1968

Leading 1968 Federal Tax Cases and Rulings

Edwin L. Kahn

LEADING 1968 FEDERAL TAX CASES AND RULINGS

EDWIN L. KAHN

Arent, Fox, Kintner, Plotkin and Kahn, Washington, D. C.

The cases and rulings selected for discussion appear to be important as of the end of 1968. However, this selection is based upon the narrow perspective of today. The use of these authorities in later years will determine whether or not the selection is correct.

Employee Compensation—Partners

In the *Armstrong*[1] case, the Fifth Circuit has held that it is possible for a partner to be an employee of his partnership for purposes of the meals and lodging exclusion of section 119 of the Internal Revenue Code of 1954. The Court reached this conclusion through its interpretation of section 707(a) of the Code. The *Armstrong* decision is in conflict with the *Wilson*[2] decision of the Court of Claims in 1967, but the Court distinguished the *Wilson* case on the ground that the Court of Claims failed to take into account in its decision the provisions of section 707(a).

The facts in *Armstrong* are simple. Armstrong had a 5% interest in a partnership which owned a 50,000 acre ranch. He managed the ranch, and was furnished a home, groceries, and so forth for himself and his family on the ranch. He did not include the value of the use of the home and these other items in his income. He took the position that he was an employee of the partnership, that the meals and lodgings were furnished to him on the premises of his employer partnership for its benefit, and that he was, therefore, entitled to the exclusion which section 119 grants to an employee who receives meals and lodging from his employer.

It has been the established position of the Internal Revenue Service that a partner cannot be an employee of his partnership. Indeed, it was this position which led to the enactment of the special rules of section 401 relating to pension and profit sharing plans for so-called owner employees, that is, the "H. R. 10" rules. This difficulty of obtaining employee benefits for partners also led to the development of state laws permitting professional corporations; in turn, the Treasury by Regulations, has sought to treat these professional corporations as partnerships. These Regulations, section 301.7701-2(h), were held invalid

---

[1]*Armstrong* v. *Phinney,* 394 F. 2d 661 (5th Cir. 1968); cert. not authorized 68-7 CCH St. Fed. Tax Service. p. 70,751.

[2]*Wilson* v. *United States,* 376 F. 2d 280 (Ct. Cls. 1967).

during 1967 and 1968 by District Courts in Colorado,[3] Ohio,[4] Florida,[5] and Georgia.[6]

The Treasury's position that a partner cannot be an employee of his partnership is based on the theory that a partnership is an aggregate of individual partners, not an entity separate from the partners. This "aggregate theory" is in fact reflected in the income tax laws and regulations which provide that the partnership operates as a conduit so that each partner is deemed to receive his distributive share of each partnership item of tax significance. Thus, each partner's gross income includes his share of partnership gross income. See Regulations section 1.702-1(b) and (c).

Section 707(a) however, provides that if a partner engages in a transaction with his partnership other than in his capacity as a member of the partnership, the transaction shall be considered as occurring between the partnership and one who is not a partner, except as otherwise provided in other subsections of section 707. Section 707 provides only two exceptions. Subsection (b) has special rules for the treatment of gains and losses on sales or exchanges between a partner and a controlled partnership. Subsection (c) provides that a guaranteed payment to a partner for services for the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). The Regulations under section 707(c) make it clear that a partner receiving a guaranteed payment for services is not entitled to the exclusion from gross income for sick pay as allowed by section 105(d); similarly, he is not burdened by having his guaranteed payments subject to withholding of tax at source. See Regulations section 1.707-1(c).

The Court in *Armstrong* dismissed in a footnote any limiting effect of section 707(c), on the ground that it refers to section 61(a), and that section in turn is subject to exceptions otherwise provided in the law, such as section 119. The Court held that in section 707(a), Congress rejected the aggregate theory for partnerships, and adopted the entity theory, in cases where a partner sells property to, or performs services for, the partnership, and that under the entity approach the transaction is to be treated in the same manner as though the partner were an outsider dealing with the partnership. Thus, the Court concluded, it is possible for a partner to stand in relation to his partnership as creditor-debtor, vendor-vendee, and employee-employer.

---

[3]*Empey* v. *United States,* 272 F. Supp. 851 (D. Colo. 1967).
[4]*O'Neill* v. *United States,* 281 F. Supp. 359 (D. Ohio 1968).
[5]*Hurtzner* v. *United States,* 68-2 USTC ¶9514 (D. Fla.).
[6]*Holder* v. *United States,* 68-2 USTC ¶9504 (D. Ga.)

As noted above, the decision in *Armstrong* appears to be in conflict with the decision in *Wilson*. However, it appears that the Government will not seek review by the Supreme Court. Assuming this decision stands, the reasoning in the decision could extend to many other areas of the law besides section 119, such as the exclusion for sick pay, the exclusion for medical reimbursement plans, and so forth. It is likely that there may have to be a substantial amount of revision of partnership agreements if the *Armstrong* case represents the final law on the subject. All partnerships with working partners will want to reconsider the extent to which they can grant fringe benefits to partners similar to those which are now available to the employees of a corporation.

Medical Reimbursement Plans

Another fringe benefit for employees provided in the 1954 Code relates to medical reimbursement plans. Section 105(b) of the Code provides an exclusion from gross income for amounts paid for an employee to reimburse him for expenses incurred for medical care. Such amounts may be received tax-free through accident or health insurance, or through a sickness and disability fund under state law, or through an accident or health *plan for employees*. Under such a plan, the employer directly pays the cost of medical care, or directly reimburses the employee for it. The Regulations state that the plan may cover one or more employees. Section 1.105-5(a).

Inasmuch as there is no stated requirement that an accident or health plan for employees be nondiscriminatory, closely-held corporations may have such plans which are primarily for the benefit of shareholder employees. In *Larkin*[7] the Tax Court assumed there was a *"plan"* but found that there was not a *"plan for employees"* in the case of medical reimbursements paid to shareholder officers of a closely-held publishing company.

The corporate minutes showed that the directors had voted "to continue the accident and health plan for such employees that the officers at their discretion consider should be covered." Thus, the plan was clearly discretionary with the officers. Of the four employees who had received benefits under the "plan", two were shareholders who were brothers, one was their father, and one was a long-time, non-shareholder employee.

The Tax Court found that the taxpayers had failed to show that the *purpose* of the assumed "plan" was to benefit *employees*. Rather, the Tax Court found, the plan was to benefit stockholders and their relatives, and only incidentally and sporadically non-stockholder em-

---

[7]Allan B. Larkin, 48 T. C. 629 (1967), aff'd 394 F. 2d 494 (1st Cir. 1968).

ployees. In *Larkin,* the Tax Court did not reach the issue whether discrimination in and of itself would disqualify the plan under section 105, but it did indicate that discrimination would be taken into account in determining whether a plan is a "plan for employees".

The Court of Appeals for the First Circuit affirmed the decision of the Tax Court by holding (1) there was no "plan", and (2) assuming there was a "plan," it was not a plan for *employees.* The Court of Appeals also did not reach the question whether discrimination per se would disqualify a plan.

In a subsequent Tax Court memorandum decision, however, the Tax Court specifically found that discrimination as to coverage in a medical reimbursement plan would not disqualify the plan. In *Bogene*[8], the corporation had adopted a plan by corporate resolution, providing that the corporation would pay *all* medical expenses of its 50% shareholder and of its 25% shareholder whose wife owned the other 25%. Since the corporation would pay all such expenses, the payments would not necessarily be in relation to the 50% stock ownership of each family. One stockholder could receive more than the other.

The Court found that there was a plan for employees, that its existence was known by the covered employees, and that the fact that it was discriminatory did not disqualify the plan. The Court distinguished *Larkin* on the basis that the only employees covered in *Larkin* were those who the officers, in their discretion, thought should be covered, whereas in *Bogene,* only the two shareholder-employees were covered. Further evidence that the plan was for their benefit as employees was shown by the fact that the shareholders were unrelated, that the amount of the benefits were unrelated to their proportionate stockholdings, and that the benefits were fixed in that the reimbursement was for *all* expenses incurred.

Tax practitioners have long had a problem as to whether a corporation should provide a medical reimbursement plan for its highly paid stockholder-employees. It may be said at this time that if the medical reimbursement plan is specific as to who is covered, and if management has no discretion under the plan as to who gets benefits and the amount thereof, the Tax Court would hold that the plan qualifies even though it is restricted to shareholder-employees.

Stock Options

For many years, stock options have been a popular type of employee benefit. Under the usual stock option, the employee is given a present right to purchase stock of the corporation at its present value. The right extends for a number of years, so that the employee makes the purchase

---

[8] *Bogene, Incorporated,* CCH Tax Court Memo 1968-147 (July 11, 1968).

only if the stock has increased substantially in value. The employee takes no risk of the stock going down in value. He has the benefit of participating without investment in any future increases in the value of the equity of the corporation. This not only benefits the employee, it is believed to benefit the corporation by giving employees a tangible incentive for increasing the value of the corporation for which they work, without the hazard of the employee becoming disgruntled if that value should go down.

The Internal Revenue Code recognizes the desirability of stock options.[9] The Code contains special statutory provisions which permit the grant of stock options to employees without the value of the stock option being treated as compensation to them. However, these statutory provisions are circumscribed with various statutory limitations designed to prevent an abuse of the system.

In order to avoid these statutory limitations, many corporations have resorted to what are known as "nonqualified" stock options or restricted options. The employee is given an option to purchase stock of the corporation in a manner that does not comply with the statutory requirements, but restrictions are placed on the employee's ownership of the option or on the stock subject to the option—for example, on his right to dispose of the stock or the option. The position is taken that these restrictions prevent the option, or the stock if the option is exercised, from having a readily ascertainable market value in the hands of the employee, and, therefore, there are no income tax consequences until these restrictions lapse and the market value of the option or of the stock can be readily ascertained.

After the employee has exercised the option, acquired the stock, and the restrictions have lapsed, he has actually received compensation in an amount equal to the difference between the option price and the value of the unrestricted stock. There is no statute which excludes this compensation from an employee's income. However, there are regulations which make this a desirable approach. Section 1.421-6 of the Regulations[10] provides that when the restrictions lapse, the employee's ordinary income will be only the *lesser* of two figures. These two figures are the compensation he would have had if there had been no restrictions on the stock at the time he received it, or the compensation he actually has when the restrictions lapse. Thus, the employee may exercise a nonstatutory option and wait for further developments. If the value of the stock goes down, his compensation is measured by using the actual value of the stock at the time the restrictions lapsed. If the value of the stock

---

[9]See sections 421-425, I. R. C.

[10]See also section 1.61-2(d) and Section 1.61-15.

goes up, his compensation cannot exceed that which he would have had at the time he acquired the stock subject to the restrictions. This is sometimes referred to as the "best of all possible worlds approach" for employees.

On October 26, 1968, the Treasury Department published in the Federal Register proposed regulations which would repeal this result for options or stock issued after October 26, 1968. The new proposed regulations would leave undisturbed the rule as to options or stock issued before that date. As to options issued after that date, the employee's compensation would be measured when the stock has a readily ascertainable value, that is, when the restrictions lapse. The employee would no longer have the benefit of the present limitation on the amount of compensation based on the value of the stock at the time the employee originally acquired it.

These are only proposed regulations. Until they are adopted, the present rules remain in effect. However, the proposed regulations do show that the present system is under close scrutiny, and it is likely that a change of some kind, either that set forth in the proposed regulations or some variation thereof, will be adopted by the Treasury. The validity of these changed rules, as well as the prior rules, will probably have to be tested through litigation.

It may be noted that to the extent the employee has compensation, the corporate employer has a deduction. Thus, the proposed regulations give the employer corporation in many cases a greater deduction. It is questionable whether the regulations can have a non-retroactive effect in denying the corporate employer the greater deduction. If the new proposed regulations become final and are valid, it would appear that a corporate employer could rely upon these regulations in order to claim a greater deduction for non-statutory options which it issued prior to October 26, 1968.

There have also been interesting administrative developments with respect to statutory stock options, that is, those stock options issued by a corporation in compliance with the provisions of the Code permitting the use of stock options. The price under a statutory option must be based upon the value of the stock at the date the option is granted to the employee. If there is a "modification" of the option agreement, the price test has to be met as of the date of modification, since the modification is treated in substance as if it were the grant of a new option.

In 1967 and 1968, there was an interesting interaction between the modification provisions of the income tax laws for stock options and the requirements of the Securities and Exchange Commission for the registration of publicly-held stock.

Stock granted under an option plan to a large number of employees, or stock which is regularly traded, usually has to be registered in order for the issuance of the stock to comply with the Securities laws. Section 4(2) of the Securities Act of 1933 exempts from the registration requirement those transactions by an issuer which do not involve a public offering. Thus, in order to comply with the Securities law, a corporation issuing stock options must either register the stock or, in order to come within an exemption from the Securities law, must require the employee to give it a so-called "investment letter", that is, a representation that the shares purchased under the option will be acquired for investment purposes and not for resale.

Despite the exemption for "investment letters", the Securities and Exchange Commission may take the view that where there are substantial numbers of optionees, there must be a registration in order to give the optionee adequate information about the corporation. Similarly, there is pressure on the corporation to register the stock so that its employees can market the stock which they will receive. Obviously, problems are going to arise when stock is registered if there has not been prior provision for this in the stock option plan.

In 1967, the Internal Revenue Service ruled that if a corporation has a plan which requires an investment letter from the optionee, and if thereafter it releases the optionee from this investment letter requirement because it has registered the stock, this release from the investment letter requirement is a modification of the plan for purposes of the tax laws.[11] Thus, although the requirement for the investment letter is solely a product of the Securities laws, the position of the Service is to this effect: If the representatives of the corporation had sufficient foresight to put in the plan a provision that issuance of the stock under the plan must not violate the Securities law, so that either there must be a registration, or, if there is no registration, there must be an investment letter, then there is no modification if the corporation does not register the stock and takes investment letters or, in the alternative, registers the stock and issues it without investment letters. On the other hand, if the corporation did not have this foresight, and merely required that there be investment letters, it must continue to obtain investment letters even if there is a subsequent registration of the stock. If it abandons the requirement for an investment letter, then there has been a modification of its stock option plan. This position which looks to form rather than substance, certainly places in an unpleasant position those corporate advisors who failed to anticipate this ruling.

A 1968 Revenue Ruling[12] has relieved the situation slightly. That Revenue Ruling relates to the registration of stock already issued

---

[11]Rev. Rul. 67-102, 1967-1, C. B. 100.

[12]Rev. Rul. 68-213, 1968 I. R. B. No. 18, at p. 12.

to optionees pursuant to a stock option plan which required an investment letter. The stock was registered *after* it was acquired by the optionee, and the optionee was then released from the investment letter requirements. It was held that this was not a modification of the plan since there had been no modification prior to the time the optionee received the stock. An additional fact stated in the ruling was that there had been no prior plan or arrangement for registration of the stock.

Still left uncertain is how the two Revenue Rulings will apply when the corporation is required to register the stock before the optionee exercises the option. There is certainty for the future, as follows: Any future stock option plan should provide that the optionee must furnish an investment letter only if the stock is not registered, and that this requirement does not apply if there is a registration. In addition, it would appear that if there is any occasion for registering stock after it has already been issued to the optionees the optionee can then be released from the investment letter.

Accounting Methods

In 1925, the Tax Court [13] stated that accounting "is founded upon certain fundamental principles which are universal and immutable and which give recognition to the fact that there is only one truth in everything and no half-truth, or quarter-truth, or approximation of the truth." The same opinion refers to the "sacred principles of accounting". Every year since then, Congress or the Courts have been required to muddle through the problem which arises when the Government and the taxpayer have different opinions as to the truth of the tax accounting to be used. The year 1968 had a few additional developments.

Installment Reporting—Payments in Year of Sale

If a taxpayer sells real property or makes a casual sale of personal property with deferred payments, section 453 of the Internal Revenue Code permits the taxpayer to elect the installment method of accounting. This is a substantial advantage, since it permits the taxpayer to pay tax on the gain on the sale out of the cash flow resulting from collections of the deferred payment obligations of the purchaser.

The installment method is elective, and the taxpayer can elect it only if the down payment is not more than 30% of the total selling price. For this purpose, the down payment includes all payments paid by the purchaser during the taxable year in which the sale is made. Obviously, the evidences of indebtedness of the purchaser are not treated as a down payment for this purpose. A more troublesome problem arises where the purchaser in the sale assumes liabilities of

---

[13] Goodell-Pratt Co., 3 B. T. A. 30 at p. 34 (1925).

the seller, or takes property subject to a mortgage or other liability. If the liabilities exceed the basis of the property to the seller, such excess is treated as a down payment.[14] If the liabilities do not exceed basis, then the liabilities are not taken into account in the mathematical formula used for determining the portion of each collection which must be reported by the seller as gain.

However, for purposes of the rule which limits payments by the purchaser in the year of sale to 30% of the total selling price, the question has arisen as to whether payments by the purchaser of liabilities to third parties after the date of sale, but during the taxable year of the sale, should be treated as part of the payments by the purchaser during the year of sale. Certainly, these payments do relieve the seller of a burden, either a personal obligation or an obligation which was applicable to the property sold. However, for purposes of reporting gain on the installment method, payment of the third-party liabilities are ignored. It would seem to be an undue emphasis on form to include these payments for the purposes of the 30% rule. This rule is only a test to determine whether the election may be made. The legislative history indicates that the formality of requiring a down payment below a certain percentage, such as 30%, was introduced into the law so as to limit installment reporting to those cases where the purchaser's deferred payment notes represented so large a portion of the purchase price to the seller, that there would be difficulty in valuing these deferred payment notes; accordingly, the discharge of obligations to third parties appears to have little relation to the purpose of the 30% limitation.[15]

---

[14]Treasury Regulations section 1.453-4(c).

[15]The installment method for a casual sale was adopted by Congress in order to avoid the difficulty of valuing the installment obligations received on a casual sale where there was only a small down payment. See S. Rep. 52, 69th Cong., Revenue Bill of 1926, 1939-1 (Part 2) C. B. 332 at 347 ("the committee amendment should eliminate necessity for appraisals of the obligations of the purchaser in deferred payment sales"); S. Rep. 960, 70th Cong., Revenue Bill of 1928, 1939-1 (Part 2) C. B. 409 at 424 ("the 25 percent limitation in the 1926 Act forced the reporting on the accrual basis of sales in which the initial payment, though larger than 25 percent, was insufficient to create a substantial assurance of the actual payment of the full amount of the deferred purchase price") and at page 425 ("It has been suggested *** that in lieu of the increase of the 25 percent limitation, gain or loss should not be recognized on receipt of installment obligations or other property if no fair market value is determinable therefor with reasonable certainty ***. *** the permitting of the installment basis to apply to transactions with an initial payment up to 40 percent cares for the greater part of any difficulty in connection with the existing law."); and S. Rep. 704, 73rd Cong., Revenue Bill of 1934, 1939-1 (Part 2) C. B. 554 at 572 ("The percentage has been changed to 30 percent, since it is believed that the 40 percent limitation results in an unreasonable postponement of tax in cases where such tax can well be paid in the year of the sale.") In the light of the preseding committee reports and of the nature of the amendment described in this last committee report, this last statement has reference to ability to *value* the installment obligation in the case of a *casual* sale.

In 1968, a divided Tax Court in *J. Karl Horneff,*[16] held that where there was a sale of a business in 1961, and the purchaser assumed current obligations of the seller due in 1961, the payments of these current obligations by the purchaser during 1961, would be treated as part of the initial payments in the year of sale for purposes of the 30% rule. The result was to disqualify the seller from the right to elect the installment method. This holding of the Tax Court is in conflict with the *Marshall* case, a 1966 decision of the Court of Appeals for the Ninth Circuit[17] and with the *Irwin* case, a 1968 decision of the Court of Appeals for the Fifth Circuit.[18] Of course, in view of the conflict in opinion on this question, and in view of the division in the Tax Court, the final word has not yet been heard on this question.

It is interesting in reading these cases to note that the whole question of the treatment of liabilities to third parties in the case of a sale rests solely on regulations, and these regulations refer only to mortgaged property. However, the principles of the regulations have been extended to other liabilities which are assumed in the sale, or which are applicable to the property sold. As is pointed out by the Tax Court in the *Horneff* case, this is necessary in order to avoid peculiar results under section 453. However, a majority of the Tax Court refuses to extend this principle to current liabilities which are paid in the year of sale.

As pointed out by the dissenting judges in the Tax Court, a taxpayer aware of this problem can protect himself to a considerable extent by varying the form of the transaction. For example, the seller may retain certain liabilities and perhaps an equal amount of recievables to cover them. Another approach is to obtain a covenant from the purchaser that the purchaser will not pay assumed liabilities during the year of sale in excess of some stated amount. Since the decisions seem to turn only on current liabilities, and do not appear to attack payments made by the purchaser on long-term liabilities, such as payments on a mortgage note, the seller might perhaps protect himself by refinancing current obligations prior to the sale by substituting for these obligations a long-term obligation.

Finally, and perhaps the best solution in the case of the sale of a business, is a Revenue Ruling issued in 1968 which makes it clear that the Service will give effect to an agreement between the seller and the purchaser which allocates the purchase price and the down payment among different assets. In other words, the seller may sell certain assets, such as inventory, all for cash, and may sell other assets, such as

---

[16]50 T. C. No. 10 (April 16, 1968), Appeal docketed (1st Cir. 1968).

[17]*United States* v. *Marshall,* 357 F. 2d, 294 (9th Cir. 1966).

[18]*Irwin, Jr.* v. *Commissioner,* 390 F. 2d 391 (5th Cir. 1968), reversing 45 T. C. 544 (1966).

equipment or real property or a leasehold, for a small or no down payment and the balance in deferred payment notes. Although the total cash received by the seller and the total of the deferred payment notes received by him are the same, the Service will recognize this allocation and will grant installment sale treatment to the portion that qualifies for it under the agreement of the parties, provided that the agreement is realistic and the amount paid down in cash for any asset is not in excess of the fair market value of that asset. This position of the Service was stated in Revenue Ruling 68-13, 1968-2 I.R.B. at page 8. If the agreement between the seller and the purchaser does not provide for this type of allocation, the Tax Court has held that the seller himself cannot make the allocation so as to try to comply with the installment sale method. *James A. Johnson,* 49 T. C. No. 12 (1968). Obviously, the difference between the Revenue Ruling and the *Johnson* case is merely the form of the contract; this difference is only of significance to the seller; there would presumably be no reason for a purchaser to object to a contract of a type which protects the seller as to installment reporting. However, the burden is on the tax advisor to the seller to be aware of these niceties.

Prepaid Income

One of the principles of the income tax law is that tax accounting should clearly reflect income. Most accountants and almost all business men will agree that prepaid income does not clearly reflect income since built into it is the burden of earning this income at some cost which may show up in a later year. In 1954, the problem was solved in the Internal Revenue Code by the enactment of section 452, relating to prepaid income, and section 462, relating to reserves for estimated expenses. The following year, in 1955, these sections were repealed retroactively at the request of the Treasury. The Treasury anticipated a substantial loss of revenue if these more accurate methods of reporting income were adopted. The Treasury did indicate that it would submit substitute legislation at some later date. In the case of *American Automobile Association* v. *United States,*[19] the Supreme Court refused to permit the deferral of prepaid income on the ground, in part, that Congress was still considering the question. See 367 U.S. 687 at pages 696-697. A close reading of the cases on the subject, including three Supreme Court cases,[20] shows that no court is willing to lay down broad general rules, but instead limits itself to a decision on the facts

[19]367 U. S. 687 (1961).

[20]*Schlude* v. *Commissioner,* 372 U. S. 128 (1963); *American Automobile Association* v. *United States,* 367 U. S. 687 (1961); *Michigan* v. *Commissioner,* 353 U. S. 180 (1957).

of the case before it. The latest such decision was the *Artnell* case in the Court of Appeals for the Seventh Circuit in 1968.[21]

Artnell was the transferee upon the liquidation of the Chicago White Sox, Inc., a corporation which operated the White Sox baseball team in Chicago. The liquidation occurred on May 31, 1962, and this closed its fiscal year. Early in the 1962 baseball season, as in previous seasons, the corporation had sold season tickets and single admission tickets for later games. Thus, it had collected cash in advance for specific games to be played at a later time. The corporation had used a method of accounting under which it took these sales receipts into income at the time when it played the games for which the receipts related; thus, it matched the receipts with the cost of playing the game for which the payments were made. However, since it liquidated on May 31, it closed its taxable year on that date, and at that time it had substantial receipts relating to games to be played after the close of this taxable year. Thus, the question was presented whether it had to include in income, for the short year ending on May 31, the receipts for games to be played after that date, or whether these receipts could be deferred so that they would be included in income only when the games were played.

The Commissioner contended that an accrual method taxpayer must include in income, in the year of receipt, prepaid items for which services will be performed in later years. The taxpayer argued that section 446 of the Code permitted it to use its method of accounting unless that method "does not clearly reflect income". It was further argued that the taxpayer's method does clearly reflect income since it matches the receipts with the actual expenses, that is, with the playing of the games.

The Court of Appeals held that the prior Supreme Court decisions on prepaid income were not controlling, since in all of the cases considered by the Supreme Court, there was uncertainty as to the time and extent of the performance of the future services to which the prepaid income related. In the *Artnell* case, there was certainty as to the future services, since the payments were made with respect to particular games. The Court further held that the Commissioner does not have complete and unreviewable discretion to reject the deferral of prepaid income. Accordingly, the Court held that the taxpayer would be sustained if its method of accounting did, in fact, clearly reflect income, even though that method provided for the deferral of prepaid income. The case was remanded to the Tax Court for a determination whether "all other relevant items were so treated in the White Sox

---

[21]*Artnell Co.* v. *Commissioner,* 1968-2 U. S. T. C. ¶9593 (7th Cir. 1968), reversing 48 T. C. 411 (1967).

method of accounting that the income attributable to * * * its * * * taxable year was clearly reflected".

The *Artnell* case, like the Supreme Court cases, dealt with the deferral of income in respect to future services. There is also a pending case which deals with the problem of prepaid income with respect to the future delivery of manufactured goods. This is the case of *Hagen Advertising Displays, Inc.*, 47 T. C. No. 13 (1966) which is now pending on appeal before the Court of Appeals for the Sixth Circuit.[21a]

In this case, the taxpayer received payments in respect of goods to be manufactured and delivered by it in a subsequent taxable year. The cost of the goods for which the payment was made could not be determined by the end of the year of payment because the manufacturing process had not then been completed. In any event, this cost could not be used as a reduction of the income until delivery of the goods because of the Commissioner's regulations with respect to inventories. Treasury Regulations section 1.47-1. The Tax Court held that the prepayment had to be included in income. A dissenting opinion in the Tax Court contended that unless the cost of goods sold is deducted from the proceeds from the sale of goods, the result is a tax on gross receipts. This problem of the tax being in effect a tax on gross receipts, rather than on gross income, will probably be argued before the Sixth Circuit. This raises the statutory issue whether the income tax law applies since that law appears to contemplate only a tax on gross income,[22] reduced by allowable deductions. In addition, there is a constitutional argument in taxing gross receipts, as distinguished from gross income, both under the 16th Amendment which removes the requirement for apportionment only in the case of an income tax, and under the due process provisions of the 5th Amendment because of the unreasonable effect of applying to grosse receipts a statutory law which is designed to reach gross income.[23]

Neither the *Artnell* case nor the *Hagen* case has provided any sweeping solution to the problem of the distortion of income resulting from prepayments. For 14 years, Congress has refrained from acting in this area, after one aborted attempt, and it is likely that there will continue to be litigation on this issue until a legislative solution is enacted.

Corporations

The 1968 decisions with respect to corporations grapple with dif-

---

[21a]On March 3, 1969 the Court of Appeals for the Sixth Circuit affirmed the tax court decision in the *Hagen Advirtising* case.

[22]Gross receipts from sales must be reduced by the cost of the goods sold in order to determine the gross income produced by the sales. Regulations section 1.61-3(a).

[23]Cf. *Schlesinger* v. *Wisconsin*, 270 U. S. 230 (1926) (gift tax imposed as part of an inheritance tax).

ferent aspects of the question whether form or substance should control. Cases worthy of discussion relate to spin-offs, to redemptions of stock, and to the basis of assets acquired in the liquidation of a subsidiary.

Spin-offs—Step Transactions

The Supreme Court decision in *Commissioner* v. *Gordon,* 391 U.S. 83 (1968), involved the taxation of minority shareholders of Pacific Telephone and Telegraph Company, a subsidiary of American Telephone and Telegraph Company. Pacific had to divide its business into two separate corporations, and for this purpose, it transferred certain assets to a new subsidiary, "Northwest". Instead of distributing all of the Northwest stock to its shareholders in a classic spin-off, however, Pacific gave its shareholders rights to purchase Northwest stock at a price below its fair market value. The rights issued in 1961, the year the plan was initiated, were sufficient to transfer only 57% of Northwest stock. The remaining 43% was offered to the Pacific shareholders in 1963.

The Commissioner contended, in addition to other arguments, that this was not a tax-free spin-off since the parent corporation had failed to distribute at least 80% of the stock of Northwest, the controlled corporation. The taxpayers argued that the requirement of section 355(a)(1)(D) for a distribution of at least 80% of the stock was satisfied because Pacific distributed 57% in 1961, and, pursuant to its plan, distributed the remaining 43% in 1963. Thus, the taxpayer was arguing that this was a step transaction and that the two steps should be considered together. The Supreme Court rejected this argument as being inconsistent with the basic premise of annual tax accounting. The Court said that the essential character of a transaction, and its tax impact, may not remain undeterminable and unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen. "If one transaction is to be characterized as a single 'first step' there must be a *binding commitment* to take the later steps." (Emphasis supplied). The court determined that there was no such binding commitment, and that even though the purpose of the statute may ultimately have been complied with, the transaction is governed by the form of the statute. Thus, the transaction failed to qualify under section 355.

It may be interesting to speculate as to the effect of this case upon the familiar "step transaction" principle. Rather than rely upon the traditional test of whether the two distributions of Northwest stock by Pacific were "interdependent", the Court said there must have been a "binding commitment" to make the second distribution in order to consider the transaction a single transaction. Since the "step transaction" theory is usually raised by the Commissioner where the taxpayer has sought to create independent transactions, this case could be important if it in fact stands for what it purports to say, that is, that there must be a binding commitment.

On the other hand, it may be that the case merely means that so far as the taxpayer, but not the Commissioner, is concerned, there must be a literal compliance with the Code as well as a compliance with its spirit.

Redemptions

Under section 302, as well as prior law, a redemption of stock by a corporation is treated as a dividend, instead of a purchase which results in capital gain, unless the redemption meets one of the specific tests of section 302(b)(2)-(4), or unless it meets the general test of section 302(b)(1) that the "redemption is not essentially equivalent to a dividend".

The question of what is substantial equivalence to a dividend was considered during 1968, in *Commissioner* v. *Antrim,* 395 F. 2d 420 (4th Cir. 1968). One of the arguments of the Commissioner in applying the substantial equivalence test is the argument that the redemption has the "net effect" of a dividend, that is, that it leaves the stockholders after the redemption in substantially the same position as if a dividend had been declared. In *Antrim,* there was a redemption of preferred stock in the amount of $80,000. Of this amount, $64,000 was distributed to persons who held only preferred stock; the remaining $16,000 was distributed to persons who also held common stock. The Commissioner argued that for purposes of determining whether the common stockholders had a dividend, the Court should regard only the redemption of preferred stock from them in the amount of $16,000, and looking only at this amount, the Court should determine whether they were in substantially the same position as if a dividend of $16,000 were paid to them.

The Court of Appeals for the Fourth Circuit rejected the Commissioner's argument and stated that it was proper to regard the entire redemption, not to fragment it into two parts, one for common stockholders and the other for persons who were not common stockholders. Looking at the redemption as a whole, there was no equivalence to a dividend when only $16,000 out of the $80,000 redemption was distributed to the common stockholders.

Redemptions—Attribution Rules for Stock Ownership

One of the most involved and least logical provisions of the Internal Revenue Code is section 318, which attributes stock ownership to persons who do not actually own the stock. Familiar examples are the attribution of ownership among members of a family, and to stockholders of a corporation. In *Estate of Byrd* v. *Commissioner,* 388 F. 2d 223 (5th Cir. 1968), the Court of Appeals for the Fifth Circuit during 1968 had a case in which the attribution rules had to be applied to two different aspects of the transaction. It refused to apply them to one aspect, and insisted upon applying them to the other aspect, so as to result in the greatest disadvantage to the taxpayer.

Byrd Estate was a case involving the redemption of stock under section 303. This section provides that a redemption of stock will not be treated as a dividend where the redemption is of stock included in the gross estate of a decedent and the amount of the redemption does not exceed the death taxes and administration expenses. It is a provision designed to permit an estate to derive funds from a closely-held corporation for the payment of death taxes and administration expenses. For purposes of section 303, the stock redeemed must represent more than 35% of the value of the gross estate or more than 50% of the taxable estate of the decedent. Furthermore, where the redemption is of stock in two or more corporations, these corporations will be aggregated for purposes of the 35% and 50% rules if the decedent owned at least 75% of the value of the outstanding stock of each such corporation.

In the *Byrd Estate* case, the decedent owned directly 66%, 32%, and 27% of the value of the stock in three corporations, and the stock of each of these corporations was redeemed. Thus, the direct ownership was below the 75% rate needed to aggregate the three stocks. The decedent also owned 89% of the stock in another corporation which owned stock in the redeeming corporations. Obviously, the stock in the corporations which were redeemed was taken into account in determining for estate tax purposes both the value of the stock the decedent owned directly and the value of the stock in the 89% ownership corporation. If the stock of the redeeming corporation which the decedent owned indirectly through his 89% ownership of the fourth corporation were included, pursuant to the attribution rules of section 318(a)(2)(C), the decedent would have been treated as owning directly and indirectly 95%, 92% and 79% of the stock of the three corporation was included, pursuant to the attribution rules of section cumstances, each of these redemptions would have qualified under section 303. The Court of Appeals for the Fifth Circuit refused to apply the attribution rules for this purpose, and therefore held that the decedent was not the owner of at least 75% of the stock of each of these three corporations. It looked only to his direct ownership, and refused to consider his indirect ownership. Accordingly, the redemptions did not fall under section 303.

Then, the parties reversed field, as the Court said. In determining under section 302 whether the redemption was essentially equivalent to a dividend, the Commissioner insisted upon the application of the attribution rules. Because of the high percentage of both direct and indirect stock ownership in the Estate when the stock was redeemed, the Commissioner contended, and the Court held, that the redemptions were essentially equivalent to a dividend and would not receive capital gain treatment.

Section 303 is a relief provision for decedents' estates. Presumably, a relief provision should be construed liberally to carry out its purpose. Instead, the Commissioner and the Court of Appeals saw fit to construe the provision narrowly since it is an exception to the general rules relating to redemption of stock. The Estate has a stepped-up basis equal to value at death, and the result of the treatment of the redemption as a dividend causes the basis of the redeemed stock to be added to the basis of the remaining stock of the Estate. Thus, the Estate will have a basis in excess of value, and will have a built-in capital loss to be taken when the remaining stock is sold.

Redemptions—Controlled Corporations

The Court of Appeals for the Sixth Circuit in 1968, had to deal with a case in which two provisions of the Internal Revenue Code reached contradictory results with respect to the acquisition of the stock of one controlled corporation by another controlled corporation. This was the case of *Commissioner* v. *Estate of Haserot,* ——F. 2d——(6th Cir. 1968).

Section 304 provides that if one controlled corporation acquires from its controlling stockholder the stock which he owns in another corporation controlled by him, the acquisition will be treated as a distribution by the acquiring corporation in redemption of its stock. This may result in dividend treatment under section 301 of the Code. For purposes of section 304, control is defined as meaning ownership of 50% of either voting power or value of each corporation, and for this purpose, the attribution of ownership rules of section 318 apply.

Section 351 of the Code applies to transfers of property to a controlled corporation. For this purpose, control means ownership of stock possessing at least 80% of the total combined voting power and at least 80% of the total number of shares of all other classes of stock of the corporation. Under section 351, the transfer of property to a controlled corporation in exchange for stock or securities is tax free; if money or other property (in addition to stock or securities) is received, gain is recognized only to the extent of this boot. Such gain is taxable as ordinary gain or capital gain by reference to the nature of the property transferred. Thus, if property transferred is stock, a capital asset, the gain will be capital gain.

In *Haserot,* the taxpayer was in control of three corporations, both under the 80% rules of section 351, and under the 50% rules of section 304. The taxpayer transferred stock in two of the corporations to a third one, in exchange for additional stock in the third corporation, and $65,000 in cash.

Under these facts, section 304 applied to create dividend income and section 351 applied to create capital gain. The court decided in favor of the taxpayer by applying section 351 and not section 304. It rested this decision on a technical analysis of the provisions. Section 304 provides that the transaction shall be treated as a redemption of stock. Section 302 provides that if the redemption is not treated as a purchase or exchange under section 302(a), it shall be treated as a distribution under section 301 "except as otherwise provided in this subchapter". Section 301(a), which provides the dividend treatment, also contains language that this treatment shall apply "except as otherwise provided in this chapter". The court felt that the tax-free consequences, and capital-gain consequences, which flowed from section 351, were an exception "otherwise provided" by the income tax chapter of the Code.

The Court recognized that this case had some awkward consequences. As a result of this decision, the only person in jeopardy under section 304 is a taxpayer who owns between 50% and 79% of the acquiring corporation. If he owns less than 50%, he is not subject to section 304, and he can obtain capital gain treatment on the sale of his stock to another corporation in which he has stock ownership. If he owns between 50% and 79% of the corporation, he is subject to section 304, and section 304 only. This may result in dividend treatment. If he owns 80% or more of the transferee corporation, he may find refuge in section 351.

Tax Basis—Liquidation of a Subsidiary

If a corporation owns more than 80% of the stock of a subsidiary, and liquidates that subsidiary, the liquidation is a tax-free transaction under section 332. Prior to the 1954 Code, the parent corporation had to take a transferred basis for the assets it received from the subsidiary. This obviously worked a hardship where the parent corporation had purchased the stock of the subsidiary for a price substantially in excess of the tax basis of the underlying assets, and where this was done solely for the purpose of acquiring these underlying assets. In *Kimbell-Diamond Milling Company,* 14 T. C. 74 (1950) affirmed per curiam 1950, 187 F. 2d 718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951), the Court held that where the purpose of the acquisition of stock was to obtain the underlying assets, it would ignore the statutory provisions for a tax-free liquidation and a transferred basis, and instead it would treat the acquisition of stock and the liquidation of the corporation as an integrated transaction for the purpose of purchasing the underlying property.

This rule was, many persons thought, codified in section 334(b)(2) of the Internal Revenue Code which provides for a cost basis, rather than a transferred basis, where the subsidiary adopts a plan of complete liquidation within two years after the parent corporation acquires its stock, with statutory provisions designed to limit this to cases where the parent corporation actually purchased the stock of the subsidiary within a 12-month period.

However, this stepped-up basis under section 334(b)(2) would not be available if the issuance of the parent stock was pursuant to a tax-free reorganization within the meaning of section 368. Thus, if the acquiring corporation issued its stock for substantially all the assets of another corporation, this would be a reorganization under section 368 (a)(1)(C), and section 362 (b) would require a transferred basis for the assets received by the acquiring corporation. If the parent corporation acquired all of the stock of the subsidiary for its stock, this would be a tax-free reorganization under section 368(a)(1)(B); it would not be a purchase for purposes of section 334(b)(2), and, therefore, there would be no stepped-up basis on the liquidation of this subsidiary.

The Commissioner's regulations with respect to reorganizations states that for purposes of a (B) Reorganization, that is, the acquisition of 80% or more of the stock of the subsidiary solely for voting stock of the issuing corporation, the subsidiary stock does not have to be acquired at one time, but can be acquired over a reasonably short period of time, such as 12 months.

All of these complex provisions were before the Court of Claims this year in the case of *American Potash and Chemical Corp* v. *United States*, 68-2 U.S.T.C, ¶9472. In that case, the parent corporation acquired 48% of the stock of the subsidiary more than 12 months before it acquired the remaining 52%. Thereafter, it liquidated the subsidiary and sought a stepped-up basis on the liquidation. It argued that the acquisition of stock of the subsidiary did not meet the test of a Clause (B) Reorganization since it occurred during more than a 12-month period. The Commissioner then argued that he would treat the acquisition of stock of the subsidiary followed by the liquidation of the subsidiary as being in substance a (C) Reorganization, in which the parent corporation acquired the underlying assets for its stock. The Court of Claims held that this was not a (B) Reorganization because of the length of time involved in the acquisition of the stock. After thorough consideration of the step-transaction theory, it also held it would not apply that theory to convert a transaction which fails as a (B) Reorganization into a good (C) Reorganization.

The Commissioner then made the argument which makes this case an interesting one. Section 334(b)(2), which would give a stepped-up basis to the parent corporation upon the liquidation, is applicable only if the parent corporation purchased the stock in the subsidiary corporation during the 12-month period. American Potash had not done this; if it had met the 12-month test, the transaction would have been a tax-free reorganization under Clause (B) of section 368(a)(1). Therefore, the Commissioner argued that section 334(b)(1) should apply, and under this section, the parent corporation upon the liquidation of the controlled subsidiary takes the assets of the subsidiary with a transferred basis. The taxpayer argued in answer to this that section 334 (B) (2) is not exclusive; that the doctrine of the *Kimbell-Diamond* case continues to be applicable; that where, as in this case, the intent of the entire transaction was for the parent corporation to acquire the underlying assets, its acquisition of stock should be ignored, and it should take the assets in the liquidation at a stepped-up basis.

The Court upheld the taxpayer's contention that the *Kimbell-Diamond* rule is still in full effect, even with respect to corporations, despite the fact that there are similar rules under section 334(b)(2).

The *Kimbell-Diamond* case has significance for individuals as well as corporations. A good example is that of an individual who purchases stock in order to obtain the underlying assets, and then liquidates the corporation. Under the *Kimbell-Diamond* rule, he can look to the assets as if they were purchased by him; he is not troubled with the question whether he has gain on the liquidation because of any increase in value after his purchase of stock.

However, this breath of new life into the *Kimbell-Diamond* case has not fully protected the taxpayer in the *American Potash* case. On November 15, 1968, the Court of Claims reconsidered the *American Potash* case, and recognized the fact that the 12-month period for the acquisition of stock in a Clause (B) Reorganization is stated in the regulations only as an example. The Court remanded the case to a Hearing Commissioner to determine whether in fact there was a Clause B Reorganization. If this is the ultimate decision in the case, then the taxpayer will not obtain a stepped-up basis on the liquidation.

There is one other significant aspect of the first Court of Claims decision in the *American Potash* case. This is a statement by the Court, as an additional reason for maintaining the *Kimbell-Diamond* doctrine, that to do otherwise would effectively give taxpayers an election with respect to a carryover or cost basis for acquired assets. If section 334(b)(2) is the only method to obtain a cost basis, a taxpayer could choose with relative ease whether or not to comply with the statutory provisions. It would seem preferable from the Government's point of view, the Court said, to retain the step transaction approach of *Kimbell-Diamond* in order to achieve substance over form where a taxpayer deliberately avoids the statute. This is consistent with the fact that the *Kimbell-Diamond* theory originated as a Government attack on a taxpayer's reliance on the form of the statute.

In other words, a taxpayer who carefully avoids section 334(b)(2) is subject to the risk of the Commissioner applying the *Kimbell-Diamond* rule if this would be to the Commissioner's advantage, for example, in a case where the underlying assets would have a higher transferred basis upon the liquidation than would be true if they were given a cost basis.

Conclusion

As noted at the beginning, the significant cases for 1968 will be determined in later years by reference to which of the cases decided during this year are important as authority for subsequent decisions. Any full reading of the cases decided in 1968 will demonstrate, however, that while new issues may arise under the income tax laws, there are an adequate number of old issues that have not been solved.
