1968

Federal and State Taxation

Dudley Warner Woodbridge

*William & Mary Law School*

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**Repository Citation**


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Starting with the December 1956 examination questions may be asked on State as well as on Federal Taxation. Some of these questions are considered in the materials on constitutional law. Additional matters are considered below.

1. The General Assembly passed a bill taxing all land in this state at its fair market value, the taxes to be used by the State for public purposes. Discuss its validity.

The act is invalid as it violates the segregation provision of the Virginia Constitution which reads in part as follows, "No State property tax for State purposes shall be levied on real estate or tangible personal property, except the rolling stock of public service corporations. Real estate and tangible personal property(except rolling stock) are hereby segregated for, and made subject to, local taxation only ***".

2. Could the General Assembly abolish the poll tax?

No without a constitutional amendment as Section 173 of the Constitution reads in part, "The General Assembly shall levy a State Capitation tax of *** one dollar and fifty cents per annum on every resident of the State not less than twenty one years of age, except those pensioned by this State for military services; one dollar of which shall be applied exclusively in aid of the public free schools, and the residue shall be returned and paid by the State into the treasury of the county or city in which it was collected ***". Note: By the 24th Amendment to the U.S. Constitution the payment of a poll tax cannot be made a condition to the right to vote for candidates for a federal office.

3. What are the principal ways in which the State Income Tax differ from the Federal?

(a) Under the State law anyone with a gross income of $1,000 or more must file a return(Federal is $600 or more) If over 65 $1,600 for State, $1,200 for Federal.  
(b) The tax rates are much lower being only 2% of the first $3,000 of taxable income, 3% on the next $2,000, and 5% on the balance.  
(c) Exemption under the State law ordinarily are $1,000 for taxpayer and another $1,000 for his spouse, and only $200 each for eligible dependents. If 65 or blind $600 more. If both $600 more.  
(d) Under the State law income taxes paid to the Federal Government are not deductible;  
(e) There are no capital gain or loss provisions, no excludable sick pay, no $100 dividend exclusion, no child care provisions, no retirement income credit.

4. X moved to Virginia from Michigan in the middle of the taxable year. To what extent if at all is he taxable on his Michigan income?

His income and his exemptions are pro-rated.

5. X moved from Virginia to State X on the first day of the taxable year, but continued to vote in Virginia by absentee ballot. All his income was derived from sources in State X. Is he taxable in Virginia?

Yes, as he is still domiciled in this State. He may, however, receive a credit on his tax to the extent of the tax paid to State X if certain conditions are met.

6. X actually resides in Virginia and all his income is derived from sources in Virginia, but he is domiciled in State S which grants him no credit for income taxes payable here. To what credit, if any, is X entitled?

None whatever. His remedy is to change his domicile to Virginia or to persuade State X to liberalize its own tax laws.

7. Does Virginia have a gift tax law?

Yes, §48-218 et seq. There are three classes of donees. Class A consisting of parents, spouse, children, or grandchildren. There is a $5,000 annual exemption for members of this group. Class B consisting of brothers, sisters, nephews, and nieces have a $2,000 annual exemption. Class C(anyone else) has a $1,000 annual exemption. Gifts to the usual charities are exempt from the tax.
8. Does Virginia have an inheritance tax?
   Yes. V/#58-152 et. seq. on property passing by will, or laws regulating descent, distributions, grants or gifts made to take effect at or after the death of the grantor or donor, grants or gifts made in contemplation of death, and survivorship. Every grant or gift made within one year next preceding the date of the death of the grantor is deemed prima facie to have been made in contemplation of death.

   The classes are the same as in the case of gift taxes described above and the usual charities take free from the tax.

9. X died intestate survived by his nephew, B. A month later B died survived by N who was X's grandnephew. Are two inheritance taxes collectable?
   By V/#58-156 if a beneficiary (B in this case) die within a year without having come into possession of the property, or without having dealt with the same, only one tax is collectable and that as if the ultimate beneficiary (N in this case) had taken directly from the first deceased.

10. Who has the duty of seeing that inheritance taxes are properly paid?
    If the personal representative has control of the property it is his duty; in the case of a devise of real property or the inheritance thereof the duty is on the devisee or the heir; in other cases it is on the person receiving the property by gift causa mortis, survivorship, etc. Note that the Virginia tax is an inheritance tax and not an estate tax.

11. X owns $5,000 worth of household property, $6,000 worth of corporate stock, a note for $10,000 fully secured by a deed of trust of valuable real estate, and a $7,000 bank deposit. Which, if any, of these are taxable?
    The household property is taxable only by the locality under our tax segregation laws. Note: Section 169 of the Virginia Constitution has been amended by vote of the people at the November 1956 election by adding at the end, "The General Assembly may define as a separate subject of taxation household goods and personal effects and may allow the governing bodies of counties, cities, and towns to exempt or partially exempt such property from taxation."

    The corporation stock is not taxable. V/#58-409 reads in part, "The taxes on incomes and the taxes on franchises and licenses imposed by the laws of this State shall be in lieu of a specific property tax on shares of stock."

    The note is not taxable. V/#58-406 provides that the income tax (which was raised when V/#58-406 was amended) shall be in lieu of a specific property tax on bonds, notes and evidences of indebtedness (with some exceptions).

    The money in the bank is not taxable, the income tax also being in lieu of a tax thereon. V/#58-408.
D lived in Portsmouth but operated and garaged taxicabs in Norfolk County. Is he liable to Norfolk County for the personal property taxes on the taxis?

Held: Yes. They were not just temporarily in Norfolk County but had an actual situs there. "At the present day the separation of the situs of personal property from the domicile of the owner for the purposes of taxation is a familiar doctrine, and the maxim "mobilia sequuntur personam" is no longer controlling on the question of taxation of personal property which has an actual situs elsewhere than at the owner's domicile". But even if the maxim were law it could be changed by statute and that is exactly what Va. §58-83h does for it reads, "The situs for the assessment and taxation of tangible personal property, merchants' capital and machinery and tools shall in all cases be the county, district or city in which such property may be physically located on the first day of the tax year."

**STATE AND LOCAL TAXATION**

The State of Virginia ceded the Washington National Airport to the United States and consented that exclusive jurisdiction therein should be in the United States upon the following conditions and no other: (1) There is hereby reserved in the Commonwealth of Virginia jurisdiction to levy a tax on the sale of motor fuels and lubricants sold on the Washington National Airport for use in over-the-road vehicles, except sales to the United States.

P operated a filling station at the Airport, Arlington County assessed him with the County and State licensing taxes which he paid under protest. Is he entitled to a refund of the amounts so paid?

Held: Yes. The licensing taxes are not taxes on the sale of motor fuels, but on the privilege of doing business. No right to levy such a tax was reserved by the State. It is elementary that where there is any substantial doubt as to whether or not a business is included in the descriptive language of a legislative enactment imposing a tax, such doubt must be resolved in favor of the taxpayer.

**STATE TAXATION**

The American Railway Express Co., a Delaware Corporation, does an interstate business in all forty-eight states and an intrastate business in all of them except in Virginia. It does, however, own all the stock of the Railway Express Agency, Inc., of Virginia which carries all intrastate-express in this State. This corporation has the same officers and employees as its owner. The Delaware Corporation refused to pay a franchise tax on the ground that it did not do any intrastate business and had no way of determining what part of the receipts derived by it from its intrastate business was earned "in business passing through, into or out of this State." The State Corporation Commission assessed a franchise tax based on a reasonable percentage of the Company's gross receipts.

Held: For the State. Corporations engaged exclusively in interstate commerce are not exempt from their fair share of local taxes—in this case a state franchise tax in lieu of all other property taxes. And this tax should include a tax based on the value of its intangibles fairly allocable to its Virginia activities in interstate commerce. Such a tax is in no way a discriminatory tax on interstate commerce, and if Virginia did not levy such a tax the Company would escape all taxes on the Virginia part of its property used in interstate commerce.

**STATE TAXATION**

P owned property that could only be used as a women's exchange and was built at a cost of $122,000 ($10,000 for land). Because of the uniqueness of the property it could not be sold for more that $85,000. It was assessed at $105,000 because its present cost less depreciation would be that amount and because it was worth that much to P.

Held: Error. The State Constitution requires property to be assessed at its fair market value (emphasis added). If it cannot be sold for more that $85,000 then $85,000 is the maximum amount for which it can be assessed. It is immaterial that the property is worth more to the owner, or that present cost of reproduction less depreciation would give a higher figure.
STATE TAXATION--Corporations

X and Y owned all the stock in two Virginia Corporations which had built large rental housing developments. The rentals were not sufficient to pay off the mortgage which had been placed on the property by the Corporations and which were guaranteed by the Federal Housing Administration, so the Corporations conveyed the property to the mortgagees who in turn conveyed to F.H.A. The Corporations were dissolved in 1941. The F.H.A. took over and in 1956 realized $254,000 from the property in excess of its cost and the expenses. Under federal statutes this excess was required to be returned to the mortgagees. X and Y are residents of New York. A representative of the dissolved Corporations received the money. The Commonwealth assessed income taxes against the two Corporations. Their representative contended that the State Tax Commissioner had no authority to assess this tax against the Corporations which had been dissolved for 12 years and had conducted no business in this State during this time.

Held: For the Commonwealth. Under Virginia statutes (W#58-128 and W#58-75) Corporations are taxable on income derived from any source in this State that grows out of ownership, use, or interest in any property in this State. Under W#13-70 to 13-73 the Corporations were resurrected. Note: While these last sections have been repealed the same result would be reached under W#13-1-101 which reads in part, "The dissolution or expiration of a corporation shall not take away or impair any remedy available to or against such corporation for any right or claim existing or any liability incurred prior to such dissolution." In the instant case the Corporations had a contingent right prior to dissolution. When they collected on this contingent right the Corporations realized income for which they must account notwithstanding their dissolution.

STATE TAXATION--Conflict of Laws

X in New York created a trust consisting of stocks and bonds worth $136,000. These stocks and bonds were in New York in the hands of a New York trustee. His daughter, D, was the beneficiary of this trust for her life and she had a general testamentary power of appointment. She duly relinquished her power to appoint to her creditors or to the creditors of her estate under her general power thereby converting the general power of appointment into a special power. In 1937 D established her residence and domicile in Virginia. She died in 1953 appointing the property in question by will to her husband, H. She also left him $118,000 of her own property. The Department of Taxation combined these two amounts thereby putting H in a higher bracket and levied an inheritance tax of about $7,000 on H. W#58-152 permits such a tax on D's separate property willed to H, and on the appointed property provided that it is within the jurisdiction of this Commonwealth.

Held: (1) It was error to combine the two amounts as part of it comes from one source and part from another. (2) That the appointed property was constructively within Virginia under the principle that movables constructively follow the person if that person has substantial powers of ownership. The power to appoint property on one's death is a substantial power and from the standpoint of inheritance taxation is the equivalent of ownership. Hence an inheritance tax was properly assessed on the value of the stocks and bonds despite the fact that they were physically in New York at all times.

STATE TAXATION--End of indebtedness

Appellants were railroads who owned obligations of states and political subdivisions thereof, other than those of Virginia. The State Corporation Commission ruled that a certain portion of these obligations was allocable to Virginia and taxable under the laws of This State. The appellants claim that they have not been taxable under these laws since 1954.

Held: The 1952 amendment to our tax laws effective in 1954 (W#58-406) exempts those who are required to pay income taxes from the payment of personal property taxes on evidence of indebtedness (unless such evidences of indebtedness are a part of the taxpayer's capital or moneyed capital or merchant's capital under certain specific sections). Railways pay franchise taxes but no income taxes. Hence the 1952 law is not applicable to them, and they are taxable on a proper portion of the obligations owned by them as heretofore.
W/58-128 provides that every foreign corporation doing business in this State shall pay an annual income tax. The F Corporation is a Delaware Corporation with its principal office in New York. It does not maintain any manufacturing facilities, stock of goods or inventory in Virginia. It does maintain a sales office in Richmond. Its salesmen solicit orders from wholesale dealers. They also interview systematically persons who may need their products and urge such persons to place orders with wholesalers who in turn have placed orders with the F Corporation.

Held that such systematic sales activities constituted doing business in Virginia within the meaning of the income tax laws.

STATE TAXATION 202 Va.86

Section 183(e) of the State Constitution exempts from taxation "real estate belonging to, actually and exclusively occupied and used by *** hospitals ***conducted not for profit, but exclusively as charities, ***". The City of Richmond attempted to collect taxes from two hospitals which were not organized for profit, whose officers and directors received no pay, which took all patients they could handle whether they could pay or not, but which insisted on pay from all those who could pay. Only a small part of the patients were not able to pay anything. The City contended that unless a considerable proportion of the patients did not pay, the hospitals were not charities.

Held for the hospitals. They are clearly charities just as private educational institutions not operated for profit but charging tuition are charities. It is the purpose for which it is organized plus the fact that no individual receives a profit (direct or indirect) from the operation that determines its status as a charity. To require that wholly indigent persons must be taken in "considerable" numbers would produce chaotic uncertainty and infinite confusion.

STATE TAXATION Constitutional Law 202 Va.409.

The town of Ashland which is an integral part of Hanover County (which county charges a license tax on cars) pursuant to power given to it by W/46.1-65 imposed a license tax of ten dollars per year on all cars owned by residents of Ashland that were operated on the city streets. The County tax was diminished by the amount paid to the town. The County contended that the statute was void because it violated section 168 of the Constitution of Virginia as to uniformity (since the town might have a higher rate than the county), and because it violated the 11th Amendment of the United States Constitution in that it denied some of the people of Hanover County the equal protection of the laws since the money collected by the County was used for the benefit of all the people in the County including the people of Ashland while that collected from them was used solely for their benefit.

Held: Statute is valid. The legislature has the power to create local tax districts. Since the license tax is not a tax on the car but on the privilege of driving the car on the city streets of Ashland, section 168 has no application as that section applies only to direct taxes on property. The fact that a tax indirectly affects property does not necessarily make it a tax on that property. Nor does the 11th Amendment require absolute equality of taxation. It permits reasonable classification and flexibility.
An ordinance of the Town of V provided that every person who "shall engage in the business of renting" property in the Town shall pay certain taxes. P leased her land to the Sun Oil Co. at a monthly rental of $125 for 25 years. She now contends that one act of leasing is not engaging in the business of renting property. The Town contends that collecting the rent every month for 25 years is more than one act and does constitute "engaging in business."

Held: For P. One act of renting is not a business. To be a business there must be a continuous and regular course of dealing. The tax is on the renting which was one act and not on the collecting, so it is immaterial that there will be hundreds of collections. Note: It was also held that revenue laws are to be strictly construed and that their meaning cannot be enlarged by implication.

STATE TAXATION Railroad Land

By Section 176 of the State Constitution the State Corporation Commission is required to appraise real property belonging to railroads. The R.F. & P. R.Co. owns 313 acres of land in the heart of Alexandria which is used for a freight and interchange yard. An interest in this property was leased to X for 99 years in the year 1901 at what was then a reasonable rent. This rent is now grossly inadequate but cannot be raised. The R.F. & P. R.Co. claims that this fact should be taken into consideration in assessing this realty for taxation.

Held: There is no merit in this contention. The entire fee simple must be taxed. A leasehold in realty is not taxable in Virginia unless the owner of the fee cannot be taxed. One cannot escape taxation on the full value of the fee by leasing it to a friend or to a corporation in which he may be the principal stockholder for a nominal sum. Note: It was also held in this case that this land should be valued as if it were real estate owned by anyone other than a public service corporation.

STATE TAXATION Exempt property

The Trustees of Randolph-Macon College became concerned about the lack of land for the College and the lack of faculty housing so they bought land adjacent to the College for use and sale to faculty members with an oral right of refusal to sell. Hanover County sought to tax this land.

Held: Exempt. "Where the dominant purpose of an institution or corporation exempt from taxation under #183(c),(d) and (e) of the Constitution is to use property or to acquire it for purposes of resale to obtain revenue or profit, although it is to be applied to the general objects of the institution, the property is liable for taxation. But if the use or sale of the property has direct reference to the purposes for which the institution was created and tends immediately and directly to promote those purposes; it is then within the exemption provision of the Constitution, although revenue or profit is derived therefrom as an incident of its use or resale". The faculty is the heart of the College, and they must have housing near the College.

STATE TAXATION Assessment

P owned two dams in the James River, A dam, and B dam. In determining the value of A dam the tax assessors had taken into consideration the fact that it would cost something like half a million dollars to build such a dam today. There is no feasible use for the dam at the present time.

Held: The assessment should be made on the basis of the present fair market value of $10,000, and excess taxes collected in prior years refunded as per V#58-1148.

In the case of B dam, X was the owner of a dominant tenement and as such owner had certain easements that affected the value of B dam.

Held: This fact should have been taken into consideration by the tax assessor, and the dominant tenement assessed at that much more and the servient tenement at that much less.
STATE TAXATION—Estate and Inheritance Tax Apportionment Page 7 204 Va. 660.

F and S were father and son. F put certain stock in escrow for S who was to have full possession and control of same on F's death. F retained during his lifetime the right to any dividends and the right to vote this stock. Portions of F's will read substantially as follows, "Having provided for S most generously by giving him certain stock all without cost to him I make no further gifts to him;" and, "I hereby direct my executor to sell any and all of my property, real or personal, which has not been specifically bequeathed or devised for the purpose of realizing sufficient cash to pay all my debts and taxes including estate and inheritance taxes." Suppose the testamentary estate is twice the value of the stock (which is part of F's gross estate under the tax laws) should the estate and inheritance taxes be paid in the proportion of 2 to 1 by those who took under the will and by S?

Held: Not in this case. The apportionment act (Va. Code Ann. §48-150 et seq.) which provides for apportionment also allows the testator to designate the property he wishes to be charged with the payment of estate and gift taxes, and if he does, then the will of the testator prevails. Here F has designated the property to be sacrificed for the payment of these taxes so that the takers of the testamentary estate are liable for the whole and S is not liable at all as among themselves.

STATE TAXATION Assessment 205 Va. 192.

The Viscose Corporation owned 207 acres of land on which were 40 buildings in the City of Roanoke. These premises were used for the manufacture of rayon. In 1959 it became impossible to operate at a profit and the plant was shut down and offered for sale as a unit for $6,000,000. Later an option was given to X for $4,000,000 but X decided against exercising the option. Finally the plant was sold for $1,250,000 to a partnership composed of several corporations. The tax assessors assessed the property at around $1,600,000. By statute such an assessment is presumed to be correct and the burden is on the taxpayer to show either that the assessment exceeds its fair market value or that the assessment is out of line with the assessment of like properties. Viscose contended that the fact that the premises were sold for some $350,000 less than their assessed value was enough in itself to overcome the presumption of correctness of the assessment.

Held: Assessment confirmed. The obtained sales price is only one element to consider. In the instant case there was no evidence introduced as to the ownership of the corporations which formed the partnership for the purchase of the property. Viscose has not met the burden of overcoming the presumption of the correctness of the assessment.
The F pipeline company was incorporated in Delaware but carried on all its business in its executive office in Atlanta. In order to obtain the right of eminent domain in Virginia, if formed a subsidiary Virginia corporation which was under F's control. In Oct. 1963 the State Corporation Commission held that there was no statute under which pipelines transporting petroleum products were taxable. The next session of the legislature (1964) passed a tax law as an emergency act which became effective on March 10, 1964 and which was made applicable from the first day of that year. This law assessed taxes on the intangibles of pipeline companies on an ad valorem basis in proportion to investment in Virginia to total investment. The company had some $19 million dollars deposited in New York banks and 31/2 million in non-taxable U.S. securities. F contended that the 1964 tax law was invalid because retroactive thereby preventing it from exchanging taxable money for non-taxable U.S. securities and hence, arbitrary and unjust and in violation of state and federal constitutions. It also contended that the state of Virginia had no power to tax intangibles having a business situs outside of the state of Virginia.

Neither of the company's contention has merit. When it learned in October of 1963 that there was no applicable taxing statute it was, as a practical matter, put on notice that the next session of the legislature would remedy this state of affairs. It did not have a vested right to know the kind of taxation in advance so that it could avoid it.

The tax law as passed which taxed F's intangibles is reasonable and constitutional as Virginia in return therefore has given F the right of eminent domain and the protection of its business. It is immaterial that these intangibles may constitutionally be taxed by some other states. Note: as a matter of fact, however, in the instant case, no other state had levied a tax in such a way that it amounted to double taxation.

STATE TAXATION--Retroactive Tax on Out of State Intangibles 206 Va. 207 Va. 174--The Citizen's Foundation of the Richmond Professional Institute, Inc., a non-stock, non-profit corporation whose function it is to acquire property for RPI, held legal title to 3 parcels of land on which a dormitory is located, and the 3rd is rented out to private citizens. By its charter, the foundation is bound to convey at any time to RPI much of its unencumbered land as RPI demands. The City of Richmond sought to impose taxes on this land, arguing that it had no indicia of ownership and no control over the property.

H.B. sec. 183 of the Va. Const. exempts from taxation property owned directly or indirectly by the state or any subdivision thereof. Though the legal title to the property may rest in someone else, if the beneficial interest therein is vested in a public corporation created, managed, and controlled by the state, then the property must be said to be owned indirectly by the state. Only property not belonging to the state, and which is otherwise exempt, loses its exemption when it is leased or becomes a source of revenue or profit.
Tax on Individuals
1. Tax Imposed
2. Joint Return Surviving Spouse

Tax on Corporation
11. Tax Imposed (22% + 46%)

Definitions
61. Gross Income
62. Adjusted AGI
63. Taxable Income

Items Included in Gross Income
71. Alimony (§215) - Income & wife minus child support payments
72. Annuities
73. Services of Child
74. Prizes and Awards
79. Life Ins. Purchased for Eeoo (Excludable up to cost of $50,000)

Items Excluded from Gross Income
101. Death Benefit ($5,000 limit - life ins. proceeds)
105. Gifts and Inheritances
104. Sick Pay - Damages for personal injury
105. Amount under Accident and Health Plans - (Sick Pay - 75% - 25%)
106. Contributions by Employer Accident & Health Plans
108. Discharge of Indebtedness (§1017) - Cancel debt & reduce income
111. Recovery - Bad Debts prior to 1957 (tax benefit not allowed)
116. Partial Dividend Exclusion ($100)
117. Tuition Exclusions (§117) - all
118. Contributions to Capital of Corp (§362)
119. Meals & Lodging (convenience of tax)

Standard Deduction
141 to 145 - Standard Deduction
Personal Exemptions Deduction
151 to 154 - Exemptions

Itemized Deductions for Individ & Corp.
162 - Trade or Business (§274) (See Reg. Sec. 263A.2334P) Travel
163 - Interest
164 - Taxes
165 - Leases
166 - Bad Debts
167 - Depreciation
170 - Charitable Contributions
172 - Net Operating Loss (Carryback 3 yrs. Carriage 5 yrs.)

Additional Itemized Deductions for Individ.
213 - Expenses for Production of Income
218 - Medical
214 - Care of Dependents (600 limitation)
215 - Alimony Payments (871 non income)
217 - Moving Expenses

Special Deductions for Corporation
243 - Dividends Recl by Corp.
248 - Organizational Expenditures (allow deduction of organ. expenses)

Items Not Deductible
334 - Interest
363 - Personal Living Expenses
365 - Capital Expenditures
366 - Expenses Relating to Tax Exempt Income
367 - Related T/P Transaction Expenses
369 - Acquisition & Realize Income Tax
374 - Entertainment Expenses (Limitation on §162) Travel
351 - Transfer to Corp. Controlled by Transferor (80%)
362 - Basis to Corp. (§118)

446 - Methods of Accounting

Taxable Yr. For Gross Income
451 - Gen. Rule
453 - Installment Method

Taxable Yr. For Deductions
461 - Gen. Rule

Adjustments
482 - Allocation of Inc. & Deductions (Adjust income/property)
483 - Deferred Payments Interest

Trust Income Rules
671 - Clifford Rules
678

70% (c) Partners Distributive Share

Gain or Loss on Disposition of Property
1001 - Adj. & Recog. of Gain or Loss
1011 - 1032 Basis
1012 - Basis of Property - Cost
1014 - Basis of Property Acquired from Decedent
1015 - " " " By Gift
1016 - Adjustments to Basis
1017 - Discharge of Indebtedness (§108) (Adjust for value basis)

Common Nontaxable Exchanges
1031 - Exchange of Production Use Property for Like Kind
1032 - Exchange of Stock for Property
1033 - Involuntary Conversions
Capital Gains & Losses

1201- Alternative Tax (Corp. & Individual)
1202- Reduction for Capital Gains
1211- Limitation on Capital Losses
1212- Capital Loss Carryover
1221- Capital Asset Defined
1231- Property used in Trade or Business & Invest. Conversions
1232- Bonds & Other Evidence of Indebtedness
1239- Gain from sale between Sponsors or between an Individual & Controlled Corp. (80%/Rule)
1245- Gains from Dispositions of Certain Depreciable Property
1250- Gain from Dispositions of Certain Depreciable Realty
Why is income allowed to be split between husband and wife if they so desire in the case of joint returns?

Prior to the split-income provisions taxpayers in community property states enjoyed a considerable tax advantage. Here is how it works: If a taxpayer has $10,000 gross income and deductions of $1500, and if his wife has no income and they have one child and they file a joint return, the combined net income is $8500 and the applicable personal exemptions are $1800 (three at $600 each). $8500 less $1800 equals $6700 taxable income. By the use of selective tax tables (Joint Return Tax Table in this case) the income of the husband will be automatically split between husband and wife so that taxpayers in community property states will be taxed in the same manner as those in community property states. In the instant case reference to the proper 1964 Tax Table shows that the tax on $6,700 is $680 plus 18% of $2,700 or a total of $1,220.

2. What are the three broad kinds of federal income taxpayers?
   (a) Individuals--Form 1040, Form 1040A or Form 1040A Separate, or Joint, or "Head of Household"
   (b) Fiduciaries--Form 1041
   (c) Corporations--Form 1120

Every individual under 65 years of age with a gross income of $600 or more whether adult, minor, or insane (the latter two through a guardian or committee) must file a return. But a taxpayer who reaches the age of 65 during the taxable year need not file a return unless his gross income exceeded $1200. Fiduciary return must be filed on behalf of an estate or trust with a gross income of $600 or more, and on or behalf of a trust with any taxable income. All partnerships must file returns, but this is for informational purposes as partnerships are not taxpaying entities and no tax liability is imposed.

3. What is meant by the expression "Taxable Year?"

The taxable year is the calendar year, except for those who wish to use a fiscal year (a 12 month period ending on the last day of any month other than December) and have an established accounting period other than the calendar year and keep their books on that basis. Those reporting on the calendar year basis must have their final return in by April 15th of the following year. (the fiscal year—on the 15th day of the fourth month following the close of such taxable year)

4. What are the basic steps in computing the tax?
   (a) First find gross income
   (b) Subtract all "business" deductions to find Adjusted Gross Income.
   (c) Subtract either the Optional Standard Deduction or the other deductions of a non-business nature (charitable contributions, interest, taxes, medical expenses, etc.
   (d) Subtract personal exemptions to find "taxable income."
   (e) Computation of the tax.
   (f) Applying credits against the tax.

5. How are income taxes collected for the most part "pay as you go?"

By two methods: (a) Withholding taxes from salaries; (b) by payments of an estimated tax in quarterly installments. Insufficiencies or excesses are adjusted upon or following the filing of the return for the taxable year.
6. Who must file a declaration of estimated tax on Form 1040-Es?
   (a) Any individual whose gross income can reasonably be expected to include more
       than $200 of income not subject to withholding.
   (b) A single person other than a head of a household, or a "surviving spouse", or
       a married person who cannot file a joint return if his gross income, even though
       subject to withholding, exceeds $5,000.
   (c) A head of a household or a "surviving spouse" who can reasonably expect an
       income, even though subject to withholding, in excess of $10,000.
   (d) A married couple eligible to file a joint return who can reasonably expect an
       income, even though subject to withholding, in excess of $10,000.

   But no declaration is necessary in any of the above cases if the estimated tax can reasonably be expected
   to be less than $50. The declaration must be filed on or before April 15, June 15, Sept. 15th, and Jan. 15 of the following year, depending upon in which quarter the requirements for filing are first met. In lieu of amendment on Jan. 15 of the following year or in lieu of filing a declaration if the requirements are first met after Sept. 1 the entire tax still due can be paid in full upon the filing of a return on or before Jan. 31st following the taxable year for which the return is made.

7. H and W were husband and wife. W died on July 1. May H still file a joint return?
   Yes, if assented to by the personal representative of the decedent, or not disaffirmed by the personal representative if the latter is appointed after the due date for the filing of the return. But this privilege is lost if the surviving spouse remarries before the close of the year.

8. What two types of accounting bases are recognized?
   Cash basis and accrual basis. Under the latter taxpayer reports income in the year in which his right to receive it becomes fixed, and takes deductions in the year in which his liability is fixed irrespective of when paid. Only those who actually keep books on the accrual basis of accounting may make their returns on such a basis.

9. Give three examples of constructive receipt of income by those on the cash basis.
   (1) Interest credited on a bank account even though not withdrawn:
   (2) Coupons on bonds that have matured but have not been cashed:
   (3) Checks received but not cashed.

10. X sued Y and recovered statutory treble damages. Is there any gross income?
   Yes. All sums received in excess of compensation for the wrong done are taxable income. So held after conflicting decisions in the courts of appeals in 75 S.Ct. 473.

11. Are tips gross income?
   Yes, even though they were paid without legal duty, as they are regarded as compensation for services performed. Gifts, on the other hand, are not taxable income unless the gift is of a right to receive income. Nor are legacies, but bonuses given for work done are taxable.

12. Taxpayer received $54,000 taxable income in 1964 from sources other than capital gains, wagering gains, income from gifts or bequests, and premature distribution received by owner-employees under a pension plan. His average income for the 1 years 1960-1963 was $9,000. What relief does the law now permit?
   It permits averaging of income if the "averagable income" (in this case $54,000 less $3,000) is in excess of $3,000 thereby lowering the tax bracket for 1964.

13. Is there double taxation in the corporate form of doing business?
   Yes. The profits earned by the corporation are taxed first to the corporation and then taxed as dividends to the stockholders upon distribution. Under the 1964 Act
1. When, if at all, are stock dividends taxable?

The general rule now is that stock dividends (even though resulting in change of interest) are treated as income only when the dividend is paid in lieu of money.

15. X owned 10 shares of common stock with a taxable base of $100 each. He received a stock dividend of 10 more shares of common stock. Five months later he sold 6 shares for $360. What was his taxable gain?

When X received 10 shares as a stock dividend he received no income. He merely had 20 shares where he used to have 10. But the taxable base is halved and becomes $50. When he sold six shares at $60 per share he received taxable income of 6 times $10 or $60.

16. How are annuities taxed?

(a) Annuities received as a gift under a trust are taxable to the extent that they are paid from the income of the trust, but to the extent they come from the principal they are gifts and not taxable as income.

(b) In the case of purchased annuity contract 3% of the cost of the annuity was treated as income prior to Jan. 1, 1954; the rest as a return of the cost, but after one had been repaid the cost then the whole was income. This was known as the 3% rule and is still of importance in spite of changes in the law. Instead of the 3% rule there are now several new rules.

Under the present law in order to find the amount of an annuity that is a return of capital (i.e. the amount excluded from income) we must find the life expectancy of the individual, the cost of the annuity called the "investment in the contract" and the "expected return" as of the annuity starting date.

Example of the "Life Expectancy Rule" for life annuities: X purchased on Jan. 1, 1950 for $40,000 a life annuity payable to him at the rate of $1,000 per year beginning Jan. 1, 1951. For the years 1951, 1952, and 1953 X recovered back $8,400 of the $31,600 under the 3% rule. He received $12,000 during the three years. 3% of $40,000 or $1,200 per year was income and $2,800 per year was a return of the cost. 3 times $2,800 is $8,400. Assume that X's life expectancy on Jan. 1, 1954 was 10 years. How much of the $4,000 is to be regarded as income and how much is to be excluded from income? First find the investment in the contract as of the date it was made if after 1953, or, if made before 1954 as of Jan. 1, 1954. In our case it is the $40,000 less $8,400 already recovered under the 3% rule or $31,600. Divide this sum by the life expectancy 10. This gives the sum to be excluded as $3,160 and the taxable income as $4,800 less the $3,160 or $3,640. If X lives 15 years instead of ten years there will be no change in the figures in spite of the fact that he will have gotten back far more than he put in.

Notes: (1) If X received dividends before 1954 these go in diminution of the investment in the contracts. Dividends received after 1953 are fully taxable income.

(2) If X buys an annuity for a definite time as for ten years paying $40,000 for it and is to receive $5,000 per year for the ten years X receives as income $1,000 per year under the installment annuity rule instead of nothing for the first eight years and $5,000 per year for the last two years as was the case before 1954 changes in the law.
(3) If an insurance policy becomes payable in a lump sum and the beneficiary within 60 days of the time it becomes payable elects to receive the proceeds in installments the rules as to annuities apply.

(4) Pensions to which an employee has contributed are treated like annuities, but payments received under the Social Security Act are not taxable income. But if retirement pay to which an employee has contributed will be large enough to repay the retired employee the full amount of his contributions to the plan within three years, then there is no tax on the sums paid to the retired employee until he has been repaid his entire contribution, and after that everything received as retirement pay is taxable.

17. X owns a frame building which he leases to a tenant at a rental of $100 per month. He paid $80 for painting, $30 for fire insurance for the year in question, $500 for an additional room completed at the end of the year, and his real estate taxes were $90. X bought the building on Jan. 1, 1954 for $9,000. It has an estimated useful life of 30 years. What is X's taxable income?

$1200 less $80 for painting less $30 fire insurance less $90 for taxes less $300 for depreciation or $700. The added room was a capital expenditure. The base of the house for the next year will be $9,000 less $300 depreciation plus $500 capital improvement or $9,200.

18. X owned a store. He took in $18,000 from goods which cost him $17,700. If he had no other income must he file a return?

No. His gross income was only $300. Gross income in the operation of a business consists of total receipts less the cost of the goods sold. The cost of goods sold is normally determined by the following formula: Inventory at beginning of year at cost or market price whichever is lower, plus cost of purchases during the year, less inventory at end of year at cost or market price whichever is lower. Inventories must be used wherever the production, purchase, or sale is an income producing factor in the business and the accrual system of accounting must be used for purchases and sales.

19. What are the three tests to determine whether an item is deductible as a business expense?

(1) It must have been incurred in connection with the operation of the business as distinguished from personal expenses paid out of business funds,(2) It must have been paid for a current expense as distinguished from a capital improvement.(3) The expense must be both "ordinary and necessary."

20. Are travelling expenses deductible?

Yes, if incurred while away from home in the pursuit of a business or profession. Street car fares and automobile expenses incurred in going to and from work from and to one's home are personal expenses and not deductible.

21. If X is a stockholder and officer of a corporation is he entitled to a salary free from corporate income taxation?

Yes, as long as the salary is a reasonable one which is a question of fact in each case. To the extent that the salary is unreasonably high the corporation is regarded as having received it as corporate income and then given it to the officer as a disguised dividend. (Note: If X runs a business and pays his brother, B, twice what should be paid for the services rendered, X can only deduct half what he pays B because of the ordinary and necessary rule, but B is taxable on the full amount paid to him.)

22. X, a doctor, kept his books on the cash basis. A patient who owed him $1,000 became totally insolvent. Can X deduct this amount as a bad debt?

No. Since X never counted it as income he cannot deduct it from his income. But if X had kept his books on an accrual basis the patient would have been charged with $1,000 and income credited to that extent. In such cases the taxpayer may either deduct specific bad debts that became worthless in whole or in part during the year, or he may deduct an annual addition to a reserve for bad debts. Having elected to do the one or the other he must be consistent over the years and cannot change his method without special permission.
23. X paid $5,000 for a new machine on Jan. 1, 1961 which has a probable useful life of five years and a salvage value of $500 at the end of the five year period. What is the largest amount deductible for the taxable year of 1961 for depreciation?

The law allows three methods of depreciation in this case and the taxpayer may take his option.

1. Straight-line depreciation of 20% ($900 per year for five years).
2. (double)declining balance method. Double the percentage used in the straight line method and apply the percentage obtained to the unrecovered cost each year. In our case doubling 20% gives 40%. The depreciation for 1961 is 40% of $5,000 (salvage value is not taken into account in using this method) or $2,000; for 1962 it is 40% of $3,000 or $1,200; for 1963 it is 40% of $1,800 or $720; for 1964 it is 40% of $1,080 or $432, and for 1965 it is 40% of $648 or $259.20 (but limited to $148 as it may not be depreciated below the $500 salvage value.) In order to use the double declining balance method the useful life of the article must be more than three years and the property must be new, i.e., new in use. Otherwise more than one person might depreciate heavily the first years of his use.
3. The sum of the digits method. The denominator of the fraction used is the sum of the digits (in our case 1 plus 2 plus 3 plus 4 plus 5 or 15 since the useful life is 5 years). The numerator is the remaining useful life of the property at the beginning of the year. Hence in our case 5/15 of $4,500 would be deductible the first year, 4/15 the second year, 3/15 the third year, etc.

Thus the answer to question 23 is $2,000 by using the (double)declining balance method. Note 1: Such assets as land, good will, and inventories are not subject to depreciation. Note 2: A taxpayer who fails to claim an allowable deduction for depreciation in any year will not be permitted to claim such a deduction in the later year, but if he sells the article ‘we will be required to take into consideration the depreciation actually allowed or that which was properly allowable, whichever is the higher. Example: Taxpayer sold a truck for $2,000 which was three years old. Assume that depreciation is $500 per year. If he neglected to take depreciation during the first year and paid $2,500 for the truck the base is nevertheless $2,500 less $1,500, or $1,000 and he has made a gain of $1,000. Note 3: A 1958 amendment provides for a new additional first year depreciation allowance for tangible personal property with a useful life of at least six years acquired after 1957 in the amount of 20 per cent of the first $10,000 of the cost thereof ($20,000 if a joint return). This is in addition to the regular depreciation previously allowed but this regular depreciation must be computed on a basis that has been reduced by the amount of this newly allowed additional first year depreciation.

24. X who was engaged in trade or business suffered a net operating loss of $50,000 in the year 1958. What are the tax consequences?

The law allows the loss to be spread out over a nine year period by a formula which allows the loss to be carried backward for three years and forward for five years.

25. X bought a home for himself in 1948 for $22,000 of which $2,000 was allocable to land. The useful life of the house was 40 years. He sold it in 1958 for $25,000. What are the tax consequences?

Since depreciation cannot be claimed on one’s home the base remains at $22,000. Hence there is a gain of $3,000.

26. Assuming that X decides to rent in the future or buys another home for $22,000 or less how is the $3,000 taxable gain taxed?

The home was a long term capital asset. Such gains are recognized in full. X is however entitled to a deduction equal to 50% of the excess of net long term capital gains over the net short term capital losses occurring during his taxable year.

27. Suppose that within a year before or after the sale X acquired another residence for $25,000 or more, or started construction of a principal residence within a year and actually occupied it within eighteen months of the sale, what are the tax consequences?

No taxable gain is realized. But the $3,000 profit will reduce the basis for the new house by that amount.
28. X paid $5,500 for a new family car with a useful life of five years and a $500 salvage value. He sold the car to Y at the end of three years for $5,000. What are the tax consequences?

None as far as X is concerned. Since he could not deduct the depreciation the basis remained at $5,500 for purposes of determining gain, and losses on sale of property used personally are not recognized.

29. In determining gain or loss in the case of a sale of property what is meant by the unadjusted basis?

(a) If acquired by purchase, it is ordinarily the cost of the property. If acquired by purchase prior to March 1, 1913 the basis for purposes of gain is the value on that date if greater than the cost.

(b) If acquired by gift, the donee's unadjusted basis for purposes of gain is the cost or other basis of the property to the donor, or to the last preceding owner by whom it was not acquired by gift (increased however by any gift tax paid by the donor to the extent that market value is not thereby exceeded).

(c) If acquired by devise, bequest, gift in contemplation of death, survivorship, dower, curtesy, or inheritance the basis of the property is its fair market value on the date of the death of decedent but if the personal representative of the decedents estate valued the property for estate tax purposes as of a date other than the date of death, the value established for such purposes constitutes the unadjusted basis. Note 1: If X buys stock at $10,000 in 1933 and dies in 1954 leaving the stock to Y by will and it is then worth $50,000 the basis for Y is $50,000, and if Y sells it for $50,000 there has been an overall profit of $40,000 which wholly escaped income taxation. Note 2: To find the adjusted basis it is necessary to take the unadjusted base and make such adjustments as are called for, such as allowable depreciation and capital improvements.

30. X bought stock for $50,000 and four months later sold it for $60,000. What are the tax consequences?

He has taxable income of $10,000 which is not entitled to a 50% deduction as it would have been had he held it for six months or more. It was a short term capital gain rather than a long term one.

31. X bought a store and the lot on which it stood for $40,000. He sold the store and lot ten months later for $50,000. What are the tax consequences assuming inventory was the same on both dates and disregarding depreciation.

Assuming that $2,000 of the profit was applicable to inventory this $2,000 is a non-capital asset transaction and is fully taxable. The other $8,000 is now treated as if it were a long term capital gain because it was a sale or exchange of depreciable business property and business real estate—i.e., realty used in connection with business as distinguished from realty that is one's stock in trade.

32. X had a capital loss of $5,000 and no capital gains. Tax consequences?

His capital losses may be carried over for an unlimited period and used to offset capital gains, and up to $1,000 of ordinary income of taxpayers other than corporations. Such losses will be treated as long-term or short-term losses in the years to which carried, depending on which they were in the year incurred.

33. A real estate dealer bought a lot in January of 1954 for $20,000. If he were to sell it in August of 1954 for $15,000 how much loss could he claim?

The full $5,000. The result reached in problem 32 would not be applicable since the lot was not a capital asset. A capital asset is any property except the following: (1) Stock in trade, (2) Property held by the taxpayer primarily for sale to customers in the ordinary course of business, (3) Depreciable property used in trade or business, (4) Realty used in trade or business, (5) ---, (6) -----. Thus it is seen that the commonest types of capital assets are securities held for investment, and the taxpayer's home or other property held for personal use.
Federal Taxation

34. X had owned a house for more than six months. Its basis was $5,000 but because of generally rising prices it was worth $8,000 and fully insured. It was completely destroyed by fire. X replaced the house (a) at a cost of $8,000; (b) at a cost of $6,000. What are the taxable consequences?

The case of an involuntary conversion of capital assets is specially treated. Under the Code this is treated as if it were a long term capital gain if no replacement is made. In (a) there is no taxable gain and the basis for the new house is $5,000. In (b) there is a taxable gain of $2,000 subject to a 50% deduction and the new basis is again $5,000.

35. X held stock for which he had paid $60,000. The value of the stock has fallen to $40,000, but X has full confidence that it will rise in value soon. X sold the stock for $40,000 on Sept. 7, 1953 and bought back similar stock at the same price 28 days later. Is he entitled to claim a $20,000 loss?

No. This is what is called a "wash sale." The period of time is 30 days before or after the sale.

36. Seller sold Buyer real estate for $100,000. Of this sum $20,000 was paid down in 1954 and secured notes were given for the balance one of which notes was for $40,000 payable in 1955 and the other for $40,000 payable in 1956. Seller made a profit of $30,000. Is this $30,000 income taxable all in one year?

It can be spread out over three years. In the case of casual sales of personal property for a price in excess of $1,000 and in any sale of real estate the gain may be reported on the installment plan provided the initial payment does not exceed 30% of the total payment. Evidence of indebtedness is not considered part of the initial payment.

37. Give several examples in which a discharge of indebtedness constitutes income?

(a) If A owes B $500 and B accepts work from A in discharge thereof A realizes $500 income; (b) A owes B $800 but discharges it by payment of $300. A has realized income of $500. But if the debtor is insolvent both before and after the settlement, or if the cancellation was intended as a gift rather than a business deal no income is realized.

38. List the commonest items that are generally regarded by the layman as income but which are excluded by law and hence are not taxable.

Life insurance proceeds paid by reason of the death of the insured, gifts, bequests, devises, inheritances, interest on state and municipal securities and a few federal bonds, compensation for injuries or sickness, rental value of dwelling house furnished to a minister of the Gospel as part of his compensation, muster-in pay, social security, military pay for service in a combat zone, certain allowances for dependents of service men and G I benefits.

39. What two types of deductions are allowed an individual taxpayer?

Those deductible from gross income in determining the individuals adjusted gross income, and those deductible from his adjusted gross income in determining his taxable income. We have already discussed the former as business expenses and capital gain losses. If an individual uses the standard deduction he is not entitled to itemize deductions of the second type. But where these deductions exceed about ten per cent of his adjusted gross income it pays to itemize deductions rather than to take the standard deduction or to figure the tax from the tax tables.

40. What should be remembered about contributions as deductions?

Contributions made to charities or to the government by individuals to be used exclusively for public purposes are deductible. Examples are Red Cross, Church, Institutions of Learning, Charitable Hospitals, Posts of War Veterans. No part of the next earnings of the recipient can inure to the benefit of any individual, and
Interested Deductible

41. X is buying his home. Is interest on the balance due deductible?

Yes. Interest paid for even personal matters is deductible. The exceptions are:
- Interest on money borrowed to carry income tax exempt securities, and paid on indebtedness incurred to purchase a single premium life insurance or endowment contract.

Tax Deductible

42. In making his return X deducted his Virginia income taxes. Was this proper?

Yes, if he has not taken the standard deduction. Other deductible taxes are state and local real estate, sales and use taxes, and gasoline taxes. Non-deductible taxes include inheritance, and gift taxes, federal taxes, assessments for local improvement, parking fees, license plates, state and local taxes on tobacco and alcoholic beverages, poll taxes.

Loss from Casualty or Theft

43. A tree fell on X's uninsured family car causing a loss of $1200. Is this loss deductible?

Yes. Losses from casualty or theft in excess of $100 (including embezzlement) even though of a non-business nature and if not due to wifil misconduct are deductible. But if property is merely lost the loss is not deductible. Note: In 327 U.S.404 it was held than an embezzler is not liable for not reporting embezzled gains because he had no claim to them and because of a definite unqualified obligation to repay such monies. But in general profits made from illegal efforts are income. It was held in a 5 to 4 decision (Rutkin v. U.S., 1952) that money obtained by extortion where there was a good chance the victim would never say anything was income.

44. X's home was ruined by termites. Is this loss deductible?

No. To be a casualty the loss must be due to sudden and unexpected causes. Thus loss caused by insects or disease or gradual erosion is not deductible. Nor are losses caused by personal injury or by the taxpayer. However, in one case where the termite invasion was shown to have been sudden, the loss was allowed.

Medical Expenses

45. X, a bachelor, had an adjusted gross income of $20,000 and medical expenses of $1300 none of which was for drugs and medicines. How much can he deduct?

If X is 65, or over, he can deduct the whole $1300. There is, with some exceptions too intricate to be considered here, a maximum medical deduction of $2500 per exemption (other than those for old age and blindness) with further maximums depending on status. If X is under 65 he can only deduct his own medical expenses in excess of 3% of his adjusted gross income—$1300 less $600 or $700. Amounts expended for drugs and medicines up to 1% of adjusted gross income are not deductible by those under 65.

46. Give examples of deductible medical expenses.

Payments to doctors, dentists, nurses, hospitals, druggists, medical appliances, ambulance, travel necessary to get medical care, eyeglasses, X-ray examinations or treatment, health insurance premiums.

Examples of non-deductible medical expenses are funeral expenses, cemetery plot, illegal operations or drugs, travel ordered by doctor for rest or change.

Note 1: Any sickness insurance received goes in diminution of the deduction.

Note 2: If taxpayer has a dependent who earns more than $600 but to whom taxpayer contributed more than half of his support taxpayer can still deduct medical expenses paid by him for the dependent within the statutory limits.

Miscellaneous Deductions

47. Which of the following are deductible as miscellaneous deductions?

- (1) Safety deposit box rent for securities
- (2) Legal fees paid for services in preparing income tax returns
- (3) Legal fees paid for contesting taxes claimed to be due
- (4) Union dues
- (5) Gambling losses in excess of gambling gains
- (6) Legal fees for preparing gift tax returns.
FEDERAL TAXATION  

All are deductible except the fifth. Gambling gains may be offset by gambling losses.

H and W were divorced and H pays W $200 per month alimony and $100 per month for the support of his child all pursuant to court order. What are the tax consequences? H may deduct $200 for alimony. This is income to W. He cannot deduct the $100 per month.

Note: For the above alimony rule to apply (1) the payments must be made periodically, i.e. for an indefinite period, or installment payments of a lump sum settlement to the extent of 10% of the principal sum if the entire principal is required to be paid within a period ending more than ten years from the date of the decree or written agreement incident to such decree. No deduction is permitted for alimony pendente lite. Amounts paid under a private separation agreement are deductible if the agreement is in writing, the parties are not living together, and no joint return is filed.

- What is the amount of the standard deduction which can be used in lieu of itemizing non-business deductions?

The taxpayer is entitled to a 10% standard deduction but not less than $100 for a married person filing a separate return plus $100 for each exemption, and not less than $200 for all other taxpayers plus $100 for each exemption. In no case is the standard deduction more than $1,000 and the maximum is $500 for married persons filing separate returns. If adjusted gross income is less than $5,000 the tax table must be used if deductions are not itemized. The three forms for individuals are:

1040 is the standard form which anyone can use.

1040A—If total adjusted gross income is less than $10,000 and consists entirely of wages reported on Withholdings Statements, or of such wages and not more than $200 total of other wages, dividends, and interest this form can be used. The Director figures the tax and sends a bill or refund if taxpayer's adjusted gross income is less than $5,000 and taxpayer elects not to compute it himself.

1040W is a streamlined version of 1040. It may be used by anyone whose gross income, regardless of amount, consists only of wages and not more than $200 of interest and dividends. Unlike 1040A, this form permits itemizing deductions whereas the 1040A can be used only if taxpayer is taking the standard deduction.

50. What are the five kinds of personal exemptions?

(1) Taxpayer's self exemption, (2) exemption for spouse, (3) blind exemptions, (4) 65 or over exemptions, (5) exemptions for dependents. Each exemption is $600.

51. What should be remembered about the spouse's exemption?

It applies only if the spouse has no gross income and is not the dependent of another person. It is the status on the last day of the taxable year that controls unless a spouse has died during the year.

52. What should be remembered about exemptions for children?

There are four requisites: (1) Child did not have $600 or more gross income unless under 19 years of age or a full-time student for at least five months of the taxable year, (2) received more than one-half support from taxpayer, (3) was either a citizen of the United States or a resident of the United States, Canada, or Mexico, or, if not such citizen or resident, was an adopted child living in the taxpayer's home and the taxpayer is a citizen of the U.S., (4) does not file a joint return with his or her spouse. Children include those adopted or placed for adoption in one's home.

53. What should be remembered about exemptions for others?

(a) The three requirements list above apply. (b) Only certain relatives are eligible. The more distant eligible ones are stepbrother-stepsister-stepmother-stepfather; mother in law-father in law-brother in law-sister in law-son in law-daughter in law, and uncle, aunt, nephew, and niece if these last are related by blood. Cousins are ordinarily too distant. Under the 1954 Code a non-relative can qualify if he is a member of taxpayer's household and lives in his home, and the relationship is not in violation of local law.
5. X, who is unmarried, supports his aged mother and father. Is he entitled to the
benefit of the split income features?

Since X is the head of a household and in good conscience entitled to equal treat­
ment with married persons special near-equalizing provisions have been passed for
the benefit of such persons.

Prizes and Awards

54.1 The Young Men's Club of the City of X gave Mr. Y a $5,000 award for being chosen
as the person under forty years of age who had done the most to "make the City of X
a better place in which to live." Mr. Y was given this award primarily because of
his work with teen agers. Is the $5,000 taxable income?

By express provision of the law (1954 #74) prizes and awards other than fellowship
grants and scholarships are includible in gross income unless they are made primarily
in recognition of religious, charitable, scientific, educational, literary or civic
achievement the recipient having been chosen without any action on his part to enter
the contest or proceeding and there is no duty to perform any substantial future
services. Mr. Y meets all these tests and hence the $5,000 award is not taxable
income.

Gift Tax

54.2 omitted because of change in law.

55. So far as federal gift and estate taxes are concerned what are the advantages of
making intervivos gifts rather than bequests or devises in a will?

(a) The gift tax rates are substantially lower, three-fourths as much.

(b) If a testator gives away some of his property both the gift tax and the estate
tax may be taxable in lower brackets.

(c) A citizen is allowed a specific exemption of $60,000 for the estate tax and an
additional specific exemption of $30,000 for the gift tax.

(d) The first $3,000 for gifts (other than of future interests) made to any person
in any year is excluded from the taxable gifts.

(e) The amount paid as a gift tax will not be part of the donor's taxable estate
on his death while no part of the estate tax is so excluded.

(f) If the donee is in a lower income tax bracket than the donor the total of in-
come taxes paid during the joint lives of the parties will be less.
FEDERAL TAXATION

56. X, a single person, made outright gifts in 1953 of $8,000 each to A, B, C, D, E, F, G, and H. In 1954 he made outright gifts of $10,000 each to A, B, C, D, and E. If these are all the gifts he has made, on how much does he owe a gift tax at the end of 1954 assuming that he paid no gift tax in 1953?

Total gifts are $64,000 plus $50,000 or $114,000. There are thirteen $3,000 exclusions in this problem, and there is a lifetime specific cumulative exemption of $30,000. Hence the amount on which X must pay a tax is $114,000 less $69,000 or $45,000.

57. X in his lifetime gave the College of William and Mary $60,000 all at one time. What gift tax, if any, is due?

None. Both the gift tax law and the estate tax law allow a deduction for gifts made to public, religious, charitable, scientific, literary and educational institutions that meet the tests specified in the statute.

58. Who is liable for the gift tax?

The gift tax is a lien upon all gifts for a period of ten years from the time the gifts are made, and if the tax is not paid by the donor when due, the donee is personally liable for such tax to the extent of the value of the gift.

59. X, a widower, wishes to give a total of $60,000 to his four children. How can he do so without even invading his $30,000 lifetime specific cumulative exemption?

He can give each child $3,000 per year for five years.

60. H and W were husband and wife. H owned realty in Virginia worth $100,000. He conveyed it to H and W as tenants by the entireties with survivorship. Both H and W had equal life expectancies. Has H made a gift of $50,000 to W?

Yes, for according to Virginia law H and W are now equal owners in all respects and one is no more apt to be the survivor than the other. However since the gift is to a spouse the marital deduction provisions apply. Under these provisions the gift is halved and then the $3,000 exclusion is applied. So the gift tax would be payable on $22,000.

Note: Effective in 1955 creation in real property of joint interests with right of survivorship will not result in immediate gift tax to the donor who furnishes all or most of the consideration, unless such donor elects to treat it as a gift at that time.

61. What is the difference between an estate tax and an inheritance tax?

An estate tax is levied on the estate as a whole at graduated rates, while under an inheritance tax system the distributable estate is first divided among the beneficiaries who are generally grouped into classes based on degree of relationship, and the property receivable by each person is subject to a tax at the rates applicable to the class of which he is a member. The federal tax is an estate tax; the Virginia tax is initially an inheritance tax.

62. A wealthy man died intestate. His sole heir wishes to sell some of the land he has inherited. How should he go about this project?

The estate tax until paid is a lien for 10 years upon all the property in the gross estate. However by following the procedure laid down in the Regulations an application may be made for release of the lien with respect to particular property which the estate may wish to transfer in advance of the final fixation of the tax.

Note: The executor is personally liable for the payment of the estate tax.

63. How large must the estate be before a return is required?

An estate tax return must be filed in every case where the gross estate exceeds $60,000.
66. What property comprises the gross estate?
   (a) All property of deceased except real property situated outside the United States. Note: There is no deduction of the gross estate for dower or curtesy.
   (b) Property transferred by decedent in his lifetime in contemplation of death, or taking effect on his death. All gift transfers made more than three years before death shall not be taxed as transfers in contemplation of death. Those made within the three year period are presumed to have been so made but the presumption is a rebuttable one.
   (c) Life insurance incidents of ownership of which were owned by the decedent, whether payable to the estate or a named beneficiary. Note: The above list is not exhaustive but constitutes the simplest of the cases. Generally, property would be included which was the subject of an inter vivos transfer made by the decedent under which he retained a substantial interest, or control over the ultimate disposition of the property, still outstanding at the time of his death.

67. What deductions are allowed?
   The specific exemption of $60,000, funeral and administration expenses, claims against the estate, charitable bequests and transfers, the marital deduction, and some others.

   There may also be a credit for a tax paid on a prior estate. The purpose of this credit is to lessen the effect of taxes on successive transfers within a reasonably short time. The Code allows a credit against the estate tax up to the amount of the tax on the property in a prior estate provided the prior decedent died not more than ten years before the present decedent. This credit cannot be more than the estate-tax saving if the property were excluded if the present decedent's estate. The credit is 100% if the first decedent died within 2 years of the present decedent; 80% if within 3 or 4 years; 60% if within 5 or 6 years; etc.

68. Explain and illustrate the marital deduction. — If one spouse leaves the other property by will or intestate succession, survivorship, dower or curtesy or statutory election in lieu of these, revocable trust, gifts in contemplation of death, life insurance and some others, the estate of the decedent is entitled to a deduction known as the marital deduction which cannot exceed 50% of the value of the adjusted gross estate. Illustration: Assume that Husband died leaving a gross estate of $200,000. To find the adjusted gross estate subtract funeral expenses, claims against deceased and costs of administration. Assume that these come to $50,000. The adjusted gross estate is thus $150,000 and $75,000 is the maximum amount allowable for the marital deduction. Now suppose Husband left Wife $70,000 by his will. Since $70,000 is less than $75,000 the whole $70,000 is deductible from the $150,000. Assuming that there are no gifts to charity there is $80,000 left in the estate. Subtracting the $60,000 exemption H's estate would be taxed on $20,000. If Husband left Wife the entire estate or any amount in excess of $75,000, the marital deduction would have been $75,000.

69. What requirements must be met in order for property interests passing to the surviving spouse to qualify for the marital deduction?
   (1) The decedent must be a citizen or resident of the United States. The status of his spouse in that respect is immaterial.
   (2) The property must be included in the gross estate for estate tax purposes. Foreign realty is not. W owns (all of the incidents of ownership in) a policy on H's life—the proceeds are not included in H's gross estate and do not qualify. More than 3 years before his death H gives W the income interest in Blackacre until his death, remainder absolutely and free of trust to W upon his death; the remainder passing absolutely to W at his death does not qualify as it is not to be included in his gross estate. But if the income had been reserved by H for himself for life, the value of Blackacre passing to W at his death would qualify as it would have been includible in his gross estate, irrespective of the interest in right having passed to her indefeasibly before his death.
   (3) The interest given to W must not be one which may terminate and pass to or merge in another's by reason of H's gift or bequest to such other. (a) A "terminable
"interest" is one which will terminate upon lapse of time (life estate, patent, copyright, term of years, joint interest with right of survivorship), or upon some contingency, precedent or subsequent, (to W so long as she uses the property as her principal place of abode—to son for life and if he should die without issue then to W—to W if she should be living at time of distribution of H’s estate—etc.) (b) If an interest in the same property is given to another by H (to W for life, remainder to X—installments of insurance proceeds to W and if she fails to survive guaranteed payment period, balance of installments to be paid to X—to X for life with power to draw upon principal, remainder to W—etc.) (c) and if by reason of such other’s interest, the interest given to W will pass to or merge in such other (to W for life, remainder to X—to W in fee but if she should remarry, then to X—etc.) If all three (a), (b), and (c), of these factors are present, the interest given to W is a non-qualifying terminable interest. However, three exceptions are provided by statute: (1) W may be given a life interest only, provided she also has a general power to appoint the remainder for the benefit of her estate if she so desires; (2) W may be given insurance proceeds installments, provided that she also has a general power to appoint the unrefunded balance in the event that she fails to survive the period of guaranteed payments; and (3) the disposition to W may be made dependent upon her survival of a common disaster or her survival of H by not more than 6 months. In general, although not conclusive, the design is that the interest given to W will qualify for the marital deduction if it is the kind of interest which, if not consumed by W during her lifetime, would be included in her gross estate upon her death.

In all events, the maximum marital deduction allowable is 50% of the adjusted gross estate, determined as set forth in 68.

70. Dr. X, who now has a net income of $20,000 a year from his practice, consults you as to how, if at all, he can make some tax savings and at the same time provide for an income after his retirement. What would you suggest?

Starting on Jan. 1, 1963 a self employed person may set up a qualified pension plan. He may contribute not to exceed 10% of his earned income or $2500—whichever is smaller—each year. Fifty per cent of this contribution is deductible as a federal income tax deduction. The earnings and capital gains of the fund are tax exempt during the period of accumulation. No withdrawals can be made without penalty until the self employed is 59 or years of age. Payment of benefits must start not later than 70½ years. If these payments take the form of an annuity, the payments are then taxed as any other annuity. If the self employed has employees, they must also be included.
1. Minimum tax rates for individuals have been reduced from 20% to 16% for 1964 and to 14% for later years.

2. Henceforth the following state and local taxes are no longer deductible: Taxes on cigarettes, tobacco or alcoholic beverages, poll taxes, and some selective sales taxes. Costs of license plates and drivers' licenses are no longer deductible.

3. In the case of non-business casualty or theft losses, only the loss in excess of each $100 theft or casualty is now deductible.

4. The first $100 of dividends (rather than the first $50) is now excluded from taxable income, and the 4% dividends received credit against the tax has been reduced to 2% for 1964 and abolished for later years.

5. Excludable Sick Pay--If an employee receives more than 75% of his regular pay while sick or injured there is now a 30 day waiting period before he can exclude such pay from income (maximum $100 per week) and this is so regardless of injury or hospitalisation. If he receives 75% or less of his pay there is only a 7 day waiting period and not even that if employee is hospitalised for at least one day (maximum exclusion in this case is $75 per week during the first 30 days.)

6. Sale of Residence by Person over 65.--A person over 65 is allowed to exclude any capital gain up to $20,000 of the sale price of his personal residence provided that the premises so sold have been used by him as his principal residence for at least 5 of the last 8 years preceding the sale.

7. Capital losses may now be carried over for an unlimited period and used to offset capital gains, and up to $1,000 of ordinary income of natural persons. Such loss carryovers will be treated as long-term or short term losses in the years to which carried, depending on their nature in the year incurred.

8. If a taxpayer is over 65 the 1% floor on medicine and drug expenses has been abolished.

9. Change in Standard Deduction.--The new minimum standard deduction for all taxpayers (other than married individuals filing separate returns) is $200 plus $100 for each exemption allowable to the taxpayer. On a joint return the minimum standard deduction is $400. In the case of a married person filing separately it is $100 plus $100 for each additional exemption. The maximum allowed is still $1,000 for joint returns or returns of single individuals, or $500 for separate returns of married taxpayers.