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I suspect that in recent years in most discussions about Revenue Rulings top priority was given to Rulings concerning deferred compensation and other related employee fringe benefits. This discussion today, absent the tax reform now pending, would have commenced by proclaiming joyously the consequences of *Technical Information Release 1019,* which concedes the status of professional corporations.[1] But, as you know, the *Tax Reform Act of 1969** will greatly reduce the impact of that recent concession.

Under the House Bill, H.R. 13270, all corporations electing under *Subchapter S of the Internal Revenue Code,* will be subject to the contribution limitations now imposed on the so-called H.R. 10 retirement plans.[2] The Senate Finance Committee, not content with reaching only those professional corporations which elect under Subchapter S, has proposed an amendment to the House version of the 69 Reform Bill, which would impose the same Contribution Limitations referred to above on all professional corporations.[3] Therefore, any shareholder of a professional corporation will for purpose of retirement plans be treated, in some respects, like a self-employed individual.

In spite of the *Tax Reform Act of 1969,* the self-employed person in his new status as an employee will avoid some of the disadvantages he experienced under a self-employed plan.[4] In addition, other employee

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[1] TIR-1019 Aug. 8, 69, 696 P-H Federal Taxes, ¶5534.

* All references to the *Tax Reform Act of 1969* reflect the status of that Act as of Dec. 6, 1969.

[2] The new section 1379(b) provides that the shareholder-employee must include in income any contributions, under any deferred compensation plan, which exceeds the lesser of: 10% of his annual compensation or $2,500. H. R. Rep. No. 413 (Part 2) 91st Cong., 1st Sess. at 122.

[3] S. Rep. No. 552, 91st Cong. 1st Sess. at 270. Moreover, the limit on contributions would apply even where the shareholder-employee owns less than a 5% interest in the professional corporation.

[4] In addition to the non-discrimination requirements, which requires virtually all employees to be covered Int. Rev. Code of 1954, §401(d) requires, inter alia, that self-employed plans provide: (1) non-forfeitable benefits for all employees; (2) that the commencement of employer-employee benefits shall be no earlier than age 59½, except for disability. The advantages of §402 with respect to capital gains treatment under corporate plans has been somewhat reduced by the 1969 Tax Reform Act. See H.R. Rep. No. 413 (Part 1), 91st Cong. 1st sess. at 153.

fringe benefits which receive preferential tax treatment will now be available to the professional man as an employee of the professional corporation.[5]

As a result of the more stringent requirements under the *Tax Reform Act,* the professional man in his search for ways to defer compensation may choose to forego the use of a qualified plan in favor of a nonqualified plan.[6] A nonqualified plan may not be a plan at all. It may simply be a contract or an informal arrangement for deferring compensation. Court decisions rather than the Code or Regulations provide the chief source of law covering the nonqualified plans. The Code requirements covering discrimination, vesting, commencement of benefits, and exempt status of qualified plans do not apply to nonqualified plans.

The rules relating to deductions and inclusions under nonqualified plans can be summarized as follows. Section 404(a)(5) provides that contributions to the nonqualified plan are deductible when paid if the rights the employee derives from such payments are nonforfeitable.[7] Where the plan is unfunded the employer will not make any contribution except the actual payment of the deferred compensation and will receive a deduction at that time.[8] There is a "trap" in which an employer may be entangled where the plan is funded but forfeitable. The Service disagrees with those cases which permit the employer a deduction when the employee receives a payment from the funded forfeitable plan.[9] The Service tests deductibility under section 404(a)(5) and section 162 at the time the contribution is made and not at the time the payment is made under the plan to the employee. Therefore, under the Service view contributions made to a funded forfeitable plan would not be deductible by the employer either at the time of contribution or at the time of the payment to the employee from the fund. There is a provision in the Reform Act of 1969 which will permit the employer a deduction at the time the amounts are taxed to the employee.[9a] If the employee is a cash basis taxpayer and the plan is either unfunded or

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5 These include: group term life insurance purchased for an employee, Int. Rev. Code of 1954, §79; contributions by employer to accident or health plans, §106; wage continuation plans, §105.

6 The Senate Finance Committee deleted the provision from the House Bill which provided for a maximum tax rate of 50% on earned income. S.R. No. 552, 91st Cong. 1st Sess. at 309. Had this provision been retained the search for deferred compensation may have been lessened considerably.

7 Int. Rev. Code of 1954, §§404(a)(5), 162.

8 Ibid.

9 Russel Mfg. Co. v. United States, 175F. Supp. 149 (Ct. Cls. 1959); Mississippi River Fuel Corp. v. United States, 314F2d953 (Ct. Cls. 1963).

9a S. Rep. No. 552, 91st Cong. 1st Sess. at 144.

funded and forfeitable, the employee includes nothing in income until he actually receives the deferred payment.[10] Of course, income earned on the funds pending payment to the employee are taxable. If the employer keeps control of the fund the income is taxable to him. If the funds are turned over to a nonqualified trust, the income earned on the funds is taxable to the trust.

There have been several recent rulings on the use of nonqualified plans. Revenue Ruling 69-49 exemplifies how a nonqualified arrangement can be a workable and uncomplicated method of deferring income.[11] The plan there consisted of nothing more than a contract arrangement between a nonprofit corporation engaged in operating medical and hospital service programs and a group of doctors engaged by the corporation to provide services. The corporation established an unfunded forfeitable retirement plan for the doctors who met the express conditions of the plan at the time each monthly payment was due. But Revenue Ruling 69-50 illustrates the problems that can result where one seeks to defer compensation by a contractual arrangement, where the relationships of the parties involved are not firmly established.[12] There a nonprofit corporation insuring medical expenses of its subscribers entered into a deferred payment arrangement with its participating physicians. It was determined that the physicians' rights emanated from the satisfaction of the contract obligations of the patients to the physicians and in so doing conferred an economic benefit on the physicians which was simply funded through the corporation. Therefore, the physicians had to take the deferred amounts into income in the year withheld by the corporation rather than in the year actually received.

Several 1969 Rulings, discussed below, indicated that even where qualified plans are involved, preferential tax treatment can be lost through some careless or inadvertent actions.

Although, self-employed plans are required to benefit all employees, the coverage requirement can be limited to those employees having a period of employment of three years or more.[13] Where the plan provides for a waiting period owner-employees must also meet the required waiting period before being covered by the plan.[14] Where the plan originally had no waiting period, and then after the owner-employee put in three years of service the plan was amended to provide a waiting

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[10] Int. Rev. Code of 1954 §402(b); Rev. Rul. 60-31, 1960-1 C.B. 174.

[11] Int. Rev. Bull. No. 6, at 17; See also Rev. Rul. 69-474, Int. Rev. Bull. No. 37, at 11.

[12] Int. Rev. Bull. No. 6, at 18.

[13] Int. Rev. Code of 1954 §401(d)(3).

[14] Regs. 1.401-12(e)(2)(iii).

period, the amendment does not substantially comply with the non-discrimination requirements.[15]

Where one self-employed plan is terminated in favor of a substituted plan care must be taken to insure the fact that no owner-employee receives the funds from the terminated plan in the interim. Even if the owner-employee simply transfers the funds from one plan to another it will be a premature distribution to him unless at the time of receipt he is under a legal obligation to make the transfer.[16] The penalties for premature distributions are set forth in section 72(m)(5) of the Code. However, the premature distribution to the owner-employee will not effect the qualification of the rest of the plan.[17]

If the total distributions payable to an employee on termination of his employment, other than an owner-employer, are distributed within one taxable year, the employee may treat the amount as long term capital gain.[18] If the total amount due him is not distributed in one taxable year he will not receive capital gains treatment for the distribution in the later or earlier year.[19] However, a payment in a later year of an amount attributable solely to the last year of service, although it will not be entitled to capital gains treatment, will not disqualify the former payment from capital gains treatment.[20]

A ruling which you may wish to note in the related area of fringe benefits is Rev. Rul. 59-154.[21] As you know, section 104(a)(3) of the Code provides that gross income does not include amounts received through accident or health insurance for personal injuries or sickness, other than amounts received by an employee to the extent such amounts are attributible to contributions by the employer not included in the employee's gross income. The Revenue Ruling not only states that in the Service view excess indemnification received under several such employee financed plans is not includible in gross income, but in addition contains a formula for apportioning the funds received between employer and employee contributions, where excess indemnification results from payments from plans financed by both the employee and employer.

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15 Rev. Rul. 69-66, Int. Rev. Bull. No. 7, at 10.

16 Rev. Rul. 69-254, Int. Rev. Bull. No. 20, at 12.

17 Rev. Rul. 69-380, Int. Rev. Bull. No. 28, at 11.

18 Int. Rev. Code of 1954 §402(a)(2).

19 Regs. 1.402(a)-1(a)(6)(ii).

20 Rev. Rul. 69-190, Int. Rev. Bull. No. 16, at 13.

21 Int. Rev. Bull. No. 14 at 8. Of course, amounts received which were allowed under section 213 of the Code for an earlier year will be included in income in all cases. Int. Rev. Code of 1954 §104(a)(3).

Real Estate Transactions

It is clear that the depreciable basis of property includes the amount of a purchase money mortgage, even where the mortgagor of the property assumes no personal liability. However, the cases which first established that holding raised a clear caveat where the mortgage exceeds the fair market value of the property.[22] The Service has made it clear that in spite of its acquiescence in *Manuel D. Mayerson* v. *Com.,* 47 T.C. 340 (1966), the question of fair market value will continue to be the crucial factor in determining the depreciable basis in this kind of financing.[23] The Service points out that it will continue to review with great care any mortgage not involving personal liability, especially where the mortgage is for a long term and a substantial amount of the purchase price is payable near the end of the term.

The Service has recently ruled that a taxpayer may not elect to report income from the sale of real or personal property on the installment method unless he receives two or more payments in two or more years.[24] Although the Ruling has received some criticism it appears correct because inherent in an installment sale is the feature of periodic payments. And that only has meaning in the tax world where the payments fall in two or more taxable years. Note, the *Tax Reform Act of 1969* contained a provision restricting the installment method to those sales where the payments were evenly spread over the term of the obligation.[25] However, the Senate Finance Committee deleted this portion of the House Bill.[26]

Two other Rulings worth noting in the real estate area concern the payment of points and the capitalization of certain expenses.

By *Rev. Rul. 69-188*[27] the Service has conceded that a payment of a loan processing fee, commonly referred to as points, may be considered interest which can be deducted under section 163 of the Code. The Ruling makes the question one of fact. Were the payments for some service rendered in the placing of the financing, or were the payments solely for the forbearance of money? Apparently the Service still takes the position that V.H.A. and F.H.A. points are payments for services and not interest.[28]

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[22] *Crane* v. *Commissioner,* 331 U.S. 1, 67S.Ct. 1047, 91 L.Ed. 1301 (1947); *Parker* v. *Delaney,* 186 F2d 455 (CA-1, 1950).

[23] Rev. Rul. 69-77, Int. Rev. Bull. No. 8, at 10.

[24] Rev. Rul. 69-462, Int. Rev. Bull. No. 35, at 14.

[25] H. Rep. No. 413 (Part 1), 91st Cong. 1st Sess. at 107.

[26] S. Rep. No. 552, 91st Cong. 1st Sess. at 144.

[27] Int. Rev. Bull. No. 16, at 8.

[28] Rev. Rul. 67-297, 67-2 C. B. 87; Rev. Rul. 68-650, 68-2 C. B. 78.

Section 266 of the Code permits certain deductible expenses to be capitalized, such as taxes, mortgage interest, and carrying charges. The most inclusive election options are with respect to unimproved and unproductive property. In Rev. Rul. 69-105[29] the Service held that unimproved and unproductive property held for subdivision purposes ceases to be unimproved and unproductive at the time the last step necessary to permit sales or construction takes place. This usually would be the recording of the subdivision plat.

Corporate Reorganizations—Loss Treatment

Section 368(a)(1)(F) of the Code defines the least complex of all corporate reorganizations. That is the reorganization commonly known as the "F Reorganization", which is "a mere change in identity, form, or place of organization however effected." Under the '39 Code it was clear that this type of reorganization was to be confined to the reorganization of a single operating company.[30] However, the "of a corporation" language was dropped in the 1954 Code. In fact, the entire "F Reorganization" was almost eliminated because of the availability of the other tax free methods of reorganizing.[31]

Several years ago someone in the Service came up with the idea that the "F" categorization might be imposed on several of the liquidation reincorporation schemes. That is the scheme whereby a stepped-up basis is obtained at only capital gains tax expense. The Service argued for such an imposed categorization in a case involving more than one operating corporation. By the time the case reached appeal in the Fifth Circuit, the Service abandoned the argument but the Fifth Circuit Court of Appeals adopted the argument.[32]

The trap the Service foresaw was with respect to the operating rules of section 381(b) of the Code. This section specifically forbids a post-reorganization loss from being carried back to a pre-reorganization year of the transferor corporation. However, "F Reorganizations" are specifically excepted from these operating rules. Regulation 1.381 b-1(a)(2) of the Income Tax Regulations provides that in the case of a reorganization qualifying as an "F Reorganization" [whether or not such reorganization qualifies under any other provision of section 368(a)(1)] a net operating loss of the acquiring corporation for any taxable year ending after the date of the transfer shall be carried back

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29 Int. Rev. Bull. No. 10 at 29.

30 For an excellent comment on the history of Section 368(a)(F), and the problem discussed herein see 66 Mich L. Rev. 498.

31 Ibid.

32 Davant v. Com. 366 F2d 874 (5th Cir. 1966).

to the taxable year of the transferor ending before the date of the transfer.

The Service correctly points out in Rev. Rul. 69-185[33] that the regulations pertaining to section 381(b) assume that an "F Reorganization" would be limited to the reorganization of a single business enterprize. In that same Ruling the service announces that it will not follow the recent Ninth Circuit Court of Appeals cases which permit "F Reorganization" status to the combination of two or more operating corporations.

Another consequence of this Ruling referred to above is that the Service will no longer be able to characterize as an "F Reorganization" the liquidation reincorporation schemes involving more than one operating company.

Another recent Ruling dealt with a very important aspect of the "F" Reorganization."[34] The moral of the Ruling is that even where only one operating corporation is being reorganized the "F" status can be lost by slight technical errors. The error cited in the Ruling was the use of stock of a common parent of the old and new corporation to acquire the assets of the old corporation. The use by a newly formed corporation of its parent corporation's stock in lieu of its own stock in acquiring the assets of the old corporation is specifically sanctioned for reorganizations of the "A", "B", "C" and "D" type. However, section 368(b) of the Code does not include as "a party to a reorganization" the parent of the acquiring corporation in an "F" type reorganization. Therefore the Service ruled that there can be no "F Reorganization" status where parent stock is used.

This did not mean that the gain had to be recognized on the transfers involved. The transaction involved qualified as a "C Reorganization." But it did mean that since the reorganization did not also qualify as an "F Reorganization", the favorable loss treatment available under section 381 was lost.

Corporations & Shareholders

Section 1239 of the Code transforms the nature of income resulting in the sale of depreciable property from capital to ordinary where the sale is directly or indirectly between related parties. The related parties specified in that section include a shareholder and his controlled corporation. The section does not specifically include a sale between two corporations even though commonly owned. The Service has held in Rev. Rul. 69-109,[35] that a sale between two commonly held corpora-

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33 Int. Rev. Bull. No. 16, at 11.

34 Rev. Rul. 69-413, Int. Rev. Bull. No. 31 at 8.

35 Int. Rev. Bull. No. 10, at 38.

tions constitutes an *indirect* sale between the shareholder and his controlled corporation.

The Service position seems to be a strained expansion of the *indirect* sale terminology. That same terminology appears in other sections of the Code covering sales between related parties—section 267 and section 707(b). However, those sections, notwithstanding the indirect terminology, *specifically include* as related parties two commonly owned corporations. Maybe under some circumstances a sale between brother-sister corporations may constitute an indirect sale between a shareholder and the controlled corporation, but certainly not in all situations.

Rev. Rul. 69-115[36] provides that a deduction will be permitted to a corporate stockholder who pays back to a corporation compensation which has not been allowed as a deduction because it was considered unreasonably high. The compensation returned, however, will not be considered money received by the shareholder on an unrestricted claim of right and, therefore, he will not be entitled to the beneficial treatment available under section 1341 of the Code. If section 1341 applied to the repayment, the stockholder would be entitled to the deduction or he could reduce his tax for the payback year by the tax he paid on the excess salary in the earlier year. It should be noted that under the facts of the Ruling there was an agreement to return unreasonably high compensation and the agreement was made prior to the receipt of the compensation by the shareholder.

You will recall the theory of the *Snively*[37] and *Cullen*[38] cases as applied to corporate liquidations. Those cases held that where stock was purchased for the sole purpose of liquidating the corporation and acquiring the assets, no gain or loss is recognized on the liquidation. In effect the whole transaction is treated as if the assets of the corporation were purchased rather than the stock of the corporation.

The theory of these cases has been applied in a section 1033 transaction, where stock is purchased solely to liquidate the corporation and acquire property to replace condemned property.[39] This may appear to be an obvious result. But obvious or not it involves an important question since under section 1033 either the stock or the property acquired on the liquidation could qualify as the replacement property. Which of the two is selected could make a substantial difference in the amount of gain to be recognized on the condemnation.

The amount of recognition under section 1033 depends upon the

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36 Int. Rev. Bull. No. 11, at 9.

37 H. B. Snively, 19 T. C. 850 (1953).

38 Ruth M. Cullen, 14 T. C. 368(1950).

39 Rev. Rul. 69-242, Int. Rev. Bull. No. 19, at 25.

cost of the replacement property. Section 1033 provides that the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of the replacement property. Where corporate property subject to a liability is purchased directly, the liability is added to the cost of the property. However, where the stock is purchased its cost is determined by the net equity of the corporate property. Therefore, if the stock were considered the replacement property the cost would be less than it would be if the corporate property itself was considered the replacement property. And it would then follow that more of the gain resulting from the condemnation would be subject to tax.

An example, set forth in the Ruling referred to in footnote 39, illustrates the point quite plainly.

Almost everybody knows that a collapsible corporation is a corporation availed of principally for the manufacture, construction or production of property.[40] Nobody knows exactly what activities will be considered construction or production. Even salesmen refer to themselves as producers.

The best way to avoid the tax treatment under the collapsible corporation provisions, (the conversion of capital gain to ordinary gain on the disposition of collapsible stock), is to meet the qualifications for exception under 341(d)(3). That exception provides that after the expiration of three years following the completion of such construction the taint of 341 vanishes.

Rev. Rul. 69-378[41] makes it clear that you don't have to physically engage in construction to construct within the meaning of section 341. If land is leased and the lessee can construct only with the approval of the lessor, and in addition the lessor shares rents on subleases, and the lessor subordinates his title to permit the lessee to finance the construction, the lessor is considered to be engaged in the construction of the lessee which for the purposes of the exception of 341(d)(3) does not end until the physical construction of the lessee ends.

Rev. Rul. 69-482[42] makes it clear that although compliance with section 1235 of the Code may be the best way to obtain capital gains treatment on the sale of a patent, where the payments are either contingent on production or coterminus with use, it is not the only way. This may seem obvious, since a patent can be a capital asset in the hands of an inventor or others and so long as a sale or exchange is made capital gains treatment is required. However, it was not obvious to the Tax

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[40] Int. Rev. Code of 1954 §341.

[41] Int. Rev. Bull. No. 29 at 6.

[42] Int. Rev. Bull. No. 36 at 16.

Court which held otherwise in *Myron C. Poole, et ux* v. *Com.* 46 T.C. 392 (1966). This Service concession in the above Ruling is particularly important where the transferor and transferee are related parties and therefore excluded from the provisions of 1235.

Miscellaneous Rulings

According to the Service the effective date of a gift to be made in future years is not the date of the transfer but the date when there is a legally enforceable obligation to make the gift. Unlike the law of contracts, in the gift tax law only a transfer will be treated as a gift unless there is consideration of money or money's worth value. You have then in the gift tax law the anomalous situation where there can be a binding obligation to make a gift.[43] But even under the gift tax it seems strange to have a gift without a transfer.[44] The Revenue Ruling in which the Service position was set forth indicates that the date the obligation is binding is the date on which the party to receive the gift has performed all obligations precedent to making the gift effective.[45] Therefore, in an antenuptial agreement the gift would be effective on the date of the marriage.

The significance of this recent ruling is the fact that the $3,000 annual exclusion will be available only once, the date of the gift, even where the actual transfers are to take place over many years.[46] The Ruling relies heavily on the *Estate of Ira C. Copley, et al.* v. *Com.,* 15 T.C. 17 (1950), affirmed 194 F2d 364 (1952), acquiescence, 1965-2 C.B. 4.

Section 2503(b) provides for an annual $3,000 gift tax exclusion. This exclusion is only available where the gift is of a present interest as contrasted with a future interest. The Service has held that a gift in trust which provides that all income must be paid the beneficiary but permits corpus to be invested in nonincome-producing property and life insurance is not a gift of a present interest. The Service announces, also, that it will not follow the decision of *Rosen* v. *Com.,* 397 F2d 245 (4th Cir. 1968).[47]

Section 2503(C) provides that certain gifts of future interest to minors will be eligible for the $3,000 exclusion so long as all income and principal may be expended for the minor before reaching 21 and will be turned over to the minor on reaching 21. Regulation 25.2503-4(b) provides that a transfer does not fail to satisfy these conditions by

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43 Int. Rev. Code of 1954 §2512(b).

44 Int. Rev. Code of 1954 §2511.

45 Rev. Rul. 69-347, Int. Rev. Bull. No. 25, at 24.

46 Int. Rev. Code of 1954 §2503.

47 Rev. Rul. 69-344, Int. Rev. Bull. No. 25 at 21.

reason of the mere fact that there is left to the discretion of the trustee the determination of the amounts to be expended. However, if there are any substantial restrictions on the exercise of such discretion the conditions of 2503(C) are not satisfied. The Service considers a provision restricting payment to the minor only after his needs cannot be met by his parents a substantial restriction.[48]

The proceeds of life insurance are fully excluded from gross income by the recipient only where the face value is received other than as a result of a transfer for value.[49] However, in order that there be a transfer for value as defined in section 101(a)(2) of the Code, the basis for determining gain or loss in the hands of the transferee must be determined wholly without reference to the basis of the policy in the hands of the transferor.[50] Therefore, the transfer of an insurance policy to your wife will not be taxable under the provisions of section 101(a)(2) so long as there is some equity in the policy.[51] The equity will cause her basis to be determined in some measure by your basis, since the equity portion will be a gift.

Where two consecutive short periods, resulting from a change in accounting periods, together make up only one calendar year, the dollar limitation on self-employment tax will be $15,600 rather than $7,800. The justification of the above conclusion is simply that the $7,800 limit is based on a taxable year not on a calendar year.[52]

Several other Rulings that you may wish to note are:

1. Rev. Rul. 69-489[53] concerning the valuation and redemption dates of marketable treasury bonds that may be redeemed in payment of estate tax.

2. Rev. Proc. 69-6[54] concerning the areas in which rulings and determination letters will be issued.

3. Rev. Proc. 69-21[55] concerning the treatment of deductions for computer soft wear.

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48 Rev. Rul. 69-345, Int. Rev. Bull. No. 25 at 22.

49 Int. Rev. Code of 1954 §101(a).

50 Int. Rev. Code of 1954 §101 (a)(2)(A).

51 Rev. Rul. 69-187, Int. Rev. Bull. No. 16, at 8.

52 Rev. Rul. 69-410, Int. Rev. Bull. No. 30, at 10.

53 Int. Rev. Bull. No. 37, at 9.

54 Int. Rev. Bull. No. 1, at 29.

55 Int. Rev. Bull. No. 43, at 18.