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Recent Developments in the Taxation of Corporations and Shareholders

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RECENT DEVELOPMENTS IN THE TAXATION OF CORPORATIONS
AND SHAREHOLDERS

THIRTY-FIFTH WILLIAM AND MARY TAX CONFERENCE

Saturday, December 9, 1989

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1. **Alternative Minimum Tax**

A. **T.D. 8249** (May 4, 1989). IRS issues proposed and temporary regulations explaining the application of the tax benefit rule to the computation of the alternative minimum tax (as required by former §58(h), applicable to taxable years between 1976 and 1986).

2. **Assignment of Income**

Caruth v. U.S. (5th Cir., January 27, 1989). Taxpayer's contribution to charity of closely held stock, and repurchase of that stock eleven months later, were bona fide transactions. Accordingly, extraordinary dividends paid during the period of the charity's ownership were not properly attributable to taxpayer.

3. **Attorney's Fees**

Wilbourn v. Commissioner (T.C. Memo 1989-222, May 9, 1989). Taxpayer is entitled to recovery of her litigation costs because IRS' position was not substantially justified. Taxpayer had clearly and correctly explained what IRS had incorrectly thought was a discrepancy between her tax return and the Form 1099 sent to her.

4. **Bad Debts: When Deductible**

Cole v. Commissioner (7th Cir., April 11, 1989). No bad debt deduction is allowable with respect to taxpayer's loan to a professional corporation of which he was a 15% shareholder. Taxpayer initiated no legal action against the corporation and did not show that its assets were insufficient to satisfy the debt.

5. **Business Expenses**

A. **Humana, Inc. v. Commissioner** (6th Cir., July 27, 1989). No deduction is allowed to parent corporation for insurance premiums paid to its wholly-owned insurance company subsidiary because the risks of loss were not shifted. However, premiums paid to that same insurance company by the parent's other subsidiaries are deductible. In such a case, sufficient risk-shifting is present.
B. **Colt Industries, Inc. v. U.S.** (Fed. Cir., July 24, 1989). Civil penalties assessed by the Environmental Protection Agency against a steel mill and payable to the state of Pennsylvania pursuant to the Clean Air Act and the Clean Water Act are "fines or similar penalties" and therefore non-deductible even though 97% of the penalty was remedial in nature and only 3% was for "recalcitrance".

C. **Lerch v. Commissioner** (7th Cir., June 21, 1989). The Court will not apply the Cohan rule when the claimed but unsubstantiated deductions are of a sort for which the taxpayer could have and should have maintained the necessary records.

D. **Proposed Regulations** relating to employee achievement awards would implement § 274(j) and § 74(c) by defining the term "tangible personal property", explaining the dollar limitation rules, and clarifying the statutory requirement that the award not be a payment of disguised compensation.

E. **National Starch and Chemical Corp. v. Commissioner** (93 T.C. No. 7, July 27, 1989). Expenses incurred by the target corporation in a successful friendly takeover bid were capital in nature and not deductible as ordinary and necessary business expenses. The expenses related more to the taxpayer's future betterment than to the carrying out of its current trade or business.

F. **L.R. 8927005**. Costs incurred by the target corporation in fending off a hostile takeover bid and finding an alternative, more acceptable buyer are deductible. The corporation's expenses were incurred to ensure the continued profitability of the corporation and to protect its shareholders. [Note: An embarrassed IRS subsequently revoked this ruling after the government prevailed in National Starch and Chemical, see item E, above.]

G. **Proposal Regulations**, published on May 4, 1989, would clarify the definition of "excess parachute payments" for purposes of § 280G(b) and § 4999, denying deductions to corporations making golden parachute payments and imposing a 20% excise tax upon the recipient of such payments.
H. Murray Brizell v. Commissioner (93 T.C. No. 16, August 3, 1989). Kickbacks paid to the purchasing agents of its customers are allowed as deductions to the paying party. The court finds that the payments were both "ordinary", in that the practice was widespread, and "necessary", inasmuch as 60% of the company's business stemmed from such payments.

I. T.D. 8247 (April 4, 1989). S corporations reporting on a fiscal year basis must apply the 20% reduction to meal or entertainment expenses paid or incurred after 1986, without regard to when the S corporation's fiscal year begins.

J. Rev. Rul. 89-7 (1989-3 I.R.B. 6). A partner (and presumably an S corporation shareholder as well) must reduce the basis of his partnership (stock) interest by the full amount of his distributive share of the partnership's (corporations's) § 179 elective expense deduction, even though the $10,000 limitation prevents his deducting all or part of that amount.


L. Proposed Regulations published in 1983 pursuant to § 174, dealing with research and experimental expenditures, were revised on May 16, 1989. IRS receded from some of the positions taken in the earlier proposal, e.g., "routine or periodic" improvements, originally treated as not qualifying for immediate write-off, now qualify. Also, computer software now is accorded the same treatment as other products or properties.

M. Danville Plywood Corp. v. U.S. (Cl. Ct., March 31, 1989). No business expense (advertising) deduction is allowed for the expenses of a "sales seminar" hosted for 116 customers and their guests in New Orleans over the Super Bowl weekend. The court found no evidence that this type of activity was "common and accepted within the particular trade or industry" of the taxpayer.
6. **Charitable Contributions**

A. **Notice 89-56** (1989-21 I.R.B. 23). IRS announces that the final regulations under § 170(a)(1), when issued, will waive the requirement of a third party appraisal of charitable contributions of property by closely held corporations and personal service corporations. Instead, IRS will require that certain summary information be included with the taxpayer's income tax return on which the deductions are claimed.

B. **Pescosolido v. Commissioner** (1st Cir., August 30, 1989). A sole shareholder's charitable contribution of § 306 stock results in a deduction only to the extent of taxpayer's $16 per share adjusted basis, and not the share's $100 fair market value. The Tax Court rejected IRS' contentions that § 306(b)(4) cannot apply to a majority shareholder, but the First Circuit affirms the Tax Court's finding that the taxpayer failed to establish that he entered into the transaction without a tax-avoidance motive.

7. **Consolidated Returns: Contiguous Country Corporation**

**U.S. Padding Corporation v. Commissioner** (6th Cir., January 12, 1989). A Canadian subsidiary was eligible to join its U.S. parent in filing a consolidated return where Canadian government policy "required" formation of a subsidiary in that country. This was sufficient to satisfy § 1504(d), even though no statute or regulation set forth such a requirement.

8. **Constructive Dividends**

**CTM Construction, Inc. v. Commissioner** (T.C. Memo 1988-590, December 28, 1988). The costs incurred by a contracting corporation to build houses owned by its shareholders constitute constructive dividends to the shareholders and are not deductible by the corporation as business expenses.

9. **Constructive Ownership of Stock: Options**

**Rev. Rul. 89-64** (1989-18 I.R.B. 5). An option to buy shares is within the scope of § 318(a)(4) notwithstanding the fact it does not become exercisable until after the passage of a specified period of time.
10. Corporate Divisions

A. Rev. Rul. 89-27 (1989-9 I.R.B. 7). Ownership of oil and gas working interests and development of those interests through entry into operating agreements with other owners of working interests in the same property is sufficient to meet the active business test of § 355, where taxpayer participates in management decisions, inspects the drilling site to see that drilling operations conform to the operating agreement, and analyzes data from drilling activities.


C. Rev. Proc. 89-39 (1989-25 I.R.B. 17). IRS lists three areas where it will not issue an advance ruling under § 1.355-2(b)'s business purpose test: each involves a case where taxpayer has both a federal tax-avoidance motive and a non-federal tax-avoidance motive for entering into the transaction and the question is whether the latter is the "substantial" motivation for the transaction.

D. Rev. Rul. 89-101 (1989-35 I.R.B. 6). A stock distribution to a domestic parent by a first-tier foreign corporation of the stock of a second-tier foreign corporation so as to reduce the rate at which withholding taxes are imposed by a foreign country upon dividends paid by the original second-tier corporation satisfies the business purpose requirement of § 355.

E. Rev. Proc. 89-28 (1989-15 I.R.B. 20). IRS specifies the conditions that must be satisfied before it will issue an advance ruling that it is satisfied that a parent corporation's retention of some of its subsidiary's stock does not have as one of its principal purposes the avoidance of federal income tax.

F. T.D. 8238 (January 4, 1989). IRS issues final regulations under § 355. The regulations had been proposed twelve years earlier. They will be effective only on a prospective basis, i.e., to transactions after February 6, 1989. The effect of General Utilities repeal upon § 355 distributions will be covered in future
regulations to be issued pursuant to § 337(d).

11. **Deferred Compensation: Constructive Receipt**

   L.R. 8921042; L.R. 8921045; L.R. 8921048; L.R. 8921049; L.R. 8921085; Highly-compensated key employees are not subject to current-year taxability on amounts transferred into trust for them by their employers, where the trust's assets remain subject to the claims of the employers' general creditors and the employer is required to inform the trustee if the employer becomes insolvent or bankrupt. The same result is achieved where the arrangement constitutes an agency rather than a trust.

12. **Depreciation**

   A. **Rev. Proc. 89-5** (1989 I.R.B. 39). IRS provides guidance as to the computation of depreciation where an asset is disposed of prior to the end of its recovery period or where the recovery period includes a short taxable year.

   B. **Action Distributing Company, Inc. v. Commissioner** (6th Cir., June 1, 1989). A liquidating corporate lessee is not entitled to a deduction for the unamortized balanced of its leasehold improvement costs upon the early termination of leases where the terminations occurred in the ordinary course of taxpayer's plan of liquidation and the lessor was the sole shareholder of the lessee corporation.

   C. **Rev. Rul. 89-25** (1989-9 I.R.B. 6). A builder of residential homes is not entitled to claim a depreciation deduction for homes used temporarily as models or sales offices. These homes were so used for only a small fraction of their expected useful lives and generated no rental income. Accordingly, they are to be treated as non-depreciable inventory or stock in trade held for sale to customers.

13. **Dividend vs. Sale Proceeds**

   A.O.D. CC 1988-028, ACQ. in Litton Industries, Inc. v. Commissioner 89 T.C. 1086 (December 3, 1987). IRS agrees that Litton is distinguishable from Waterman Steamship, 50 T.C. 650, reversed 430 F.2d 1185 (5th Cir., 1970), but disagrees with any implication in Litton that the Tax Court's
majority opinion in Waterman Steamship is correct. IRS will continue to litigate any case whose facts more closely resemble the facts in Waterman Steamship than those in Litton.

14. Employee Benefit Plans


D. Notice 89-25 (1989-12 I.R.B. 68). IRS provides question-and-answer guidance on the taxation of distributions from qualified plans. The notice includes a simplified and more liberal rule for computing the non-taxable portion of an early distribution of appreciated employer securities. Also, IRS provides 3 alternative methods for computing "substantially equal periodic payments" that will avoid the imposition of the 10% early withdrawal penalty.

E. I.R. 89-10 (January 26, 1989). IRS announces the cost-of-living adjustments for the various dollar limitations imposed by the Code, e.g., the excise tax on excess distributions, the maximum benefit under a defined benefit plan, the maximum exclusion under § 401(k), and the definition of a "highly compensated employee."


G. Martin Fireproofing Profit-Sharing Plan and Trust v. Commissioner (92 T.C. No. 77, May 31, 1989). IRS did not abuse its discretion in declining to permit a retroactive correction of excessive allocations to a participant's account. As a
result, the plan lost its tax-exempt status.


I. Rev. Rul. 89-14 (1989-6 I.R.B. 6). Loans to plan participants secured by accrued vested benefits are permissible unless they constitute prohibited transactions. Here, the loan was made at an unreasonably low interest rate. As a result, the plan is disqualified.

J. Proposed Regulations (May 17, 1989). IRS provides proposed rules under the minimum coverage requirements of § 410(b). For years after 1988, a qualified plan must meet one of three minimum coverage tests: percentage, ratio, or average benefit.

K. D.J. Lee, M.D., Inc. v. Commissioner (92 T.C. No. 16, February 7, 1989). Corporation incurs the penalty excise tax under § 4971(a) for failure to make timely employer contributions. The facts that its pension consultant misinformed taxpayer as to the due date and that money to make the payments had been set aside in a separate checking account do not negate liability for the penalty.

L. Proposed Regulations (February 13, 1989). IRS provides proposed rules under § 401(a)(26), requiring that a qualified plan benefit at least the lesser of 50 employees or 40% of all of the employees of the employer.

M. Rev. Proc. 89-22 (1989-10 I.R.B. 24). IRS will not rule on when compensation is realized by a person who, in connection with the performance of services, receives a nonstatutory stock option without a readily ascertainable fair market value on the date it is granted.

N. Notice 89-47 (1989-16 I.R.B. 17). IRS explains the § 6659A penalty for the overstatement of pension liabilities (and consequent underpayment of income tax due to excessive contributions to the retirement plan).

P. Proposed Regulations (March 2, 1989). IRS issues proposed regulations on non-discrimination rules under § 89 for employee health and welfare plans. The rules provide for transitional relief and a good faith compliance standard. IRS subsequently deferred, in Notices 89-65 and 89-100, the effective date for compliance with § 89's requirements. Compliance is now not required until December 1, 1989. Subsequently, Congress imposed a one-year ban on the enforcement of § 89's non-discrimination rules.

Q. T.D. 8235 (1989-6 I.R.B. 7). The regulations under § 423 and 422A are amended to provide uniform rules relating to shareholder approval required for employee stock purchase plans and incentive stock option plans.

R. Bash v. Firstmark Standard Life Insurance Co. (7th Cir., November 7, 1988). Participants in a defined benefit pension plan which was terminated by their employer, who received the full amount of their accrued benefits, are not also entitled to receive the $1,000,000 surplus in the plan. That surplus is properly to be turned over to the employer corporation.

S. Notice 89-53 (1989-18 I.R.B. 18). IRS provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates that may be used to calculate current liability for purposes of the full-funding limitation of § 412(c)(7).


15. Employment Taxes

A. O'Hare v. U.S. (6th Cir., July 10, 1989). A third-party payroll lender is liable for unpaid withholding taxes owed by its borrower, where the lender had actual notice or knowledge that the funds were to be used to pay wages.
B. **Heimark v. U.S.** (Cl. Ct., August 18, 1989).

Plaintiff was not a "responsible person" within § 6672 because he had trivial status, limited duties and very little actual authority. He was a bookkeeper and clerk with the uncompensated title of treasurer. He neither controlled the corporation's financial process nor exercised authority over the corporation's funds.

16. **Estate Tax**

A. **Estate of Maddox v. Commissioner** (93 T.C. No. 21, August 10, 1989). Where the estate has elected special use valuation under § 2032A, no further reduction is available by reason of the fact decedent held only a minority interest in the corporation's stock.

B. **Notice 89-99** (August 31, 1989). Life insurance policies and personal residences are not subject to the "estate freeze" rules of § 2036(c) because they are used for personal rather than business or investment reasons. Only "enterprises" are covered by § 2036(c).

17. **Foreign Tax Credit**

**T.D. 8228** (1988-2 C.B. 136). IRS issues temporary regulations dealing with allocation and apportionment of interest expense and certain other expenses for purposes of determining the foreign tax credit.

18. **Fringe Benefits**

**T.D. 8256** (July 5, 1989). IRS issues temporary and final regulations relating to the taxation and valuation of fringe benefits. Covered are such items as employer-provided vehicles, flights on employer-provided or commercial aircraft, and meals at employer-operated eating facilities.

19. **General Utilities Repeal**

**Notice 89-37** (1989-13 I.R.B. 7). IRS plans to issue regulations aimed at preventing circumvention of General Utilities repeal by use of a partnership to acquire stock in one of its corporate partners. The regulations will cover actual and deemed distributions by the partnership to a corporate partner of its own stock.
20. **Gift Tax**

*Rev. Rul. 89-3 (1989-2 I.R.B. 5).* Sole shareholder's transfer of 11% of a corporation's stock to a trust for his children and grandchildren, followed by a recapitalization under which his retained shares are converted into a new class of stock that will lose its voting rights at the time of his death, results in a taxable gift to the beneficiaries of the trust as well as an addition to the trust triggering the generation-skipping transfer tax.

21. **Golden Parachutes**

*Proposed Regulations* IRS proposes guidelines dealing with the definition of a disqualified individual; when a payment is contingent upon a change in ownership; what constitutes a change in ownership or control; and what constitutes reasonable compensation.

22. **Goodwill: Allocation of Purchase Price**

*UFE, Inc. v. Commissioner* (92 T.C. No. 88, June 22, 1989). The Tax Court rejects IRS' claim that an acquired business had a going concern value to which a portion of the purchase price for the business' assets must be allocated. IRS had contended that every operating business must have a going concern (i.e., goodwill) value.

23. **Gross Income**

**A.** *Robert Anderson v. Commissioner* (92 T.C. No. 9, January 26, 1989). In a pre-TRA 86 case, the Tax Court rejects IRS' attempt to expand the Supreme Court's 1945 *Court Holding Company* doctrine. (With *General Utilities* repeal, this issue is no longer of current significance.)

**B.** *Commissioner v. Indianapolis Power & Light Co.* (Certiorari granted, April 24, 1989). The Supreme Court will resolve a conflict between the 7th Circuit (*Indianapolis Power & Light*) and the 11th Circuit (*City Gas Co. of Florida*) regarding the taxability of security deposits by utility-company customers.

**C.** *Colonial Wholesale Beverage Corp. v. Commissioner* (1st Cir., June 28, 1989); *Dana Distributors, Inc. v. Commissioner* (2nd Cir., May 10, 1989). Bottle
deposits received by a beverage distributor pursuant to a state law imposing a 5 cents-per-bottle refundable deposit are includable in income when received. No deduction is allowed for the offsetting refund liability because the "all events" test of § 1.446-1 is not satisfied.

D. **Centel Communications Co., Inc. v. Commissioner** (92 T.C. No. 34, March 23, 1989). Section 83 is not applicable to the receipt of warrants to buy stock at a bargain price, issued to shareholder-directors in return for their guarantee of loans made to the corporation by banks. Section 83 applies only to property issued in connection with the rendering of services, not to the assumption of additional risk by shareholder-investors.

24. **Incentive Stock Options**

T.D. 8235 (1989-6 I.R.B. 7) IRS amends the regulations under §§ 423 and 422A to provide uniform rules relating to shareholder approval required for employee stock purchase plans and incentive stock option plans.

25. **Interest Expense**

Notice 89-36 (March 9, 1989). IRS provides additional guidance (beyond the temporary regulations) with respect to the allocation of interest expense in connection with certain transactions involving "pass-through" entities, including S corporations.

26. **Inventory: LIFO Conformity Requirement**

Rev. Proc. 89-10 (1989-6 I.R.B. 31). Notwithstanding § 472(c) requiring that taxpayers using LIFO use no other method for purposes of reporting to shareholders or creditors, IRS will not disallow LIFO reporting solely because of the application of paragraph 27 of APB 20 requiring those taxpayers who change from LIFO to another method to restate all prior years' financial statements using the new method.

27. **Investment Tax Credit: Recapture**

A. **Rev. Rul. 89-18** (1989-7 I.R.B. 4). A disposition triggering recapture of investment tax credit occurs in the year a corporation transfers § 38 property to a newly-formed subsidiary, not in the
subsequent year in which the subsidiary's stock is distributed (pursuant to a pre-arranged plan) to its parent's shareholders.

B. **Tandy Corporation v. Commissioner** (92 T.C. No. 76, May 31, 1989). Investment tax credit recapture does not occur until year two where taxpayer, in preparation for a spin-off, transfers § 38 assets to two wholly-owned subsidiaries in year one but does not complete the transaction, i.e., the spin-off, until year two because it did not receive S.E.C. clearance and an IRS ruling until then. The Tax Court rejects Rev. Rul. 89-18, 1989-7 I.R.B. 4.

28. **Involuntary Conversions**

Rev. Rul. 89-2 (1989-2 I.R.B. 4). Property that is rendered unsafe for its intended use as a result of chemical contamination is considered destroyed for purposes of the involuntary conversion provisions of § 1033.

29. **Proposed Legislation**

A. President's Budget Message  
B. Alternative Minimum Tax  
C. Capital Gains  
D. Dividends-Received Deduction  
E. Employee Benefit Plans: ESOP's  
F. Employee Health and Welfare Plans: § 89  
G. Estate Tax Valuation Freezes  
H. Expired or Expiring Provisions  
I. Tax Penalties  
J. Incremental Research Credit  
K. Leveraged Buy-outs  
L. Like-Kind Exchanges  
M. Medicare Catastrophic Insurance Program  
N. Unemployment Tax  

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30. **Like-Kind Exchanges**

*Maloney v. Commissioner* (93 T.C. No. 9, July 25, 1989). A like-kind exchange of real estate held by a corporation for investment qualifies for nonrecognition under § 1031 notwithstanding the nontaxable § 333 liquidation of the corporation a few days later.

31. **Losses: Abandonment**

*CRST Inc. v. Commissioner* (92 T.C. No. 81, June 12, 1989). No abandonment loss is allowed a regulated motor carrier by reason of the enactment of the Motor Carrier Act of 1980 deregulating the trucking industry. Taxpayer did not abandon its operating certificates.

32. **Losses: Passive Activities**

Proposed and Temporary Regulations (T.D. 8253). IRS issues regulations under § 469 defining "activity". Its rules permit the aggregation of several undertakings into larger (single) groups.

33. **Losses: Restitution Payments**

*Stephens v. Commissioner* (93 T.C. No. 11, July 26, 1989). No deduction is allowed for court-ordered payments serving as restitution of amounts taxpayers had obtained through fraud. The court applies § 162(f) by analogy notwithstanding the fact that Code section refers only to fines or similar payments paid "to a government."

34. **National Economic Commission**

The Commission's majority report backs away from endorsing any of the 23 tax-increase options that the Commission had considered as a deficit-reduction measure. Instead, the Commission leaves it to Congress and the President to agree on a deficit-reduction plan.

35. **Net Operating Losses**

A. *Rev. Rul. 89-80* (1989-25 I.R.B. 8). The unrelated common parent corporations of a small affiliated group and a large affiliated group merged into a new corporation, which became the parent corporation of the surviving group. IRS rules that this qualifies as a reverse acquisition.
with the result that net operating losses of the new group may be carried back to the taxable years of the large group to the extent those losses are attributable to members of that group.

B. Proposed and Temporary Regulations (T.D. 8264 (September 19, 1989). IRS limits the amount of capital gain or tax liability that may be offset by capital losses and excess credits of the loss corporation attributable to periods ending before an ownership change. T.D. 8264 also amends the previously-issued temporary regulations (T.D. 8149), which explained what constitutes a corporate ownership change under § 382.

36. Nominee Corporations

A. Greenberg v. Commissioner (T.C. Memo 1989-12, January 10, 1989). The Tax Court rejects taxpayer's contention that a corporation formed to avoid state usury laws was merely holding title to its assets as an agent for its shareholders. Accordingly, the shareholders are not entitled to deduct its losses on their own returns.

B. Sparks Farm, Inc. v. Commissioner (T.C. Memo. 1988-492). As in Greenberg, the Tax Court refuses to treat the shareholders' corporation as a mere agent or nominee. In both cases, the Tax Court distinguishes Commissioner v. Bollinger (S.Ct. 1988), where an agency on behalf of the shareholders was shown to exist.

37. Personal Holding Companies


C. Pleasant Summit Land Corp. v. Commissioner (3rd Cir., November 25, 1988). Taxpayer's sale of apartment buildings produced capital gain which, under § 543(b)(1)(a), is to be excluded from both the numerator and the denominator for purposes of the 60 percent of income test. As a result, the corporation is subject to the personal holding
company rules because its only other income was from interest.

D. **Rod Warren Ink v. Commissioner** (92 T.C. No. 62, May 11, 1989). For purposes of the personal holding company tax provisions, theft losses are not deductible prior to the year of their discovery. §165(e) precludes deduction prior to that time.

38. **Reallocation of Income: § 482**

**Bausch & Lomb, Inc. v. Commissioner** (92 T.C. No. 33, March 23, 1989). The Tax Court finds that IRS abused its discretion in treating as non-arm's length the price at which a subsidiary sold goods to its parent corporation.

39. **Redemptions of Stock**

A. **Gerson v. Commissioner** (T.C. Memo 1989-52, February 6, 1989). Redemption of a deceased shareholder's stock by a corporation represented a constructive dividend to the corporation's continuing shareholder, who was legally obligated to buy that stock.

B. **H & M Auto Electric, Inc. v. Commissioner** (92 T.C. No. 84, June 15, 1989). Under prior-law §311(c), dealing with the distribution of property subject to a liability in an amount exceeding the property's basis, gain was to be computed on an asset-by-asset basis, not on an overall basis as under §357(c).

C. **Rev. Rul. 89-57** (1989-17 I.R.B. 4). In a sale of stock between brother-sister corporations, the "50% of the total value of shares of all classes of stock" test is to be applied on an aggregate basis. It therefore is irrelevant that a shareholder may own none of the shares of a particular class of stock.

D. **Dale Gunther v. Commissioner** (92 T.C. No. 5, January 19, 1989). In a pre-1982 case, the Tax Court holds that §351 overrides §§304, 302 and 301 in transactions where those sections overlap. Accordingly, taxpayer's exchange of stock for stock plus debentures is tax-free. (Code §304(b)(3) now provides for a contrary result.)
40. **Reorganizations**

A. *Rev. Proc. 89-50* (1989-35 I.R.B. 12). IRS sets forth the conditions, in the form of representations to be included in a ruling request, under which it will rule that the distribution requirement for a (C) or (D) reorganization is met even though the target corporation retains its charter and minimum capital.

B. *Commissioner v. Donald E. Clark* (S.Ct., March 22, 1989). Resolving a split among the circuits, the Supreme Court holds that the "meaningful reduction" and "substantially disproportionate" tests are to be applied as though stock of the acquiring corporation (rather than the target corporation) was redeemed.

41. **Research and Development Expenses**

*Driggs v. U.S.* (N.D. Tex., February 23, 1989). Unlike § 162, § 174 imposes no reasonableness limitation upon the deductibility of research and experimentation expenses. So long as an expenditure is in fact for research and experimentation, it is deductible.

42. **Section 306 Stock**


43. **Shareholder's Payment of Corporate Expense**

*Dietrick v. Commissioner* (6th Cir., August 10, 1989). A shareholder may not deduct, on Schedule C of his return, expenses he incurred on behalf of his closely held corporation. The court rejects the taxpayer's claim that he paid the corporation's expense to protect his own business reputation.
44. **Shareholder's Repayment of Misappropriated Funds**

*Murphee v. U.S.* (5th Cir., March 15, 1989). Taxpayers are entitled to deduct, as a loss, the amounts they repaid to their closely held corporation. These amounts had been improperly appropriated, and tax had been paid upon them after IRS audited taxpayers and discovered the facts. Taxpayers had a legally enforceable obligation to repay these amounts.

45. **Stock Purchases Treated As Asset Acquisitions**

*Rev. Proc. 89-40* (1989-27 I.R.B. 15). IRS sets forth the procedure to be followed by corporate taxpayers requesting the IRS district director to impose a deemed § 338 election with respect to an asset acquisition that includes a qualified stock purchase of a target corporation.

46. **Subchapter C Study by Treasury Department**

Although the Ways and Means Committee has prodded the Treasury to submit its long-overdue report on Subchapter C, the study remains far from complete. It appears likely that when the report is finally issued, it will be substantially less comprehensive than originally contemplated, probably focusing on only three or four major topics.

47. **Subchapter S**

A. *Notice 89-39* (1989-14 I.R.B. 21). An S corporation's activities may be aggregated, for purposes of the at-risk rules of § 465, within each of four categories for taxable years ending in 1988 (and for subsequent years if further guidance has not yet been published.)

B. *L.R. 8922004.* Where a parent corporation splits off a new subsidiary which then elects under Subchapter S for its first taxable year, the parent's Subchapter S election remains effective. Its control of the subsidiary was only momentary.

C. **Conformity of State and Federal Law.** At its 1989 annual meeting, the American Bar Association Tax Section approved a resolution urging state legislatures to adopt uniform tax legislation conforming with the federal treatment of S corporations. The resolution now goes to ABA's
House of Delegates.

D. **Proposed Regulations.** IRS publishes proposed regulations under §§ 1362 and 1363 relating to election, revocation, termination and effect of electing Subchapter S treatment.

E. **Notice 89-41 (1989-15 I.R.B. 16).** IRS sets forth the procedure for securing a refund of the prepayment required under § 444 if there is a decrease in the amount of the deferral in a subsequent year or if the entity terminates its § 444 election or if it liquidates.

F. **Rev. Rul. 89-82 (1989-26 I.R.B. 15).** S corporations are not subject to the environmental tax imposed by § 59A. The tax is imposed upon corporations, but S corporations are not subject to the taxes imposed upon corporations by Chapter 1 of the Code except as expressly otherwise provided.

G. **Miller v. U.S. (N.D. Ga., April 10, 1989)** The § 6321 exemption from entity-level tax determination for small partnerships (ten or fewer partners) has no counterpart under Subchapter S. § 6244, stating that the provisions that "relate to partnership items" apply to Subchapter S items "except to the extent modified or made inapplicable in regulations", does not make the small partnership exemption applicable to S corporations.

H. **L.R. 8912016: L.R. 8907044.** Under § 1362(f), IRS disregards the termination of S corporation status where (8912016) the S corporation purchased control of another corporation as a convenience for its absent shareholder, who had planned to buy 51% of the other corporation's stock; and (8907044) where a shareholder gave some of his S corporation shares to two charitable corporations. In both cases, IRS conditioned relief upon the parties' fully treating the transactions as if they had not occurred.

I. **L.R. 8915067.** Transfer of shares of an S corporation to the shareholder's IRA results in terminating the S corporation election. However, IRS disregards the termination under § 1362(f) upon a showing that the transfer was made without any intent to terminate the election, but conditions such disregard upon the shareholder's
agreeing to treat as his income the corporation's income (if it has income during the period the IRA held the stock) and to treat the corporation's losses as the IRA's losses (if the corporation had losses during the period the IRA held the stock).

J. L.R. 8927039. An S corporation does not have passive investment income where it has its land farmed under a crop-sharing agreement and the directors of the S corporation play an active role in the farming business, participating to a material degree in the production of farm commodities through physical work or management decisions or a combination of both.

K. L.R. 8852021. Although a limited partnership interest is treated as a passive activity for purposes of the passive loss limitation rules, this does not answer the question whether income from the limited partnership interest is passive for purposes of terminating the S corporation's election (a result reached only if prior C corporation earnings exist). The test will depend upon the amount and nature of the partnership's income that is passed through to the S corporation shareholder.

L. Rev. Rul. 89-45 (1989-14 I.R.B. 15). A trust does not qualify as a "qualified subchapter S trust" where provision is made for transferring some of its assets (originally devoted to providing income and corpus to one grandchild) to new trusts as additional grandchildren are born. Such a provision breaches the rule that corpus can be distributed only to the current income beneficiary.

M. Rev. Rul. 89-55 (1989-15 I.R.B. 14). A trust fails to qualify as a "qualified Subchapter S trust" where there are successive income beneficiaries, A and B, where A is the sole income beneficiary during his lifetime, but where termination can occur during his lifetime (if the trust no longer holds any of the S corporation stock), with distribution then being made to both A and B.

N. L.R. 8915018. IRS applies § 1.9100-1(a), finding good cause to grant an extension of time for filing Form 8716 (election to have a tax year other than a required tax year). § 444 does not expressly prescribe the time for filing the
election. IRS grants relief where the delay was caused by a tax professional and not by any action of the taxpayer.

O. **L.R. 8927043.** Where a calendar year corporation revoked its Subchapter S election on March 12, 1988, effective as of January 1, 1988, and then changed its mind in July, IRS is without authority to cancel the revocation and to reinstate S corporation status. § 1362(f) applies only if the termination was inadvertent and only if it occurred in the manner specified in § 1362(d)(2) or (3).

P. **T.D. 8247** (April 4, 1989). Final regulations require S corporations to state meal, travel and entertainment expenses separately. This applies to all expenses paid or incurred after December 31, 1986, without regard to whether the corporation reports on a calendar or a fiscal year basis.

Q. **Leavitt Estate v. Commissioner** (4th Cir., May 19, 1989). Shareholder's guarantee of a bank loan to his S corporation does not constitute an economic outlay and therefore cannot increase his basis in his stock. Taxpayers are bound by the form of their transaction and may not argue that the "substance of the transaction" triggers different tax consequences.

R. **Ellis v. Commissioner** (T.C. Memo 1989-280). Shareholder cannot increase basis in S corporation's stock by reason of co-signing the corporation's consolidation note payable to the bank. There was no economic outlay by the shareholder; in a guarantee situation, this does not occur until the shareholder is called upon to fulfill her guarantee and thus becomes subrogated to the bank's claim against the corporation.

S. **Kelley v. Commissioner** (9th Cir., June 7, 1989). In a case arising under prior law, the Ninth Circuit reverses the Tax Court and holds that IRS cannot adjust the taxpayer's return based on an adjustment to an S corporation's return if the statute of limitations has run as to the corporation's return. The statute of limitations applies at the corporate level. (§§ 6241-6245 now expressly incorporate this rule from § 6229, applicable to partnerships).
T.  **L.R. 8927027.** A shareholders' agreement restricting ownership of stock to employees or retired employees of the corporation, with a mandatory buy-out arrangement in cases where qualification no longer exists, does not create a second class of stock.

48.  **Tax Accounting**

A.  **Burnham Corporation v. Commissioner** (2nd Cir., June 27, 1989). In a pre-$461(h)$ case, the Second Circuit permits an accrual-method taxpayer to deduct currently the full, undiscounted amount anticipated to be paid over to a patent-infringement plaintiff pursuant to a settlement agreement. $461(h)$ now precludes such a result.

B.  **L.R. 8910008.** IRS will not permit a late election out of the installment sale rules by reason of a subsequent change in the law (presumably, the repeal of the capital gain preference). Such a circumstance does not constitute "good cause for failing to make a timely election".

C.  **Everett Bolton v. Commissioner** (92 T.C. No. 17, February 17, 1989). Election out of the installment method is invalid where it was made on the 1983 return. The property had been sold in 1982 and taxpayer received the first payment in 1982. Consequently, to be valid, the election must have been made on the earlier return.

D.  **Notice 89-15** (January 12, 1989). IRS provides guidance regarding the restrictions imposed by § 460 upon the use of the completed-contract method of accounting for long-term contracts.

49.  **Tax Credits**

A.  **T.D. 8251** (May 16, 1989). IRS issues final regulations, as well as additional proposed regulations, under § 41 relating to the credit for incremental research expenditures. The final regulations do not yet reflect the Tax Reform Act of 1986.

B.  **Rev. Rul. 89-90** (1989-30 I.R.B. 4). Where a rehabilitation tax credit was allowed with respect to a building and then a facade easement is sold or donated to a local historical society, a portion of the credit must be recaptured in the
year of sale or donation. (This revokes a 1987 private letter ruling that permitted the donation without requiring recapture.)

50. Tax Procedure


F. Rev. Proc. 89-34 (1989-20 I.R.B. 145). Except for extraordinary circumstances, IRS is discontinuing the issuance of private letter rulings on issues that are "clearly and adequately addressed by published authorities." This policy was originally scheduled to go into effect in June, but has now been delayed until February 5, 1990 "in order to give further consideration to comments received." Rev. Proc. 89-51 (1989-36 I.R.B. 19). Announcements 89-104 and 89-105 respond to a number of questions generated by this new policy.

G. Polyco, Inc. v. Commissioner (91 T.C. 963, December 5, 1988). The Tax Court denies taxpayer's claim for litigation costs because it failed to exhaust its administrative remedies.
Taxpayer did not file a protest and taxpayer's counsel declined to meet with IRS counsel until shortly before the trial date.

H. National Tax Court of Appeals. Although ABA's Standing Committee on Federal Judicial Improvements has recommended a single, specialized tax court of appeals, that position has been strongly criticized by tax practitioners and by IRS and Department of Justice officials.

51. Tax Treaties

The Treasury Department announced, on June 28, 1989, that the United States has entered into a tax-information exchange agreement with member nations of O.E.C.D. and the Council of Europe. The convention must be ratified by the U.S. Senate and at least 5 member nations of O.E.C.D. or the Council of Europe before it becomes effective for the United States.

52. Valuation: Annuity Tables

Notice 89-60 (1989-22 I.R.B. 16). IRS issues revised valuation tables to be used for valuing transfers of partial interests in property made after April 30, 1989, as required by § 7520.

53. Valuation of Stock: Transfer Restrictions

Estate of Joyce Hall v. Commissioner (92 T.C. No. 19, February 14, 1989). The Tax Court values decedent's stock for estate tax purposes by reference to the transfer restrictions and buy-sell agreements pertaining to the stock. IRS was unable to prove that these restrictions had no bona fide business purpose and would not be enforced by the corporation.