1965

Panel Discussion: Certain Problem Areas Under the Internal Revenue Code

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Repository Citation
https://scholarship.law.wm.edu/tax/617

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PANEL DISCUSSION

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PROPER TAX ELECTIONS

Howard A. Rumpf, Editor of Taxes Interpreted, New York.

CURRENT PROBLEMS—Under the Installment Method of Reporting; and, Exchange of Investment Property for Like Property.


1964 TAX LAW—Reviewed One Year Later

Lawrence Philip Roesen, Daniels, Turnbull and Freeman, Newport News, Virginia.

MR. WILLIAMS:

The remark has been attributed to Voltaire that government is a means whereby wealth be transferred from one group in society to another. We are faced with that type of proposition obviously when we hear talks such as the one Mr. Horsley gave this morning and it brings us to a recognition of the fact that our state taxation system, not only in Virginia, but throughout the United States, is a matter of increasing concern to us. Our first topic this afternoon is Elections. Perhaps it is not amiss for me to say having just been through two elections myself of an entirely different type, I invite all of you to become more of policy makers and less of the technician. I am perfectly serious when I say that because as a tax lawyer I have found myself dropping into the pattern of becoming too much of a technician and not so much forming my own independent opinions. For better or for worse the electorate of Fairfax County has made me a so-called policy maker, if a freshman member of the House can be called that—and I am sincere when I ask your increasing participation and creative thinking toward the problems of our tax system in Virginia, about which we heard a very excellent presentation by Mr. Horsley this morning.

The first topic this afternoon, “Proper Tax Elections,” brings us to the question of tax planning in the broadest sense. When we say “election” in the broadest sense, obviously a great deal of what we do constitutes an election of a sort, whether it be the corporation executive who dumps all his assets into a corporation and then comes to you years later when it is big and fat and says “please get it out without any tax,” he has made
the election. We are talking about those types of elections this afternoon. This brings to mind the old adage "of all sad words of tongue or pen, the saddest of these—'it might have been.'" So the taxpayer comes to you and says, "I have all of this here; what should I do?" And you immediately think, well, what he should have done years ago is A B C.

But in helping us reach those conclusions in advising our clients our first speaker is going to talk about elections. He is Mr. Howard A. Rumpf, who, as you can see from your brochure, is the editor of Taxes Interpreted, Chairman of the Department of Taxation of the Sobelsohn School, and former lecturer at New York University. And former editor of that greatly used book, Prentice-Hall Federal Tax Course. It gives me a great deal of pleasure to introduce our first panelist, Mr. Rumpf.

MR. RUMPF:

Many sections of the Internal Revenue Code require the taxpayer to make certain elections in order to fall within their provisions. The Code usually uses stereotype wording similar to the following—

"the written elections referred to must be made and filed in such manner as to be not in contravention of regulations prescribed by the Secretary or his delegate"

The problem of the proper interpretation of the provisions of these regulations has constantly arisen. Do the provisions require a strict compliance or merely substantial compliance by the taxpayer? The Commissioner in his Regulations and the Courts in their decisions have attempted to analyze and determine the intent of Congress at the time of the enactment of the particular section.

REDEMPTION OF STOCK—SECTION 302(b) (3) (c)

TERMINATION OF SHAREHOLDER'S INTEREST

TEN YEAR RULE

For tax purposes, a redemption of stock occurs when a corporation acquires its stock from a shareholder for money or other property whether or not the stock is cancelled, retired, or held as treasury stock (Sec. 302(a); 317(a) (b). Section 302 provides three methods for redemption of a shareholder's stock which results in capital gain to the shareholder (Sec. 302(b) (1) (2) (3). Briefly, the redemption methods are (a) where the redemption of the stock is not essentially equivalent to a dividend; (b) where the redemption is substantially disproportionate with respect to the stockholder; and (c) a complete termination of the shareholder's stock interest in the corporation. The question of a proper election is the essential problem with respect to the complete termination of the shareholder's stock interest in the corporation (c) above.

If a corporation redeems all of the stock which is owned in the corpora-
tion by the stockholder, the redemption is treated as an exchange resulting in capital gain or loss. The redemption in such a case will not be treated as an ordinary dividend in the hands of the stockholder. However, the general rule just stated is affected by the rule of constructive ownership (Sec. 302(c)(1)(2)). In applying the complete termination test, the stock owned by the redeeming stockholder's family, a partnership of which he is a member, a trust or an estate and a corporation (Sec. 318(a)) may be attributed to the redeeming stockholder so that there would be no termination of interest.

Example 1: Adams, Brown and Jones own all of the stock of the Hilo Corporation. Adams owns 50 shares. The three stockholders are not related for tax purposes under the rules of constructive ownership. The corporation redeems the 50 shares owned by Adams, paying him $100,000. Adams original investment in the corporation was $60,000. The recognized gain ($40,000) is treated as a capital gain.

Example 2: Adams, Adams son and Brown own all of the stock of the Hilo Corporation. Each of the stockholders own 50 shares. The corporation redeems the 50 shares owned by Adams. The redemption is not a complete termination of Adams stock interest and could be taxed to Adams as an ordinary dividend (to the extent of the earned surplus) since the shares owned by Adams son would be attributed to Adams.

The statute, however, provides a way out of the situation described in Example 2 by abrogating the attribution rules between members of a family provided a proper procedure is followed and a proper election is made (Sec. 302(c)(2); Reg. Sec. 1.302-4(a)(b)).

If all of the following conditions are met, the redeeming stockholder is not considered to own stock actually owned by members of his family. Therefore, in Example 2 above, the redemption of Adams stock would be considered a complete termination of interest and a redemption giving rise to capital gain or loss.

(a) Immediately following the redemption, the stockholder must have no interest in the corporation other than as a creditor. An interest in a corporation includes being an officer, director or employee of the corporation (Sec. 302(c)(2)(A)(i)).

(b) The redeeming stockholder must not acquire any interest in the corporation other than as a creditor or other than by bequest or inheritance within ten years after the date of the redemption (Sec. 302(c)(2)(A)(ii)).

(c) The stockholder must file an agreement to notify the Commissioner if he does acquire an interest in the corporation within ten years other than as a creditor or other than by bequest or inheritance (Sec. 302(c)(2)(A)(iii)).
(d) The stockholder must not within ten years before the redemption acquire stock from a person, the ownership of whose stock would be attributable to the distributee under the constructive rules of ownership (Sec. 302(c)(2)(B)(i)).

(e) The stockholder must not within ten years before the redemption transfer stock to a person who owns stock on the date of redemption, the ownership of which is attributable to the stockholder under the constructive rules of ownership (Sec. 302(c)(2)(B)(ii)).

With respect to the agreement mentioned in (c) above, the Regulations provide as follows:

“(a) The agreement specified in Section 302(c)(2)(A)(iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to his return timely filed for the year in which the distribution described in Section 302(b)(3) occurs. The agreement shall recite that the distributee has not acquired any interest in the corporation (as described in Section 302(c)(2)(A)(i) since such distribution, and that he agrees to notify the District Director for the Internal Revenue district in which such return is filed of any acquisition of such an interest in the corporation within 30 days after such acquisition if such acquisition occurs within 10 years from the date of such distribution.

(b) The distributee who files an agreement under Section 302(c)(2)(A)(iii) shall retain copies of income tax returns and any other records indicating fully the amount of tax which would have been payable had the redemption been treated as a distribution subject to Section 301.” (Reg. Sec. 1.302-4).

The Commissioner has taken the position that the stockholder must strictly follow the Regulations and “attach (the agreement) to his return timely filed for the year in which the distribution occurs.” The Courts have taken both sides of the issue in their attempt to determine the meaning of the statute and the Regulations. In other words, are the statutory provisions mandatory, requiring strict compliance, or directory, requiring substantial compliance?

Thus far, the District Court in New Jersey, (and affirmed by a Per Curiam decision in the Circuit Court in the 3rd Circuit) has upheld the Commissioner (Archbold v. US, 201 F. Supp. 329, aff. 311 F 2d 228). A strong decision in the District Court in Kansas and affirmed by an equally strong opinion in the Circuit Court (10 Cir.) has upheld the taxpayer who did not attach the agreement to a timely filed return but did file the agreement within the statutory period on the basis of substantial compliance (Van Keppel v. US, 206 F. Supp. 42, aff. 321 F 2d 717). The Tax Court in two decisions favors substantial compliance (Cary, 41 TC 214; Barclay Company, TC Memo 1964-279). The District Court in
New York has also upheld the taxpayer (Pearce v. US, 226 F. Supp. 702).

INSTALLMENT SALES—SECTION 453
ELECTION—REAL AND PERSONAL PROPERTY

A taxpayer may elect to report the recognition of gain on the sale or other disposition of real property or personal property under the installment plan provided certain conditions are met (Sec. 453(b)). The Code provides definite prerequisites. In respect to real property, the initial payment in the year of sale must not exceed 30 per cent of the gross selling price. For personal property, two prerequisites apply (a) the selling price must be more than $1,000 and (b) the initial payment in the year of sale must not exceed 30 per cent of the gross selling price.

The use of the installment sale method is at the option of the taxpayer. The Commissioner cannot require its use (Max Viault, 36 BTA 430; Truman Bowen, 12 TC 446, Acq.) A partner may not report his share of the partnership gain on the sale of property on the installment method if the partnership does not elect the installment method (John G. Scherf, Jr., 20 TC 346). Real estate dealers may elect to report all or any part of their sales on the installment method if they qualify (GCM 3350, CB June 1928, pg 62).

In addition to the specific prerequisites provided in the statute for the election of the installment method, the Regulations defines the proper way to make the election. The Regulations, effective for taxable years ending after 12/16/58, provide as follows—

“(1) A taxpayer who sells or otherwise disposes of real property, or who makes a casual sale or other casual disposition of personal property, and who elects to report the income therefrom on the installment method must set forth in his income tax return (or in a statement attached thereto) for the year of the sale or other disposition the computation of the gross profit on the sale or other disposition under the installment method. In any taxable year in which the taxpayer receives payments attributable to such sale or other disposition, he must also show in his income tax return the computation of the amount of income which is being reported in that year on such sale or other disposition.

(2) The information required by subparagraph (1) of this paragraph must be submitted for each separate sale or other disposition but, in the case of multiple sales or other dispositions, separate computations may be shown in a single statement.” (Reg. Sec. 1.453-8(b) (1) (2)).

Thus, if a taxpayer were to comply strictly to the Regulations above, he would be required to elect the installment method in the tax return, or by attaching to the tax return, for the year of sale a statement showing a detailed computation of the installment sale. The words “for the year of
sale” have been litigated for many years. The Courts in some cases have upheld the Commissioner, thereby strictly interpreting the Regulations (Ackerman v US, 318 F 2d, 402 (1963), aff. 205 F. Supp. 365).

In the more recent cases, there has been an overwhelming number of decisions allowing for substantial compliance rather than a strict compliance. Thus, the election to report on the installment method was allowed where the taxpayer did not mention the sale on the original tax return for the year of the sale but made the election on an amended return for that year (within the statute of limitations) (Robert L. Griffin, TC Memo 1965-91; John P. Reaver, 42 TC 72, Nonacq. 1/65). The installment method was also allowed where the taxpayer did not give notice of the sale in the year of the sale since no payment was received in that year but did report the installment gain the succeeding two years when he received payments (Jack & Celia Farber, 36 TC 1142, aff. 312 F 2d 729). The election was also allowed where the return was untimely filed. (C’dé Baca v. Comm., 326 F 2d 189, rev. 38 TC 609) and where the taxpayer claimed nonrecognition of gain on the transaction but thereafter on an amended Tax Court petition, the election was made (John F. Bayley, 35 TC 288). The Court has held that the Commissioner cannot refuse to accept an election to report on the installment method made at the time of the tax audit (Bookwalter v. Joe & Imogene Mayer, 345 F 2d 476).

As the result of the many decisions against the strict interpretation of the Internal Revenue Service, the Commissioner has issued an advanced ruling pending the amendment of the Regulations (TIR—756 8/24/65). The Service will no longer require that the election to report a sale of property on the installment method be made on a timely filed return for the taxable year of the sale. The new ruling states that if the taxpayer, in good faith, failed to exercise the installment method to report income from the sale of property on a timely filed original return for the year of sale, the elections will be recognized as valid elections if made under the following circumstances—

(a) Those cases where the sale took place in a taxable year ended before 12/18/58, if the election was made in the return for the year the first payment from the sale was received;

(b) Those cases where election of the installment method was made on an amended return for the year of sale not barred by the statute of limitations or the operation of any other law or rule of law, if the facts indicate no election inconsistent with the installment election had been made with respect to the sale;

(c) Those cases where the election was made on a delinquent return for the year of sale.

However, an installment election made after the due date (including
extensions thereof) for filing the return for the taxable year of the sale will not be recognized as a valid election if the assessment or collection of any portion of the tax for any taxable year resulting from the application of the installment method to such sale is prevented by the operation of the statute of limitations or of any other law or rule of law (Howbert v. Norris, 72 F 2d 753).

12 MONTH LIQUIDATION—SECTION 337, IRC 1954

No gain or loss is recognized to a corporation where the corporation sells its assets provided two prerequisites are met—

(a) the corporation adopts a plan of liquidation on or after 6/22/54, and

(b) within the twelve month period beginning on the date of adoption of the plan, all of the assets of the corporation are distributed in complete liquidation (less any assets retained to meet claims) (Sec. 337(a), IRC 1954; Reg. Sec. 1.337-1).

The statute is specific. The consecutive steps to eliminate the recognition and taxing of the gain or loss to the corporation are (a) adoption of the plan of liquidation; (b) the sale (closing) of the assets; and (c) the distribution of the proceeds of the sale and the other assets; if any, remaining unsold other than those retained, to meet claims within 12 months after the date of adoption of the plan. If all of the steps are executed properly the corporation will not have recognized gain or loss. The recognized gain or loss is taxable to the stockholders at the time of distribution (based upon the difference between the total net property received and their basis in the stock).

The Internal Revenue Code and the Regulations provide for the filing of certain forms covering the adoption of the plan of liquidation, and information on the amount distributed to the stockholders in liquidation of the corporation. In addition, certain information and records are required to be retained in a permanent form by the stockholder. The liquidation corporation also is required to attach to its final corporate income tax return (Form 1120; Form 1120-S) certain schedules and other information pertinent to the liquidation. Recently, the Regulations which were issued in 1960 have been modified by Revenue Rulings and court decisions.

The Code provides that within 30 days after the adoption by a corporation of a resolution or plan for the dissolution of the corporation or for the liquidation of the whole or any part of its corporate stock, the corporation shall file Form 966 and attach thereto the terms of such resolution or plan (Sec. 6043, IRC 1954). The requirement with respect to the information as to the terms of the resolution or plan is fulfilled by attaching a certified copy of the resolution or plan to Form 966 (Reg.
Sec. 1.6043-1(a)(b)(1)). If there are any amendments to the resolution or plan as originally adopted, an additional Form 966 with the amended resolution or plan is required (Reg. Sec. 1.6043-1 (a)).

Form 966 is required to be filed whether or not any part of the gain or loss to the shareholders upon the liquidation is recognized for tax purposes (Reg. Sec. 1.6043-1(a); Sec. 1002, IRC 1954). Form 966 is filed with the District Director for the tax district in which the income tax return of the corporation is filed (Reg. Sec. 1.6043-1(a)).

Generally, the plan of liquidation of a corporation is adopted on the date the stockholders approve the directors resolution that the corporation shall be liquidated (Virginia Ice and Freezing Corporation, 30 TC 1251; Reg. Sec. 1.337-2(b)). However, the Internal Revenue Service has recently modified, under certain conditions, the rule that the date of adoption is the date of the stockholders approval of the directors action. The Service will no longer contend that the nonrecognition provisions of Section 337 are inapplicable on the ground that the plan of liquidation was not adopted until the passage by the shareholders’ resolution. The current ruling applies to closely held corporations with facts similar to the following (TIR—755 (8/16/65)).

In November, shareholders owning 75 per cent of the outstanding stock agreed at an informal meeting that the corporation should sell its assets and distribute the proceeds in complete liquidation (local law required only 66½ per cent ownership of the stock to authorize and approve a corporate dissolution). Immediately thereafter, the Board of Directors resolved at a special meeting (a) to accept the offer by another corporation to purchase all of the assets; (b) to discontinue the corporate business; and (c) to recommend the dissolution of the corporation at the regular annual meeting of the stockholders to be held the following January. In December, the Board of Directors sold all of the assets at a gain. In January, at the regular annual stockholders’ meeting, 100 per cent of the stockholders passed a resolution authorizing the distribution of the proceeds in redemption of the stock.

Thus, under the current ruling, the date of adoption of the plan was apparently the date the Board of Directors resolved to sell the assets and distribute the proceeds.

In an earlier Tax Court decision, informal “actions” by a husband-wife stockholder (the sole stockholders) constituted the adoption of the plan of liquidation. No formal plan of liquidation was adopted and there was no formal resolution. The husband and wife rarely held corporate meetings. The proposed sale of the corporate assets was discussed “over the table”. The Commissioner acquiesced in this decision in 1964 (Alameda Realty Corp., 42 TC 273, Acq.).

The Code provides that all the assets, tangible and intangible, less the assets retained to meet claims, must be distributed within 12 months
after the date of the adoption of the plan of liquidation. The 12 month period begins on the date of the adoption of the plan (Reg. Sec. 1.337-1). Thus, if the plan was adopted on December 4, 1964, the corporation must distribute its assets (except those retained to meet claims) to the stockholders on or before December 3, 1965 (Letter Ruling, dated 11/30/55, signed H. T. Swartz, Director, Income Tax Ruling Division, U. S. Treasury Dept.). No extension of the 12 month period will be granted by the Commissioner (Reg. Sec. 1.337-1; Maxine Development Co., Inc. Memo TC 1963-300).

The Regulations, as amended in 1961, also requires that the liquidating corporation attach to its income tax return the following information—

(a) a copy of the minutes of the stockholders' meeting at which the plan of liquidation was formally adopted, including a copy of the plan of liquidation;
(b) a statement of the assets sold after the adoption of the plan of liquidation including the dates of the sales;
(c) the date of the final liquidating distribution; and
(d) a statement of the assets, if any, which were retained to pay liabilities and the nature of the liabilities (Reg. Sec. 1.337-6(a)).

Certain additional material must be filed where the plan of liquidation relates (a) to the nonrecognition of gain on sales to subsidiaries (Sec. 337(c)(2)(B), IRC 1954; Reg. Sec. 1.337-6(a)), and (b) to the election of a minority stockholder (Sec. 337(d), IRC 1954; Reg. Sec. 1.337-6(b)).

As a result of a current Revenue Ruling, the requirements of the above 1961 Regulations appear to be generally superseded (Rev. Rul. 65-30 (2/65)). The Ruling provides that a corporation will not be denied the benefits of Section 337 for the failure to report the information on its income tax return required by the Regulations as outlined above. The Commissioner's reasoning is based upon the fact that Section 337 is not elective but that its application is mandatory to any transaction which fits the fact situation described in Section 337(a). Hence, the Regulations Section 1.337-6 were not intended to impose a further condition upon the applicability of the statute.

However, the Commissioner does provide in the current Revenue Ruling that under certain conditions the failure to furnish the information required by the Regulations may subject the corporation to the provisions of Section 7203. This Section, which covers the willful failure to supply information required by the Regulations, carries a misdemeanor penalty of $10,000 fine or imprisonment for not more than 1 year or both plus cost of prosecution.

The Regulations require the liquidating corporation to file an infor-
mation return on Form 1099L for each shareholder receiving a distribution amounting to $600 or more during each calendar year in which a liquidating distribution is made (Reg. Sec. 1.6043-2(a)). Form 1099L for each shareholder must be attached to the form of transmittal (Form 1096) and filed with the Director at one of the Internal Revenue Service Centers.

CALENDAR MONTH LIQUIDATION — SECTION 333, IRC 1954

Section 333, under its rules, provides for a limited recognition of gain to the qualified electing stockholders. The rules are strictly applied. All of the following conditions must be met (Sec. 333(a)), IRC 1954).

(a) there must be a complete liquidation of the corporation;
(b) the liquidation must be made pursuant to a plan liquidation;
(c) the plan of liquidation must be adopted before the first distribution under the liquidation is made;
(d) the distribution must be in complete cancellation or redemption of all of the stock of the corporation;
(e) the transfer of the property (except cash to pay unascertained or contingent liabilities) must occur within one calendar month; and
(f) certain written elections must be timely filed.

The predominant condition for the successful use of this section allowing for the limited recognition of the gain on the liquidation is the proper and timely filing of the elections by the stockholders.

An election to use the provisions of Section 333 must be made by the stockholders on Form 964. The original and one copy of Form 964 must be filed by the shareholder with the District Director of the district in which the corporation files its corporate income tax return. Form 964 must be filed within 30 days after the adoption of the plan of liquidation. An election is considered as timely filed if it is placed in the mail on or before midnight of the 30th day after the adoption of the plan of liquidation as shown by the postmark on the envelope containing the written election or as shown by other available evidence of the mailing date (Reg. Sec. 1.333-3; Ralph D. Lambert, Memo TC 1963, aff. CA3).

The Courts have strictly upheld the filing date as a condition of the election. In one case where the election Form 964 was filed on the 31st day after the adoption of the plan, the election was held not timely (N. H. Kelley, Memo TC 1951). It is suggested that the tax practitioner insure the receipt within the 30 days by hand delivery to Internal Revenue so that the time stamp can be imprinted. In lieu of hand delivery, registered or certified mail should be used, enclosing a duplicate copy with a request that it be stamped in by Internal Revenue and returned to the practitioner.
The stockholders election is binding and cannot be withdrawn or revoked (Reg. Sec. 1.333-2(b) (1); Shull v. Comm., 291 F 2d 680).

Permanent records in substantial form must be kept by every qualified electing shareholder receiving distributions in complete liquidation of a domestic corporation. The electing stockholder is also required to attach to his income tax return for the taxable year in which the liquidation occurs a statement of all the facts which are pertinent to the recognition and treatment of the gain. The statement must include the following—

(a) A statement of his stock ownership in the liquidating corporation as of the date of the distribution, showing the number of shares of each class owned on such date and the cost or other basis of each such share;

(b) A list of all the property including money, received upon the distribution, showing the fair market value of each item of such property other than money on the date distributed and stating what items, if any, consist of stock or securities acquired by the liquidating corporation after December 31, 1953;

(c) A statement of his ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, computed without deduction by reasons of distributions made during the month of liquidation.

In addition, a copy of the shareholder's election on Form 964 must be attached to the stockholder's income tax return (Reg. Sec. 1.333-5).

The Code provides that within 30 days after the adoption of the plan of liquidation, the corporation must file Form 966 and attach thereto the terms of the resolution to liquidate or the plan. The requirement with respect to the information as to the terms of the resolution or plan is fulfilled by attaching a certified copy of the resolution or plan to Form 966 (Sec. 6043, IRC 1954; Reg. Sec. 1.6043-1(a) (b) (1)). If there are any amendments to the resolution or plan as originally adopted, an additional Form 966 with the amended resolution or plan is required (Reg. Sec. 1.6043-1(a)).

For a discussion of the problem of when the Plan of liquidation is adopted, see above discussion under Section 337, IRC 1954—12 Month Liquidation.

MR. WILLIAMS:

Thank you, Mr. Rumpf, for a very clear, explicit exposition of the elections which you have discussed here.

Our next speaker is from Greensboro, North Carolina, he is a member of the American Institute of Certified Public Accountants; he is a lecturer at New York University's Institute, contributor to various publications, past president of the North Carolina Association of CPA's, and a member of A. M. Pullen & Company of Greensboro. Mr. William H.
Westphal of Greensboro will discuss Current Problems under the Installment Method of Reporting and Exchange of Investment Property for Like Property. Mr. Westphal.

MR. WESTPHAL:

It is a very happy privilege to be here with you today; in fact, I feel myself quite inspired as I look out over this sea of faces, the faces of so many who seem disposed to drink very deeply from the Pierian Spring of tax knowledge. I know that everyone here is obsessed with the idea that his client shall pay every cent of taxes that is rightfully due but not one cent more. Now an occasion like this sometimes gives one a bit of yearning, something of a temptation to seek to engage in oratory if one has any flair for this or any talent in this direction, and I am going to give you an example which, I think, will illustrate the reason for this. If I were to say to you, "two plus two equals four," you would say, and quite rightly so, "so what?" "It has always done that." And you wouldn't come away from this meeting the slightest bit edified. Now let me put it to you as a real orator would;—and it took me a long, long time to learn to do this. "When in the course of human events one takes a numeral of the second denomination and adds to it the figure two, I say to you, and I say it without fear—the slightest fear—of successful contradiction, that the result is inevitably the numeral four." I could just as well have said the numeral five and it wouldn't have made a particle of difference, because by the time I got down to the end, you would have been so transported into ecstasy by this rhetorical flight that you would have forgotten what I was trying to talk about and you would have said, "Isn't this impressive?" "What profundity!" It had been my aim and purpose to utilize five minutes in this preamble so that we could cut the time down from thirty-five minutes to thirty minutes because I have a double-barreled subject and then I might be able to approach more intelligently the task of assigning time. I find if I have thirty minutes, I can divide by two which allows fifteen minutes for each. If one uses thirty five minutes there are complexities involved. That results in the apportionment of seventeen point five minutes or seventeen minutes and thirty seconds to each subject and then I am not so sure of myself. So we are going to bring it down to fifteen minutes apiece, which is much easier.

What is the purpose of undertaking an installment sale? Why do we seek a non-taxable exchange? An exchange of property for property of like kind? Purely and simply because we have involved here a basic method of tax economy and one of the very few basic methods. For in spite of everything that has been said about the complexity of the law and the proliferation of tax schemes, there are only a few basic concepts of tax economy, one of which is the deferment of income and the
tax—deferment until a later or better time. By doing this one doesn't have to look at the nasty thing for the current year and he hopes that it will disappear in the later year. There is therefore a great deal of attractiveness to an installment sale; and also, to an exchange of property that may be non-taxable. An installment sale can be very simple and yet its possible complexities may be infinite in variety. It is a sale in which payments are received in more than one year, while the initial payment or the total amount received in the year of sale does not equal more than 30% of the entire sales price. In making this determination one does not reduce the sales price by any mortgages that have been transferred or assumed or any mortgages to which the property is subject, nor by any commission applicable to the sale.

These installment sale privileges are extended to both dealers and non-dealers in real property if the initial payment does not exceed this 30%. They are also available in the case of casual sales made of non-inventoriable personal property if the sales price exceeds $1,000. At one time it was of paramount importance that something must be received in the year of sale. On many an occasion a taxpayer who had studiously refrained from taking anything in the year of sale imagined that he had complete, absolute compliance with the installment provisions of the law and that he wouldn’t have to report anything. This again was a case where a little knowledge was a dangerous thing because in the law in those ‘good old days’ if one did not receive something in the year of sale, one couldn’t report on the installment sale basis at all and the entire profit received would be reported in the year of sale. Since then we have become more civilized and the pain that was caused by the previous law has been alleviated by this very humanitarian provision that if you receive nothing in the year of sale, you may still report on the installment basis. The installment sale presents one very definite advantage. It makes possible payment of a tax applicable to a sale in the year in which the money is available for the payment of this tax; for if the installment sale provisions are not utilized it is again conceivable that the poor taxpayer may find that he is out of pocket in tax money considerably more than he takes in during this year and he has to go to the bank to borrow in order to be able to pay his income taxes, which is a dreadful state of affairs and indicates a singular lack of planning on your part as tax counselor.

It is of great importance in the consideration of this question of the availability of installment sales provisions that one be assured that inventoriable property is not included in the sale. Sometimes this creeps in unawares as would be the case when all the properties,—a mixed aggregation of a heterogeneous collection of property—is sold with an initial payment that did not constitute more than 30% of the price. Here the taxpayer may well think he has accomplished the installment sale insofar
as every asset is concerned, but that portion applicable to the inventory
would have to be treated on a different basis. This is something one must
bear in mind because misunderstandings of this kind may sometimes
arise in an undertaking to define and accomplish an installment sale.

Now this privilege of installment sale reporting, though presenting
advantages, may likewise result in disadvantages if inadvertently the
taxpayer some way and somehow falls afoul of the provisions of the
law that require immediate payment of the tax on the installment obli-
gations. This can happen if there is a transmission of obligations through
liquidation; also, this advantage of installment reporting may be lost if
there should be an acceleration of the payments or if there should be a
sale of the obligations, and so one must very carefully bear in mind
the fact that if any one of these occurs, it is conceivable that the income
tax on all of the profits may immediately become due.

I want to give brief consideration to some of the difficulties inherent
in the installment sale reporting. We have the question of just what oc-
curs if this sale is made incident to a Sec. 337 liquidation. As you know,
a Sec. 337 liquidation occurs when pursuant to a plan of liquidation the
properties of a corporation are sold within a year and the proceeds, to-
gether with all other assets remaining after the discharge of liabilities,
are distributed to the stockholders to apply against their equity. If an
installment sale should take place as the result of this plan, what then
would be the status of the distribution of the installment obliga-
tions? Since there would be no ordinary income tax due as the result of a sale
made pursuant to a plan of liquidation under Sec. 337, likewise there
would be no tax resulting from the transmission of these obligations.
However, the obligations themselves, having a sale or market value,
would represent a part of the distribution received by the stockholder in
liquidation and would for this reason be added to the amount of his
capital gain. The subsequent liquidation of the obligation would not be
likely to result in additional income.

We have other questions involved in various corporate transfers. We
might give some consideration to the tax status of installment obligations
when they are distributed in accordance with a plan of liquidation under
Sec. 332 of the Internal Revenue Code. You may recall that this type of
liquidation may occur when 80% or more of the stock of the corporation
is held by another corporation, and pursuant to a plan of liquidation
after the stock has thus been held for two years, the assets subject to
the liquidation are transferred from the subsidiary to the parent com-
pany. We have a good many of these Sec. 332 liquidations and of course
under ordinary circumstances the primary consideration is likely to be
whether or not a net operating loss carryover from the subsidiary to the
parent company is possible. We do have, however, a problem insofar as
the transmission of these installment obligations is concerned. In the case
of the ordinary Sec. 332 liquidation, appropriately made after the holding of the stock for a two year period or more, no gain or loss will be recognized and the basis of these obligations will come over intact to the acquiring or transferee company. An exception to this rule, however, may occur in a case where this liquidation thus made under Sec. 332 qualified for the special treatment set forth in Sec. 334(b). You will recall that this section has to do with those cases in which 80% of the stock was acquired by the parent within a twelve month period, the stock is held less than 2 years, and it was acquired by purchase; and upon the liquidation of the corporation, the cost of the stock to the acquiring corporation is spread over the assets and constitutes their basis in the hands of the transferee corporation. Net operating losses are not permitted to be carried over under these circumstances. This is distinguishable from the case of the ordinary section 332 liquidation, following which the basis of the assets in the hands of the acquiring corporation is the basis in the hands of the transferor corporation. In those cases where installment obligations are distributed in a liquidation qualifying under Section 332, but subject to the exceptions in 334(b) (c), it is conceivable that gain may be recognized on such a distribution. You will recall that under the 332 liquidation amended and qualified by 334, it is possible for the distributor corporation to sustain a tax on Sec. 1245 gain. That is the theoretical gain that may result because the sales price of these assets exceed the depreciation sustained from the beginning of 1962. There is a similar provision under Sec. 1250 with respect to real estate, although the focal date and the treatment of the depreciation is somewhat different. To the extent that such gain would have been recognized under 1245 or 1250 on the sale of the assets giving rise to the installment obligations, the distribution of these installment obligations in such a Section 332 liquidation would likewise result in gain of this type.

We have, likewise, the problem inherent in the transfer of installment obligations from one corporation to another in reorganizations that qualify under the various reorganization sections of the law. The ordinary reorganization exchange does not result in immediate realization of profit on installment obligations by reason of their transmission. I am referring here to transfer of such obligations pursuant to a statutory merger or consolidation or to a “C” type reorganization. Installment obligations may be transferred to a corporation solely in exchange for its capital stock under the provisions of Sec. 351 of the Internal Revenue Code. This, you will recall, provides that no gain or loss is recognized on the transfer of property to a corporation solely in exchange for stock or securities if the transferrer is in control immediately after the exchange. Under these circumstances, the basis of the transferred property in the hands of the acquiring corporation is the basis in the hands of the
transferor, and this rule is applicable if the installment obligations are thus transferred to a corporation. However, they will come over to the acquiring corporation at a basis that is reduced by the unrealized profit thereon and subsequent collection of the obligations will result in the taxation of this profit to the corporation that had acquired the obligations just as though this collection had been made by the original holder.

If installment obligations are transferred by reason of death there is no immediate income taxation as a result. These obligations are subject to estate tax at their fair market value in the hands of the estate, and when collected at a later date by the estate’s executor or administrator or by an eventual beneficiary, the income is taxable in the income tax return of the recipient. That portion of the estate tax which, in the estate tax return, had been applicable to the profit on these installment obligations constitute an income tax deduction in that particular income tax return.

I think you have in mind rather clearly the ordinary method of reporting gain on these transactions. There is a determination on the basis of the relationship of the profit to what is known as the contract price. The contract price is the sales price reduced by any mortgage to which the property is subject or constituting a lien against it as it is conveyed. This net price, the difference between the sales price and the obligation, constitutes the contract price, and one ascertains the relationship of the profit on the transaction to this contract price. This percentage is applied to every payment that is received and thus gain or loss is determined. Needless to say, generally speaking, the gain that is reported on such sales is gain as determined by reference to the capital loss or gain provisions of the law and its status depends on the class of assets that are sold.

If the price is changed as the result of subsequent negotiations, one may have some more complicated problems. First I want to make mention of the possibility of a forgiveness of an indebtedness, and then of a conveyance of the property subject to an indemnifying agreement. It is quite possible that the person who thus forgives the indebtedness, particularly if this is done in consideration of natural affection growing out of a family relationship, may be subject to immediate income taxation of the entire gain on the transaction and that he will likewise have made a taxable gift. However, if there is an adjustment of the price as a result of the negotiations between the parties and they are not actuated by motives of love and affection or family consideration, this will ordinarily result in a change in the remainder of the amount to be received and in an adjustment in the profits on the installments to be collected from that point on. We have a rather graphic example of this in those cases where the taxpayer has made a sale of property on the installment basis subject
to certain indemnifying provisions with respect to the possibility of income tax assessments. For example, he has sold his stock on an installment basis but it is desired that certain funds shall be placed in escrow and shall not be released until after an examination of the income tax returns of the corporation has ascertained that here will be no material increase in tax liability, and these funds are to be applied to save the purchaser harmless in the event an unanticipated liability should arise. In such circumstances, if it becomes necessary to discharge this contingent liability,—this liability that was contingent at the time of sale,—the proceeds that are received that are applicable to the later installments will be scaled down proportionately.

So far as the bad debt question is concerned, needless to say when bad debts are charged off and there is no repossession or foreclosure on the property, the unrecovered amounts thus charged off are reduced by the unreported portion of the gain. Now there are several possibilities we may consider here. When property is involved in a repossession the tax treatment may depend upon whether or not the title has been passed. The property may be sold with the title passed and the retention of a lien, or it may be sold with title retained. In the case where the title is retained, gain or loss to the vendor for the year of repossession is measured by the difference between the entire payments received plus the fair market value of any improvements that may have been placed on the property by the purchaser, and the total profits previously reported plus the depreciation of the property during the period it was in the hands of the purchaser. The difference between these two is the gain on repossession; if the payments received are less than the total profits plus depreciation there is a loss on the repossession. If the title is transferred you have the question of the fair market value of this property when it is taken back at the time it is repossessed. One must make an adjustment likewise for the reserve for unrealized profits applicable to the unpaid installments. This can result in a gain or loss. If it is a gain it will be an ordinary gain; if it is a loss, it is a bad debt.

There is an exception to this general rule in the case of real estate, growing out of a recent amendment to the Internal Revenue Code, which will be discussed by another speaker.

There are certain provisions of the 1964 Revenue Act as it amended the Internal Revenue Code providing for the imputation of interest in any case where the installment contract does not call for interest to be paid to the seller at certain minimum rates. This change in the law, which will be discussed by another speaker, should be carefully considered, because its application may cause the amount received in the year of sale to be regarded as in excess of 30% of the sale price and thus invalidate the installment sale for income tax purposes.
If more than 30% of the sales price is received in the year of sale, the deferred payment method of reporting may be used. This results in taking into account the installment obligations at their fair market value at the date of the sale, which may be a discounted value. However, when the collections are made, the proportionate amount representing the excess over the fair market value is taxed as ordinary income.

There is one exception to these general rules. If an obligation has no value because of presently unascertainable conditions or contingencies, then the basis of the property sold is to be recovered before reporting gain. There are a few sales of this type. They occur rather rarely, but occasionally you will find yourself in a situation in which it is completely impossible, because of conditions that cannot be presently anticipated, to forecast whether the indebtedness to the seller on the property sold will ever be paid. If this is true, the basis of the asset sold is to be recovered before any gain is recognized.

Now a dealer in real estate can to a remarkable degree control his gain or loss as taxable income. He can make an election or refuse to make an election on any piece of property he sells because each one is a separate asset. His ability to do this depends upon whether 30% or less is received in the year of sale. He can therefore plot his course in a manner that will enable him to minimize considerably his tax bracket by a continual deferment. Sometimes by such intelligent planning, which is entirely within the framework of the law, it is possible to have this gain on such real estate taxed to a corporation only at normal tax, and not at surtax rates. Likewise, whereas the casual vendor of real estate is required to reduce his sales price by the amount of his commission and thus charge it off proportionately over the installments received, the dealer in real estate can accrue this commission immediately and deduct it in the year of sale.

There are many things I could say to you, if I didn't have to go forward into the matter or non-taxable exchanges, with regard to sales by dealers in personalty. A dealer in personalty may choose to report his gain on sales of personal property on the installment basis and deal with this as a specific method of accounting. Of course, he must begin with this particular operation in this fashion. Otherwise, it is necessary for him, under the regulations, to seek permission to change from the accrual basis to the installment basis. If he should report gain from personalty on the installment basis, he would necessarily make a determination year by year of the profit margin applicable to the sales for the year. He would classify his sales and his collections on sales on this yearly basis and maintain his record of the profit percentages relating to each year so that these may be used to determine the profits realized on the collections applicable to sales made in the current and the preceding years. Sometimes,
if collections on these sales are spread over a number of years it becomes necessary to have three, four, five or even six years of figures representing a determination of the profit margin for the prior years.

Now we want to give some brief consideration to the question of a nontaxable exchange under Sec. 1031 of the Internal Revenue Code. A non-taxable exchange occurs when property held for investment or use in trade or business is exchanged for property of like kind held for investment or use in trade or business. Bear in mind that this does not result in expunging the tax from the record. It does not obliterate,—it merely defers it. But again let me say, sufficient unto the day is the evil thereof. The basic date of the property acquired in the exchange will be determined by reference to the basic date of the property that has been given up in the exchange. This does not apply to inventory property nor to property held for resale to customers. It has no application to exchanges of stocks or bonds, generally speaking. These exchanges of stocks or securities are non-taxable only if they meet the statutory requirements of the reorganization sections of the law, or if they qualify under sec. 1036 of the Internal Revenue Code, which provides that no gain or loss is recognized on the exchange of common stock for common stock or preferred stock for preferred stock in the same corporation. There is likewise a special dispensation with respect to government bond exchanges, allowing them non-taxable treatment under sec. 1037 of the Internal Revenue Code.

Gain on such transactions may be recognized to the extent of cash or other property received, but loss is not generally recognized. When gain is recognized, the basis of the property received is the adjusted basis of the old property increased by the gain recognized and decreased by the money received. When property is exchanged for other property, and each is subject to a mortgage which is assumed by the other party, the mortgages are considered to be other property. When property is sold and immediately afterwards other property of like kind is bought from the person to whom the sale had been made, gain will be recognized. However, an exception may arise in the case where the Internal Revenue Service on a form versus substance basis seeks to treat the transaction as an exchange. The Service's purpose would be to prevent an increase in depreciation basis by the taxpayer through the simple expedient of his having paid a capital gain tax.

The term 'property of like kind' is broadly defined. Real estate, in the very general sense is a classification of property. This has reference to character and nature and not to its grade and quality. Thus city property may be exchanged for farm property and unimproved property for improved property. There are many fine distinctions that have been set up in the cases but the exchange of oil, gas and mineral rights for im-
proved realty and the transfer of oil leases extending to exhaustion for a fee in a ranch have been held qualified exchanges. Also, the transfer of perpetual water rights for a fee interest in land where local law treats the water rights as real property has been regarded as a transfer of property for property of like kind. The interest must be substantially identical in legal character.

One of the most serious problems that may arise in these exchanges has to do with three-party transactions. These occur, for example, where B agrees to buy C's property and exchange it for A's. Can this be done? This may be allowed as an exchange, however, if A in this case had previously been negotiating with C, the Government may seek to apply the agency principle, holding that B had really sold to A and then as an agent for A had bought C's property. In these would-be exchanges involving three parties, when extensive negotiations had been conducted and the course of the transaction had been changed, one must exercise extreme care. There are many pitfalls in these exchanges of property for property of like kind.

You must give some consideration to the possibility resulting if Sec. 1245 property is exchanged for an asset that is not Sec. 1245 property. Here it may be possible that Sec. 1245 will be operative and cut right through all of the sections giving effect to some immediate realization of income.

Since our time is drawing to a close and it is extremely difficult to cover many complex provisions of the law, I am not going to try to talk to you any further about exchanges. I had a rather confused and voluminous discussion of elections in the case of installment sales. That has been admirably covered by my predecessor so I have left it out in the interest of time and I know you are going to be grateful for that. Let me, however, sound this one word of warning with respect to the matter of elections and flexibility. Don't you be the person, if you can possibly help it, who must rely on any kind of special dispensation or any favorable court cases; be assured the very soundest tax practice in every case will call for an undertaking to be as explicit as possible and as completely in compliance with the regulations as you can whenever you wish to establish an installment sale. And let me make this little comment in conclusion: These sections of the law are very admirable and they offer excellent opportunity for tax savings if they are capably applied by knowledgeable practitioners and I know that you are all in this classification. But let's beware of any laxity or any carelessness in our undertaking to insure this tax-free compliance.

I am often caused to think of the man who was about to be released from the penitentiary and as he was going through the various examinations necessary and was receiving his bit of money and his suit of
clothes, he was requested to sign a certain form indicating that he had received it. He said, "I am sorry I can't do it, Captain, I can't read and write." "What! You can't read and write?" "What are you trying to tell us?" "You were in here for forgery, what do you mean you can't read and write?" "Oh, that, I know what you are talking about. I just had a bum lawyer." So whenever one of these tax savings provisions of the law proves inadequate under your client's circumstances, you don't want him to say, "Yes, I thought I was under the law, but I had a bum practitioner." Thank you very much for your time and attention.

MR. WILLIAMS:

Thank you very much, Mr. Westphal, for a very fine presentation. I did not say earlier that we will be getting to the questions later on after our presentations in chief and if we have time I would be interested in Mr. Westphal's comments, if he wishes to make any, on a question of long-term leases and lease-backs under the Jordan-Marsh case and the Century Electric case. And also some questions I have about partnership interests.

Our next speaker is also a CPA by practice. He is a lawyer in addition. He is a member of the American Institute of CPA's. He is a member of the Virginia Bar. He has received the Seidman and Seidman Tax Award presented by the Marshall-Wythe School of Law here at William and Mary of which he is a graduate. He is a member of Phi Beta Kappa. He is a member of the firm of Daniels, Turnbull and Freeman of Newport News, and is going to talk to us about a revisit of the 1964 Tax Law, the law that had so much in it for everybody. The great reductions made the headlines and now that the favorable result of this has probably worn off, we come down to how do we live as practitioners with the substantive provisions beyond the rate reduction, whether they be income averaging which can be a blessing if it helps you, but gosh what a headache to work through—the question of disallowance of corporate surtax exemptions, multiple corporations, and then of course the problems in helping individuals and businesses, like imputed interest, stock options, and so on. Mr. Lawrence Roesen of Newport News, Mr. Roesen.

MR. ROESEN:

Dr. Atkeson, Mr. Chairman, ladies and gentlemen. It is indeed an honor for me to be asked to speak to such a distinguished group. My topic this afternoon is the 1964 Tax Law, Reviewed One year Later. Last year's panel very ably covered this topic in detail; therefore, it is not my intention to cover the same ground again, but merely to hit the highlights and to look at certain sections after one year's experience and to determine what questions and what answers or what knowledge
we have now which we did not have then. In some instances there have been proposed or final regulations by which we could make our answers and in other cases we are still just guessing, but with the help of one year's experience and some leading tax services.

One of the new sections of the 1964 Act was sec. 483 dealing with imputed interest. Through the magical power of this section, the government is able to convert capital gain into dreaded ordinary income. It is normally most tax practitioners' ideal to do just the opposite, to strive for capital gain whenever possible. However, now the Internal Revenue Service has a Code section in their favor to do just the opposite. This section is effective to all sales or exchanges made after June 30, 1963 which called for at least one deferred payment. In these instances the government will impute 5% interest where no interest or an unreasonably low amount of interest is called for in a particular agreement. Generally, the computed amount will be treated as interest to both the buyer and the seller for all tax purposes. Regulations indicate, as was previously advised, that the minimum amount of interest that will be allowed in order to avoid sec. 483 is 4%. What happens if a contract or option entered into prior to June 30, 1963 is substantially changed after that date? What effect does the substantial change have on that contract or agreement? According to the regulations any payment pursuant to such a changed contract or option shall be considered a payment on account of a sale or exchange entered into after June 30, 1963. Therefore they will apply sec. 483.

A good question arises as to whether or not sec. 483 applies only if cash is the means of deferred payment. Again, the regulations give us an answer. They say it makes no difference whether or not the deferred payment is cash or tangible or intangible personal property and in the case where it is tangible or intangible personal property, the fair market value of that property will be the basis for computing the imputed interest. A method of avoiding sec. 483 could be a scheme like this: Suppose an employee wishes to buy stock from his employer on an interest-free installment basis. Clearly if he handled it this way sec. 483 would apply and impute part of the payments as interest to both parties. But suppose, instead, he turns around and borrows funds on a five year installment interest free method from his employer and uses these funds to pay off the stock, to buy for cash. Clearly it does not come within the terms of sec. 483 for there has been no sale or exchange. But again the regulations say they will telescope the transaction as a step transaction and impute interest on the payment of these notes. Query, whether or not a third party who will be willing to give an interest free loan would be useful in this situation? If any agreement calls for a certain percent of interest, then it is clear whether or not you meet the 4% rule. However, where there is an indicated amount as stated interest throughout the
terms of the agreement then it is not always clear as to whether or not the amount of 4% interest is met. There the Regulations have present value tables by which you can compute the present value of each of the deferred payments. If that does not meet the 4% rule then the government will impute 5%.

I have been over some of the obvious results of sec. 483; that is, 5% interest will be imputed if the minimum amount of 4% is not indicated in the agreement. However, there are some hidden effects of sec. 483. I hate to say it, but my sec. 483 will revoke some of Mr. Westphal’s installment elections. They can do this in one of two ways. First of all, in order for an election to apply, the transaction must result in a gain. Consequently, if we convert part of the sales price to interest income and interest deduction, we reduce the sales price and it could easily convert a gain to a loss—and therefore revoke the election. Also by reducing the sales price we reduce the amount by which 30% cash can be received and thereby too much cash could be received in the year of sale and revoke the election.

Section 483 will also have an effect on transactions, negotiations between a buyer and a seller of property. If a buyer is purchasing non-depreciable property and no interest is included in the agreement, then sec. 483 will apply and convert part of the purchase price to interest deduction which of course is of great benefit to the buyer because he could not deduct or depreciate any of the property originally. Therefore, the seller would be in a position to bargain for a higher price of that particular property.

We have an unusual set of circumstances in the case of bulk sales of inventory. Sec. 483 will not apply to the seller but will apply to the buyer. The seller on the one hand is not selling a capital asset or a sec. 1231 asset, therefore, it makes no difference if he has interest income or income on the sale of inventory. In either case it will be ordinary income. However, in the case of the buyer a part of the purchase price of the inventory will become a deduction. Therefore, he is reducing the cost of goods sold currently when he makes a sales of that inventory, only to be compensated by a future interest deduction when he makes payments on those payables to the original seller. Therefore that is not worth as much to him as a current deduction, and, consequently, he would not be willing to pay a high price for that property.

Another new section in the 1964 tax law is on multiple corporations, sec. 1561, 1562 and 1563. Let us assume for our discussion this afternoon that a group of corporations are component members of a controlled group with either the brother-sister or the parent-subsidiary relationship as defined in sec. 1563. Of course, it is not always that easy to determine whether or not a group of corporations are members of a controlled group, but let us assume they are members. It is at this point that we
must begin to do some detective work to determine which of the various elections which are available will be the most beneficial this year or in the long run. We have four choices under a multiple corporation set-up. One, we can file a consolidated return if the proper relationship exists. Second, we can allocate a single surtax exemption. Thirdly, we can elect a 100% dividend receipt deduction, or we can elect a multiple surtax exemption. It appears from some of the sections of the Code and in some of the sections that were passed in the 1964 Act that the Revenue Service is attempting to have all taxpayers deal out of one large corporation. However, there are many non-tax motives and other factors which will warrant and require that individual corporations be set up. So I am confident that we will always be faced with some choice as to which taxing method to use. If we file a consolidated return, that is, if we have the proper parent-subsidiary group, then of course the current losses of one corporation will offset the current profits of others and losses will carry over from prior years to be used against current profits. There is also the elimination of inter-company profits on sales from one corporation to another and the elimination of dividends from one corporation to the other. And of course the 1964 law revoked the 2% penalty for the filing of these consolidated returns and, therefore, makes it more beneficial.

On the other hand, there are certain drawbacks to filing consolidated returns. Once they have been filed it is difficult to break a consolidation. All these corporations must be on the same fiscal year which may, or may not, be practical. All the corporations are treated as one for the accumulated earnings credit and all the corporations are treated as one for the filing of the estimated income tax return. And, after taking a brief look at the new consolidated regulations, there appears many more problems in filing consolidated returns. There is the new special rule income which is in connection with the inter-company sales and inventory from one to the other which must be reckoned with.

Suppose we have this controlled group and we do nothing except file the returns on time. Then when the Revenue Service examines these returns they will allocate a single surtax exemption equally among the corporations involved. Of course, if the corporations do not earn income equally, which is normally the case, it will not be beneficial for us to have them do this. If, however, we don’t want that to be done, then at the time of the filing of the return as of any given December 31st each can elect or we can have a plan of apportionment and allocate the single surtax exemption in any way we see fit. Once this plan is adopted it is effective for the current year and for all succeeding years until it is amended or terminated or we file an election under the multiple surtax exemption. If we do not make any plan of apportionment at the time of filing the return and later we decide upon one, then we can amend
that return as long as there is at least one year left in the statute of limitations for deficiencies. As the Regulations say, if there is less than one year left for the statute of limitations, then normally you can apply to the Commissioner for an extension of time.

A third choice under the multiple corporation set-up is to elect the 100% dividends received deduction. That is, it is available to a parent-subsidiary group that does not want to file a consolidated return, and yet it gets the benefit of eliminating inter-company dividends. On the other hand, the Revenue Service makes sure that this corporation is treated as one. They are not permitted the multiple surtax exemption; they are treated as one for purposes of the accumulated earnings credit and they are treated as one in filing estimated income tax returns.

The fourth choice under a multiple corporation set up is to elect multiple surtax exemptions. Normally this is the cheapest way of paying taxes if more than one of the corporations makes money and the controlled group makes in total $32,500 under the 1965 rates. Each corporation will be allowed $25,000 surtax exemption. However, they must pay an additional 6% tax on this $25,000 or a maximum of an additional $1500. This election once made is effective for the year in which it is made and for all succeeding years until it is terminated by consent or another corporation comes in and does not consent. Once the election is terminated a new election cannot be made for five years.

A practical question arises concerning the filing of the multiple surtax exemption where one individual owns 80% of one corporation and 100% of another and each corporation earns in excess of $25,000. There it is easily seen that the cheapest way of paying tax would be to elect the multiple surtax exemption. But it will cost each corporation an additional $1500 in tax. The reason it is costing the additional $1500 in tax is because of the majority stockholder. Well, there is one minority stockholder holding 20%. What rights does he have? It is not his fault that they are paying $1500 in tax. But it is the fault of the majority stockholder. Although there is no answer to this question I can see a great many problems concerning minority stockholders in the future.

The next section I wish to discuss is a new section of the Code. And although it was not a part of the 1964 tax law, it was passed in the latter part of 1964 and I believe it deserves mentioning here. This is the new section 1038 of the Internal Revenue Code and deals with the amount of gain that is to be recognized in the repossession of real estate. Prior to the enactment of this section a seller who had to repossess real estate that was sold at a gain on the installment basis had to recognize the gain in the year of repossession to the extent of any excess of the fair market value of the property at that time over the basis of the installment obligations related to the property. Although the seller was put in the same position as he was prior to any sale, he had to pay tax on the fair market
value and consequently a lot of people failed to repossess property, when it was warranted. This new section, 1038, removes this harsh rule and provides that the seller will recognize gain to the extent of the cash or other property he received prior to the repossession less any cost of repossession and less any gain already reported. The gain recognized in this instance cannot exceed the gain on the original sale less gain already reported and less cost of repossession. This section is mandatory for repossession in taxable years beginning after September 2, 1964 and is elective for prior years beginning after 1957. Where this section is applied on an elective basis, however, the limitation that the gain in the year of repossession cannot exceed the amount of the gain on the original sale does not apply and therefore all cash and all other property that is received will be picked up as gain regardless of the amount of the original gain on the original sale. These rules apply to the seller who repossesses but not to any of his assignees. However, the seller may repossess from the original purchaser or from the purchaser’s transferee. It is also immaterial as to whether or not he repossesses as a voluntary reconveyance or as court foreclosure.

The big question then arises as to what constitutes cash to the seller. Suppose when the original sale was made there was a first deed of trust existing on the property and the seller takes that and a second purchase money mortgage. In the regulation, any payments made by the purchaser on that first deed of trust will be deemed cash paid to the seller and he will have to pick up that as part of his gain on repossession. However, had there been no first deed of trust on the property and the seller had taken back his first purchase money mortgage at the time of the sale and later had gone out and gotten a second deed of trust on the property any payments made on that second deed of trust would not have been considered cash to the seller. The reason being of course that the first deed of trust in the first instance existed on the property at the time of the sale.

Section 1038 applies only to the amount of gain recognized and does not have any effect on the character of the gain recognized. In order to determine whether you have capital gain or ordinary income it is necessary to look to the other sections of the Code.

Section 1250 which deals with the recapture of depreciation on the value of real estate was also a new section in the 1964 law. As yet there have not been any regulations issued under this section and as everyone knows who has worked with this section in projections or actual figures there are many unanswered questions. Basically, if real estate is sold within twelve months after its purchase then any gain to the extent of depreciation taken will be ordinary income. Any gain in excess of that depreciation will be capital gain. If the property is sold between 12 months and 20 months after purchase then only the excess depreciation
will be taken as ordinary income. Excess depreciation is the difference between accelerated depreciation actually taken and straight line depreciation on the same life. If the property is sold between 20 months and ten years (120 months) then that excess depreciation is reduced 1% point a month so that after ten years all gain is capital gain.

The Cohn Rule has a tremendous effect on the sale of real estate. This rule provides that no depreciation is allowed in the year of sale if the property is sold at a gain. Unlike sec. 1245, where the Cohn Rule is no longer of any importance, sec. 1250 does not attempt to recapture all of the depreciation that has been taken after Jan. 1, 1964, but only a certain part of it. Section 1250 is an overriding section and creates income in certain areas of the Code which were originally tax free. We have had some discussion on sec. 333 and 332. Those are two of the sections which, although 333 may give you some small income to the stockholder, there never was any income to the corporation merely for liquidating. Likewise with 332 there is normally no gain or loss to the corporation or to the parent into which it merges because of liquidation. However sec. 1250 overrides both of these sections, and where there is sec. 1250 property involved then that income must be recognized and taxed to the corporation merely because it has liquidated.

An interesting question arises where section 1250 property is sold on the installment basis. As you know, when you sell something on the installment basis you have to compute a gross profit percentage and that gross profit percentage is used against each installment as it is received. Since sec. 1250 you can have both ordinary income and capital gain in the same transaction. How do you report it? Is it all ordinary income at first or is each payment partially capital gain and partially ordinary income? There are no regulations under sec. 1250, so there is no answer. But if we look at sec. 1245 and apply the same provisions they have there, then it is a requirement that you report your ordinary income first until all of it has been reported and after that you report capital gain.

Section 1250 is designed as a penalty section. It will cause people not to sell property for ten years because it bunches as ordinary income all in one year and makes the sale of it too expensive. Consequently some people will die with the property and thus it will avoid income tax altogether. Section 1250 will have a tremendous effect in negotiations between a buyer and a seller of a corporation. Section 1250 will cause a seller to want to sell stock and will cause a buyer to want to buy assets of that corporation. The reason being of course that each wants the other to recognize any potential 1250 gain before he gets that property.

The last section I wish to cover is some of the provisions that were changed as to personal holding companies. We could spend a whole afternoon on the complexities and the changes in the personal holding
company law and so, therefore, I only want to hit upon some of the highlights. The new law passed in 1964 had as its object to restrict the advantages and ways of sheltering passive incomes. Under the old law $4 of passive income could be sheltered by $1 of active income. Under the changes $3 of passive income require $2 of active income to avoid the personal holding company income tax. There are many problems and complications that arise from small, closely held corporations and each corporation must be examined very closely and continuously throughout the year in order to watch its status. What can be done to avoid personal holding company status? There are some types of tax planning which will avoid this status. One, we can increase the number of shareholders, but we must make certain that the new stockholders and the old stockholders are not related in any way and do not come under the rules of attribution. If possible we could increase operating gross income so that it always equals more than 40% of the adjusted, ordinary gross income. For this purpose gross receipts from sales must be reduced by the cost of goods sold in order to determine the actual amount that goes into computing the gross income. We can decrease personal holding income. That can be done by shifting our stock investments from high dividend paying stocks to low dividend stocks. If the corporation stock that is owned is a subsidiary of that corporation, we can control dividends through the board of directors. We could also transfer funds into tax exempt securities and thereby avoid personal holding company status that way. The big item in most personal holding corporations is rent. And under the new law adjusted rents must equal at least 50% of adjusted ordinary gross income. Adjusted ordinary gross income means it is ordinary, there is no capital gain from securities and there is no sec. 1231 gain. Both rents and total income are adjusted by depreciation, property taxes, interest and rents paid. There is a further test that must be met in order to keep rent from personal holding company income. That is that the other personal holding company income other than rents must not exceed 10% of the ordinary gross income. It is important to note there that we are no longer talking about adjusted ordinary gross income but ordinary gross income. In order to keep rents and help them to meet the requirements we could probably increase the rent role so that it equals the 50% test, or we could decrease some of the adjustments to help meet the test, by converting accelerated depreciation to straight line depreciation. We could decrease interest payments by paying off the debt or we could reduce the rent payments by purchasing the property. We could help satisfy the 10% rule by distributing any of the personal holding company income other than rent in excess of that 10%. Since the passage of the changes there have been two sets of proposed regulations. One deals with the manner of handling liquidating dividends and the
other deals with the liquidation of a personal holding company under the new section 333(g).

I just want to make one comment on sec. 333(g). As you know, in most instances under 333, once you make that election, you cannot revoke it and no matter what you want to do later on, you are stuck with the election under 333. However, there is a provision under 333(g) which relates to personal holding companies which qualify as "would have been" corporations. This provision covers "mistake as to applicability of the subsection." Thus if you put a comment on the form 964 when you file it that you think you qualify under the new law and expect to be taxed as capital gain on all accumulated earnings and profits and in fact upon examination you do not qualify, then you can come under 331 and have a fair market value capital gain liquidation. This is the one time which they will permit you to more or less revoke your election under 333, but you must include that comment on your 964 when filed.

As I have stated before there are always potential problems with closely held corporations that have passive income. And therefore these corporations have to be continuously watched during the course of the year. Proper tax planning and an awareness of the problems can usually eliminate a great deal of these tax problems. Thank you very much.

MR. WILLIAMS:

Thank you, Mr. Roesen, for a very fine presentation. That brings us to the close of our formal presentation. It has been a real pleasure for me to work with such able speakers and I would like to express to you their appreciation, as well as mine, for being such a splendid and responsive audience. I am sure that many of you have questions on which you would like the panelists to comment. We are going to give you time for that but unfortunately our recording mechanism won’t pick up the discussion from the floor so we will not be able to make this a part of the official record. This is a matter which I am told will be corrected for future Conferences. Before proceeding with the question and answer session, I would like to once again thank each and every one for their cooperation in making these Conferences possible.