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A Commentary on 1966 Federal Tax Legislation

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The 1966 tax legislation is volumnious and complex. There is no 1966 Revenue Act as such. We had a Revenue Act of 1962 and a Revenue Act of 1964. However, in 1966 the major revenue legislation is contained in four major acts, and a number of minor enactments. The principal enactments are the Tax Adjustment Act of 1966, the Foreign Investors Tax Act of 1966, the Act Suspending the Investment Credit and Accelerated Depreciation and the Federal Tax Lien Act. There are also other enactments. Don't let the names of these Acts confuse you. They are merely the names of the major provisions of the acts. The Tax Adjustment Act of 1966, for example, also includes social security amendments, and the Foreign Investors Tax Act permits individuals to appropriate money for presidential campaigns.

I do not propose to expound or to explain all of the tax legislation that was enacted in 1966. I don't think you would have the patience to bear with me if I tried to do it and there is too much to cover in the time allowed. I will instead try to indicate to you the general areas where there have been significant changes in the statutory law.

First of all, with respect to the Foreign Investors Tax Act, this represents, inasmuch as it relates to non-resident aliens or foreign corporations, the most substantial change in this area in the last twenty-five years. It is intensely complex but basically it attempts to stimulate investment in the United States by non-resident aliens or foreign corporations. It does so by creating a concept called "Income effectively connected with conduct of business within the United States." Such income when received by a non-resident alien or foreign corporation will generally be taxed as though it were earned by a domestic individual or corporation. Under the Act, passive income will continue to be treated at the maximum 30% rate when received by a non-resident alien or foreign corporation.

Probably the provisions that have stimulated the greatest interest and are likely to have the greatest impact on taxpayers are those suspending

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the investment credit and accelerated depreciation. These provisions, while complex in meaning, are not particularly difficult structurally. The basic concept to the legislation is the concept of suspension period property. This generally is property constructed, acquired or ordered during the suspension period. The suspension period is that period of time from October 10, 1966 to December 31, 1967. Once property has been identified as being suspension period property, there are three general rules that are applicable to it. First of all, the investment credit generally is not allowable. Secondly, when suspension period property is placed in use the maximum investment credit which would otherwise be allowable for such year must be reduced by the amount of the investment credit that has been disallowed with respect to that property. Thirdly, and as a general rule, where the property acquired is a building, accelerated depreciation will not be available as to such property. This is a permanent bar to the use of accelerated depreciation, that is, to the use of the double declining balance method and to the sum of the digits method. These are the three general rules applicable once you have established that you have received suspension period property.

There are some broad exceptions to these rules. First of all, with respect to the investment credit there is an allowance provided of up to $20,000 with respect to which property designated within that limitation will not be considered suspension period property and the investment credit will still be allowable as to that property. This means that the maximum credit allowable on property which would otherwise be suspension period property is $1,400. However, you will get this $1,400 credit only if you select the property included within this $20,000 provision in accordance with principles necessary to get the full credit. For example, you would want to select property for this purpose having the maximum useful life. You would not want to use property having a useful life of four years when you could use property having a useful life of ten years in designating property for this $20,000 provision.

As the second broad exception, buildings costing less than $50,000 even though acquired during the suspension period will continue to be eligible for accelerated depreciation. Now this $50,000 figure is not a threshold figure. By this I mean if the building cost $52,000, you cannot take accelerated depreciation on it. However, if you have two buildings costing $25,000 you may take accelerated depreciation as to both of these buildings.

In addition to these broad exceptions there are some special exceptions which prevent certain types of property from being treated as suspension period property and hence permit qualification for the previous treatment afforded. One of the exceptions is the so-called "binding contracts rule." Under this rule, property consisting of buildings or machinery acquired pursuant to binding contracts entered into before October 10, 1966, will not be treated as suspension period property. There is also an "equipped building" rule to the effect that where the taxpayer on or before October 10, 1966 had specific plans to build and equip a building and in addition had, before that date, contracted out more than 50% of the cost of the equipped building, the building and its equipment will not be classified and tainted as suspension period property.

There is a similar rule applicable to certain plant facilities and there are other exceptions applicable to certain types of machinery and equipment and to certain property subject to lease arrangements.

There are also provisions affecting the investment credit which do not relate to suspension of the credit or suspension of accelerated depreciation contained in the 1966 legislation. More significant among these provisions is that effective for years beginning after December 31, 1967, that is, after the suspension period, the maximum investment credit available for the taxable years after such date is increased. Presently that credit is $25,000 of tax liability plus 25% of tax liability in excess of $25,000. Beginning after 1967 this limitation will be raised to $25,000 of tax liability plus 50% of the excess over $25,000. In addition, beginning in 1967, the period in which an investment credit carry-over may be taken is extended by two years. It is currently five years; it will become seven years. There is also a provision for quick refunds on investment credit carry-backs and this will be retroactive to years ending after 1961. And finally, the investment credit will be available for investment in qualified property in possessions of the United States. Until the legislation was enacted, the investment credit was limited generally to property within the territorial limits of the United States.

Another area where there are major changes in the tax law is Subchapter S. Subchapter S has been amended to adopt a "look-back" rule with respect to distributions by a Subchapter S corporation to its shareholders where the distribution occurred within the first two and one-half months following the end of its taxable year. Under law prior to the amendment, a distribution by a Subchapter S corporation during a taxable year of that corporation was considered first to be out of earnings and profits of the corporation and hence to that extent was taxable to the shareholders. This resulted in some problems where the shareholder and the corporation were on different taxable years and in some instances brought about situations where the taxpayer would be taxed twice on what was really income earned once within the taxable period. The look-back rule in effect permits amounts distributed to shareholders by a Subchapter S corporation during the 2-1/2 months after the close of the Subchapter S corporation's year to be treated as distributions of previously taxed income and to that extent such distributions will not be taxable a second time. There is a provision for retroactive application of this remedial rule.

A second change in the Subchapter S area has resulted in making certain Subchapter S corporations taxable entities. Is the past the Subchapter S corporation was frequently used as the one-shot proposition to pass through capital gains to the shareholders without tax at the corporate level. By this I mean a corporation would elect S corporation status for just one taxable year in order to pass through a substantial capital gain which it anticipated it would receive during that year. In order to prevent what was thought to be an improper use of Subchapter S for this purpose, Congress amended Subchapter S by adding § 1378 which provides for a capital gains tax to be paid by the Subchapter S corporation when its capital gain income exceeds $25,000 and such income is also in excess of 50% of taxable income computed under §1373. Generally, then, if you have a Subchapter S corporation that has less than $25,000 in capital gains in its income, it is not affected by this provision. In addition, there are other exceptions. Even if the corporation has capital gains income in excess of $25,000 for the taxable year, it will not have a taxable status with respect to such income if the Subchapter S corporation was an electing Subchapter S corporation for each of the three preceding taxable years. A similar rule applies where the corporation has been in existence for less than four years, and has been a Subchapter S corporation each year of its existence. For example, if a corporation has been in existence for two years and has been a Subchapter S corporation for each of these years, capital gains provisions generally will not apply.

A liberalizing amendment has been added which makes it easier to elect and maintain Subchapter S status. Under prior rules, if passive income received by an electing Subchapter S corporation were more than 20% of its gross income, the election terminated automatically. This resulted in a large number of terminations during the first and second years of a corporation's existence where the corporation, because of unforeseen circumstances, did not conduct the volume of business that it expected to do. The law has been amended so that notwithstanding the 20% limitation, if, during the first two years of corporate existence, the passive income of the corporation is less than $3,000, the Subchapter S election will not terminate automatically.

One bit of good news: every year the tax law becomes more complex—more complicated—more difficult to understand. This year a subchapter of the Internal Revenue Code has been repealed. Subchapter R is the reverse side of Subchapter S. Under Subchapter R an unincorporated business could elect to be taxed as a corporation. Subchapter R generally will not be of interest to any of you after this year. As to corporations that have never been in Subchapter R status, the Subchapter is repealed. Corporations currently in Subchapter R status will, by 1970, have to relinquish that status. The elections will terminate automatically by that time.

Some procedural changes were brought about by the tax law. The regional filing of tax returns bill simplifies a number of problems that existed before, and also increases the authority of the Secretary of the Treasury. First, the regional filing bill authorizes the Secretary of the Treasury to require returns to be filed at a service center rather than with the District Director. My understanding is that this requirement will not be effective as to income tax returns to be filed for the current year. The law really gives the Secretary of the Treasury or his delegate the discretion to designate where the tax returns are to be filed. As the data processing facilities of the Revenue Service become more and more utilized it is anticipated that substantially all of the returns with the Revenue Service will be filed with service centers. There is a provision that provides that timely mailing of a tax return is timely filing. Up until the amendment, this was not the case. But from now on tax returns mailed on or before the due date will be properly filed.

There are other conforming amendments to reflect these changes. Among these is a provision that refund suits can be brought only against the United States; no longer can you sue the District Director for a refund. By another amendment, appeals from the Tax Court to circuit courts will lie to the circuit court having jurisdiction over the place of residence of the taxpayer at the time the taxpayer filed his petition with the Tax Court. The place of the filing of the tax return will no longer determine jurisdiction on appeals from the Tax Court.

There are other changes which are of more limited application but which may be of interest. One I would like to discuss with you is the tax treatment of swap funds. A swap fund is an arrangement where persons holding highly appreciated securities seek to diversify their holdings without recognizing gain by utilizing § 351 to form a new corporation, transfer their securities to the new corporation, and take back stock. The Revenue Service has adopted the position that where a stock broker is actively involved in this type of arrangement, you do not have a situation contemplated by § 351(a) and the non-recognition provision of that section will not apply. This has caused quite a degree of controversy particularly because the arrangement seems to fall literally within § 351. Congress has passed a law which expressly provides that these swap fund arrangements will qualify for § 351 treatment where the transfers are made before July 1, 1967.

A bill that was of considerable interest to a large number of taxpayers, popularly known as H.R. 10, related to liberalization of retirement and pensions plans for the self-employed. H. R. 10 became part of the Foreign Investors Tax Act of 1966 and is now part of the tax law. It brings about some limited changes in the treatment of contributions made by self-employed individuals on their behalf to qualifying pension plans. Prior to the amendment, a self-employed taxpayer could contribute for himself up to 10% of self-employment income but not in excess of $2500 yearly and could deduct one-half of the contribution, that is a maximum of $1,250. However, in determining what was self-employment income, where capital and services were both income producing factors, self-employment income was limited to 30% of business profits. These rules have been changed. Now self-employed income is not subject to the 30% of business income limitation where capital and services are both income producing factors and all the business income can qualify as self-employment income. Secondly, up to 10% of self-employment income can be contributed up to the maximum of $2,500 and that amount can be fully deducted. These liberalizations, however, are not effective except as to taxable years beginning after December 31, 1967. They are not effective as to present taxable years.There has been some confusion about this because the bill as originally introduced would have been retroactive; the bill is not retroactive; it does not take effect until the prospective date.

There are a number of retired military personnel in the Peninsula area and there has been a significant piece of legislation which will be of significance to them. There is a bill amending provisions applicable to the treatment of servicemen's retirement pay. Until the amendment was enacted, a serviceman retiring on a pension from the armed forces could elect to accept a reduced pension in order to provide an annuity for his surviving spouse or dependent children. Suppose that he was entitled to a monthly pension of $400 and elected to receive a pension of $300 in order to provide this annuity. The law before the 1966 amendment provided that the $100 difference between the $400 he was entitled to receive and the $300 he actually received was taxable to him as constructively received during the month. That is, when a retired serviceman elected to accept a reduced pension, he was, for tax purposes, regarded as receiving the full amount of his pension. This general treatment was significantly different from that afforded retired civil service personnel. In order to conform the treatment of retired service men to that of retired civil service personnel, § 122 has been added to the Revenue Code. § 72 has been amended and § 101(b)(2) has been amended. The amendments generally provide that when the serviceman elects to accept a reduced pension, the amount that he is not receiving by reason of his election to receive the reduced pension will not be taxable to him. In addition, where the serviceman retires on a disability and dies before normal retirement age, his wife will be entitled to the death benefit exclusion of $5,000 which will normally enter into the computation of "investment in the contract" for purposes of determining tax treatment of her annuity payments. There are also transitional rules which give effect to these principles where the taxpayer has made his election to accept reduced payments prior to the present time.

A law which is probably known to most of you since it has been operable for the substantial part of this taxable year is the Tax Adjustment Act of 1966. Since its provisions are generally known, I will cover only the highlights. The Tax Adjustment Act of 1966 provides for graduated withholding. The rates are no longer limited to 14%; they are graduated up to 30%. To provide for possible over-withholding, § 3402 has been added to the Revenue Code and it in effect permits a taxpayer to elect an additional withholding allowance in multiples of $700. This will reduce the amount of his withholding. The right to elect this additional withholding allowance is applicable only to wages received after December 31, 1966. You may not have heard much about this provision since it is not currently applicable but it will be applicable very shortly.

Another change brought about by the Tax Adjustment Act of 1966 is that individuals in filing their declaration of estimated tax and in making quarterly payments thereon must account for the self-employment tax. This is effective in January as to earnings after that time. There is also a provision for accelerated payment of estimated taxes by corporations and for taxable years after 1967 it is anticipated that the estimated tax payments by affected corporations will be payable currently on income as earned.

Other nominal changes brought about by the Tax Adjustment Act of 1966 include new § 276, which disallows any deduction for payments made for advertising in political programs or for admission charges to political conventions. This was designed to get around the indirect political contributions device whereby a person could buy a full page advertisement in the Democratic or Republican Convention programs and take advertising expense deductions.

Another important but little known change brought about by the Tax Adjustment Act of 1966 does not relate to income taxation but to social security benefits. A person who is over the age of 72 and who has not previously been covered by social security will, under the Tax Adjustment Act of 1966, be eligible for up to a maximum monthly payment of $35. This means that every person 72 of age today potentially qualifies for some social security benefits. There are limitations requiring that the $35 maximum amount be reduced by other governmental payments that the taxpayer may receive.

The 1966 legislation impliedly amends § 162 to provide deductions for accrued vacation pay. This is really a continuation of current practice.

The position of the Revenue Service has been that when vacation pay is accrued but the liability to the employee is not legally established at the time of the accrual, no deduction should be allowed. Beginning with the Technical Amendments Act of 1958 and every two or three years thereafter, the Congress has been suspending the application of this Revenue Service position and if you are currently accruing vacation pay, you may continue to do so until 1969.

As all of you may know the combat pay received by a person enlisted in the armed forces is excludable from gross income. Up until the 1966 amendments officers' combat pay was excludable to the extent of $200 per month. This exclusion has been increased to $500 a month.

Section 166 provides a bad-debt deduction and under § 166 there are provisions for deductibility of additions to bad debt reserves. The position of the Revenue Service has been that a bad debt reserve addition is deductible only if the debt is owing principally and directly to the taxpayer. A business practice, widespread and commonly known, is for dealers in personal property and real estate to sell their property for installment notes and for the dealers to discount these notes, signing the notes with recourse to the dealer in case of default. Dealers have been trying, unsuccessfully in most cases, to set aside reserves for their contingent liability on such installment paper. The 1966 legislation has reversed the position of the Revenue Service by amending § 166 and it now provides that dealers may take a deduction for bad debt reserves for guaranteed obligations. The provision is intensely complex; it requires in the first year that the taxpayer elects to do this the establishment of a suspense account computed as though the taxpayer had always been on the reserve method. The amount involved in the creation of the suspense account is not currently deductible. You will want to take a close look at this provision if you have a dealer as a client who guarantees discount obligations that he sells.

Another limited change is probably of only limited interest to you; it is a change respecting the treatment of straddle options. A straddle option is generally an option written by a taxpayer that embraces both a put and a call on the same security exercisable over the same period of time and the straddle option, that is the put and call, is sold for a premium. The Revenue Service has required that the premium be allocated between the put and to the call elements. Generally a 55% allocation of the premium to the call and a 45% allocation to the put is permitted. What happens when either the put or the call or both are not exercised? Generally the put will not be exercised if the call is exercised and a call will not be exercised if a put is exercised. So the amount of the premium attributed to the put or the call will in most instances result in some type of income to the taxpayer. The Revenue Service recently published a position that income with respect to the lapse of a straddle option should be taxable as ordinary income. The Congress in 1966 amended § 1234 of the Code to provide that income attributable to the lapse of a straddle option will be treated as short-term capital gain rather than as ordinary income. This treatment, however, is generally not applicable to security dealers.

There is one change in the Subchapter C area which may be of interest to you. Section 334(b) permits a corporation acquiring another corporation to treat the cost of acquisition of that corporation as the cost of the assets of that corporation when the acquired corporation is liquidated. To use this provision you must purchase 80% of the control of the acquired corporation within twelve months and liquidate the acquired corporation within two years. However, prior to the amendment, for purposes of determining whether or not 80% of control had been purchased within the twelve month period, stock acquired from a related taxpayer other than the acquired corporation could not be counted as part of the 80% control. The law has been amended to provide that stock in the acquired corporation acquired from a subsidiary corporation of the taxpayer will not be treated as stock acquired from a related corporation for purposes of determining the 80% control requirement. Accordingly, it is a little easier to use § 334(b) than it was before. However, there is a restrictive limitation applicable. A corporation being liquidated under § 334(b) must now treat the distribution of certain installment notes as an event that can produce taxable income. This is a change from prior law.

Other changes brought about by the 1966 legislation are not of significant importance in the substantive tax area but are of great interest to tax practitioners generally. Public Law 89-496 provides for dischargeability of taxes in bankruptcy. Prior to 1966 taxes were not generally dischargeable in bankruptcy. Under the amendment to the Bankruptcy Act taxes, whether they be state, federal or local, can be discharged in bankruptcy if they became due and owing more than three years prior to the date of bankruptcy. This provision, however, does not weaken or undermine the strength of any outstanding tax liens on property. Where there is a lien on property, the property will still be available to pay the tax. A discharge will not be available where no tax return has been filed or where there is fraud or an attempt to evade taxation.

Other changes of interest are found in the Federal Tax Lien Act of 1966. As a result of the enactment federal tax liens will in many instances be inferior to liens which recently were subordinate to tax liens. I will not make an attempt to explain the ramifications of the tax lien bill to you but will stop by calling your attention to the fact that if you have a federal tax lien situation, there has been a material change in the law and you will want to examine the 1966 legislation very closely.

The remaining changes in the 1966 legislation are of very limited significance, and I will pass over them very hurriedly. There is a change which, in defining "personal holding company income," provides that the term does not include rental income attributable to the leasing of property manufactured by the corporation. There are also changes in the 1966 legislation affecting the treatment of per unit retain certificates issued by cooperatives. There are limited changes in the interest equalization tax. There are also changes in percentage depletion applicable to certain mined products including clams and oyster shells used for certain purposes. There are also changes affecting the treatment of certain mining exploration expenses.

In this presentation I have endeavored to summarize only the major changes resulting from the 1966 tax legislation. An adequate understanding of the scope of this legislation and an appreciation of the many interpretative problems inherent in its provisions can be acquired only through a study of the legislation itself.