman-Hirschheimer Company, 15 B.T.A. 64 (1929); American Cigar Company, 21 B.T.A. 464 (1930); Albert C. Becken, Jr., 5 T.C. 498 (1945).

17. David J. Joseph Company v. Commissioner, 136 F. 2d 410 (5th Cir. 1943).

18. Wayne Title & Trust Company v. Commissioner, 195 F. 2d 401 (3rd Cir. 1952); Alston, 4 B.T.A. 1159 (1926).

reserve funds were set up in a separate bank deposit was not an adequate reason for permitting its deduction.[19]

In all of these cases the expense was certain and the income to which the expense related was attributable to the taxable year or to a prior taxable year. They would therefore qualify for the reserve expense deduction if they could be estimated with reasonable accuracy. As in the case of a reserve for bad debts the section is applicable to a particular taxpayer only in the discretion of the Commissioner; any excess of the reserve at the end of each year should be added back into income or other adjustments should be made; and to avoid duplication of deductions, the expenses, when they are actually incurred, may only be charged to the reserve account, or, if charged to expense, a portion of the reserve account must be returned to income. Unless the expense can be estimated with reasonable certainty it cannot be the basis for a credit to the reserve (Section 462).

The new procedure may be followed without any affirmative action by the taxpayer, in making his election, for any year beginning in 1954 or thereafter, in which there are any expenses to be provided for by reserves. A change thereafter requires the Commissioner's consent.

B. *Prepaid income.* One of the instances in which tax accounting and business accounting differ radically is the treatment to be accorded prepaid income. An insurance company will frequently receive premiums for policies covering three years or longer. Not only are the prepaid premiums not earned but they may be subject to refund if the policy is cancelled. Nevertheless, all premiums received have been considered taxable income.[20] Payments received from the sale of round-trip transportation tickets in one taxable year which can be used for transportation during the next taxable year are, nevertheless, income of the taxpayer when the ticket is purchased, not when it is used.[21]

In *South Tacoma Motor Company*,[22] the taxpayer was a dealer for Chevrolet cars and, by agreement with General Motors Corporation, sold coupon books to his customers. Each book contained a number of coupons entitling the purchaser to have his automobile serviced and lubricated in the future. Petitioner kept his books in

19. Oppenheimer, 16 B.T.A. 993 (1929).
20. Brown v. Helvering, 291 U.S. 193 (1934).
21. National Air Lines, Inc., 9 T.C. 159 (1947); East Penn. Transportation Company, 6 CCH TCM 1097 (1947).
22. 3 T.C. 411 (1944).

accordance with a "manual of accounting" prescribed by General Motors and reported as gross income from the sale of the coupon books only that part of the proceeds therefrom represented by actual performance by the petitioner, during the particular tax year, of the services specified in the agreement. The balance of the proceeds was carried on the books of the petitioner as being offset by a future liability. Taxpayer contended that the entire proceeds from the sale of the coupon books were not taxable income in the year of sale because (1) the customer had the right to rescind the contract and receive his money back and (2) the nature of the contract was such that coupons, unused in the year sold, required future services. The Tax Court held that neither of these reasons were sufficient; that no trust was created and that the taxpayer received the proceeds from the sale of the coupon books with no restriction on the use of those funds.

The administrative difficulties in administering the old Code which did not allow the deferment of prepaid income is brought out in the so-called "lease" cases. In these cases it was held that if the prepaid amount was a deposit its deferment was permissible but if it were a prepayment of rent its deferment was not allowed.[23] The theory of the Bureau was that the prepaid income or rent should be accrued, since it was received, regardless of the fact that it was not earned.[24]

The 1954 Code permits accrual basis taxpayers (but not cash basis taxpayers) to defer the reporting of advance payments as income until the year or years in which the income is earned (Section 452). If, however, the income may not be earned within a five-year period, it is required to be apportioned to the taxpayer's income in the taxable year involved and the succeeding five years. Nevertheless, the Commissioner may consent to a spreading of the income over more than a five-year period (Section 452 (b) ).

As in the case of estimated expenses the taxpayer must make an election with respect to the trade or business in which the prepaid income is applicable. Here, also, no affirmative action by the taxpayer is necessary if, for the first year in which prepaid income is received, it is reported under this section. Later elections do require prior consent. A separate election may be with respect to each trade or business in which the taxpayer is engaged.

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

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23. See Hirsch Improvement Company v. Commissioner, 143 F. 2d 912 (2d Cir. 1944), *cert. den'd* 323 U.S. 750 (1944).
24. See note 14 *supra*.

It should be observed that in some instances it is very difficult to distinguish between prepaid income to be earned in the future, and income received subject to an estimated future expense. The application in a particular case of the two sections of the new statute may be the determining criteria. For example, if the income is prepaid it would seem to be immaterial, in deferring it to estimate the future expenses, in connection with the income with "reasonable certainty". On the other hand, the creation of a reserve for estimated future expenses does not have the five-year limitation.

C. *Claim of right.* In *North American Oil Consolidated v. Burnet,*[25] it was held (a) that income received under a claim of right and without restriction on its disposition was taxable income when received, and (b) that, if it later had to be repaid, the taxpayer was entitled to a deduction in the year of repayment. This decision established a basic fiscal policy and has been uniformly followed.[26]

This doctrine was severely criticized on the ground that it resulted in the taxation of gross income.[27] If the repayments exceeded the taxpayer's other income in the year of repayment, or if the other income was substantially lower in the year of repayment than in the year of receipt, the deduction of the repayment would not compensate the taxpayer for the additional tax paid in the year the payment was received.

The 1954 Code eliminates this inequity if the amount repaid exceeds $3,000. In such case the taxpayer may reduce his tax for the year of repayment by the amount of additional tax he had paid for the year in which the sum was received, on account of the receipt of such sum. If a smaller tax liability results from simply deducting the repaid amount in the year of repayment, as under the old law, the taxpayer may claim such deduction instead. The return for the prior year in which the item was received is not reopened, so there will be no allowance for interest on the tax paid for the earlier year. The provision is applicable to repayments made in any taxable year ending after enactment of the 1954 Code. It expressly

25. 286 U.S. 417 (1932).
26. The lower federal courts have, in some cases, attempted to carve out exceptions. For example, in Greenwald v. U. S., 57 F. Supp. 569 (1944), the Court of Claims held that the doctrine was inapplicable to a payment made because of an innocent mistake of fact. This decision was overruled in U. S. v. Lewis, 340 U.S. 590 (1951), but, under the principle of the Greenwald decision, the doctrine of the North American Oil Consolidated case has been held by the Court of Claims to be inapplicable to bonuses based on government contracts which were renegotiated downward. Gargaro v. U. S., 86 F. Supp. 840 (Ct. Cl. 1949).
27. MONTGOMERY, GENERAL INCOME TAX HANDBOOK 97 (1937).

does not apply to the refund of payments received from the sale of inventory or stock in trade except in the case of utility rate refunds (Section 1341).

While this statutory provision removes the inequity and will presumably reverse the "claim of right" decisions, it does not precisely conform to the manner in which payments subject to a refund are handled under good accounting practice. A reserve for the repayment would seem to be more appropriate.[28]

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Other changes in accounting methods made by the new Act, which are not discussed, include the following:

(1) Installment sales no longer require a down payment (Section 453).

(2) In changes to the installment basis any portions of profits which have previously been reported in taxable income may be eliminated (Section 453 (c) ).

(3) A taxpayer may now elect to use a fifty-two or fifty-three week taxable year if books are kept on that basis (Section 441).

(4) Hybrid accounting methods may be accepted so long as they reflect the true income of the taxpayer (Section 446).

(5) If a taxpayer changes his method of accounting, whether voluntarily or involuntarily, adjustment shall be made to prevent amounts from being duplicated or omitted; if the adjustments result in a bunching of income in one year, such income may, under certain circumstances, be spread over a three-year period (Section 481).

## V. PARTNERS AND PARTNERSHIPS*

The 1939 Code contained but nine sections dealing with partnerships. While there have been many rulings, much litigation and detailed regulations on this subject, the simplicity of the statute is undoubtedly for the reason that the partnership was treated merely as an aggregate of the individuals. If the Commissioner felt that a particular partnership was organized and operated primarily as an

28. See Surrey and Warren, *The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness*, 66 HARV. L. REV. 761 (1953).

*Much of this Chapter is taken from an article by Mr. Bruton in the September 1954 issue of TAXES — THE TAX MAGAZINE at page 724.

entity the Bureau would declare such partnership to be an association taxable as a corporation. However, in many situations wholly unrelated to the formation or operation of a partnership the question would arise as to whether the partnership should be regarded as an aggregate of individuals or as an entity, and this accounts for the multitude of court decisions and rulings on this subject.

The 1954 Code does not adopt either the aggregate or entity theory to the exclusion of the other. It does, however, provide rules for many types of situations, starting with the formation of the partnership, going on into its operation and dealing with the sale of an interest, the death of a partner and its final dissolution. From the lawyers' viewpoint this makes the statute too rigid; its former simplicity was better.

A. *Formation.* Now as under the prior law, when property is contributed to a partnership, regardless of its fair market value there is no recognition of gain to the contributing partner; the partnership acquires the property at the partner's adjusted basis therefor at the time of the contribution (Section 721-723). There is a carry-over basis to the partnership.[29] There is also a "tacking-on" of the holding period of the contributor (Section 332 (b) ), although under the prior Code this was evidently not the case.[30]

However, the stage is set at the formation for the determination of subsequent tax liabilities. The contribution by each partner — whether it be property or money, or both — is the initial basis of the partnership interest of the partners. This initial basis is adjusted by adding to it the partner's distributive share of the partnership income (whether or not taxable) and the excess of any depletion deduction of the basis of the property subject to depletion. The initial basis is further adjusted by deducting distributions, his distributive share of partnership losses and expenses which are not deductible and not chargeable to a capital account (Section 705). The deduction cannot reduce the partner's basis below zero.

The initial basis is also increased or decreased by any liabilities of the contributing partner assumed by the partnership or by the other partners. The personal liabilities of a partner are assumed, in whole or in part, but the partnership is treated as though they

29. Prior to 1934 this question was unsettled. In Helvering v. Walbridge, 70 F. 2d 683 (2d Cir. 1934), *cert. den'd* 293 U.S. 594 (1934), it was held that the partnership acquired the contributed property at the stepped-up basis of its fair market value at the time of the contribution. The 1934 Revenue Act, however, provided for a carry-over basis to the partnership.
30. See Edwards v. Hogg, 214 F. 2d 640 (5th Cir. 1954).

were cash distributions to the partner. Similarly, the assumption by a partner of liabilities of the partnership or of the other partners, is treated as though it was a cash contribution, increasing or decreasing accordingly the initial basis of the partner (Section 752).[31]

The distributive share of each of the partners in earnings, capital gain and losses — ordinary or capital — may be set by the partnership agreement. Here, it should be noted, is the distinction between a partner's distributive share of income (his participation interest) and his capital interest in the partnership. This distinction is all important in the case of a personal service partnership.

While the partnership agreement may provide for the partner's distributive share of any item of partnership income or gain, such provision cannot be designed primarily to avoid or evade any tax. If so, it will be disregarded (Section 704 (b) ). The distributive share of each partner in capital gains or losses and in depreciation or depletion, with respect to contributed property, must coincide with the distribution of such items as if the partnership had purchased the property, unless the variation is on account of a difference between the fair market value of the property at the time of contribution and its basis to the contributing partner (Section 704 (c) ).[32]

*Taxable year.* The formation of a partnership requires the adoption of a taxable year, which is usually also the accounting year. The distributive shares of the partners are taxable income to them only when the partnership year ends. In many cases the partnership has a different taxable year from that of its members. The *status quo* of this situation as to partnership years, or partners' years, is not affected by the new Code except as to partnerships changing to or adopting a fiscal year after April 1, 1954. However, applicable to years commencing after April 1, 1954, Section 706 (b) prevents a partnership from adopting, or changing to, a taxable year other than that of all partners owning as much as a 5 per cent capital or participation interest therein, without the approval of the Bureau. (Approval will be given only when the request has a firm business

31. Upon termination of the partnership, the adjusted basis of each of the partners may be further adjusted, by the Bureau, by reference to each partner's proportionate share in the adjusted basis of the partnership's property (Sec. 705 (b) ).

32. If the contributed property had previously been owned by the partners in undivided interest — unless the partnership agreement otherwise provides — the depreciation, depletion or gain or loss on sale of the property may be attributed to the owners as though the property had not been contributed to the partnership (Sec. 704 (c) ).

basis.) Without consent, also, a partner owning more than a 5 per cent capital or participation interest may not change to a taxable year other than that of the partnership (Section 706 (d) ).

This change is designed to eliminate the occasional practice of a partnership adopting a fiscal year ending shortly after the partner's year, thus throwing the entire partnership income into the partners' following taxable year, most of the income having been earned the previous year.

B. *Operation.* In the computation of partnership taxable income the new Code makes no substantial change in existing practice. The partnership is treated as an entity and files an information return (Section 701). While the firm is an *entity* for tax computation, it is merely an aggregate of taxpayers. It must severally state all items of income (Section 702 (a) ) and these items are then taken proportionately into the individual partner's returns (Section 703 (a) ).

Depreciation of partnership property must be prorated among the partners according to their distributive shares of income unless the partnership agreement otherwise provides, and this is also applicable to contributed property (Section 704 (c) ).

Section 704 (d) provides that in the transposition of partnership income to the individual partners any loss of the partnership shall not be allowed to the individual partners, to the extent that such loss exceeds the partners' basis in the firm. Such a limitation of loss is inconsistent with the legal concept of a partnership — unlimited liability. (This concept of a partnership is recognized in South Carolina.)

C. *Transactions between partnership and individual partners.* Prior to the 1954 Code there was no definite rule covering such situations, although certain decisions had indicated that transactions designed to avoid or minimize taxes would be treated one way and transactions having a legitimate business motive would be treated another.[33] The 1954 Code establishes a definite rule in Section 707 that all dealings between a partnership and a partner shall be treated as though the

33. In Brown, 10 B.T.A. 1036 (1928), a partner sold property to his partnership at a loss. The court refused to recognize the loss on the ground that the sale was made to establish a tax loss and was not *bona fide*. The language of the opinion, however, indicates that such sales will give rise to recognized gain or loss if they are not made for tax purposes. In Landreth v. United States, 70 F. Supp. 991 (N.D. Texas 1946), *aff'd* 164 F. 2d 340 (5th Cir. 1947), the court implied that a gain would be recognized if free from the taint of tax avoidance, regardless of the amount of the sales price. See also Popineau, 16 T.C. 130 (1951).

partner were an outside party.[34] To prevent the possible use of such a rule to establish fictitious losses, or to acquire a stepped-up basis at capital gains rates for depreciation purposes, Section 707 (b) provides that losses in sales of property between the partnership and any of its partners owning more than a 50 per cent interest therein (or two partnerships with more than a 50 per cent joint interest) shall not be recognized, and that gains realized from such sales shall be ordinary income when the partner owns more than an 80 per cent interest in the partnership (or in transactions between two partnerships where there is more than 80 per cent joint ownership).[35]

Heretofore, salaries and interest have been considered as part of a distributive share of the partners. In periods during which there was a loss the salary and interest were considered income only to the extent paid out of the capital of the other partners. By Section 707 (c) of the new Code, if the salaries or interest are to be paid, regardless of earnings, they are deductible in full from partnership income or are carried as a loss, which may be used, carried over or carried back by members of the firm. Section 706 (a) apparently provides that such salaries or interst shall be taken into the partner's income only in the year in which the partnership year closes. As far as the partners are concerned it would seem that the fact that these payments are guaranteed, would make no difference in their tax status.

D. *Distributions of Property.* Here we are concerned with distributions of property during the continuance of the partnership — not in liquidation. Current distributions of *cash* present no problem. Under the 1954 Code, as under the prior law, the income of a partnership is taxable to the partners when it is earned and it is immaterial, as far as taxation is concerned, whether or not that income is distributed. However, any undistributed income is added to the partner's basis for his partnership interest.

The 1954 Code provides no change from the existing rules re-

34. This use of the "entity" approach in the treatment of transactions between a partner and a partnership cannot be considered as a recognition by Congress of the validity of considering the partnership an entity in all situations. The Conference Committee Report, in referring to Sec. 707, states:

> No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions. An illustration of such a provision is section 543 (a) (6), which treats income from the rental of property to shareholders as personal holding company income under certain conditions.

35. This is similar to the rule with respect to property transactions between a corporation and a controlling stockholder.

garding the distribution of property. Such a distribution gives rise to no recognized gain or loss until the property received in distribution is disposed of. This is true regardless of the nature of the property and regardless of the fact that its partnership basis may be substantially in excess of the partner's basis for his partnership interest (Section 731 (a) (1) ). Nevertheless, the establishment of the basis of the property, which the partner has received in distribution, determines his gain or loss upon the subsequent disposition of the property.[36] His basis is that of the partnership *unless* the partnership basis for the distributed property exceeds the adjusted basis of the partnership interest of the distributee partner, in which case the partner's basis for his partnership interest is his basis for the distributed property (Section 732 (a) (2) ).[37]

The 1954 Code is in this respect a radical departure from the prior law which generally required only that a proportionate part of the partner's basis of his partnership interest be allocated to each distributed asset, in accordance with the market value of such asset.[38]

In the disposition of property received by a partner from a partnership distribution to him, any excess of proceeds over his basis is normally a capital gain and any loss is a capital loss. This, however, is not true in the case of gain or loss from the disposition of unrealized accounts receivable or inventory items (Section 735). In every provision of the 1954 Code dealing with the disposition of property received from a partnership distribution, whether current or in final liquidation, it is evident that all possible precautions were taken to prevent the possibility of taxpayers converting ordinary income into capital gain. Section 735 provides that the distribution of unrealized accounts receivable or inventory items which are not sold or exchanged within five years from the date of distribution shall, upon the disposition of such distributed property, give rise to

36. Whenever cash and property are distributed to a partner, the basis of his partnership interest is reduced by the amount of the cash distributed (Sec. 732).

37. Where the adjusted basis for the property, in the hands of the partnership, exceeds the distributee partner's basis for his partnership interest, there will be an unused basis which the partnership may elect to allocate to its remaining assets, and thus increase their basis to the partnership. If, on termination of the partnership, there is a loss on distribution, the election requires a recognition of such loss (Sec. 734).

38. There are apparently no decisions on this question, but the Bureau has ruled that the basis for distributed property must be allocated by reference to the "present value" of the distributed assets (G. C. M. 20, 251, 1938-2 CB 169). For the discussion of the formula used in such allocation, see Sec. 8.2 of LITTLE, FEDERAL INCOME TAXATION OF PARTNERSHIP (1952). See also Rabkin and Johnson, *The Partnership Under the Federal Tax Laws,* 55 HARV. L. REV. 909 (1942).

ordinary income and not capital gain. Section 751 (a) provides that any cash or property, received by a partner in exchange for all or part of his interest in the partnership, which is attributable to (1) unrealized accounts receivable or (2) inventory items which have increased more than 20 per cent in value and which constitute more than 10 per cent of the value of all partnership assets, shall be ordinary income. Section 751 (b) provides that property received by a partner in distribution, in exchange for his interest in the accounts receivable or inventory, shall be ordinary income.

If a partner has acquired his interest by purchase or inheritance within two years before the partnership assets are distributed to him, and the partnership had not elected to adjust the basis of its assets pursuant to Section 743 (b), the partner may elect to have a special basis representing the difference between the basis of his partnership interest and his proportionate share in the basis of all partnership assets (Section 732 (d) ). The Bureau may force a transferee partner to make this election regardless of the two-year limitation if the fair market value of partnership property has increased more than 10 per cent over its adjusted basis.

E. *Continuation of partnership.* At common law no distinction has been made between the dissolution of a partnership and its termination. The death or withdrawal of an existing partner, the admission of a new partner or partners or a change in the partnership interests of the partners resulted in the dissolution of the firm; if the business was continued, a new organization was formed. This rule, applied to income tax law, permitted the termination of partnership accounting and taxable periods almost at the will of the partners, thus enabling them to throw anticipated partnership income into subsequent taxable years whenever they wished to do so. Also, the death of a partner, by terminating the partnership year, might throw more than 12 months' income into the taxable year of the members of the partnership. Revenue Ruling No. 144 put an end to the practice of partners terminating the partnership year by changing their interests or admitting new partners into the firm, and through the tortuous path of litigation the result was reached that the death of a partner closed the year as to him — not as to the other members.[39]

It remained, however, for the 1954 Code to clarify this entire problem. Under Section 708, a partnership year continues despite the death or withdrawal of members, the admission of new members or

39. Revenue Ruling 144, 16 INT. REV. BULL. 29 (1953).

a change in the partnership interests of old members. However, when a partner disposes of his entire interest in the partnership (as distinct from less than his entire interest) the partnership year closes as to him but not as to the other members (Section 706 (c) ). A partnership year terminates only if no part of the business is continued in partnership form or if there is a sale or exchange within a 12-month period of 50 per cent or more of the total interest of the old partners (Section 708 (b) ).[40] The death of a partner does not result in the closing of the partnership year — even with respect to the deceased partner — and the distributive share of the deceased partner in the partnership income constitutes income to his estate, and not income reportable in his final return (Section 706 (c) ).

F. *Purchase or sale of partnership interest.* A partnership interest has been held, by Bureau ruling, to be a capital asset. A recent decision holds that the partnership interest is a capital asset even though it includes untaxed ordinary income.[41] To close this loophole, which permitted the use of a partnership for converting ordinary income into capital gain, the 1954 Code requires that any portions of the purchase price of a partnership interest attributable to unrealized receivables or inventory and stock in trade will constitute ordinary income to the seller (Section 751 (a) ). The purchaser of the interest is permitted (provided the partnership does not elect to adjust the partnership basis of partnership property to reflect the increased or decreased value as shown by the purchase price) to have a special basis which, in substance, excludes from his gross income, when there is a subsequent realization by him from the receivables or inventory, an amount equal to the income recognized to the seller with respect to such items (Section 743 (b) ).

G. *Death or withdrawal of member.* As has been noted, the death, retirement or withdrawal of a partner will not result in the closing of the partnership's taxable year (Section 706 (c) ). However, in all such cases there are usually payments made to the retiring partner or to the estate (or successor in interest) of the deceased partner. The nature of such payments and their effect on the taxable income of the remaining or surviving partners have given rise to much litigation.[42] In order to understand this problem it is necessary to distinguish between a partner's distributive share of partnership income

40. Special rules are provided in case of merger, consolidation, or division of partnerships (Sec. 708 (b) (2) ).
41. Meyer v. United States, 211 F. 2d 406 (7th Cir. 1954).
42. See Bull v. U. S., 295 U.S. 247 (1935); Rabkin and Johnson work cited at p. 934.

(which also may be referred to as his participation interest) and the partner's capital interest in the firm. The 1954 Code makes it clear that payments on account of the partner's capital interest will be treated as capital gains, except to the extent that such payments are on account of inventory items which have appreciated in value as much as 20 per cent, and which constitute at least 10 per cent of the firm's assets (Section 736). Payments attributable to the partner's capital interest do not include amounts paid for unrealized accounts receivable or for good will (unless the partnership agreement provides for a payment with respect to good will). All other payments are treated as ordinary income to the recipients. If the amount thereof is dependent on the income of the partner, they reduce the distributive share of the remaining or surviving partners. If they are payable regardless of the income in the partnership, they constitute a deductible expense by the firm (Section 736 (a) ).

H. *Final Dissolution.* When there are distributions in final liquidation, a partner receives capital gain or taxable income only to the extent that the cash distributed to him exceeds his adjusted basis for his partnership interest (Section 731 (a) (1) ). The cash distributed is a reduction in his adjusted basis for his partnership interest and there is no gain until the property distributed is disposed of, as in the case of current distributions. The character of the gain or loss on the disposition of the distributed property is governed by the same rules that determine the character of such proceeds from the disposition of property received in current distributions. A loss is recognized upon final liquidation only where cash and uncollected receivables and inventory items (taken at the partnership basis) are less than the partner's basis for his interest.

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*Family partnerships.* The provisions of the 1951 Amendment to the old Code permitting family partnerships, under some circumstances, have been re-enacted practically verbatim in Section 704 (e) of the 1954 Code.

*Partnership electing to be taxed as a corporation.* Heretofore if two or more individuals (but less than 50) wished to conduct business as a partnership for *business reasons,* they were compelled also to be taxed as a partnership. Now they may elect to be taxed as a corporation.

Section 1361 of the 1954 Code permits, under some circumstances,

a partnership of no more than 50 members to elect to be taxed as a corporation where, in substance, capital is a material income-producing factor, or 50 per cent or more of the gross income consists of gains, profits or income derived from dealings as a principal or from the purchase and sale of certain property for the account of others. Once a partnership elects to be taxed as a corporation, the election must be continued unless there is a change of more than 20 per cent in membership. The election of this privilege might be highly advantageous to partnerships where earnings are high and most of the profits must be retained for use in the business.

## VI. CORPORATE DISTRIBUTIONS, LIQUIDATIONS AND REORGANIZATIONS

All of us learned in law school that a corporation is a separate and distinct legal entity from its shareholders.[43] We also learned that there are a number of exceptions to this general rule.[44] In tax law the exception is of corporations that have no "business purpose". This concept of "business purpose" has come to be a highly significant one and the fact that the activities of corporations are now subject to the 1954 Code instead of the 1939 Code does not minimize to any extent the importance of the "business purpose" doctrine. Thus, a lawyer should be wary of forming a corporation where its purpose is to aid in some tax saving device or technique.

The actual formation, however, may be tax free. Usually the subscribers to the capital stock of the new corporation transfer to it property (not services) which has appreciated in value since it was acquired. Inasmuch as the subscriber receives "stock or securities" of the new corporation, the value of which is based on the fair market value of the property transferred, if it were not for Section 351 of the new Code (similar to Section 112 (b) (5) of the 1939 Code) he would "realize" gain in the amount of the appreciation. The transaction though is declared to be a tax-free one; provided that the subscriber (or subscribers) is in control of the corporation immediately after the transfer. There is one exception to this: where the property transferred to the new corporation is subject to a liability and the new corporation either assumes the liability or takes the

43. Lynch v. Hornby, 247 U.S. 339 (1918).

44. Since the formation of a corporation may usually be accomplished without tax consequences, the formation and use of corporations in tax saving techniques became widespread. The Supreme Court put a stop to this practice in the case of Gregory v. Helvering, 293 U.S. 465 (1935), where it held that a corporation, formed for a particular tax distribution, would not be recognized where not formed for a legitimate business purpose.

property subject thereto, a taxable gain is realized to the extent of the excess of the liability over the transferors' adjusted basis (Section 357 (c) ).[45] If there are two or more subscribers they may receive "stock or securities" of the new corporation in any proportion agreed upon, regardless of the value of the property contributed by each of them.[46] Under the 1939 Code one requirement for tax-free status was that subscribers receive "stock or securities" in substantial proportion to the value of the property transferred. This "substantial proportion" rule resulted in much litigation and threw in doubt the tax-free status of many corporate organizations. Its elimination in the 1954 Code is without doubt a great improvement.

Under Section 351 the subscribers may receive "stock or securities" for property contributed to the corporation. The word "stock" is familiar to everyone and its meaning is clear. The word "securities" however, is slightly more obscure. It is not defined, for this purpose, in the statute and cannot be assumed to refer generally to corporate obligations. It does indeed cover corporate notes, debentures, bonds or other obligations, but they cannot be short-term obligations. This subject has been the issue in considerable litigation and those cases should be carefully studied before the issuance of "securities" under this section. The organizers of the corporation should consider issuing some "securities" for a part of the property transferred to the corporation. If there is not too "thin" an incorporation — that is, if the amount contributed to capital stock is not too disportionate to the entire capital — the corporation may deduct interest on the securities whereas it could not deduct dividends.

A. *Distributions.* As we have previously pointed out, when a business is conducted in corporate form its earnings may be subject to

45. Insofar as the new corporation assumes the liability, the validity of this statutory provision cannot be questioned. United States v. Hendler, 303 U.S. 564 (1938). In that case property subject to a liability of $534,297 was transferred to a corporation in exchange for the corporation's "stock or securities" and the transferee corporation assumed the indebtedness. The Supreme Court held that the assumption of this indebtedness (which was paid off) was equivalent to a cash payment so that the transferor realized gain to the extent that the liability assumed exceeded the transferors' basis. Congress thereafter promptly enacted Section 112 (k) which in general provided that the fact that the property transferred was encumbered by debt, and that the debt was assumed by the transferee corporation, did not affect the tax-free status of the transfer. However, the application of this section to the transfer of property which is subject to a liability, *without* an assumption of the liability by the transferee corporation is another matter entirely. It is difficult to see, in such circumstances, how there can be a realization of income in a constitutional sense.

46. It should be observed, however, that if the stock acquired is not proportional to the value of the property transferred to the corporation there may be a gift or a realization of income on account of services, etc.

a double tax; one at the corporate level and another at the shareholder level, when its earnings are distributed in dividends. The dividend credit and exclusion represent a minor recognition of this fact. They are of little assistance however, in the case of a taxpayer who conducts his business in corporate form rather than in partnership or individual form. In this situation there is a constant search by the business executive as to how he may receive some of the corporate earnings without such profits being taxed to him as ordinary income.

Despite this constant search by the business executive most corporate distributions are considered dividends and taxed as such. To the extent that they are paid in cash from current earnings or from earnings since February 28, 1913, they are taxable to the shareholder as ordinary income. If the distribution is not in cash but in property the non-corporate shareholder must include the fair market value of the property received in his gross income (for tax at rates applicable to ordinary income). A corporate stockholder, however, is permitted to include the property received only at its basis (adjusted cost) to the distributing corporation or at its fair market value, whichever is smaller (Section 301). (Unless the property distributed is inventory carried on an LIFO basis (Sections 301 and 311).)

Distributions by a corporation even though they do not purport to be dividends and are made in partial redemption of the stock of the corporation must be included in the gross income of the shareholder as ordinary income unless (1) the redemption is not essentially equivalent to a dividend (Section 302 (b) (1) ), or (2) the redemption is substantially disproportionate with respect to the shareholder and after the redemption the shareholder owns less than 50% of the voting stock of the corporation (Section 302 (b) ). A redemption is substantially disproportionate if after the redemption (together with other redemptions under the same plan) the stockholder's ratio of ownership of voting stock as well as common stock is less than 80% of what it was prior to the redemption, or (3) the redemption is in complete termination of the shareholder's interest in the corporation (including an interest as officer, director or employee), or (4) the redeemed stock is by a railroad corporation pursuant to a plan of reorganization under Section 77 of the Bankruptcy Act. If the distribution comes within the above rules the shareholder will be accorded capital gains treatment on the proceeds from the redemption.

In determining whether the redemption is substantially dispropor-

tionate and also whether it completely terminates the shareholder's interest an individual is considered as owning the stock owned by his spouse, children, grandchildren or parents; his interest in an estate or trust of which he is a beneficiary or in a corporation where he owns 50% or more in value of the stock (Section 318). However, the interest of a stockholder may be considered as completely terminated even though the spouse, children, grandchildren or parents continue to have an interest, provided that the shareholder whose stock is redeemed does not acquire (except by inheritance) an interest in the corporation within a period of ten years after the redemption. In the event of such acquisition he must notify the Commissioner and the statute of limitation is held open on the entire redemption until one year after such notice (Section 302 (c) ). Since the interest of the stockholder may be completely terminated though his family continues to have an interest, he is precluded from acquiring stock from family members, for purpose of redemption, for a period of ten years prior to the distribution. He is also prevented from disposing of any of his stock to family members within such ten-year period, unless the stock is redeemed in the same transaction (Section 302 (c) (2) (B) ).

*Redemption to pay death taxes.* Regardless of the above restrictions on redemptions the statute specifically allows a redemption of stock to pay death duties, funeral and administration expenses, without consideration of whether or not it is a dividend. An amendment to the 1939 Code (Section 115 (g) (3) ) in 1950 allowed redemption of stock of a corporation to pay death duties where the value of the stock constitute more than 50% of the net estate (later this was amended to require that the value of the stock constitute more than 35% of the gross estate). Section 303 of the 1954 Code allows the deduction when either of these percentage requirements are met and broadens it to allow the redemption in an amount also to pay funeral and administration expenses of the decedent. The new section also applies to two or more corporations where the decedent owned at least 75% of the stock of such corporations. It is immaterial that the stock redeemed is "new stock" which was acquired after the decedent's death in a tax-free exchange (Section 303 (c) ).

So far we have been concerned with distribution from the corporation directly to the stockholder. Section 304 treats transactions made through related corporations which, although strictly speaking are not distributions, nevertheless are treated as distributions. If one or more persons are in control of two corporations (by "control" is

meant the ownership of at least 50% of the voting stock of such corporations, directly or indirectly, through family, trust, estates or other corporations) and one of the corporations buys stock of the other corporation from such person or persons, the amount paid for the stock is considered as a distribution by the corporation acquiring such stock, and the stock so acquired is considered as a capital contribution. If a subsidiary acquires stock of its parent (subsidiary and parent for this purpose are established by 50% or more of stock ownership) from a shareholder of the parent, the transaction is deemed a distribution from the parent to the shareholder (Section 304). The transaction is thus removed from the rules applicable to the purchase and sale of stock and is subject to the provisions of the Code applicable to distributions by corporations.

*Distributions of stock and rights.* Congress has always had a great deal of difficulty in attempting to tax stock dividends. In *Eisner v. McComber*[47] the Supreme Court held that a common stock dividend on similar common stock owned by the taxpayer was not income within the 16th amendment to the Constitution, and therefore, was not taxable. On the other hand, a dividend of stock differing from that on which the dividend is paid was regarded as income and hence taxable. In *Koshland v. Helvering,*[48] the Supreme Court held that a dividend of common stock to holders of cumulative non-voting preferred stock represented income, to the extent of the market value of the common stock, and hence was fully taxable. In *Helvering v. Gowran,*[49] a dividend of preferred stock was paid on common stock. It was held by the Court that the dividend was fully taxable. In both of these cases, the rationale of the Court had been that the stockholder received, by the dividend, "an interest different from that which his former stockholdings represented". In *Helvering v. Sprouse,*[50] it was held that, although the dividend was in a new class of stock, no taxable income was realized since there had been only one class of stock outstanding prior to the dividend. Thus, the proportionate interest of each stockholder of the corporation was not altered by the receipt of the dividend. In the comparatively recent case of *Commissioner v. Griffith,*[51] the doctrine of the old *McComber* case was apparently reaffirmed.

Administratively this rule for determining the taxability of stock

47. 252 U.S. 189 (1920).
48. 298 U.S. 441 (1936).
49. 302 U.S. 238 (1937).
50. 318 U.S. 604 (1943).
51. 318 U.S. 381 (1943).

dividends produced many difficulties. It was necessary for the Bureau in each case of a stock dividend to determine whether or not it changed the proportionate interest of the shareholders. This rule too proved an inequitable one to shareholders in that frequently an additional tax was assessed which could only be paid by the sale of stock received which resulted in more tax. Some times there was no market for such stock—particularly in a small closely held corporation.

The 1954 Code provides an entirely new approach to this problem. It now taxes no stock dividends, or rights, except those distributed in lieu of money (such as a distribution which may be in stock or in money at the election of the stockholder, or in payment of preference dividends) (Section 305), but upon the subsequent disposition of the stock a tax is imposed, which may be a capital gains tax or it may be an ordinary income tax. Section 306 of the new Code defines in subsection (c) stock which is called "Section 306 stock". Section 306 stock apparently includes *all* stock received by a shareholder as a stock dividend or pursuant to a tax-free corporate reorganization other than common stock (except common stock received as a stock dividend on preferred stock).[52]

If and when Section 306 stock is sold, the proceeds from the sale are considered ordinary income to the extent that the distributing corporation could have paid the stockholder a cash dividend at that time. (For example, it is limited to the available earnings and profits at the time of the distribution.) (Section 306 (a) (1) ). The proceeds of the sale are given the same character as a cash dividend would have been given. (For example, if the earnings have been derived from sources within the United States, the proceeds from the sale of the stock shall be considered as derived from sources within the United States.) (Section 306 (f) ). If the stock is redeemed, the proceeds are still considered ordinary income unless the redemption qualifies for a capital gains treatment under the general principles applicable to partial redemptions of stock, which have been discussed above, or to complete liquidations, which will be discussed later.

As heretofore the basis of stock acquired in a tax-free distribution

52. It is probable that Congress intended that Section 306 stock should not include any common stock because Section 306 (e) provides that any stock received in a distribution which is converted into common stock shall not be considered as Section 306 stock but that common stock which is convertible into other stock shall not be treated as common stock. Regardless, however, of the Congressional intention in this regard subsection (c) (1) (A) states very explicitly that the exception is common stock issued on common, which would not include common issued on preferred.

is determined by allocating a proper proportion of the basis of the old stock to the new. A new rule is provided for stock rights in that no basis need be allocated to them unless the fair market value equals or exceeds 15% of the fair market value of the old stock (Section 307).

Section 306 will effectively prevent the so-called preferred stock, "bail out" technique. This technique has been used on occasions to permit shareholders to obtain the accumulated corporate earnings upon payment of capital gains tax rather than ordinary income tax. Here is the way it has worked: a closely held corporation would issue a dividend of preferred stock to the common stockholders. This dividend would be a tax-free one since theretofore only common stock was outstanding and the new preferred stock did not affect in any way each shareholders proportionate interest in the corporation. This preferred stock would then be sold or redeemed. The Commissioner refused to accept this procedure and claimed that the distribution of preferred stock, as outlined above, was obviously designed as a distribution of earnings and profits and therefore should be taxed as a dividend. The Tax Court upheld the Commissioner in this contention,[53] but the Circuit Court of Appeals (Sixth Circuit) reversed the Commissioner, held that under Constitutional decisions of the Supreme Court the dividend did not represent "realized" income and could not be taxable in any event. Moreover, the stock being a capital asset, gave rise to capital gain upon its subsequent disposition.[54]

*Effect of distributions upon distributing corporation.* The Supreme Court in the case of *General Utilities and Operating Company v. Commissioner*,[55] held that a corporation does not realize taxable income when it distributes to its shareholders property the value of which exceeds its basis. The new Code introduces two exceptions to this rule. First, if the distributor corporation distributed items of inventory (inventory assets) and it has inventoried such items under the LIFO method, then upon the distribution it realizes gain, to the extent that the amount at which such items are carried is less than the amount at which such items would be carried under another recognized method of valuing inventory (Section 311 (b) ). Second, if the corporation distributes property upon which there is a liability attached which exceeds its adjusted basis therefor, if the shareholders assume such liability, the corporation recognizes gain of the dif-

53. Chamberlin, 18 T.C. 164 (1952).
54. Chamberlin v. Commissioner, 207 F. 2d 462 (6th Cir. 1953); *cert. denied*, 347 U.S. 918 (1954).
55. 296 U.S. 200 (1935).

ference between its adjusted basis for the property and the liability assumed. If the shareholders merely take the property subject to the liability, gain is recognized to the distributing corporation, limited, however, to the excess of the fair market value of the property over its adjusted basis to the distributing corporation (Section 311 (c) ).

Section 312 provides in some detail the accounting adjustments necessary in the case of distributions. These rules do not involve tax consequences except insofar as they increase or diminish corporate earnings and profits accounts.

B. *Liquidations.* We are concerned here with the liquidation of the corporation. This liquidation may be complete or partial. If the shareholders are individuals, the amount received in complete or partial liquidation is, with the exceptions hereinafter noted, treated as in payment for the stock (Section 331). Any amounts received, including the fair market value of property received, in excess of the stockholder's adjusted basis for his stock, represents a gain which is taxed as a capital gain.

If on the other hand, the shareholder is a corporation which owns more than 80% of all stock of the liquidating corporation (except preferred) and the liquidation occurs within one taxable year (or if it is made in accordance with a plan of liquidation which is completed within three taxable years) no gain or loss is recognized (Section 332). This tax-free status is not affected by the fact that the liquidating corporation is indebted to its parent and as a part of such liquidation pays the debt (Section 332 (c) ). Since the statute permits the transfer of property in accordance with a plan of liquidation to be completed within a period of three taxable years, the Commissioner is authorized to require the taxpayer to furnish a bond or waiver of the statute of limitations to be sure that the transfer is completed within the three years' period.

There are two exceptions to the rule that property distributed in complete liquidation results in a recognition of capital gains to the shareholders (except where the liquidation distribution is tax-free in the case of a corporate owner).

One permits "qualified" shareholders to elect to have their proportion of earnings and profits of the corporation taxed to them as an ordinary dividend, with a deferment of the recognition of appreciation in the value of corporate assets. In this case the distribution in complete redemption of stock and the transfer of property under the liquidation must occur within one calendar month (Section 333). The other is liquidation of collapsible corporations. A collapsible

corporation is one that is formed or availed of for the manufacture, construction or production of property, for the purchase of property held primarily for sale to customers or for the ownership of stock of a corporation engaged in the foregoing activities. In general, upon the liquidation of a collapsible corporation within three years after it is used, any gain is treated as ordinary income instead of capital gain. Before the statute specifically dealt with the problem of the collapsible corporation it was used to convert ordinary income into capital gain in the following manner: after the corporation had created an income-producing property, but before any actual income was received therefrom, the corporation would be dissolved and the assets distributed in liquidation to its shareholders. Thus assets, including primarily the income-producing property, would be reported as assets with an unascertainable value or at an estimated value sufficient to cover most of the income to be received. The shareholders would then pay a capital gains tax instead of an ordinary income tax.

Everyone knows what a complete liquidation means. However, the general understanding of a "partial liquidation" is not so clear. Section 346 defines partial liquidation. First it may be one of a series of distributions, all of which will result in a complete liquidation or second, it may stand alone — that is, it concerns the redemption of a part only of the stock of the corporation. In the latter case it must be pursuant to a plan, occur within the taxable year in which the plan is adopted or within the succeeding taxable year and (in general) must result from the contraction of the business of the corporation or the termination of a portion of its business. If it is due to the termination of a portion of the corporation's business, the business given up by the corporation or transferred to the stockholders must have been one conducted at least five years, and the corporation must retain a business which it has been conducting for at least five years (Section 346).

In general property received in liquidations (whether complete or partial) has a basis in the hands of the shareholder equal to the fair market value of such property at the time of the distribution. Where, however, the liquidation was a tax-free one, the property is received at the basis of stock relinquished therefor, adjusted with respect to any money received, for any liabilities assumed or subject to which the property was received (Section 334).

*Effect of liquidation distributions upon the liquidating corporation.* Normally no gain or loss is recognized to the corporation from its

complete or partial liquidation (Section 336). However, in *Commissioner v. Court Holding Company*,[56] it was held that where a sale of corporate property had apparently been negotiated by the corporation prior to its liquidation, but the actual sale of the property was consummated by the stockholders *after* liquidation, it would be deemed to be a sale by the corporation. This rule deterred many sales of property owned by closely held corporations; especially to related interests. In the later case of *U. S. v. Cumberland Public Service Company*,[57] it was held that this rule did not apply where the corporate property was distributed to the shareholders in liquidation prior to the negotiations leading to the sale.

To avoid a tax consequence being dependent upon the events leading up to the transaction (which created enormous administrative difficulties) Section 337 (a) of the new Code provides that if a corporation adopts a plan of complete liquidation and all of the corporate assets (except amounts retained to meet claims) are distributed thereunder within a twelve months' period, then no gain nor loss shall be recognized to the corporation from the sale of property by it during such twelve months' period. This rule, however, does not apply in the case of a sale of inventory or of installment obligations (Section 337 (b) ).

In the event the liquidating corporation distributes to its shareholders any installment obligations, gain to the corporation is recognized to the extent that the fair market value of the obligations exceeds the corporate basis therefor (Section 336 and 453 (d) ).

C. *Reorganizations.* Section 354 (a) provides that "no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance to the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." This provision is substantially equivalent to Sections 112 (b) (2) and (3) of the 1939 Code. However, it is expressly provided that if securities are received and the principal amount of such securities exceeds the principal amount of any securities surrendered, such excess shall be taxable. It is specifically stated that the section shall not apply unless the corporation acquires substantially all of the assets of the transferor and that the "stock, securities and other properties received by the transferor, are distributed in pursuance to the plan of reorganization." If the exchange is made pursuant to a reorganization of a

56. 324 U.S. 451 (1945).
57. 338 U.S. 341 (1949).

railroad company under Section 77 of the Bankruptcy Act or under Section 20 (b) of the Interstate Commerce Act, the exchange is tax free regardless of whether securities are surrendered in exchange and regardless of whether all or substantially all assets of the transferor are transferred and whether or not there is any distribution.

Section 355 covers distributions of stock generally called "split-offs" or "spin-offs". Whether a transaction is a "split-off" or a "spin-off" is principally a matter of form but prior to the addition, in 1951, of Section 112 (b) (11) to the 1939 Code a genuine "split-off" was tax free but a "spin-off" was taxable. The difference in form is that in a "split-off" there is a partial redemption of the stock of the distributing corporation; that is to say, there is an exchange; the "spin-off", however, is merely a distribution.[58] There is no difference in substance.

A "spin-off" distribution to be tax free under the 1951 Amendment must have had a legitimate business purpose. If it were used for the purpose of the distribution of earnings and profits to the shareholders to the tax-free status was withheld. Moreover, the distribution had to be in proportion to the stockholdings or the transaction did not qualify as a tax-free one. This rule was administratively most difficult to apply. Whether or not a stock distribution to shareholders resulted in a distribution of earnings and profits was a question of fact which would differ in each case.

Under Section 355 of the 1954 Code, rules are established which will make administration of the provisions of the law very much less difficult. The test is not so much one of subjective intent but of actualities. In the first place the stock distributed must be in a corporation conducting a trade or business which has been carried on for at least five years. Furthermore, the distributing corporation must continue to carry on a trade or business which it has been conducting at least five years. This limitation will automatically eliminate many of the normal situations where a "split-off" or a "spin-off" is indicated. Also the distributing corporation must have distributed

58. Apparently the tax distinction which existed under federal law prior to the 1951 Amendment of Section 112 (b) (11) still prevails in South Carolina. In Wilson v. S. C. Tax Commission, 220 S.C. 171, 66 S.E. 2d 698 (1951), a new corporation was formed in which a portion of the surplus of an existing corporation was transferred. As part of the plan the shares of the new corporation were distributed subsequently to the shareholders of the old corporation. It was held that the shareholders received a distribution of profits of the old corporation and were liable for income taxes thereon. The Court said that while the law provides for a tax-free reorganization, consolidation, or merger, the term "reorganization" could not include the formation of a new corporation without impairment of the corporation's existence or function of the old one.

all of the stock or securities held by it, or at least 80% of such stock. Apparently this provision is designed to prevent any claim by the shareholders that they do not have "control" of the new corporation or corporations. If the distributing corporation acquires stock in the other corporation within five years prior to the distribution, such acquired stock, if distributed is not considered tax free to the distributees but is treated as "other property" taxable in the amount of its fair market value (however, such stock is counted in computing whether 80% of such stock is distributed). The distributing corporation however is not considered "acquiring" stock which it receives as a result of a tax-free transaction. Thus, there would be no statutory prohibition against the usual type of "split-off" or "spin-off", where a corporation puts property used in a trade or business conducted by it into a separate corporation (tax free) and distributes the stock of such new corporation to its stockholders. However, now the trade or business must have been one carried on by it for at least five years.

Where there is a tax-free exchange of property for stock or securities, but money or other property is received in connection with the exchange, the entire transaction is not rendered taxable as was true under the 1939 Code; the only consequence is that then the money or fair market value of such other property is taxed as a gain. This gain may be ordinary income if it is considered a dividend (to the extent of the ratable share of the distributee in the undistributed earnings and profits of the corporation accumulated after February 28, 1913), or it may be a capital gain if it is considered a partial redemption (Section 356).

If a corporation receives property pursuant to a tax-free exchange and as part of the consideration it assumes a liability or acquires the property subject to a liability, then such liability shall not affect the tax-free status of the transfer, unless the purpose of the transaction was not a *bona fide* business one or was designed to avoid income taxes. (In this respect the rule is similar to Section 112 (k) of the 1939 Code.) However, if the liabilities assumed or to which the property is subject exceed the transferee's adjusted basis for such property, then such excess is subject to tax (Section 357). This, however, does not apply in the case of a reorganization pursuant to a receivership or bankruptcy proceeding (Section 371).

Under the 1939 Code a "spin-off" distribution was required to be pursuant to a plan of reorganization, but this is no longer necessary. The definition of "reorganization" in Section 368 (a) does not

differ materially from the definition set forth in Section 112 (g) of the old Code. However, under the old Code a parent corporation of an acquiring corporation would not seem to be a "party to a reorganization", and if its stock, even though voting stock, was used to permit the subsidiary to acquire substantially all the properties of another corporation, such stock would be deemed "other property".[59] Section 361 amends the old law so as to permit the parent to be a "party to the reorganization" where, if it receives the assets, it immediately transfers part or all of them to a subsidiary.

Section 368 (c) defines "control" to mean the ownership of at least 80% of the stock of another corporation, including voting stock.[60]

The effect of a corporate merger, consolidation or reorganization upon the allowance of a carryback or carryover of a net operating loss must be considered very carefully. Prior to the 1954 Code the Supreme Court had held that a corporation which was a "successor corporation" under a tax-free reorganization was not entitled to deduct the net loss of its predecessor.[61] The question at issue was always whether or not the taxpayer, resulting from the merger, consolidation or other reorganization, was the same taxpayer as incurred the net loss.

Section 381 of the 1954 Code specifies nineteen situations in which a carryover net operating loss may be taken by the acquiring corporation in the case of a corporate liquidation or reorganization. This liberalizes the former rule.

*Effective dates.* Generally speaking, June 22, 1954, has been selected by Congress as the effective date of the provisions of the new statute applicable to corporate distributions, adjustments and reorganizations (Sections 391, 392 and 393 (a) ). The reason why this date was selected is that on that date the Bill was passed by the Senate. Section 393 (b) however, provides that if a plan of reorganization was adopted prior to June 22, 1954, or submitted for a

59. Groman v. Commissioner, 302 U.S. 82 (1937); Helvering v. Bashford, 302 U.S. 454 (1938).

60. In any merger, consolidation or reorganization it is necessary that the formalities be followed literally and that transactions not be given labels inconsistent with the reorganization being effected. For example, if all of the assets of a subsidiary corporation be acquired pursuant to a consolidation, it is important that the assets not be treated as received pursuant to a liquidating dividend. In Henry P. Moses Company v. S. C. Tax Commissioner, 224 S.C. 193, 78 S.E. 2d 187 (1953), a closely held corporation intended to accomplish a tax free reorganization, merger, or consolidation rather than a liquidation. However, the assets received from the subsidiary were reported as a "liquidating dividend" from the subsidiary and the parent corporation was held taxable on the excess of the value of the property received over its basis for the stock.

61. New Colonial Ice Company v. Helvering, 292 U.S. 435 (1934).

ruling to the Commissioner's office before that date, the corporations which are parties to the reorganization may elect to have the 1939 Code provisions apply. (Section 393 (b) (2) ). If a plan of reorganization, adopted after March 1, 1954, and before June 22, 1954, was pursuant to a Court decree, the shareholder of the corporation may elect to have the 1954 Code apply thereto in lieu of the 1939 Code (Section 393 (b) (3) ).

## VII. TRUSTS AND BENEFICIARIES

The 1954 Code places all trusts (testamentary as well as *inter vivos*) in two categories. First, simple trusts — which require the distribution of all current income — and second, so-called complex trusts — which are all other trusts and also decedents' estates. A "simple trust" is allowed a $300.00 exemption but "complex trusts" are allowed only the former exemption of $100.00.[62] (Section 642 (b) ). In general the former laws applicable to trusts are continued (for example, a trust is a separate taxable entity, but is taxed as an individual). Nevertheless, the sections have been entirely rewritten and many former rules resulting from judicial interpretations have been incorporated into the Statute. There are many changes in the sections of the Statute applicable to this subject but apparently the only significant change is the addition of provisions applicable to trusts in which income is accumulated.

In order to prevent the distribution in a year in which the beneficiary is in a low income tax bracket, a five year throwback rule is provided (Sections 666 and 668). Under this provision all distributions (of more than $2,000) to the beneficiary of a trust in excess of the distributive net income for the distribution year is carried back to preceding years up to five years to the extent that the income actually was earned in the preceding years. This provision was obviously designed to apply only in the case of discretionary accumulations of income, because it is specified in Section 665 that distributions do not come within the throwback rule (under certain circumstances) when the income is accumulated: (a) prior to the beneficiary's twenty-first birthday (b) to be paid to the beneficiary only in the event of an emergency (c) to be paid only upon termination, more than nine years after the last transfer to the trust or (d) to be paid to the beneficiary, under specified limitations, at stated ages. Section 667 provides that the throwback adjustments are made for the year in which the beneficiary receives the accumulated distribution. His returns for

62. Estates, however, are allowed the previous exemption of $600.00.

prior years are not reopened, nor are those of the trust. However, he receives a credit for the taxes paid by the trust (Section 667). The throwback rules do not apply unless the distribution is at least $2,000 and they do not apply to a decedent's estate (although rules applicable in general to "complex trusts" do apply to decedents' estates. Incidentally, on the subject of decedent's estates, it must be remembered that the estate is a separate tax entity; but it will be recognized as such only for a reasonable period of administration).

*Trusts for benefit of donor.* Following the decision of the Supreme Court in the case of *Helvering v. Clifford*,[63] the Bureau issued a long and complicated Regulation (Regulation 118, Sec. 39.22 (a)-21) setting forth detailed provisions as to when and how the income of an *inter vivos* trust would be considered as taxable income of the donor. In general this regulation provided that the income of the trust was taxable to the donor:

(a) if the trust was to revert to the donor in ten years or less, or, if the donor retained certain administrative controls and it would revert in 15 years or less,

(b) if the donor (or some person in his family or amenable to his will) retained certain rights as to the diversion of trust income,

(c) if the donor retained certain reversionary interests in the trust and had specified administrative controls,

(d) if the donor retained rights of administration or control which were inconsistent with the free and unrestrained use of the income of the trust by the beneficiary, or

(e) where the donor (or some member of his family or person amenable to his will) retained administrative controls over the trust which could be exercised for the benefit of the donor rather than for the benefit of the beneficiary.

This Regulation engendered much criticism as administrative legislation by the Bureau.[64] The new Code incorporates (with slight changes) the provisions of this Regulation. They will not change the existing law in this respect but will put an end to questions concerning the validity of the prior regulations. Since the income of a trust is attributed, under certain circumstances, to the donor if he has a reversionary interest, it is appropriate at this point to mention

63. 309 U.S. 331 (1940).

64. See *e. g.* Pavenstedt, *The Treasury Legislates: The Distortion of the Clifford Rule,* 2 TAX L. REV. 7 (1946); Eisenstein, *The Clifford Regulations and the Heavenly City of Legislative Intention,* 2 TAX L. REV. (1946).

briefly that a legal reversionary interest exists only when the trust principal (or income) or proceeds of an insurance policy, may revert to the donor *in his own right* — not by inheritance.

## VIII. ESTATE AND GIFT TAXES

The 1954 Code remedies an inequity which has heretofore existed under the prior statutes. Technically speaking it is not a question of estate law at all — rather it is a question of basis — but it is more appropriately pointed out in this chapter. Heretofore a spouse owning property under a deed of co-ownership with the right of survivorship (such as an estate by the entirety) and acquiring full ownership by reason of the death of the other spouse, had a basis in the property of the adjusted cost of such property, regardless of the fact that it was included wholly or partially in the estate of the deceased spouse. This is no longer true and any portion of the property included in the estate of the joint owner gives rise to an increase in basis equal to the estate value of that portion so included (Section 1014 (b) (9) ).

There have been few changes of substance in the estate and gift tax sections. The changes of major interest only will be discussed.

A. *Estate tax.* The most important change is that removing the "premium payment" test in determining whether or not the proceeds of insurance on the life of a decedent are includable in his gross estate. Where the insurance is payable to the estate, or when the insurance policy is owned by the decedent, the proceeds are taxable in the estate, but not otherwise. However, the insurance is considered as "owned" by the decedent if he had, immediately preceding his death, a reversionary interest therein of more than 5% (Section 2042). It should be observed, however, that if the insurance policy is transferred by gift to someone other than the insured, if the transferor dies within three years of the date of the gift, the gift may be held to have been in contemplation of death. In which case the insurance proceeds would be included in the estate of the transferor. If the transferor makes a gift of the insurance policy and later inherits all or a portion thereof, the proceeds will be thrown back into his estate.

Many discussions of the 1954 Code indicate that the marital deduction is now available where the surviving spouse is given a "legal life estate" in property. However, the substance of the Section (Section 2056) does not justify this label. The "legal life estate" qualifies for

the marital deduction only where the surviving spouse is given the right to consume the property or appoint it generally, including an appointment to his or her own estate. The only way in which this provision differs from the prior law is that formerly the interest had to be in trust.

B. *Gift Tax.* The "future interest" restrictions have been liberalized to exclude certain transfers in trust to minors. If the gift may be used by, or for the benefit of the minor donee during his minority, and if not used is paid to him absolutely when he is twenty-one, (or if he dies before twenty-one it will pass to his estate or to his appointees) it will not be regarded as a gift of future interest (Section 2503).

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Other changes in the estate and gift tax sections which are not discussed, include:

(1) The consolidation of the former "basic estate tax" rates with those of the "additional estate tax" rates and the adjustments of the exemptions and the state tax credit thereunder (Section 2001, 2011, 2101 and 2052).

(2) Exemption from estate taxes of persons who are killed or die while in combat service (Section 2201).

(3) Credit to the estate tax on account of gift taxes or foreign death duties (Sections 2012, 2013, and 2014).

(4) Inclusion in the estate of a deceased spouse of a survivorship annuity for the surviving spouse (Section 2039).

(5) Exclusion from estates in the case of renunciation of certain life interests in charitable remainder gifts (Section 2055).

(6) Gifts of survivorship interest in property to spouses (Section 2515).

(7) Gifts under separation or divorce settlements (Section 2516).

## IX. ADMINISTRATION AND PROCEDURE

The 1954 Code groups all procedural and administrative provisions together under Subtitle F. Formerly such provisions were scattered throughout the entire Code. Not only is the present arrangement more convenient but it has also added a degree of uniformity to some of these provisions. This change, although of substantial importance and assistance to employees of the Internal Revenue Service and to tax practitioners, is of little significance to most taxpayers.

A. *Returns, payments and additional assessments.* As we have previously mentioned, individual income and gift tax returns and declarations are now due April 15th (or the 15th day of the fourth month after the close of the taxpayer's fiscal year). The information returns of partnerships and the returns of fiduciaries are also due at that time. Corporate returns are still due on March 15th (or the 15th day of the third month after the close of the taxpayer's fiscal year). The estate tax return is due fifteen months after date of death (with a preliminary notice sixty days after date of death or appointment of fiduciary).

The payment of the tax due is anticipated by estimates in the case of individuals and corporations, as previously pointed out. If the amounts estimated are less than the ultimate tax liability (but are within the required percentage for estimates), the balance, in the case of individuals, must be paid with the final return, and in the case of corporations must be paid with the return or in two installments, one due with the return and the other due in three months thereafter, as previously discussed. In the case of returns by fiduciaries (such as trustees, guardians, and the like) no estimates are required.

The procedure on additional assessments has not been substantially revised. If the auditing division of the Service reassesses the tax due and imposes an additional tax, the taxpayer may protest such additional assessment and have it reviewed by the Appellate Division prior to filing a petition with the Tax Court, or paying the tax and seeking a refund. The administrative procedure within the Bureau is stated in the excellent discussion by Mr. Mintz published herewith at page 251.

B. *Limitations.* Section 6501 (a) enacts a three year period of limitations upon the assessment of all taxes. Under the 1939 Code the three year period of limitations applied only to income, estate and gift taxes (with some exceptions), other taxes were barred after four years. The time commences to run from the required filing date of the return. Formerly an early return, except for income taxes, commenced the running of the statute. As before, this limitation period does not apply in the case of false or fraudulent returns or when no return is filed.

In the case of the omission of more than 25% from gross income, gross estate or gross gifts, as the case may be, in a return the limitation period is six years (Section 6501 (e) ). Under the old Code this limitation was five years and applied only to income taxes. To resolve a conflict in decisions this subsection redefines gross income

for this purpose in the case of a trade or business as gross receipts without diminution for the cost of sales or services. Also under the terms of this subsection the six year limit does not apply if there is sufficient disclosure of omitted items. On the question of whether a return has been filed there is a new section which will prevent hardship in certain cases. If a taxpayer in good faith determines that it is a trust, a partnership or an exempt organization, and files a return as such and is later held to be taxable as a corporation for that year, such return will nevertheless be deemed the return of the corporation for that year (Section 6501 (g) ).

Filing of a claim for credit or refund is limited uniformly to three years from the required filing date of the return (without regard to an extension of time), or two years from the date the tax was paid, whichever expires later. Contrary to previous law the filing of an early return or advance payment of taxes is deemed made on the date the return was due to be filed (Section 6511).

Extended from three to six years is the limitation for criminal prosecution for (1) willful failure to pay a tax or make a return, (2) making false statements and fraudulent documents, (3) intimidating United States officers and employees and (4) offenses committed by United States officers and employees (Section 6531).[65]

C. *Judicial proceedings.* A thorny jurisdictional problem arose under prior law when two cases were pending in different courts involving the same tax question. This occurred when the taxpayer had filed a suit for refund in a district court or the Court of Claims and the Commissioner assessed a deficiency involving the same tax question; such as an additional assessment in an operation which the taxpayer claimed was exempt. In this situation the taxpayer might file a petition to the Tax Court on the deficiency assessment. Under the old law the first court to reach the case on its calendar for trial had jurisdiction. Section 7422 (e) now gives the taxpayer his choice of forums. If prior to trial of a pending refund action in the dis-

65. While the statute of limitations, as above discussed, will normally prevent the reopening of tax returns, Part II of Subchapter Q permits the reopening of a return barred by the statute of limitations in order to make an adjustment with respect to an earlier taxable year when an inconsistent position by the taxpayer (or a related person) or the Commissioner results in omission of income or the duplication of items by reason of (1) a decision by a court in a tax proceeding, (2) a closing agreement, (3) a final disposition on a claim for refund or (4) an agreement between the taxpayer and the Commissioner with respect to the taxpayer's liability. Thus, for example, if a donor is held taxable on trust income, the beneficiary or the trustee may obtain a refund despite the fact that the claim for refund is now barred by the statute of limitations (Sections 1311-15).

trict court or Court of Claims the Commissioner issues a deficiency notice on the same question and the taxpayer files a Tax Court petition, that court has sole jurisdiction. If he fails to file such a petition the court before which the refund action is pending has sole jurisdiction but the government may then file a counterclaim in that action.

When a party has filed a petition for review of a Tax Court decision before the Court of Appeals the other party now has four months instead of three to file a cross appeal (Section 7483).

It is now provided that the Tax Court shall follow the rules of evidence applicable to nonjury trials in the District Court of the District of Columbia (Section 7453). The former rule was that the pre-1938 equity rules of the District of Columbia courts applied.

An amendment to the Judicial Code allows a taxpayer to sue the United States in the district of his residence, regardless of the amount and with a jury trial (P. L. 559 83d Congress, amending Sec. 1346 (a) of Title 28 of the Judicial Code). This easing of requirements of suits against the United States is a convenience to taxpayers because refund suits against the director must be brought in the district of the director's residence. Formerly suits against the United States could be brought only when the refund sought was at least $10,000 and the collection officer was out of office or dead, and there was no right to a trial by jury.

D. *Interest and penalties.* Under prior law there was a complicated set of penalties for an individual's failure to make a declaration of estimated tax, failure to pay the estimate and an underestimate of more than 20% of the actual tax liability. These penalties were concurrent and could amount to 16% of the estimated tax due. Section 6654 now imposes a uniform penalty of 6% on underpayments of the estimated tax. It is imposed upon the amount by which the installment is less than 70% of the quarterly installment due on the basis of the final return of the year, but is only effective for years after December 1, 1954 (Section 6654 (h) ). As before amounts withheld are considered as payments of estimated tax.

A relief measure in the 1954 Code eliminates the payment of interest on interest on assessments. Formerly interest was assessed from the due date of the tax to the date of assessment and added to the deficiency with interest running on the total thereafter. However, there is no longer any interest imposed on interest (Section 6601 (f) ). The uniform rate of 6% on overpayments and underpayments has been retained with a 4% rate concerning estate taxes in two exceptional situations (Section 6601 (b) ).

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There is a uniform fraud penalty of 50% of the underpayment of all taxes, but the delinquency penalty for failure to file a return will not be added in such cases (Section 6653).

## CONCLUSION

A statute almost four hundred printed pages long, and with some eight thousand pages of legislative history (reports and hearings) obviously cannot be discussed in detail in one article. Here we have attempted to point out most of the material changes in the law, but some of the sections are so complicated and the meaning and intent of Congress so obscure that it will take years for their final interpretation to evolve.[66] The new statute being prospective and not retrospective in application, will apply to the future and not to the past. However, an immediate consequence is the immense problem imposed upon the Bureau by reason of the transition from the old to the new statute. While the enforcement procedure will be substantially the same, entirely new forms have been or will have to be prepared for taxpayers and of course completely new regulations will have to be issued. Undoubtedly employees of the Internal Revenue Service are, and will be for some time working overtime. In the meanwhile, the Treasury Department has issued T. D. 6091 which states that all prior rulings and regulations, issued under the 1939 Code, shall be applicable to corresponding provisions of the 1954 Code except where such regulations are inconsistent with the new Code provisions. It must be remembered that the 1954 Code, with few exceptions, is applicable to the year 1954 and succeeding years. Accordingly, matters affecting years prior to 1954 will be concerned with the 1939 Code and the regulations, rulings and decisions thereunder.

Some advertisements of tax guides for laymen are hinting that there is now an open season for tax avoidance schemes. Tax avoidance will, however, continue to be uncertain and perhaps expensive. (We are referring of course to tax "avoidance", which is legitimate; tax "evasion" on the other hand is entirely improper, if not illegal, under the old law as well as the new.) As a matter of fact, probably more loopholes have been closed than opened by the new law. The newspaper publicity surrounding the passage of the Code has apparently in some instances overstated the effect of relief provisions.

66. Congress stated (in the Committee Reports) that one of its major objectives was to make the statute more understandable. This was a noble objective, but unfortunately not one crowned with success.

For example, the new provisions concerning real estate subdividers are going to benefit very few taxpayers.

Taxpayers and practitioners must be aware of the fact that this Code, as any new, long and complicated statute, creates many uncertainties. There are questions which will not be answered for years to come. Probably most of the regulations will not be issued until sometime next year at best. Litigation over 1954 taxes will not be in full swing until 1957 or later. Thus, questions which are posed for example by the new provisions on corporate spin-offs and split-offs in Section 355 will be sticklers for quite a while. As is usually the case, there are undoubtedly questions lurking beneath the surface and have not been mentioned by us or any other commentators which can trap the unwary. The long and short of it is that neither taxpayers nor practitioners can unfurrow their brows as a result of the new Code. Complicated questions will continue to permit only complicated answers.