Panel Discussion: Certain Problem Areas Under the Revenue Act of 1964

Laurence N. Woodworth
Forrest W. Brown Jr.
Hugh C. Stromswold
Thomas D. Terry
David O. Williams Jr.

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PANEL DISCUSSION

Chairman, LAURENCE N. WOODWORTH

Chief of Staff, Joint Committee on Internal Revenue Taxation
U. S. Congress

GENERAL TOPIC: CERTAIN PROBLEM AREAS UNDER THE REVENUE ACT OF 1964.

PERSONAL HOLDING COMPANIES, AND INTEREST ON CERTAIN DEFERRED PAYMENTS.
Forrest W. Brown, Jr., A. M. Pullen and Company, Richmond, Virginia.

STOCK OPTIONS
Hugh C. Stromswold, Tax Attorney, Law Department, Reynolds Metals Company, Richmond, Virginia.

MULTIPLE SURTAX EXEMPTIONS AND THE REVENUE ACT OF 1964
Thomas D. Terry, Attorney, Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, Washington

INCOME AVERAGING—REVENUE ACT OF 1964
David O. Williams, Jr., Attorney and Branch Chief, Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, Washington

MR. WOODWORTH:
The 1964 Act was not supposed to be as complicated an Act as the 1962 Act, and I believe there is general agreement that that is true. However, after this afternoon, you may question this statement. If one were to search for the five most technical and difficult provisions in the 1964 Act, I believe the five on which there is to be a discussion this afternoon would be selected.

The 1964 Act, as is true of all the major revenue acts, has a long history. Its public history began on January 24, 1963, when the then President Kennedy sent down his tax message. Congressional action was completed on it on February 26, 1964, approximately thirteen months later. On the one hand, it should be said that not all of this thirteen months was spent exclusively on the 1964 Act. Numerous other lesser bills were considered as well. On the other hand, I know that the Treasury Department staff was considering what became the 1964 Act early in 1962, before the passage of the 1962 Revenue Act. In my dealings with the Treasury, I found that there were many people that
had stopped working on the 1962 Act and were working on other projects which eventually turned up as provisions in the Revenue Act of 1964.

I don't want to take too much time because I know that you came to hear the panelists speak on specific subjects. However, I thought I might outline very briefly some of the procedures followed in considering a revenue act. Since we are now discussing provisions of the 1964 Act, I thought it might be appropriate for me to outline the procedures followed in considering that act.

As I have already indicated to you, the act started out as ideas in minds of the Treasury Department staff and their consultants. Various alternative proposals were discussed and analyzed. From the standpoint of our staff, we first became fully aware of the broad outlines of the Treasury proposals in November and December of 1962. At that time, we began consultation with the Treasury Department to help in the technical implementation of the various proposals. A major portion of the work of our staff, as Dr. Atkeson has intimated, is to help the Ways and Means and Senate Finance Committee in working out the technical details of the problems they consider, including the recommendations of the Treasury Department. We believe that it is useful to the tax committees for our staff to have worked with the Treasury in advance of their presentation. We analyze their proposals not from the standpoint of major policy, but from the standpoint of workability of the various proposals. This accounts for our work through much of November and December of 1962 with the Treasury Department.

As I have already indicated to you, the President sent down his message in January of 1963. This was followed by extended public hearings before the House Committee on Ways and Means in February and March of 1963. This, in turn, was followed by executive sessions of the committee which, although intermittent, continued throughout much of April and May and June, 1963. These sessions, of course, are where much of the work of a revenue bill is done. It is here that the committee members have the opportunity to hold frank discussions on the provisions, to ask the questions which need to be asked, to have our staff explain as best we can exactly how the various provisions would work, to hear the Treasury point of view on the proposals, and to have our staff explain any conflicting points of view. This is a very difficult and hard-working period, but I believe it is a really productive period. This is the formulative stage for a tax bill. It is during this period that it is converted from Treasury proposals into congressional policy.

The next step was to convert the general congressional policy into statutory language. In the case of the 1964 Act, I believe this was done largely during July. This is accomplished in drafting sessions in the office of the House Legislative Counsel. The participants in these sessions, in addition to specialized tax attorneys from the House Legislative Counsel's office, are members of the staff of the Joint Committee on Internal
Revenue Taxation, the Treasury Department, and the Legislation and Regulations Division and other units in the Internal Revenue Service. It is our job to work out in specific statutory language what we understand the congressional policy to be. By this time, it is no longer a question of administration policy but the policy of the committee.

A draft bill prepared in these sessions then was presented to the Ways and Means Committee, again in executive session during the month of August. The staff then explained the draft to the committee which in turn informed us wherein the draft did, or did not, follow the committee intent. Corrections were then made to reflect the committee views. This is followed by preparation of the committee report which was completed on September 13. The next step was committee presentation of the bill on the floor of the House. The floor debate occurred on September 24 and 25. The consideration in the House was quite brief because the House considered tax bills under what proponents of a bill call a closed rule and what the opponents call a gag rule.

The bill then went to the Senate and was referred to the Finance Committee. The Finance Committee held hearings on the bill beginning in the middle of October and lasting until December 10. This was followed by executive sessions of the Finance Committee beginning on December 12 and continuing, except for a short interval around Christmas, until the 23rd of January.

The drafting on the Senate side which occurred next, was held under the guidance of the Senate Legislative Counsel and was quite similar to that on the House side.

The bill then went to the floor but the Senate floor operation was quite different, as I am sure most of you know, because there is no closed rule in the Senate. As a result, there was an extensive debate on the Senate floor with various amendments being offered and a number accepted. This Senate debate began on January 30, 1964, and ended on February 7, a relatively short period of time for a Senate floor debate on a major tax bill.

The bill then went to conference. This time the conference between the two houses was relatively brief. Agreement was reached and the House accepted the conference report on February 25. The next day, the Senate completed action on the conference report and on the same day the President signed the bill and it became law.

Now let me turn to the topics before us today. As I have already indicated to you, the topics which you are going to consider this afternoon are relatively technical. I find that one of them falls into the category of a liberalizing amendment and four into the category of tightening amendments. I don't believe, however, that this is representative of the ratio of the liberalizing and tightening provisions in the 1964 Act. If you take the rate reduction in account, I suspect that there were more liberalizing than tightening changes, at least in terms of revenue impact.
The liberalizing amendment, of course, is the averaging amendment. Of the tightening amendments, two of these deal with capital gains, namely stock options, and deferred income payments. The two others deal with corporate tax problems. One of these is the provision relating to personal holding companies and the other is the provision relating to multiple surtax exemptions.

The first panelist is Mr. Forrest W. Brown, Jr., who is a certified public accountant in the firm of A. M. Pullen & Co. in Richmond, Virginia. He is going to talk both on the personal holding company provision and also on the provision relating to interest in the case of certain deferred payments.

MR. BROWN:

Mr. Chairman, ladies and gentlemen, as the Chairman stated I have some remarks on two subjects, personal holding companies and unstated interest on certain deferred payment contracts.

As you know the 1964 Act contains some very far-reaching provisions in respect to personal holding companies. The Code section taxing unstated interest on certain deferred payment contracts is completely new in the 1964 Act. I suppose these provisions have nothing in common except that they are both directed at sources of income which Congress felt was not being completely or fairly taxed under prior law. In other words I suppose we could say at least to some extent both of these are loop-hole closing provisions. Congress first imposed a tax on personal holding companies in 1934 to prevent individuals in high surtax brackets from avoiding income tax by having investment income taxed at the low rate applicable to corporations. The attack has been directed to closely held corporations deriving their income generally from passive investment or other sources which are identified with the stockholders rather than the corporation. The tactic of the government in this attack on corporations has been to tax the undistributed income of these corporations at a very high rate forcing the corporation to pay dividends to the stockholders and have it taxed in his individual return.

Now the problem here is to separate this one class of taxpayers from all other corporations. It, therefore, becomes a matter of definition and the definition was based on mathematical tests and the affairs of many corporate taxpayers could be arranged to avoid the impact of these tests. Congress apparently felt that the taxpayer was winning the game too often here so Congress changed the rules. The tax on undistributed income of personal holding companies is, of course, in addition to the regular corporate tax and under prior law the undistributed income of corporations was taxed at 75% of the first $2,000 of income and 85% of the excess over $2,000.

With the lower rates imposed on individuals in the 1964 Act, the personal holding company tax is also reduced. The maximum rate on
individuals in 1965 will be 70% so Congress apparently felt that a 70% rate would be just as effective in forcing these corporations to distribute income to their stockholders and the rate of personal holding company tax for 1964 and thereafter is 70%. Prior to 1964 a corporation fitted into the definition of a personal holding company, if two conditions were present. First, if at sometime during the last half of the year more than 50% in value of the outstanding stock was owned directly or indirectly by not more than five individuals; and, second, if at least 80% of its total gross income for the year was personal holding company income as defined in the Code. In computing the stock ownership in the application of that first rule, the rules of attribution in Section 544 of the Code were applied. This stock ownership test has not been changed by the 1964 Act.

For purposes of the income test, personal holding income was generally defined as dividends, rents, annuities and other forms of passive income. Provisions were included to exempt banks and certain finance companies which, although they derived a major portion of their income from interest, were conducting active businesses. Under prior law rents did not constitute personal holding income if gross rent exceeded 50% of gross income. The test of the prior law was written in terms of gross income. Net income was not a factor. Under these provisions the corporation could escape the classification of a personal holding company by deriving more than 20% of its gross income from the active conduct of a business or by deriving more than 50% of its gross income from gross rents. The 1964 Act introduces two new terms into the test for determining the liability for personal holding companies. The new Act gets away from this test in terms of gross income only. The first of these terms is ordinary gross income. Ordinary gross income is defined as gross income less capital gain. Capital gains are no longer a factor in determining classification as a personal holding company.

The second of these new terms is adjusted ordinary gross income which is ordinary gross income with adjustments to three classes of income. First, rents; second, oil, gas and mineral royalties; and, third, certain interest income. For 1964 and later years a corporation will be a personal holding company if 60% or more of adjusted gross income consists of personal holding company income. This 60% test is substituted for the previous 80% test and of course will require a great deal more non-personal holding company income to shelter a given amount of personal holding income. The change in the treatment of rental income is probably the most striking in relation to the returns which we prepare and have contact with. No longer will gross rents in excess of 50% of gross income provide a shelter. There is still a 50% test for rent but the test is now applied to determine if adjusted income from rents exceeds 50% of adjusted income. Both rents and gross income are adjusted for certain expenses. The adjusted income from rents is gross rents less depreciation,
amortization, property taxes, interest paid and rents paid in relation to the property. However, these expenses do not reduce the rental income below zero. Somewhat similar adjustments are made in oil, gas and mineral royalties. These expenses are applied against gross rents to compute adjusted income from rent and the same expenses are then applied against gross income to compute adjusted ordinary gross income. And the resulting figures are used in the 50% test. If adjusted income from rent exceeds 50% of adjusted ordinary gross income, then the rental income is not personal holding company income. If the 50% test is not met then the adjusted rental income is added to dividends, interest and other forms of personal holding income, to ascertain if 60% of the adjusted ordinary income is personal holding company income. So it is much more difficult to avoid the personal holding company classification by generating rental income within the corporation. That test makes it much more difficult to avoid the classification, but Congress was not satisfied merely with that test. The new law goes beyond this in preventing rental income from sheltering other investment income. A new 10% test is introduced. Even though adjusted income from rents exceeds 50% of adjusted ordinary gross income, if other forms of personal holding company income, the dividends, the interest, etc., exceeds 10% of ordinary gross income then rents are still classified as personal holding company income, unless the corporation pays the dividends to its stockholders in an amount of at least the excess of such other personal holding income over 10% of its ordinary gross income. That is a very confusing test. You will note that in that 10% test the test is against ordinary gross income not against adjusted ordinary gross income. The ordinary gross income, as we said, is the gross income less the capital gains and the effect of this test is that even though the corporation meets the first test, even though its adjusted income from rents is more than 50% of its adjusted ordinary gross income, if the corporation has a substantial amount of interest and dividend income it is still forced to make a distribution to its stockholders to avoid the personal holding company tax. It is still forced to distribute the excess over 10% of its ordinary gross income.

Other changes in respect to the definition of a personal holding company involve the definition of lending and finance companies which are excluded from the classification. As you can see from this the definition of a personal holding company will reach many corporations which were not so classified under the prior law. The new law does create one escape hatch for these corporations. A special provision for their liquidation is provided, and here a new term has been introduced into the law, the term, “would have been corporation.” These “would have been corporations” are corporations which were not personal holding companies under the definition of the prior law but would have been a personal holding company if the tests of the new law were applied.
Specifically, the 1964 Act provides that new personal holding rules and
definitions will not apply to "would have been corporations" which
liquidate before 1966. Would have been corporations are defined as
those which were not personal holding companies in at least one of the
two most recent taxable years ending before February 26, 1964, but
would have been a personal holding company in such year if the 1964
law had been applied. A special provision makes it possible to liquidate
a would have been corporation with a minimum of tax to its stockholders
and this is accomplished by adding a provision to section 333 in respect
to one month liquidations. If the would have been corporation is
liquidated before January 1, 1967, in a one month liquidation and the
proper elections are made under section 333, the tax effect to a stock-
holder other than a corporation is as follows: first, the prorata portion
of the corporation's earnings and profits accumulated after February 28,
1913, is taxed as long-term capital gain provided of course that the
stockholders held the stock more than six months. If the gain exceeds
the prorata part of the surplus and the taxpayer receives an amount
in excess of the prorata part of the surplus in cash or securities acquired
after December 31, 1962, that excess is also taxed as capital gain. Both of
these provisions are far more favorable than the general provisions of sec.
333 which result in taxing the prorata part of the surplus as a dividend
and reach back to December 31, 1953, in taxing the excess of cash and
securities over the prorata part of the surplus as capital gain. As in many
of these provisions the effective date complicates the situation consid-
erably in respect to these would have been corporations. And these provi-
sions can be summarized I think generally as follows: if the "would have
been corporation" is liquidated before 1966 the favorable provision for
liquidation applies. The unfavorable definitions and rules of the 1964
law defining a personal holding company do not apply. The corporation
determines its classification as a personal holding company under the
terms of the prior law. "Would have been corporations" which liquidate
after 1965, liquidate under the favorable liquidation provisions but will
be subject to the new rules and definitions of the 1964 Act. There is
another provision in respect to these "would have been corporations"
which had what is termed "qualified indebtedness" outstanding at De-
cember 31, 1963 and these corporations may under certain circumstances
liquidate after 1966 with the earnings after 1966 taxed as a dividend.
There is one other unfavorable provision in respect to the new law. Of
course, as we stated earlier the personal holding company taxes are im-
posed on undistributed personal holding company income and a dividend
distribution, therefore, reduces the amount of tax and generally enough
dividends would be distributed to eliminate the tax. For years prior to
1964 a distribution in liquidation was classified as a distribution in com-
puting undistributed income subject to the tax. The corporation in this
manner received a deduction for a liquidating distribution which was
taxed to the shareholder as capital gain. This was a situation which Congress thought needed a remedy. And of course under this section a corporation which would otherwise be a personal holding company would avoid the tax completely in the year in which it was liquidated. Under the 1964 law where there is a complete liquidation within twenty-four months after the adoption of a plan of liquidation, the corporation will not be entitled to a dividend paid deduction unless the corporation designates the distribution as a dividend and the shareholders treat such amount as a dividend to the extent of that year's income. So that the corporation can no longer match a deduction against the personal holding company income an item that is taxed as capital gain to the shareholder. A corporation must designate the distribution as a dividend and the shareholder must pay ordinary income tax on it. One danger in respect to these distributions which has not been changed in the new law but which I think we should note is that a preferential dividend of a personal holding company is not eligible for the dividend paid deduction.

The second and last subject which I have for discussion here is the new provisions in respect to interest on certain deferred payment contracts, so called unstated interest. These rules are added by new Code section 483 and in the absence of regulations the application of these sections in many cases is still very much in doubt. We do know that we will have some complicated situations under this section although the irony of it is that the committee report states that the additional revenue generated by this provision will be negligible. The reason for the provision, of course, is the practice under previous law of the taxpayer selling a capital asset on the installment basis under a contract that makes no specific provision for interest payment. The taxpayer may of course have computed the interest element, included it in the sales price but did not state it separately. He therefore, if he were selling a capital asset, reported the full amount of gain as capital gain and no interest was taxed as ordinary income. Conversely, the purchaser received no interest deduction but he may not have been hurt too badly. At least that is the way Congress felt. He may not have been hurt too badly because he may have bought a depreciable asset, included the full purchase price in his tax basis and therefore received his depreciation deduction. And of course he may have received his investment credit. Congress felt that this was an unfair result and determined that even though the taxpayer did not recognize any interest element when he drew the contract, the Internal Revenue Service would recognize it for him. So this section provides that if property is sold under a deferred payment contract which requires payments more than one year after the date of the sale and no interest is specified, or the interest which is specified is at an unrealistically low rate, a part of each payment which is due more than six months from the date of sale is to be treated as interest rather than as part of the
sales price. The new provisions apply to payments received after 1963 or sales or exchanges occurring after June 30, 1963, except in the case of a binding, written contract which was entered into prior to July 1, 1963. The portion of a payment which is regarded as interest under these provisions is treated as interest for all purposes under the Code and is treated as interest by both the buyer and the seller. Thus the seller excludes the interest portion from his sales price and reports interest income. And the buyer excludes the interest element from his tax basis and claims an interest deduction. The section applies to transactions resulting in losses as well as those resulting in gain. As in almost all provisions there are some exceptions. The section does not apply if it can be determined at the time of the sale that the sales price excluding interest specified in the contract cannot exceed $3,000. The section does not apply to the purchaser if the contract specifies carrying charges which are deductible under sec. 163 relating to interest deductions on installment purchases. The provisions do not apply to the seller if no portion of the gain is taxed as capital gain or is gain from a sec. 1231 asset. In other words, if all of the income is ordinary income under other provisions of the Code, the section which would otherwise make interest ordinary income would not apply to the seller. However, it does apply to the buyer. The section does not apply to certain transfers of patents which are considered capital assets and does not apply to those rare cases where property is exchanged for an annuity which is dependent upon life expectancy. If the section does apply it becomes necessary to compute what is called in the Code total unstated interest. And total unstated interest is defined as the excess of the total payment to which the section applies over the present value of the payments. Regulations will provide tables for the computation of the value of the deferred payment. Payments due not more than six months from the date of the sale will be regarded as having a present value of 100% of the payment. For all those due more than six months from date of sale it will not be necessary to compute the interest on a daily basis, the computation will be made to the nearest date which marks the six-months interval from the date of the sale. In cases where the future payments are indefinite as to the time and amount and cannot be determined at the date of sale, the determination of unstated interest is made separately for each payment. The determination is made at the time the payment is received taking into account the time interval between the date of sale and the date of payment. If we can force our way through those provisions and determine the total unstated interest, the unstated interest in each payment must be determined. And the unstated interest in each payment is computed by multiplying the payment by a fraction, the numerator of which is the total of the unstated interest and the denominator of which is the total payments due under the contract. In other words each dollar collected will represent the same proportion of unstated
interest regardless of the interval between the date of sale and the payment. Such a computation will have to be made for payments due under an installment contract which does not specify any interest and the computation will also have to be made for contracts which specify some interest but at a rate which is determined to be unreasonably low. Under temporary regulations which have been issued, if some interest is provided in the contract, there will be unstated interest only if the rate provided is less than 4% simple interest. Of course, this matter of unstated interest becomes particularly important in a transaction which the taxpayer intends to qualify as an installment sale and relates to the test of 30% of the sales price received in the year of sale. Apparently reducing deferred payments for unstated interest would decrease the selling price and might disqualify the sale from the installment basis by reason of the amount received in the year of sale. The moral to all this is to provide at least a 4% interest rate in these contracts and then we just won’t have to worry with the section. Thank you.

MR. WOODWORTH:

Thank you, Mr. Brown. I believe you will agree with me that these are very technical provisions Mr. Brown has been discussing. I believe it might be interesting to note that in the two provisions discussed by Mr. Brown, the recommendations of the Treasury probably were followed more closely by Congress than in the case of any of the other tightening provisions that you will hear discussed this afternoon. I would say that the recommendations of the Treasury in the case of both of these provisions were adopted almost without exception. There were some minor exceptions in the personal holding company area but the basic Treasury proposals were retained almost exactly as presented.

You might also have noted some of these phrases that Mr. Brown used like the "would-have-been corporation" and "unstated interest" and may wonder how terms like these arise. When the provision on deferred payments, for example, was being considered, it was necessary to attach some name to the payments. One suggestion was that they be referred to as the "imputed interest" provision. However, it was decided to give this provision a name more in accord with the accepted view, indicating that the interest was paid, but merely not stated separately from the other payments. In other words, the interest payment was there even though not stated. You might also have noted from Mr. Brown's discussion this was probably the first time the words "ordinary income" appeared in the Internal Revenue Code, although they are used with additional adjectives. One of the problems that we have had for many years is the fact that capital gains could be referred to rather readily, but if a class of income was to be treated as ordinary income, it was never thought appropriate to refer to it as "ordinary income" in the Code. It was always considered necessary to refer to such income as
income other than capital gain income. Now perhaps there will be more general use of the words "ordinary income" in the Internal Revenue Code.

The next provision you will hear discussed deals with stock options. In this case, I believe that Congress in the 1964 Act made sizable changes in the tax treatment of these options, but went nothing like as far as the administration proposed. The administration, in effect, wanted the special stock option provision deleted entirely. The Presidential message suggests in view of the lower tax rates provided by the new bill, that there no longer was any desirable or necessary reason for continuing any special treatment for stock options. It suggested instead that larger salary payments should be a more effective means of attracting and holding corporate executives. Congress did not quite accept this view, however. Congress still felt that stock options were important from the standpoint of providing an incentive for the executives and also that it was important to give the executive a stake in the business. At the same time, Congress recognized that there had been abuse in the stock option provisions and for that reason a series of provisions were developed to tighten the application of the stock option provisions. Mr. Hugh C. Stromswold, attorney of the Law Department of Reynolds Metals Co. of Richmond, Virginia, will tell you about these modifications. Mr. Stromswold.

MR. STROMSWOLD:

Mr. Chairman, Dr. Atkeson, ladies and gentlemen: As our Chairman has confirmed to us, the topic is Problem Areas in the Revenue Act of 1964, and the subdivision is Stock Options. Certainly stock options are a problem area, and not for the first time in the 1964 Act. Since 1950, when the concept of restricted stock options was first introduced into the Code, they have posed problems, and even before 1950 when inside and outside the courts, the Commissioner and numerous taxpayers contested bitterly the rather abstruse concept of whether options were essentially "compensatory" or "proprietary."

A certain bias can be confessed in favor of stock options as widespread and evidently very useful management tools, at the same time admitting that in some areas options have acquired a fishy odor that cannot always pass an initial sniff test. The connotations may be ludicrous; a *New Yorker* cartoon in a board room setting where an aging and affluent chairman addresses his prosperous associates: "I think we must all be congratulated for our foresight in approving these options for ourselves and thereby insuring our corporation of our continued loyal services for two more years."

**Prevailing Criticisms of Pre-1964 Options**

More serious charges were leveled against pre-1964 stock options, often by tax technicians themselves. It was said by the more technically mind-
ed that such options violated the recognized tax principle that bargain purchases from an employer are basically compensatory, and the spread between value and purchase price must be ordinary income; that capital gains treatment of the spread between the option price and the value at exercise was conceptually improper because no capital was at risk; and that the technical rules were prolix, complex and arbitrary to an extreme.

Unpleasant allegations were also asserted by some dissident shareholders groups, who said that options were unsatisfactory incentive devices—no one could ever demonstrate that profit levels or stock performance of option corporations was superior to non-option corporations; that because options were in such widespread use they were self-defeating and ineffective in attracting outside management, and in practice were used for perpetuating an aging management having no intentions of leaving with or without stock options; that consideration to the employer was inadequate and the employment contracts largely illusory since the optionees were already firmly entrenched; that such investment representations as might be required were meaningless and often no net increase in stock ownership occurred because exercise of the options required the sale of other stock in the same corporation; and that if options had no unique incentive characteristics they could only be justified as a less expensive compensatory device than cash—entirely contrary to fact since the employer obtained no tax deductions for compensation and obscured his true costs by burying them as capital transactions, ultimately leading to increased pressures on earnings per share and even constituting a substantial market depressant if large number of options were outstanding.

And even more general attacks were based on corporate morality and public policy: We heard that the law favored business executives as compared to professional classes, say lawyers or even investment brokers; that the law of restricted stock options contained no self-executing, non-discriminatory provisions customarily included in other employees benefit programs, such as pension and group insurance; and finally that options simply weren’t sporting—a kind of heads-I-win, tails-you-lose lottery, or a bet on the favorite pony after the race was over.

**Qualified Options Under the 1964 Act**

In early 1963 the Administration suggested a forthright solution to all the foregoing difficulties: outright repeal. After much soul searching and some wrenching testimony, Congress came up with its own solution. It rejected outright repeal because, as Ways and Means reported in perhaps not its most incisive statement of that period, options were incentives “to expand and improve the profit positions of the companies involved. This is not only good for the specific businesses involved, but also for the economy as a whole.” All of which is reminiscent of that
other trenchant statement, a Lincolnism aptly applied to stock options: “people who like this sort of thing will find this just the sort of thing they like.”

In any event the ultimate Congressional solution was not to repeal the old system, but to approve three systems:

—Restricted stock options were retained with certain limitations provided they had been granted (or a binding contract to grant them had been entered into) before 1964. Thus, eventually but not now restricted stock options will find their way to the boneyard of discarded tax schemes.

—Employee stock purchase plans were approved, the rules resembling those for the old restricted stock options except for the inclusion of numerous non-discriminatory provisions.

—Qualified stock options were instituted, largely preempting the field being vacated by restricted stock options.

Since most of the recent interest has been in the latter category of qualified stock options, our discussion will be limited to that group. The new statutory rules reek with numerical limitations, even more arbitrary than those for which the old restricted stock options were roundly criticized. First, there must be a Plan and then an Option under the Plan. Then, take any number from ten to zero and somewhere it fits into the scheme. Our more mathematically inclined friends tell us that all these numbers are susceptible to arrangement in a geometric progression and that so arranged they might make some sense. But it is not apparent from the committee reports that this arrangement is particularly significant, so we will start at the back and creep up, which is a practical way of approaching anything so elusive as a qualified stock option. Arranged in such backwards order, the numbers are:

10 Years The grant must be within ten years of the date of adoption of the Plan or its approval by the shareholders, whichever is earlier. No corresponding limitation was in prior law.

5 Years The maximum term of the option is five years, which compares to ten years under prior law.

3 Years The minimum holding period of the stock for favorable tax treatment is three years, which corresponds roughly to the requirement in prior law permitting disposition of stock within two years from the date of option grant and six months from the date of option exercise with overlapping periods permitted. Earlier disposition of qualified option stock will lead to treatment of the spread as ordinary income to the employee and an allowable deduction to the employer in the year of disposition—if the employer is fortunate enough to learn of the disposition.
1 Year

The period within which a Plan must be approved by the shareholders is one year—before or after adoption by the corporation.

3 Months

The period within which the option must have been exercised by the employee is three months following termination of employment.

0 Days

The employee must have been continuously in the employment of the granting corporation (or its subsidiary or parent) from the date of grant to the date of exercise. This supersedes the so-called four-day loophole under prior law where, shareholders and employers willing, it was said that employees might work two days at the time of grant and two days at the time of exercise and obtain complete statutory benefits.

Then there are certain percentage limitations starting at:

150%

The amount of the spread to be treated as ordinary income is 150% if a good faith but faulty attempt is made to determine fair market value (the spread being the difference between option price and fair market at date of grant).

100%

The option price must be at least 100% of fair market on the date of grant.

10%

If equity capital is $1,000,000 or less an employee is eligible for options if he does not own more than 10% of all classes of stock.

9%, 8%, 7%, 6%, 5%

For each $200,000 increase in equity capital above $1,000,000, the percentage of permissible stock ownership decreases by one point, with 5% the maximum permissible ownership when equity capital is $2,000,000 or more. All this replaces the provisions in prior law (widely regarded as a placebo to a small group of willful men who happened also to be members of the Senate Finance Committee in the late forties and opposed all restricted stock options in principle), which permitted 5-year—110% options to persons owning more than 10% of the voting stock.

Other limitations do not lend themselves to arithmetical expression. The meaning of some of them is not entirely clear but of others it is all too obvious. Hope for clarifying regulations before some irrevocable and perhaps tragic decisions are made in 1964 has all but faded. As of this December day none have as yet even been proposed.

Perhaps the most significant of the non-arithmetical provisions is the so-called reset or more precisely the antireset rule. In prior law limited prohibitions against reset of the option price were achieved by including any attempted reset in a definition of a "modification" and providing
that the option price would be based on the higher of the price at the time of the original grant or at the time of the attempted reset or modification. But then there was a lollipop provision—a noble monument to the persuasive power of some ancient advocate—that if the market dropped significantly so that for twelve consecutive months the stock value was less than 80% of market at the time of grant, the price could be reset to the lower value and all this anti-reset nonsense would be inapplicable. Thus nobody could get badly hurt so long as the resetting corporation was willing to run the risk of incurring the wrath of any dissident outside shareholders, who having fretfully endured sharp value decreases in their own equity holdings might not be charitably inclined if a fairy godmother committee should reset the option prices near the anticipated bottom of the market.

Cancellation of Restricted Options in 1964

No longer is such convenient reset possible. Under the 1964 Act, with one notable exception once an option has been issued it will be deemed outstanding despite any corporate action to cancel or change the option price; and, more important, so long as it is so deemed it must be exercised before any exercise of a subsequently issued, lower priced qualified option. The notable exception is that restricted stock options apparently may be terminated in 1964 and if this is done they will no longer be deemed outstanding. Thus, although myth hath it that some regulatory strings might be attempted on what has been appropriately dubbed the “too much candy for a nickel” theory, it would appear that for 26 more days (including Christmas, which is appropriate under such circumstances) cancellations of restricted stock options will remove all such options from the realm of the outstanding.

Whether or not outstanding restricted options should be cancelled in 1964 has occasioned many moments of the most excruciating agony. Superficially, it might seem a splendid thing to do if substantial options are outstanding at prices significantly above current market, which could effectively paralyze the entire stock option plan. But there are important countervailing considerations: stock acquired under new options must now be held for at least three years, whereas that acquired under old options could be disposed of in six months assuming the two-year holding period for the option has already been met. This could be a significant disadvantage, not only because the acquisition must be financed for a much longer holding period but also because the option holder would be precluded from all trading at any peak market prices occurring during the additional 2-½ years for which the stock must be held. The evaluation of all relevant consideration demands certain clairvoyant powers quite beyond the ken of the moving parties. Another obvious disadvantage is that if the old options were issued only a year or so ago, their remaining term will be longer than the maximum per-
missible term for new qualified options, and thus the old options would again afford greater market opportunities.

Propects

All this suggests that the warm and pleasant glow commonly associated with stock options has faded, if not indeed wholly departed. The 1964 Act cuts stock options twice and deeply: not only have the mechanical limitations greatly reduced their appeal, but the narrowed spread between capital gains and ordinary income tax rates has further diminished their usefulness except for highly compensated employees or the more sensational stock appreciations. Simple arithmetic computations, where the spread between the option price of the stock and its fair value on date of exercise is properly treated as a non-deductible capital cost to the employer, will disclose that for a given after-tax cost to the employer, most employees will probably do better with ordinary income than with stock options unless the employee’s compensation is approaching $100,000 per year or stock appreciation is particularly large. This result follows not only from the decreased spread between capital gain and individual ordinary income rates, but because corporate rates have been reduced by a maximum of 4 points whereas individual rates have been reduced by as much as 21 points. Hence, loss of the deduction if compensation is in the form of a stock option is now relatively more significant to the corporation than would be loss of capital gains to the employee if the compensation is in cash.

Of course substantial arguments remain in favor of the unique incentive status of stock options, even if they may now have become generally more costly than ordinary compensation. For 15 years the relative merits of stock options have been debated. A moment of truth may be at hand: if the principal attraction of stock options is the unique incentive value of a proprietary interest in the employer, stock options can be expected to remain an important part of the executive compensation package. But if the motivation is to get maximum cash in the employee’s pocket with a minimum cost to the employer, the days of the everywhere abounding stock option may indeed have been numbered by the 1964 Act.

MR. WOODWORTH:

Thank you very much, Mr. Stromswold, for your views on the new stock option provisions.

The next speaker is going to deal with a topic which in some ways is even more complex than those you have heard up to this point: namely, the problem of multiple corporations. This, too, is an area where the administration initially recommended the deletion of multiple surtax exemptions. While this may sound like a simple solution to the problem; nevertheless, in proposing the deletion, they found no easy way of saying
what groups of corporations should be treated as one. That was the big
problem.

In any event, Congress did not quite see the problem the same way
the executive branch did. Congress, in essence, decided to permit mul-
tiple groups of corporations to retain their present relative position,
but be sure that the congressional action taken in lowering the tax rate
applying to the first $25,000 did not increase the incentive to set up
multiple corporations. In other words, the idea was to leave the
companies involved essentially where they were. Thus, there was an
attempt to remove the advantage of the additional lowering of rates
for multiple corporations but essentially to leave them with whatever
advantages they previously had.

Fortunately, to discuss this provision we have Thomas Terry. He is
an attorney in the Legislation and Regulations Division in the Chief
Counsel's office of the Internal Revenue Service. Mr. Terry has a vast
store of knowledge on this topic. He sat in on the drafting of this pro-
vision and was one of the chief architects of this provision. I do not
mean to saddle him with the responsibility for the form of this provision,
however. He was given a series of objectives which by themselves estab-
lished much of the format to be followed. Mr. Terry.

MR. TERRY:

Introduction

My assignment on this panel is a discussion of the provisions of the
Revenue Act of 1964 relating to multiple corporations. I am sure that
those of you who have studied the 1964 Act understand the problems I
face in trying to do justice to my subject in the time allotted, so I'll
dispense with the customary apologies and get right down to business.
There is one reservation, however, which I should make clear at the
outset—particularly in view of the distinguished audience we have to-
day. The views I express during the course of my presentation are my
own and they do not necessarily represent the position of the Acting
Commissioner, the Chief Counsel—or anybody else who is the slightest
bit important.

There are 5 provisions of the new Revenue Act which have consider-
able impact on the multiple corporate form of business organizations:

(1) The corporate rate reduction itself is obviously of vital im-
portance. When the tax cuts are fully effective in 1965, corpora-
tions will pay 22 per cent on the first $25,000 of their taxable in-
come and 48 percent on the excess.

(2) In the case of multiple corporations which are subject to
common ownership, there is a new penalty tax which increases the
22 percent rate to 28 percent.

(3) Section 1551 of the Code, which deals with the creation of
multiple corporations for the purposes of tax avoidance, has been "tightened".

(4) Certain multiple corporate organizations are now eligible to elect to receive a 100-percent dividends received deduction in the case of intercorporate dividends, instead of an 85-percent deduction.

(5) Finally, the additional 2 percent tax which formerly applied to groups of corporations joining in the filing of a consolidated return has been repealed.

I am going to focus primarily on the first three areas, the rate reduction, the new penalty tax, and the amendment to section 1551. The Chief Counsel, Mr. Cohen, in his remarks on the Revenue Act of 1964, will discuss the 100-percent dividends received deduction election in some detail. As far as the repeal of the 2-percent tax on consolidated returns is concerned, I will mention it only briefly.

BACKGROUND

Before launching into the specific details of these new provisions, let me review briefly the multiple corporations situation as it existed before the 1964 Act. For many years now, our corporate income tax structure has had a two-step graduation feature. For example, immediately before the Revenue Act of 1964, a normal tax of 30 percent was imposed on every dollar of corporate income and a surtax of 22 percent tax was imposed on corporate income in excess of $25,000. In other words, the rate of tax applicable to corporate income not in excess of the $25,000 "surtax exemption" was 30 percent, and the rate applicable to corporate income in excess of $25,000 was 52 percent (that is, the 30 percent normal tax plus the 22 percent surtax). The legislative history of this 2-step corporate rate structure makes it quite clear that the reason for the exemption from surtax for corporate income of $25,000 and below is to provide a tax concession for small business. However, this small business tax concession has proved to be a stimulus for large and medium-sized businesses to split up into multiple corporations and thereby escape the surtax on a large proportion of the aggregate taxable income of the business as a whole. Traditionally, the only means available to the Revenue Service to prevent this multiple corporation distortion of the surtax exemption were certain statutory provisions and judicially developed rules which required a finding of tax avoidance on the part of the taxpayer. For example, sections 269, 482, and 1551 of the Code have all been used against multiple incorporations.

The Treasury and the Revenue Service have never been satisfied with this situation. The multiple corporation problem, as they see it, is strictly a matter of confining the benefits of the surtax exemption to
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the taxpayers who Congress intended to benefit. The Treasury argues that since, insofar as the surtax exemption is concerned, "small business" is the intended beneficiary, why should a multi-million dollar business merely through the legal formality of organizing separate corporations, be entitled to several dozen—or several hundred—small business concessions (that is, several hundred surtax exemptions)? Even if there are very substantial business reasons for separate corporations—and, thus, the separate corporations are immune from attack on "tax avoidance" grounds—isn't there something wrong when a small bonus for small business is being converted into a large bonus for large business?

PROPOSED RATE CHANGES

This, then, was the situation when the tax reduction and reform program was being readied by the Administration for presentation to the Congress in 1963. Furthermore, included within these tax reduction proposals was a plan to grant even greater tax concessions to small business than was the case under existing law. This was ultimately achieved by reducing the 30 percent normal tax to 22 percent—a rate reduction of approximately 27 percent—while the overall corporate rate of 52 percent was reduced to 48 percent—a rate reduction of only 7.7 percent. In other words, the surtax exemption was to become even more valuable ($5,500 under the old rate vs. $6,500 under the new rates). So, if Treasury was unhappy with the multiple corporation situation before the new rate changes, it was positively mortified at the possibilities inherent in the new rate structure.

ADMINISTRATION PROPOSAL AND CONGRESSIONAL REACTION

It was against this background, then, that the Administration's multiple corporation recommendations were developed. Generally speaking, it was recommended that after a 5-year transition period groups of corporations subject to common ownership and control be treated as a single corporation for surtax exemption purposes. That is, each such group would receive a single surtax exemption—and thus the 22 percent rate would apply to only $25,000 of the aggregate taxable income of the business as a whole. If Congress had adopted this recommendation, of course, it would have been the coup de grace in the multiple corporation area from the Treasury's point of view. Not only would the recommendation have prevented the windfall which multiple corporate groups would receive as a result of the reduction in the normal rate from 30 percent to 22 percent, but it would also have eliminated the tax advantage this form of business organization enjoyed over businesses utilizing a single corporate structure. Congress, on the other hand, had something else in mind. Rather than accept the "complete solution" to the multiple corporation problem as advocated by the Treasury, the
Ways and Means Committee developed an elective penalty tax system which was designed only to prevent multiple corporate groups from receiving a windfall tax reduction.

**Statutory Pattern**

Let us turn now from the legislative background to the new statutory provisions. The multiple surtax exemption provisions are contained in new sections 1561 through 1563 of the Code. Under section 1561, the corporations which are members of a "controlled group of corporations" are limited to a single $25,000 surtax exemption instead of a separate $25,000 exemption for each corporation. This means that a single $25,000 exemption must be allocated among the members of the group. This—so far—is the Treasury's original proposal. However, and this of course was not a part of the Treasury's proposal—under section 1562 a controlled group of corporations may elect to retain multiple surtax exemptions. If the group makes this election, each corporation in the group must pay an "additional tax" of 6 percent on its taxable income not in excess of $25,000. To summarize, then, the effect of the new statute:

1. A corporation which is not a member of a controlled group of corporations pays 22 percent on the first $25,000 of its taxable income and 48 percent on the remainder.
2. In the case of a controlled group of corporations which does not elect multiple surtax exemptions under section 1562, the first $25,000 of the group's income will be taxed at 22 percent and the balance at 48 percent.
3. In the case of a controlled group of corporations which does elect under section 1562, each corporation in the group will pay a tax of 28 percent on the first $25,000 of its taxable income (that is 22 percent normal tax plus the 6 percent penalty, or "additional" tax). The balance will be taxable at 48 percent.

Obviously, the best category to be in is the "non-controlled" corporation class. If a corporation is independently owned and has taxable income of $25,000, the 1964 Act produces a tax cut of 27 percent (that is, from 30 percent to 22 percent). On the other hand, corporations which are members of a controlled group electing multiple surtax exemptions receive a tax cut of only 6.7 percent on this lower bracket income (that is, from 30 percent to 28 percent). This is approximately the same percentage tax reduction which all corporations receive on their taxable income in excess of $25,000 (from 52 percent to 48 percent, or a 7.7 percent reduction). It should be noted that it is not always advantageous for a multiple group to elect multiple exemptions and pay the 6 percent penalty. I will cover this possibility in more detail later.
The key definitions and concepts which are necessary to apply the rules contained in sections 1561 and 1562 appear in section 1563. First, the definition of a “controlled group of corporations” is obviously of vital importance. Basically there are two types of “controlled groups”—parent-subsidiary and brother-sister. A parent-subsidiary controlled group is defined in section 1563(a)(1) as one or more chains of corporations connected through 80-percent stock ownership with a common parent corporation. A simple example of a parent-subsidiary controlled group is a parent corporation owning 80 percent of the stock of a subsidiary which in turn owns 80 percent of a sub-subsidiary. The “chain concept” used here is similar to the technique used in section 1504 in defining an “affiliated group” for purposes of consolidated returns. Actually, the controlled group definition is broader, that is, it is possible for a group of corporations to be ineligible to file consolidated returns and yet constitute a “controlled group” for multiple surtax exemption purposes.

The second basic category of controlled groups is a brother-sister group. This covers situations where one individual, estate, or trust owns 80 percent of the stock of 2 or more corporations. Although tax lawyers and accountants have used the term “brother-sister” corporations for years, as far as I know this is the first occasion when the concept has been dignified by actually appearing in the statute.

Attribution

In determining stock ownership for purposes of applying these definitions, attribution rules are applicable. In testing for parent-subsidiary controlled groups, attribution is limited to situations where a corporation has an option to acquire the stock of another corporation. In testing for brother-sister groups, however, a full set of attribution rules apply. These are contained in section 1563(e). Generally speaking, these rules cover the same type of relationships which are covered in section 318 of the Code. However, they are considerably more liberal than the section 318 rules in several important respects. For example, back attribution has been eliminated and the family attribution rules have been liberalized. One of the more interesting liberalizations is the husband-wife attribution rule. Under section 1563(e)(5), a husband is not considered to own stock of a corporation owned by his wife, if the husband does not own directly any stock in that particular corporation and if the husband doesn’t participate in the management of the wife’s corporation, among other things. I realize that some of our Revenue Agents are pretty resourceful guys, but I somehow doubt that they should be expected to determine whether Dad is giving Mom some business advice in the sanctity of the bedroom, particularly in view of the Supreme Court’s recent discussion outlawing the spike-mike!
EXCLUDED STOCK

In addition to the attribution rules which are applicable in testing for stock ownership, there is a new concept called "excluded stock". Under these rules certain outstanding stock of a corporation is treated as if it were not outstanding. The effect is to "shrink" the denominator of the fraction in testing for 80 percent stock ownership. For example, stock in a corporation held by employees of the corporation is treated as excluded stock if the stock, in the employee's hands, is subject to a right of first refusal (or a similar restriction) running in favor of a substantial corporate shareholder of the corporation. Thus, assume a parent corporation owns 70 percent of the stock of 10 subsidiaries and the other 30 percent of the subsidiaries' stock is owned by the manager of each subsidiary subject to a right of first refusal running in favor of the parent corporation. In the absence of the excluded stock rules, the parent would own only 70 percent of the stock of each subsidiary and the corporations would fall outside the definition of a parent-subsidiary controlled group. However, after excluding the manager's stock, the parent is treated as owning 100 percent of the stock of each of the 10 subsidiaries and the result is a parent-subsidiary controlled group. The justification for this rule is that the stock ownership of the manager in these situations is a transitory arrangement which typically forms a method of compensating the employee and should not be recognized as a true minority interest.

COMPONENT MEMBERS

Up to this point, I have used the term "member" of a controlled group of corporations rather loosely. In fact, the only corporations which are affected by the new provisions are corporations which are component members of a controlled group of corporations, as defined in section 1563(b). The corporations which are component members of a controlled group are determined in the following manner:

Step I—The corporations which are members of a controlled group are determined as of December 31 by applying the stock ownership tests I have previously described. A graphic method of expressing this is to say a "still picture" of the stock ownership situation is taken as of December 31.

Step II—A corporation which is not a member of the group on the December 31 but which has been a member for one-half or more of the number of days in its taxable year preceding the December 31 (that is, has met the stock ownership tests for this period) is treated as an additional member of the group on the December 31. Conversely, a corporation which is a member of the group on the December 31 but which has not been a member for at least one-half of the number of days in its taxable year preceding the December 31 is treated as an
excluded member of the group on the December 31. Thus, the "still picture" taken in Step I is modified by the "moving picture" taken in Step II.

**Step III**—Finally, certain types of corporations—generally, corporations which derive no benefit from the surtax exemption—are treated as excluded members. For example, tax-exempt corporations and non-resident foreign corporations.

**Operating Details**

Now that we have the general statutory pattern and the key definitions and concepts mastered, I would like to briefly cover several additional points relating to the multiple surtax exemption election:

(1) The election of multiple surtax exemptions by a controlled group under section 1562 is made with respect to a particular December 31 and may be made at anytime within the three-year period prescribed by section 1562(e)(1). The election is to be made in the manner prescribed by regulations. The Revenue Service published temporary regulations in May of this year giving the details of how an election with respect to December 31, 1963 is to be made. These temporary rules will, in the near future, be superseded by permanent regulations which will, of course, cover all phases of the new multiple corporation provisions.¹

(2) Once an election under section 1562 is made it remains in effect, without renewal, until terminated in one of the ways described in section 1562(c). Again, a termination by consent under section 1562(c)(1) is made with respect to a particular December 31 and may be made within the 3-year period prescribed by section 1562(e)(2).

(3) Once an election is terminated, in any of the four ways described in section 1562(c), however, the group may not reelect under section 1562 for 5 years. Since I have noticed some confusion on the part of the commentators as to when this 5-year period begins to run, let me give you a simple example. Assume a controlled group makes a multiple surtax exemption election with respect to December 31, 1964, sometime in 1965. Later, say in 1967, the group discovers that it would be better off taxwise had the election never been made. So, the election is terminated by

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¹**Editor's note:** Proposed regulations under section 1561 through 1563 of the Code were published in the Federal Register for February 25, 1965. The Internal Revenue Service has recently announced that, pending issuance of final Regulations, controlled groups of corporations may rely on the rules in the proposed Regulations to elect multiple surtax exemptions under section 1562(a)(1). See Internal Revenue Service, Technical Information Release No. 700, dated February 25, 1965.
consent with respect to December 31, 1964. The important point is that the 5-year "waiting period" begins to run on December 31, 1964, and not in 1967 when the consents to the termination are filed. Thus, in this example, the group could reelect multiple exemptions with respect to December 31, 1970.

Amendment of Section 1551

To return to a point I made early in this presentation, the 6-percent penalty tax system is not and does not purport to be, a complete solution to the multiple corporation problem. Congress specifically stated in the committee reports accompanying the 1964 Act that multiple corporate organizations electing multiple surtax exemptions under section 1562 were not immune from attack under the tax avoidance provisions of the Code. In fact, Congress strengthened the most important weapon the Commissioner has in his multiple corporation arsenal—section 1551. Section 1551, in general, provides that the surtax exemption of a corporation created by the transfer of property will be disallowed unless it is proven that the securing of the surtax exemption was not a major purpose of the transfer. First, section 1551 as amended, now covers "indirect" transfers of property. Under prior law, the section was interpreted to reach only direct transfers of property other than money. The amendment is designed to bring within the scope of section 1551 transfers of money to a newly created subsidiary followed by a "buy back" of property from the transferor. Secondly, section 1551 has been expanded to include the creation of brother-sister corporations by five or fewer individuals.

Conclusion

I will conclude by making some random observations on the new multiple corporation package:

(1) Controlled groups of corporations which have, in the aggregate, income of $32,500 and below after 1964 will be better off apportioning a single surtax exemption under section 1561 than if they elect multiple exemptions under section 1562, provided that the $32,500 is divided among the members so that no member has income over $25,000.

(2) The three-year period within which a controlled group can elect multiple exemptions can lull you into a false sense of security. This is particularly true in the case of parent-subsidiary controlled groups which must weigh the advantages of a section 1562 election against the possibility of electing the 100-percent dividends received deduction under new section 243(b) and the filing of a consolidated return. These latter elections must be made long before the three-year period for electing multiple surtax exemptions runs. Thus, you should analyze your particular situation while you still have time to go either way. Moreover, even in the case of a brother-sister group which can only
choose section 1561 or 1562, if you wait and a corporation leaves the group (for example, the stock is sold off to another person) it may be difficult, or costly, to get its consent to the retroactive section 1562 election.

(3) Since, the Revenue Act of 1964 repeals the 2 percent penalty tax on consolidated returns, controlled groups which qualify as affiliated groups under section 1504 should seriously consider the possibility of filing consolidated returns. The advice is not altogether altruistic, I might add, because the Internal Revenue Service and the Treasury are convinced that consolidated returns produce the conceptually correct method of measuring the income of related corporations. And, of course, only one surtax exemption is available on a consolidated return.

(4) Obviously, objective stock ownership tests used for purposes defining a controlled group of corporations—particularly the one individual rule in the case of brother-sister groups—invite some stock ownership manipulation for “de control” purposes. Bona fide, no strings attached transfers of stock to a stranger (for example, your brother) of course are above reproach. However, be very wary of agreements, express or implied, between the purchaser or donee of this stock which, in effect, permit the seller or donor to retain the voting power of the stock sold or given away.2

(5) The problem which seems to be the most popular, at least insofar as the commentators are concerned, is the applicability of the multiple corporation provisions in situations where the controlled group of corporations includes a corporation which has elected not to be taxed as a corporation under Subchapter S of the Code. For example, assume an individual owns all the stock of corporations X, Y, and S and corporation S has made the subchapter S election. X, Y, and S, of course, are members of a brother-sister controlled group. Assume also that the group elects multiple surtax exemptions under section 1562. X and Y will be subject to the 6-percent additional tax imposed by section 1562(b), but what about S? Since S obtains no benefit from a surtax exemption (its income is not subject to the corporate tax), from a pure policy standpoint the correct result would seem to be that the 6-percent penalty does not apply. Moreover, a careful reading of the provisions of section 1562 which relate to the imposition of the penalty tax, and section 1372(b), relating to the effect of a subchapter S election, indicate that this, in fact, is the result obtained. Section 1562(b)(2) provides that the 6-percent tax “shall be treated as imposed by section 11” if, for the taxable year of the corporation, a tax is imposed by section 11 on the taxable income of the corporation. Now as I read section 11 and section 1372(b), a tax is technically imposed

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2Editor's note: See paragraph (a) (6) of § 1.1563-1 of the proposed regulations published in the Federal Register for February 25, 1965.
on the taxable income of the subchapter S corporation by section 11, but the tax so imposed is "forgiven" under section 1372(b). Thus, since the 6-percent tax is treated as if imposed by section 11 both the section 11 and the 6-percent penalty tax is rendered nonapplicable by section 1372(b). I suspect you will find something on this in the regulations.3

This concludes my prepared material. I will be very interested in any questions you might have. Thank you for your attention.

MR. WOODWORTH:
Thank you, Mr. Terry, for that excellent presentation. Our next, and final panelist, will discuss for us the new averaging provisions. This is a subject as old as the graduated income tax. However, every step that has been taken in the evolutionary process of trying to achieve real averaging is greeted with renewed interest and this is no exception. This is perhaps the longest single step ever taken on our pathway towards the goal of true averaging. I would like to review for you the history of the previous steps that have helped to bring us to the position attained by the 1964 Act, but our time is running short and I do not want to impose unduly upon our speaker's time. Our speaker is Mr. David O. Williams, attorney and Branch Chief in the Legislation and Regulations Division of the office of the Chief Counsel for the Internal Revenue Service. He should feel very much at home down here with you as he earned both his law degree and his degree of Master of Law and Taxation from the College of William and Mary. Mr. Williams.

MR. WILLIAMS:
Dr. Atkeson, Mr. Chairman, panel members, and members of the conference. It is indeed a real honor for me to have been invited to participate in this Tenth Annual Tax Conference. It is always a pleasure for me to return to Williamsburg especially when I can visit with my close friend and adviser, Dr. Atkeson. It is a privilege for me to be associated with these distinguished members of the panel and our renowned Chairman, Dr. Woodworth. As Dr. Woodworth has stated, I will discuss with you the Income Averaging provisions of the Revenue Act of 1964.

The income tax burden of taxpayers whose income is bunched in a single taxable year, or whose income fluctuates from year to year, has been a matter of concern to Congress and commentators on the income tax laws for more than two decades. The combination of a progressive rate structure 1963—20 to 91%; 1964—16 to 77%; 1965—14 to 70%)

*Editor's note: See paragraph (c) (1) of § 1.1561-1 and paragraph (b) (2) (ii) of § 1.1563-1 of the proposed regulations published in the Federal Register for February 25, 1965.*
and a necessary annual accounting period have combined to require taxpayers with widely fluctuating incomes to pay far greater amounts of income tax than taxpayers with the same total amount of income spread evenly over the same number of years.

This inequity has been alleviated very substantially by the income averaging provisions of the Revenue Act of 1964. These provisions were recommended by President Kennedy in his 1963 Tax Message to Congress. He recommended that an income averaging provision be enacted to provide more equitable tax treatment for those who receive in a single taxable year unusually large amounts of income as compared to their average income for preceding years. In discussing the recommendation President Kennedy said:

This proposal will go beyond the narrowly confined and complex averaging provisions of present law and will permit their elimination from the Internal Revenue Code. It will provide one formula of general application to those with wide fluctuations in income. This means fairer tax treatment for authors, professional artists, actors, and athletes, as well as farmers, ranchers, fishermen, attorneys, architects, and others.

Prior to the Revenue Act of 1964, Congress had afforded a measure of relief in certain bunched income situations. These former averaging provisions were applicable to income from specific sources. They were:

1. Compensation from an employment;
2. Income from an invention or artistic work;
3. Income from back pay;
4. Damages from patent infringement;
5. Breach of contract; and
6. Damages for anti-trust injuries.

With a single exception, these provisions have been eliminated from the Code. Congress did, however, allow taxpayer having compensation from a qualifying employment to elect the former treatment of such income. However, the compensation must arise from an employment which began before February 6, 1963.

The averaging provisions eliminated by Congress were difficult to use. They required a recomputation of the amount of income and the amount of tax due for prior years as if the allocable portion of the bunched income had actually been received in those years. Under the 1964 Act provisions, no recomputations are necessary. A tax computation is made only for the year for which a taxpayer chooses to use the income averaging provisions.

The income averaging provisions of the 1964 Act are contained in
sections 1301 through 1305 of the Code. They are applicable to taxable years beginning after December 31, 1963. They are available only to certain “eligible individuals” who choose the benefits of the provisions and who have more than $3,000 of “averagable income”.

This provision is available for most kinds of ordinary income, such as, professional fees, salaries, commissions, dividends, interest, income from a sole proprietorship, or a partnership. Averaging is not available for income arising from wagering transactions, or in certain cases, for income from interests in property received by gift, bequest, devise, or inheritance. In addition, income averaging is not available for long-term capital gains.

Section 1301 of the Code (relating to limitation on tax) provides that if an eligible individual has averagable income for the computation year, and if the amount of such income exceeds $3,000, then the tax imposed by section 1 for the computation year which is attributable to the averagable income shall be 5 times the increase in tax under such section which would result from adding 20 percent of such income to the sum of—

1. 133-\(\frac{1}{2}\) percent of average base period income, and
2. the amount (if any) of the average base period capital gain net income.

Although the nomenclature used in section 1301 is novel, the fundamental principle is rather simple. In effect, section 1301 requires a comparison between the amount of an individual’s income for the current taxable year (i.e., the computation year) and his average income for the four immediately preceding taxable years (i.e., the base period years).

In order to make the required comparison, three basic determinations must be made. First, an individual’s average base period income must be determined. Average base period income is the average of the taxable incomes, with certain adjustments, for each of an individual’s 4 immediately preceding taxable years. Next, an individual’s taxable income for the computation year must be determined; i.e., his taxable income for the current taxable year for which he chooses the benefits of income averaging. After having made the adjustments for the current taxable year, the resulting amount is his “adjusted taxable income.”

The third determination necessary in making the comparison is the computation of the individual’s “averagable income”. The amount by which “adjusted taxable income” exceeds 133-\(\frac{1}{2}\) percent of average base period income is the individual’s “averagable income” for the current taxable year. However, if a taxpayer normally has long-term capital gain income, but receives ordinary income in the computation year, Congress has provided for a reduction in the amount of income subject to averaging. This reduction is the amount by which the individual’s
average base period capital gain net income (i.e., an amount equal to \( \frac{1}{4} \) of the sum of the excess of an individual's net long-term capital gains over his net short-term capital losses for each of his four base period years) exceeds his capital gain net income for the computation year.

While 1964 is the first year that may be used as a computation year, years prior to 1964 may be used as base period years. In most cases the only adjustment an individual will have to make in using the income averaging provisions is the adjustment for capital gains. In extraordinary cases several adjustments will, however, be necessary.

The relative simplicity of income averaging can be illustrated by the following example. In this example, the taxable income of the individual does not require any adjustments. John Smith, an eligible individual, is a salaried employee; he has never been married; and his taxable year is the calendar year. Mr. Smith decides to take advantage of the income averaging provisions for the taxable year 1964 since he has received bunched income in the amount of $40,000. First, Mr. Smith computes the average of his taxable incomes for the four taxable years preceding 1964. Since Mr. Smith had only salary income as taxable income for the preceding four years, these same amounts of taxable income are used in computing Mr. Smith's average base period income.

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>$2,000</td>
</tr>
<tr>
<td>1961</td>
<td>2,500</td>
</tr>
<tr>
<td>1962</td>
<td>3,000</td>
</tr>
<tr>
<td>1963</td>
<td>4,500</td>
</tr>
</tbody>
</table>

\[ \$12,000 \div 4 = \$3,000 \] (the average base period income).

Next, Mr. Smith computes his taxable income for 1964 and determines it to be $44,000, all of which is ordinary income. Mr. Smith then computes his averagable income in the following manner. First, Mr. Smith computes the amount of his income which is not subject to averaging; that is \( 133\frac{1}{3} \) percent of $3,000 (average base period income) or $4,000. Second, the $4,000 is subtracted from the $44,000 leaving $40,000 which is Mr. Smith's averagable income. Since Mr. Smith's averagable income is more than $3,000, then he is eligible to average. It is important to note the requirement that the amount subject to averaging be in excess of $3,000 is only a test to determine eligibility. Once eligibility has been established, the full excess is subject to averaging.

**Computation of Tax**

Since Mr. Smith's taxable income required no adjustments, his taxable income for 1964 is divided into two segments:

(1) 133-\( \frac{1}{3} \) percent of the average base period income $4,000—the amount not subject to averaging; and

(2) The averagable income ($40,000).
Using the 1964 tax tables, Mr. Smith's tax liability is computed as follows:

1. Tax on amount not subject to averaging ($4,000) and the 1/5 of the averagable income ($8,000) $ 3,040

2. Tax on 1/5 of the averagable income:
   Tax from (1) = $3,040
   Less tax on $4,000 740 2,300

3. Total tax on averagable income (5 x $2,300) 11,500

4. Total tax liability ($11,500 - $740) 12,240

Tax liability without averaging 20,130

Tax saving: $7,890

If Mr. Smith's income had included such items as capital gains, wagering income, or income attributable to gifts, bequests, devises, or inheritances, the computation of the amount of averagable income and of tax liability would be more complex. Let's examine the adjustments that are necessary to the income for the computation year and to the income of the base period years when an individual's income includes such items.

**ADJUSTED TAXABLE INCOME**

Adjustments are made to the taxable income for the computation year in the following situations. After the taxable income for the computation year has been determined, it is decreased by the following amounts:

1. Taxable income is reduced by the amount of capital gain net income for that year. "Capital gain net income" is 50 percent of the amount by which net long-term capital gains exceed net short-term capital losses. Capital gain net income may never be less than zero. The House Committee Report states that net capital gains are excluded from the income subject to averaging in the computation year on the grounds that such income does not require averaging because only 50 percent of the capital gain income is included in the tax base in any event. Moreover, the maximum tax rate applicable to such income may never exceed 25 percent of its dollar amount.

2. Taxable income for the computation year is reduced by the excess of wagering gains in the year over wagering losses; and also taxable income is reduced by certain amounts of income of owner-employees for pension plan purposes to which penalties are applicable. The House Committee Report indicates that these amounts are excluded from averagable income in order to prevent them from receiving a preferred status.

3. (a) Taxable income for the computation year is further reduced
by the net income attributable to interests in property received by gift, bequest, devise, or inheritance, if (1) the amount of net income exceeds $3,000, and (2) the interest in property was received in the computation year or in a base period year. (If a joint return is filed for the computation year, taxable income is adjusted only if the sum of the net income attributable to interests in property received by the husband and wife exceed $3,000.)

The Committee Report states that these amounts are excluded because such income does not arise from any additional efforts on the part of the taxpayer but merely represents a transfer to the taxpayer of income previously received by someone else. The term “net income” means the excess of items of gross income attributable to such interest over the deductions properly allocable to or chargeable against such items. However, capital gains and losses are not taken into account for purposes of computing net income.

(b) Income attributable to gifts, bequests, devises, or inheritances between husband and a wife is not deducted from the taxable income for the computation year if they file a joint return for that year, or if one of them makes a return for that year as a surviving spouse. Since it may, in many cases, be difficult to trace specific income to specific property interests in gifts, bequests, devises, or inheritances, section 1302 provides that the income for any taxable year attributable to such an interest in property shall be deemed to be 6 percent of the fair market value of such property interest at the time of its receipt unless the taxpayer establishes the actual amount of the net income.

Any adjustments made to taxable income for the computation year to determine “adjusted taxable income” is made only for purposes of income averaging. These adjustments have no effect, for example, on the amount of a credit or a deduction taken into account in computing taxable income.

**Base Period Income**

In computing base period income for a base period year, taxable income for each base period year is increased and then decreased by certain adjustments. In no case may base period income be less than zero. Earned income from sources without the United States and income from within United States possessions, which had previously been excluded in computing taxable income for a base period year, must be added to the taxable income for that year. The amount of the adjustment is the excess of the income from these sources over deductions properly allocable to or chargeable against such income.

Two other adjustments to taxable income of a base period year parallel those made in the determination of adjusted taxable income for
the computation year. Capital gain net income for the base period is excluded. Also, if any amount of "net income" attributable to a gift, bequest, devise, or inheritance was excluded in computing adjusted taxable income in the computation year, then all such income is excluded in the base period year even though it is less than $3,000 in amount.

In computing base period income, no adjustment is made to taxable income in respect to income from wagering transactions during the base period year.

The average base period income is determined by taking \( \frac{1}{4} \) of the sum of the base period income for the 4 base period years.

**Stacking Rules**

In order to determine the total tax liability for the computation year, the income for the computation year is divided into segments. These segments, in ascending order from the standpoint of the tax rate brackets applicable to them, are as follows:

Segment 1. The amount of income equal to 133-\( \frac{1}{3} \) percent of average base period income. (The income not subject to averaging.)

Segment 2. The amount (if any) of the adjustment for capital gains made to averagable income. (Under section 1302(a)(2).)

Segment 3. The amount (if any) of capital gain net income for the computation year which is less than or equal to average base period capital gain net income.

Segment 4. Twenty percent of averagable income.

Segment 5. The amount (if any) of certain other items of income (including, for example, amounts of income under section 1304(b)(1), relating to gift or wagering income).

Segment 6. The amount (if any) of capital gain net income for the computation year which exceeds average base period capital gain net income.

Segment 7. The amount (if any) of other items of income (including, for example, amounts of income under section 1304(f)(2), relating to certain distributions to owner-employees subject to penalties).

These several segments of income will become more obvious when you use Schedule G to make a computation of tax liability. That schedule will be available to you in the next few weeks. To assist you, detailed instructions are included with the schedule.

**Alternative Tax**

The income averaging provisions have no substantive effect on the computation of the alternative tax on capital gains. The alternative tax limits a taxpayer's liability to 25 percent of the excess of his net long-term capital gain over his short-term capital loss. This limitation is applied by reducing the total tax, computed under the income averag-
ing provisions, by the amount by which the tax imposed on capital gains in the stack exceeds 25 percent of the amount of such capital gains.

**Income Averaging Provisions are Elective**

The income averaging provisions are applicable only when the taxpayer chooses to make use of them. The choice is made by completing Schedule G and attaching it to Form 1040 for the taxable year. An eligible individual may choose to compute his tax under the income averaging provisions at any time prior to the expiration of the period prescribed for filing a claim for a credit or refund for the year for which the tax is to be computed under the averaging provisions. You may also change your choice at any time within that period.

**Subsequent Eligibility or Ineligibility**

It is possible for a taxpayer who has chosen the benefits of income averaging for a taxable year to subsequently become ineligible for such benefits for such year. For example, if the taxpayer has a net operating loss in a taxable year subsequent to a taxable year in which he chose the benefits of income averaging, and if the carryback of the net operating loss reduces his income for the taxable year for which he made such choice, so that he is no longer eligible under section 1301 to choose the benefits of income averaging, then such taxpayer must recompute his tax liability for that year as if he had not originally chosen to average his income.

The carryback of a net operating loss may also serve to provide a taxpayer with an opportunity he did not previously have to use income averaging. For example, the carryback of such loss may reduce a taxpayer's average base period income so much that he becomes eligible to choose the benefits of income averaging for a taxable year for which he was not previously eligible to make such choice.

**Individuals Eligible for Averaging**

Only eligible individuals may chose the benefits of income averaging. Section 1303 defines the term "eligible individual". It provides that an individual must meet a citizenship or residence test, and a support test. First, no individual is eligible for averaging if he was a non-resident alien in any of the four base period years or in the computation year. To be eligible an individual must be a citizen or resident of the United States for the computation year, and all of his base period years. If a husband and wife make a joint return for a taxable year, both individuals must satisfy the citizenship or residence requirements.

In order to meet the support test, an individual (and his spouse) must have furnished at least one-half of his support in each of the base period years. However, there are three exceptions to the support rule. (1) "Child Bride Rule". If a husband and wife make a joint return
and the wife has earned less than 25 percent of the income properly reportable on that return, the wife need not have supported herself during the 4 base period years.

(2) "The Student Rule". The support test does not apply if the individual was not a full-time student during at least four taxable years (including the computation year) after the individual attained age 21. Thus, under this exception averaging is available to anyone age 25 or older who was not a student for any four preceding taxable years.

(3) "Kid Genius Rule". The support requirement does not apply if more than one-half of the individual’s taxable income for the computation year is attributable to work performed by him in substantial part during two or more of his base period years. This exception will be beneficial, for example, to youthful inventors or novelists.

**Marital Status Rules**

As has been previously pointed out, the amount of an individual’s income for the computation year must reflect a comparison between his income for that year and his average income for his 4 base period years. If an individual is unmarried during the base period years and in the computation year no problems arise in making the required comparison of income. Also, where a husband and wife who are married to each other for the entire 5-year period and make a joint return for the computation year and each of their base period years, no comparison problems arise. If a husband and wife make a joint return for the computation year and were both previously unmarried, or were married to each other but filed separate returns for any base period year, their separate base period incomes for such base period year must be combined to achieve the required comparison between their aggregate income for the computation year and their aggregate income for the base period year in question.

If an individual is (1) unmarried for his computation year but was married for any base period year, or (2) is married for his computation year but was married to a different spouse for any base period year, or (3) is filing a return as a surviving spouse for the computation year but was married to another spouse during any base period year, then the rules in section 1304 (relating to “minimum base period income”) apply. Under these rules an individual must take into account as his base period income for the base period year in question, the largest of the following amounts:

1. The base period income resulting solely from his own income and deductions for such year; or
2. An amount equal to 50 percent of the aggregate base period
income resulting from the combined income and deductions of himself and the person who is his spouse in the computation year; or
3. An amount equal to 50 percent of the aggregate base period income resulting from the combined income and deductions of himself and the individual who was his spouse in the relevant base period year.

For any such base period year, section 1304 provides that an individual's "minimum base period capital gain net income" for that year shall not be less than 50% of the sum of his capital gain net income for that year and that of the individual with whom he combines his separate income and deductions.

Section 1304(c) does not resolve a number of technical problems arising in the computation of an individual's separate income and deductions. These difficulties will be worked out in the proposed regulations. Of course, any comments you have concerning the proposed rules will be welcomed.

PROVISIONS OF THE CODE INAPPLICABLE IF INCOME AVERAGING IS CHOSEN

If a taxpayer chooses the benefits of income averaging for any taxable year, the following provisions of the Code will not apply for that year.

1. Section 3 (relating to optional tax if adjusted gross income is less than $5,000);
2. Section 72(n)(2) (relating to limitation of tax in case of certain distributions with respect to contributions by self-employed individuals);
3. Section 911 (relating to income from sources without the United States); and
4. Section 931, and following (relating to income from sources within possessions of the United States). However, if the individuals subsequently becomes ineligible for income averaging, these above-mentioned provisions will be applicable in recomputing his tax liability.

This is the end of my formal presentation on income averaging. I welcome any questions that you might have at the conclusion of the program.

MR. WOODWORTH:

Thank you, Mr. Williams. That brings us to the close of our formal presentation. On behalf of the panel, I want to thank you for the reception that you have accorded us; and, if I may, on your behalf I want to thank our panelists for a job well done. This has been a very fine experience for me and I am grateful for the privilege of having worked with such an able panel and with such a splendid audience.