FEDERAL INCOME TAX DEVELOPMENTS: 1974

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INTRODUCTION

FEDERAL INCOME TAX DEVELOPMENTS: 1974 is the second of an annual series of articles to be published in the Winter Issue of the Akron Law Review. The thrust of this article is not only to identify the new developments, but also to trace these concepts through their formative stages. A synopsis of recent legislation appears before the Table of Contents, and a Table of Cases, Table of Internal Revenue Code Sections, and Table of Recent Revenue Rulings can be found following the text of the article.

Research for this article includes cases decided through November 30, 1974. As with any comprehensive publication which attempts to summarize current events in a field as volatile as taxation, assistance is required to minimize the lead time between research and publication. For their substantial contributions and complete dedication, the author is deeply indebted to the following members of the Akron Law Review: Allen M. Cabral, Donald P. Kepple, Edward P. O'Brien, and Philip D. Shepherd. Special recognition is extended to Linda M. Siulborski for her efforts.

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SUMMARY OF PUB. L. No. 93-625 (January 3, 1975)

Presented below is a brief synopsis intended to familiarize the reader with basic changes set forth in recent legislation.

INTEREST ON TAX OBLIGATIONS

As of July 1, 1975, the interest rate which taxpayers pay on tax obligations will be increased from six to nine percent. The nine percent rate applies to underpayments of income tax, the underpayment of both individual and corporate estimated income tax, and the personal liability of taxpayers who do not surrender property which has been levied against by the government. Even more dramatic is the 125% increase from four to nine percent for interest on the estate tax attributable to closely held businesses which may be paid over 10 years. If an extension for the payment of the estate tax is granted due to undue hardship, the interest accrues at the nine percent rate. Interest paid by the government to taxpayers on overpayments not refunded within 45 days is also increased to nine percent.

The Secretary of the Treasury will annually redetermine the interest rate to be effective on February 1 of the following year. The rate will approximate 90% of the average prime interest rate for the month of September and will be announced on October 15.

POLITICAL CONTRIBUTIONS

Effective January 1, 1975, the political contribution deduction is increased from $100 to $200 for joint returns and from $25 to $50 for single or separate returns. The alternative credit is increased from $25 to $50 for joint returns and from $12.50 to $25 for single or separate returns. Also, the deduction or credit can now be claimed for payments made in the year preceding the date the candidate formally declares his candidacy. Contributions to a candidate's newsletter will also qualify for the deduction or credit.

Contributions to political organizations after May 7, 1974, are not subject to the gift tax.

Political organizations, intended to influence the selection, appointment, nomination or election of individuals seeking public office will have tax exempt status after January 1, 1975. Investment income, however, will be subject to the income tax.

If appreciated property is given to a political organization, the contribution is measured by the fair market value at the date of transfer. However the contributor is required to recognize as gain the difference between basis and fair-market value, as the transfer is treated as a sale. A loss will not be recognized if the value is less than basis. If the property transferred is a capital asset, the resulting income is subject to capital gains treatment, but if the item is held for sale in the normal course of business, then ordinary income results.
INJURED VETERANS AND MIA'S

Beneficial tax treatment has been legislated for wounded veterans and for the families of soldiers classified as missing in action. Section 112 previously excluded from pay income a maximum of $500 per month for officers and the entire pay for enlisted men. Although the exclusion applied during hospitalization, it was dependent upon the continuation of hostilities. The new statute provides for a full exclusion for months commencing not more than two years after hostilities cease.

Section 692 forgives individual income taxes of a serviceman who dies from wounds, disease or injury incurred while serving in a combat zone. The forgiveness applies only to the year death occurred. The benefits of Section 692 are extended through the year in which the missing-in-action status is changed, not just the year in which a determination is made that he died.

SIXTY MONTH AMORTIZATION

The five-year amortization provisions, in lieu of depreciation, for rehabilitation of low and moderate income housing pollution control facilities, railroad rolling stock, and some coal mine safety equipment have been extended an additional year until January 1, 1976. Also extended until December 31, 1975, are the older more liberal depreciation recapture rules for low and moderate income housing construction under government subsidy programs.

REAL ESTATE EXEMPTED FROM ASSET DEPRECIATION RANGE (ADR)

In 1971 when the ADR system of selecting lives for depreciation was enacted, Congress stated that real property would also have to be converted to the ADR system. Since the new regulations have not been issued by the Treasury, real estate is exempted until such time as new class lines are established by the Treasury.

VACATION PAY ACCRUAL

Accrual basis taxpayers are permitted to elect to deduct the cost of accrued vacation pay in the year the employer becomes liable for such pay, even though the employee does not take the vacation, and actual payments are not made until a subsequent tax year. This revises the rules previously set forth in Revenue Ruling 54-604.

FORECLOSED PROPERTY—REAL ESTATE INVESTMENT TRUSTS (R.E.I.T.)

To maintain their favorable tax status, real estate investment trusts are not permitted to hold property for sale, or to receive income from leases, where the rentals are based on the profit earned by the lessee. The new law permits real estate investment trusts to acquire property where there is an actual or anticipated default by the mortgagor on mortgages held by the real estate investment trust. Property so acquired and operated must be disposed of within two years after acquisition, although two one-year extensions are permissible.
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1.00 Income

1.01 Assignment of Income. Revenue Ruling 74-581\textsuperscript{1} has authorized an exception to the all-inclusive definition of gross income under Section 61(a). This ruling permits law school attorney-professors, who have received compensation under the Criminal Justice Act for representing indigent defendants through various clinical programs set up by the law school, to assign the payments received over to the law school without having to include the amounts in their individual gross income. Under an interpretation of the Criminal Justice Act, the payments cannot be made directly to the law schools. Since the attorney-professors are working solely as agents of the law school and assign any compensation received to the school, they derive no personal gain and therefore should not be subjected to any adverse tax consequences.

There have been a few other similar rulings where the Service has permitted the assignment of income in unique fact situations. Examples include a legal aid attorney turning over statutory legal fees to his employer,\textsuperscript{2} and a medical school physician-professor turning over to

his school fees for treating indigent patients. Aside from these few exceptions, the rule against the assignment of income, long ago established in *Lucas v. Earl* and *Helvering v. Horst*, remains solidly entrenched as a basic principal of tax law.

1.02 Constructive Dividends. The Internal Revenue Service has announced its disagreement with the 1961 Tax Court ruling in *J. Simpson Dean*. The court there held that a shareholder's two-million-dollar interest-free loan from his personal holding company did not constitute a constructive dividend (valued at the free use of the capital). Despite numerous cases which found constructive dividends to shareholders in the areas of bargain rentals from a corporation, or the use of corporate funds for a shareholder's travel expenses, his purchase of stock, or payment of his personal debts and obligations, the *Dean* case has never been overruled.

In *Roy M. Berger*, a 1965 property settlement pursuant to a divorce decree ordered Mr. Berger to buy out his wife's 40% minority interest in Evergreen Industries, Inc., in which he owned the remaining 60% interest. The purchase price was set at $64,896, payable at $400 per month. By corporate resolution later in 1965, the corporation began paying the $400 per month, and by an additional resolution in 1969, established an irrevocable trust to redeem the still-outstanding stock. The Commissioner claimed that Berger had received a constructive dividend under Sections 301 and 316 in the amount of the trust, because his corporation was discharging his personal obligation. The Tax Court agreed that Mr. Berger had a "personal and unconditional obligation to purchase" his ex-wife's stock despite his weak arguments to the contrary. Because Mr. Berger's closely held corporation had discharged this entire personal obligation for his economic benefit, the finding that he received a constructive dividend has unanimous support in the case law.

1.03 Advance Rentals. Revenue Ruling 73-549 dealt a blow to a retirement community which sought to defer lump-sum advance rental payments for an apartment unit and the use of the common facilities over the actuarially determined life expectancy of its residents. Relying on Treasury Regulation 1.61-8(b), the Ruling pointed out that advance

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4 281 U.S. 111 (1930).
5 311 U.S. 112 (1940).
6 35 T.C. 1083 (1961).
12 Id. at 74-692.
rentals must be included in gross income in the year of receipt, regardless of the period covered or the accounting procedures used. The Ruling indicated, however, that a separate lump-sum payment for services, such as meals, medical care, laundry and social entertainment, could be deferred over more than one tax year, because such significant services are not within the scope of the term "rent" under 1.61-8(b).

1.04 Income Averaging. The income averaging provisions of the Code, Sections 1301-1305, were enacted "to accord those whose incomes fluctuate widely from year to year the same treatment accorded those with relatively stable incomes as in the case of authors, professional artists and actors." In William L. Frost the issue was whether petitioner could income-average a $15,000 bonus he received after college in 1966 to play baseball with the San Francisco Giants. He conceded that he had not furnished at least one-half of his support during each of the four preceding base years, but argued that his college baseball career was work during two of the base period years and that his $15,000 bonus, which was more than one-half of his adjusted taxable income in 1966, was attributable to his work in improving his baseball skills during college.

The Tax Court did not go along with this argument. Testimony by an agent for the Giants termed the bonus an inducement for Frost to sign a player contract, and obviously not for his training and excellent pitching while in college. This alone was not entirely determinative of whether work was performed during the base-period years. However, a study of congressional intent behind Section 1303(c)(2)(B), and case law decided under it, implies that the word "work" means gainful employment, for an employer or one's self, which generates income, and that training and toil in order to achieve a marketable personal skill does not fit within the definition. Thus an individual who sells a novel may income average, because the payment is for the finished work product and not for the training to produce that finished product.

Form 4972 has been issued under proposed Treasury Regulation 1.72-19. The new Regulation allows a seven-year forward averaging break for the ordinary income element of a lump-sum distribution to post-1969 retirees. The form sets up separate tax computations for (1) the ordinary income element of the lump-sum distribution, and (2) the capital gains element plus the balance of the taxpayer's income in the distribution.

15 61 T.C. No. 54 (Jan. 28, 1974).
16 Int. Rev. Code of 1954, § 1303(c)(1) defines this as the general test for an individual to be eligible for income averaging.
17 Int. Rev. Code of 1954, § 1303(c)(2)(b) allows income averaging for an otherwise non-eligible person if he meets these tests.
year. The resulting computation may produce a lesser tax than under the pre-1970 "all capital gain" rule or the standard five-year income averaging option. A 1971 retiree, for whom Form 4972 will save some tax, has until April 15, 1975 to file an amended 1971 return for a refund.

1.05 Sale of a Partnership Interest. Regulation 1.721-1(b)(1) implies that the receipt of an interest in partnership profits in consideration for services, often called a profit-share, is not a taxable event. Secondary authorities, and case law dictum provided significant support for this interpretation. Profit shares thus increasingly became important as a means of deferred compensation for high-bracket taxpayers who could render immediate services in return for a share in the future profits of an enterprise. However, this regulation was apparently not followed in the case of Diamond v. Commissioner. Sol Diamond was a mortgage broker who, in return for arranging the financing on the purchase of a $1,100,000 office building, received a 60% interest in the partnership which took title to the building. Less than three weeks after the partnership had acquired title, Diamond sold his 60% interest for $40,000 and reported this sale as a short-term capital gain under Section 741, which would offset an unrelated short-term capital loss.

The IRS notice of deficiency had reclassified the $40,000 gain as ordinary income. The Tax Court ruled that when Diamond received his partnership interest, it had an ascertainable market value ($40,000), and this amount was ordinary income under Section 61(a) at that time. The court attached no importance to the implication of Regulation 1.721-1(b)(1), and held that Diamond's receipt of the profit-share was in exchange for services (the financing) worth $40,000. The Seventh Circuit has affirmed the Tax Court ruling. Its decision discussed the unanimous positions of the commentators upholding Diamond's claim and criticizing the Tax Court holding, as well as previous judicial interpretation, legislative history and policy considerations on the point, but found nothing to convince it that the Tax Court ruling was erroneous. It is suggested that the courts have reached the right decision under the circumstances in Diamond, but for the wrong reasons. The near-total

21 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).
22 56 T.C. at 546.
24 492 F.2d at 291. "But in the absence of regulation, we think it sound policy to defer to the expertise of the Commissioner and the Judges of the Tax Court, and to sustain their decision..."
disregard for Regulation 1.721-1(b)(1) in favor of Section 61(a), whose applicability to the case is debatable, has been criticized. Two other approaches do lead to the same ultimate result. If Diamond is considered to have acquired an interest in the capital of the partnership, the unrealized appreciation is taxable immediately to the service partner. Alternatively, the court could have viewed the partnership as a sham. Since Diamond did not have any management responsibilities, and so quickly sold his profit-share interest, the transaction could have been treated as a compensation of $40,000 for services rendered. In any event, the *Diamond* decision renders suspect the tax advantages of a service partner receiving a profit share. A Supreme Court decision or new regulations on this matter seems certain.

An attempt to use the *Diamond* holding for one's advantage failed in *Vestal v. United States*. Vestal convinced some friends in 1962 to invest a total of $235,000 in a partnership for oil and gas field development and, in return, he received a contractual right to one-eighth of any future profits accruing to the investors. In 1964 when the partnership was sold, Vestal's one-eighth share was worth $140,000. Vestal claimed that his 1962 contract rights were worth $29,000, leaving him a long-term capital gain of $111,000. The Eighth Circuit disagreed, holding that the $140,000 constituted a payment by the investors for his services and was ordinary income. The court based its decision on the grounds that: (1) there were no 1962 tax consequences arising out of the contract due to the speculative nature of the transaction, and (2) no accurate basis could be established for capital gain purposes in the contract rights. *Diamond* was distinguished since its taxable event was the acquisition of a profit-share which had a determinable market value, whereas in *Vestal*, the taxable event was the 1964 sale of the partnership, and not the 1962 contract with an undeterminable market value.

**1.06 Gratuitous Transfers.** Aspects of income tax law, estate tax law and gift tax law often overlap with various tax consequences when there is a transfer of property, whether it is by inter-vivos gift, by revocable or irrevocable trust, or by bequest. The Sixth Circuit has rendered two decisions in this area, both adverse to the taxpayers.

Section 2502(d) requires the donor of a gift to pay the resulting gift

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27 Treas. Reg. 1.731-1(c)(3) provides that a tax-free transfer of property to a partnership under Section 721 followed shortly thereafter by a normally tax-free distribution of other property under Section 731 will be considered a taxable sale or exchange.
29 *Vestal* did not report this $29,000 as part of his 1962 income, but he would not have to pay any tax on this unreported income since the six-year statute of limitations had run.
tax. In the 1969 case of *Turner v. Commissioner*, where a donor conditioned a gift of appreciated property upon the donee's acceptance of the gift tax liability, the Sixth Circuit turned down the government's contention that this constituted a part-gift and part-sale transaction, and that the proceeds from the donee's sale of part of the property (used to pay the gift tax) should be taxed as a capital gain to the donor. However, the same court has apparently changed its position as to net gifts with its decision in *Johnson, Jr. v. Commissioner*. In 1965, Dr. Johnson obtained a $200,000 loan, secured by stock with a market value of $500,000 and a basis of only $10,000. He then transferred the stock into an irrevocable trust with the trust assuming the $200,000 loan obligation. Dr. Johnson used $150,000 of the loan to pay the gift tax and ended up with $50,000 in cash and no loan obligation. The government used its part-gift, part-sale theory, and the doctrine found in *Crane v. Commissioner* to assess a capital gains tax against Dr. Johnson for the amount of the loan ($200,000) less the basis in the transferred stock ($10,000). The Commissioner, applying the *Crane* doctrine, stated that the transfer of Dr. Johnson's stock, encumbered by an obligation in excess of its basis and the assumption of the obligation by the trust, was the equivalent of a sale, resulting in capital gains liability. Dr. Johnson argued that, under the *Turner* decision, $150,000 of the gain which was paid for gift taxes should not be taxed. Nonetheless, the court weakly distinguished *Turner* on the grounds that the loans here should not be equated with the *Turner* gift tax liabilities and that this gift was not conditioned on the payment of the gift tax by the donees. The trust's new basis in the stock became $300,000 (the $200,000 loan obligation paid plus the $150,000 gift tax, but limited to the gift's fair market value of $300,000). While the Sixth Circuit did not expressly overrule *Turner*, the advantageous estate planning aspects of net gifts may now be limited to those patterned exclusively after *Turner*.

Property is often transferred into various types of trusts in order to gain certain tax advantages. In *Krause v. Commissioner*, however, a transfer of the Krauses' limited partnership interest into six irrevocable trusts for the benefit of their children and grandchildren in return for 80% of the trust's income proved highly disadvantageous. The tax motivation behind the trusts was to transfer the ownership of income-producing capital to the trusts which would pay a lower income

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32 Trans. Reg. § 1.1001-1(e)(1). "Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property."
33 331 U.S. 1 (1947).
34 495 F.2d at 1085.
35 57 T.C. 890 (1972), aff'd, 497 F.2d 1109 (6th Cir. 1974).
tax rate than the grantors. Reliance was placed on Section 704(e)(1), Family Partnerships—Recognition of interest created by purchase or gift, to wit: "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."

Despite Section 704(e)(1), the Commissioner sought to tax the Krauses on the trust income on the grounds that the trusts were not bona fide partners because the grantor retained too many incidents of ownership. The Tax Court agreed, citing the legislative history of Section 704(e) as allowing the courts to inquire into the true ownership of a partnership interest. The total effect of: (1) the necessity of the grantor's consent to any assignment or disposal of property; (2) the right of the grantors to remove the trustee; (3) the right, after 12 years, to require distribution of the trust's principal, and (4) the fact that Adolph Krause was president and the family controlled 45% of the stock in Wolverine Shoe & Tanning Corporation, and thereby could greatly influence the amount of trust income through the corporation's dividend policy, did not remove the grantors' incidents of ownership in the property, and therefore the income was taxable to them.36

On appeal, the taxpayers argued that United States v. Byrum,37 a 1972 Supreme Court case, controlled the incidents of ownership issue. The Sixth Circuit disagreed, citing the difference between Section 2036(a), the estate tax statute in Byrum, and Section 704(e), and noting the retention of even greater incidents of ownership here than in Byrum.

It was the court's construction of Section 671, which permits the grantor-deemed-owner to take any deductions or credits available to the trust, which had the most destructive effect on the Krauses. The court did not allow any credit for the income taxes paid by the trust as an offset against the increased personal tax liability of the grantors, since the trust and the Krauses constituted separate tax entities. This construction seems to mean that Internal Revenue Service collects twice on the same income if the trust's three-year statute of limitations for filing for a refund has expired.

These two decisions are representative of the increased reliance, at least in the Sixth Circuit, of the substance test. The court discounted the form, and studied the total effect of the transactions. Thus, Judge Gardner's 1930 dictum, that a transaction designed solely "to avoid the burden of taxation, or to lessen that burden, is not for that reason alone illegal,"38 appears no longer true in 1974.

36See, e.g., Treas. Reg. § 1.704-1(e)(iii). "A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of Section 704(e) (1) . . . if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest."
37408 U.S. 125 (1972).
38Iowa Bridge Co. v. Comm'r, 39 F.2d 777, 781 (8th Cir. 1930).
1.07 Testamentary Bequests for Services Previously Rendered. Section 102 exempts testamentary bequests from inclusion as taxable income. However, the Second Circuit in the case of Wolder v. Commissioner declared that a testamentary gift of stock made for services previously rendered and pursuant to a written contract was taxable income to the recipient. Attorney Wolder and his client, Mrs. Boyce, entered into a written agreement by which he would perform free legal services during her life in exchange for her promise to bequeath to him certain stock. Had Mrs. Boyce not kept her promise, previous case law has held that the settlement proceeds received from litigation to enforce the contract would be taxable. The court saw no difference or distinction in the fact that Mrs. Boyce kept her promise; the bequest was for services previously rendered and is therefore taxable.

Attorney Wolder had relied on the 1923 Supreme Court decision in United States v. Merriam, which held non-taxable the bequests made in lieu of compensation to the executors of the estate. The Second Circuit, after distinguishing Merriam on its facts, questioned the current validity of the case under a form-versus-substance test. With the government victory in this case, it is not unlikely that the Service will challenge future bequests made to unrelated lawyers, doctors or other professionals who served decedents for little or no compensation. One previous case on point, decided in favor of the taxpayer, held that the decedent's intent was controlling as to the taxability of the bequest. Backed by the Wolder case, the Service will probably try to expand the subjective intent requirement to include objective evidentiary standards in determining the taxability of this type of bequest.

1.08 Property Settlements. Ever since the 1962 case of United States v. Davis, property settlements pursuant to a divorce decree have been considered a taxable event. In Davis, the husband transferred appreciated securities to his wife in exchange for her inchoate marital rights. The Supreme Court ruled that the property settlement was bargained for in an arm's length transaction and that the husband realized income for the difference between the basis of the securities and their present fair market value.

31 493 F.2d 611-12. An analogy was made to Comm'r v. Duberstein, 363 U.S. 278 (1960), pointing out that under certain circumstances, gifts are a method of paying compensation.
32 493 F.2d at 611-12. An analogy was made to Comm'r v. Duberstein, 363 U.S. 278 (1960), pointing out that under certain circumstances, gifts are a method of paying compensation.
33 See Lee S. Jones, 33 P-H Tax Ct. Mem. 259 (1964). Here, there was evidence that Attorney Jones never billed the decedent for services rendered. However, there was no evidence of a written or oral contract between the parties.
34 370 U.S. 65 (1962).
In Revenue Ruling 74-347, the Davis rationale was applied to the following property settlement situation. The husband had title to their $40,000 house in his name alone. All other property, which primarily consisted of stock and securities, was owned jointly by husband and wife. At the time of the divorce, this property had a fair market value of $70,000 and a basis of $35,000. The property settlement gave the husband the house and $15,000 worth of securities, while the wife received the balance of their previously jointly owned property valued at $55,000.

Under these facts, the unequal division of jointly owned property leads to a taxable gain of $10,000 for the husband, calculated as follows:

**Step 1.** Determine the excess of jointly owned property received by wife.

Jointly owned property received by the wife .......... $55,000

One-half share of all jointly owned property
(½ of $70,000) ...................................... $35,000

Excess of jointly owned property received by the wife . $20,000

This amount, under Davis, is considered equal to the value of the wife's inchoate marital rights in the husband's individually owned residence.

**Step 2.** Determine the adjusted basis of excess jointly owned property received by the wife.

Net fair market value of excess jointly owned property received by the wife Adjusted basis of excess jointly owned property

Adjusted basis of all jointly owned property Adjusted basis of

Net fair market value of all jointly owned property received by the wife

These steps, when applied to the present figures, create the following:

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\frac{20,000 \times 27,500}{55,000} = 10,000
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**Step 3.** The taxable gain is the excess of jointly owned property received by the wife (Step 1) minus the adjusted basis in said property (Step 2).

In this situation, $10,000 represents taxable income to the husband. The wife's new basis in the property she receives is equal to her adjusted basis in the property ($27,500) plus the taxable gain ($10,000), or $37,500. Since property settlements are presumed to be made at arm's length and are, under Davis, a taxable event, the tax consequences resulting therefrom must always be taken into consideration.

1.09 Illegal Income. Section 61(a) defines gross income as "all income from whatever source derived." Under this broad definition, money which has been obtained by such illegal means as gambling, embezzlement or extortion is taxable to the recipient.\textsuperscript{46} In \textit{Buff v. Commissioner},\textsuperscript{47} the petitioner contested the inclusion of $22,000 in his 1965 gross income which he had embezzled from his employer in that year. Apprehended after spending the money, he subsequently confessed and signed a confession of judgment for the entire amount in favor of his employer.

An 8-7 Tax Court majority, relying on \textit{United States v. Merrill},\textsuperscript{48} found that the embezzled funds should not be included in Buff's 1965 gross income. The confession of judgment changed the transaction at the end of the tax year from a taxable embezzlement to the equivalent of a non-taxable loan, or in the court's language, "a consensual recognition of indebtedness."\textsuperscript{49}

The Second Circuit reversed on two grounds. First, a cash basis taxpayer should not be allowed to balance for tax purposes the receipt of income with a promise, which is not given in connection with the receipt of the income, to repay it in a later tax period.\textsuperscript{50} Merrill can be distinguished, since it was the lack of Buff's "consensual recognition of indebtedness" at the time he embezzled the money which triggered the taxability thereof, and the confession of judgment signed before the end of the year does not change the tax consequences. Second, the confession of judgment was "not worth the paper it was written on."\textsuperscript{51} Seven years had passed without any payments being made. The Tax Court decision relied on the bona fide appearance of the promise to repay, which subsequently proved to be worthless.

If Buff \textit{had} made weekly repayments to his ex-employer, he would have at least been able to deduct these amounts from his income.\textsuperscript{52} Since part of the Buff decision was based on the worthlessness of his promise to make restitution, evidence of actual repayments might have made a difference. A "wait and see" test, successfully used in Merrill, might have been applied.

1.10 Medical Student Loan Cancellation. Revenue Ruling 73-256\textsuperscript{53} provides that amounts advanced to a medical student under the State

\textsuperscript{47} 496 F.2d 847 (2d Cir. 1974), rev'g 58 T.C. 224 (1972).
\textsuperscript{48} 211 F.2d 297 (9th Cir. 1954). This case held that income is not realized where taxpayer acknowledges the mistake, renounces any claim to the funds, and in the year of receipt agrees to repay the rightful owner, and repayment is actually made in a subsequent year.
\textsuperscript{49} 58 T.C. at 232.
\textsuperscript{50} 496 F.2d at 848.
\textsuperscript{51} 58 T.C. at 235 (Hoyt, J., dissenting).
\textsuperscript{52} Rev. Rul. 65-254, 1965-2 \textit{CUM. BULL.} 50 would preclude Buff from using § 1341 to subsequently offset the tax effect of including the embezzled funds in his gross income.
\textsuperscript{53} Rev. Rul. 73-256, 1973-1 \textit{CUM. BULL.} 56.
Medical Education Loan Scholarship Program, which are cancelled upon fulfillment of a condition to practice in a rural area of the state, are includable in gross income under Section 61 of the Code in each taxable year to the extent that repayment of a portion of the loan is no longer required.

Under the authority of 7805(b), the Service by way of Revenue Ruling 74-540\(^\text{54}\) has made the provisions of 73-256 applicable only to loans of the type described made after June 11, 1973. Thus, cancelled loan repayments under a State's Medical Education Loan Scholarship Program made prior to June 11, 1973 need not be included in gross income.

2.00 Exclusions from Income

2.01 Food and Lodging. The lodging and meals exclusion from gross income, embodied in Section 119, has been an area where very fine distinctions have been drawn in a series of cases. Treasury Regulation 1.119-1(a) permits the value of employer-supplied meals to be excluded if certain tests are met, to wit: the meals are furnished by the employer, for its convenience, and furnished on the business premises.

Most of the previous cases under this section dealt with interpretations of "employer convenience" or "business premises."\(^\text{55}\) However, in Jacob v. United States,\(^\text{56}\) the issue was whether employer-supplied groceries were the equivalent of meals for exclusion purposes. A mental institute, where Dr. Jacob was the director, provided housing for the Jacobs on its business premises and also furnished free groceries for their consumption. The Service challenged Dr. Jacob when he excluded the value of the groceries on his 1964-1966 income tax returns. The Third Circuit affirmed a decision for the taxpayer, but emphasized that the decision was limited to the particular facts of the case. It would not be expanded to a situation where employer-supplied groceries were prepared off the business premises. The court also allowed the exclusion for the value of the napkins, toilet paper, soap and other miscellaneous items supplied by the Institute, calling them integrally related to the meals and lodging furnished.

Since Section 119 continues to be an oft-litigated area, with conflicting views between the Tax Court and some of the circuits, it is the author's opinion that a definitive statement is needed from the Supreme Court for clarification.

2.02 Sick Pay. Section 105(d) of the Code allows employees who are absent from work on account of personal injuries or sickness to exclude from gross income amounts received in lieu of wages, but not in excess of $100 per week. To be excludable, the amounts must be paid


under an accident or health insurance plan and must either be paid by the employer or attributable to contributions by him to such plans which were not includable in the employee's gross income. The Commissioner's position concerning the issue of when an employee's excludable sick pay income ended and his taxable pension and retirement benefits began, as expressed in Treasury Regulation 1.105-4(a)(3)(i)(b), was that the exclusion ended at the employee's minimum retirement age. It was asserted that this was appropriate even if this age is several years less than the age the employee would have faced mandatory retirement. Recently, several courts have found this regulation invalid and inapplicable on the grounds that it was unreasonable to deny the sick pay exclusion to employees who, although having reached a minimum retirement, would have continued working but for a sickness or disease. The Service has now changed its position, announcing that it would no longer follow the regulation imposing the earlier exclusion cut-off date, and would allow employees the sick pay exclusion until mandatory retirement age. Revised regulations as to this position should be forthcoming sometime this year. Amended returns (Form 1040X) or claims for refund (Form 843) for 1971 must be filed by April 15, 1975.

Under Revenue Ruling 74-542, alcoholism has been formally recognized as a "sickness" as that term is used in Section 105(d). Thus, the sick pay exclusion is applicable to amounts received under a qualified health insurance plan on account of the employee's alcoholism.

2.03 Foreign Income. Income, up to a maximum of $35,000, which is earned by a citizen of the United States who is a bona fide resident of a foreign country is generally exempt from taxation under Section 911. To obtain the exemption, the taxpayer must prove his resident status to the Internal Revenue Service or be present in a foreign country for 510 days out of an 18-month period.

In Carpenter, Jr. v. United States, the plaintiff, who had previously established a bona fide foreign residence, tried to exclude income earned in a newly formed oil partnership in the Middle East from January through August, 1964. The Commissioner objected to the exclusion under the theory that Carpenter had spent a 10-month vacation in the United States during 1962-1963 before the partnership began, and that this extended vacation terminated Carpenter's status as a bona fide foreign resident. The district court held that, as a matter of law, Carpenter's 10-month vacation did not terminate his foreign residence status for he

60 495 F.2d 175 (5th Cir. 1974), revg 348 F. Supp. 179 (N.D. Tex. 1972).
had retained the intention of returning to the Middle East when his partner had successfully handled the preliminaries so that their partnership business could begin.

In reversing the district court determination, the Fifth Circuit laid down a strict two-step test to cover situations involving taxpayers who return to the United States between jobs in a foreign country. First, the taxpayer's return to a foreign residency must be reasonably definite as to fact and time. Second, the taxpayer's stay in the United States cannot be unreasonably long. The court held that Carpenter failed the first test, since his return to the Middle East was conditioned on the success of his partner initiating the business venture. Consequently, the date of the taxpayer's ultimate return was largely beyond his control. Interestingly, the court did not discuss how long a stay in the United States would be permitted under the second test.

The Treasury Department has adopted final Regulations giving American citizens residing abroad and married to nonresident aliens a limited right to elect out of foreign community property laws for United States tax purposes in post-1966 tax years. To be eligible, the United States citizen must be (1) a bona fide resident of a foreign country for the entire tax year, and (2) married to a nonresident alien during the entire year. In general, the Regulations permit the spouse to waive community property rights, as defined under foreign law, to one-half of the taxpayer spouse's earned income without subjecting it to United States taxation. Unearned income of the taxpayer, such as dividends and interest, is treated differently. The spouse must include one-half of the taxpayer's unearned income in the federal tax return.

3.00 Exemptions

3.01 Dependency Exemption. A prerequisite to claiming dependency exemptions under Section 151(e) is that the person claiming the exemption must furnish one-half the support of the dependent. At issue in Helen M. Lutter was whether aid to dependent children (ADC) and State of Illinois medical assistance grants, which were paid to Mrs. Lutter for the benefit of her two children and the amount of which exceeded Mrs. Lutter's income, constituted support provided by the mother, thus entitling her to claim the dependency exemptions.

In ruling against the mother, the Tax Court separated the enforceable economic right Mrs. Lutter had to the state assistance grants from the fact that the support payments were for the direct benefit of her children. The Tax Court concluded that it was the State of Illinois which contributed over one-half of the support for the children, and caused Mrs. Lutter to lose two dependency exemptions.

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61 T.D. 7330, 1974 INT. REV. BULL. No. 48, at 8.
62 61 T.C. No. 72 (Feb. 27, 1974).
Two new Revenue Rulings are analogous. Revenue Ruling 74-153 states that payments made to adoptive parents from a state agency for the support and maintenance of their adopted child must be taken into account in determining who provided the principal support of the child. Similarly, under Revenue Ruling 74-543, Social Security benefit payments made to the child of a disabled parent are deemed to be the child's contribution toward his own support, and must be considered in determining the parent's dependency exemption.

4.00 Deductions

4.01 Research and Development Expense. The Supreme Court provided an economic incentive for investors in new businesses by permitting current research and development deductions when it unanimously reversed the Sixth Circuit and Tax Court decisions in Snow v. Commissioner. Mr. Snow, a vice president of Procter & Gamble, invested $10,000 in a new partnership, headed by an investor who planned to make, patent, and market commercially a trash-burning device. The partnership's first year of operation consisted solely of experimental research and development expenses. Mr. Snow deducted his prorata share of the research and development expenses on his personal income tax return relying on Section 174(a).

The Commissioner challenged the legitimacy of the deduction on the grounds that the pre-operating expense was incurred before the partnership was actively engaged in a trade or business, and therefore Section 174(a) did not apply. The Tax Court and the Sixth Circuit agreed with the Commissioner, and added that under the doctrine of Whipple v. Commissioner a mere investor is not deemed to be in a trade or business.

In reversing, the Supreme Court relied on the congressional intent behind Section 174: "This provision will greatly stimulate the search for new products and the new inventions upon which the future economic and military strength of a nation depends. It will be particularly valuable to small and growing businesses." Furthermore, the deduction applies even if there is not an ongoing business or the product is not at the marketable stages, as long as the research and development expenditures are simply connected with the taxpayer's trade or business.
deductibility test will be easier for taxpayers to meet than the "ordinary and necessary" test under Section 162.

The economic effect of Snow is to place new businesses on equal footing with established corporations as far as deducting research and development expenses for a new product during the preparation stage. New partnerships and Subchapter S corporations should find it easier to raise risk capital since the expected losses in the first years can now be deducted by the investors. All the taxpayer must show is a profit motive and that the research and development expense was in connection with the development of a new product or service.

4.02 Bond Discount Amortization. Section 163(a) allows a deduction of all interest paid or accrued within the taxable year on indebtedness. In Helvering v. United Pacific R.R. Co.\(^7^0\) the Supreme Court recognized a debt discount\(^7^1\) as an additional cost incurred in borrowing money. The described bond discount was classified not only as a loss to be prorated over the life of the bonds sold, but also as interest paid for the use of capital received under the bond issued. This loss-interest approach was clarified in United States v. Midland Ross Corp.,\(^7^2\) where the court stated the original issue discount serves the same function as interest,\(^7^3\) and that the court has treated the economic function of discount as interest.\(^7^4\)

Thus the law is established that a debt discount may be amortized over the life of the obligation when a corporate debt obligation is issued at a discount price. Does it necessarily follow that a debt discount results when debt obligations are issued for property other than cash? The Supreme Court in Commissioner v. National Alfalfa Dehydrating and Milling Co.\(^7^5\) held that it did not where a corporate taxpayer issues the obligation for its own outstanding preferred stock. The Court held that this was not a cost or expense of acquiring the use of capital.

Pursuant to a recapitalization plan the corporate taxpayer had issued $50 face value 5% sinking fund debentures in exchange for its outstanding, unlisted $50 par 5% cumulative preferred shares. The preferred shares had an over-the-counter market price of about $33. The corporation claimed an interest deduction in the amount of the difference between the face value of the debentures and the claimed value of the preferred stock. The taxpayer's contention was that had it actually issued $50 debentures for $33 in cash and then used the money to retire its outstanding preferred stock, an interest deduction would have been allowed.\(^7^6\)

\(^7^0\) 293 U.S. 282 (1934).
\(^7^1\) The difference between the issue price and the stated redemption price at maturity.
\(^7^2\) 381 U.S. 54 (1965).
\(^7^3\) Id. at 57.
\(^7^4\) Id. at 66.
\(^7^5\) 94 S. Ct. 2129 (1974).
\(^7^6\) Accepted by the Tenth Circuit in Comm'r v. Nat'l Alfalfa Dehydrating and Milling Co., 472 F.2d 796 (10th Cir. 1973).
The court rejected taxpayer's contention. To accept the interest deduction, the court stated that it would have to disregard the principle that a transaction is to be given its tax effect in accordance with what actually happened, and not in accordance with what might have occurred. In addition, the court stated that recognizing the deduction would require speculation about the market price and the value of the debentures to the corporation had the debentures been sold on the open market. This would prove to be impossible because of the private nature of the transaction. The court held that where a corporation issues new debt obligations to its preferred shareholders for the corporation's outstanding preferred, the claimed fair market value of both securities is artificial.

4.03 Moving Expenses. Section 217(a) provides that moving expenses incurred during a taxable year in connection with the commencement of work by an employee are deductible. However, the taxpayer may not be allowed a moving expense deduction if he maintains an inconsistent position by claiming a deduction for meals and lodging while away from home (incurred in the general location of a new principal place of work) under Section 162. If the taxpayer claims both a moving expense deduction and the expense of meals and lodging it will be a question of facts and circumstances whether the taxpayer's new place of work will be considered a principal place of work, and accordingly, under which Code section the deductions will be allowed.77

In Goldman v. Commissioner,78 the taxpayer moved himself, his family and their household goods from Kentucky to Washington, D.C. In Kentucky, he was employed as a professor of law. His move to Washington occurred during a one-year leave of absence. While in Washington he was to be employed by the National Labor Relations Board for a period not exceeding one year. After this period, the taxpayer returned to Kentucky and resumed his teaching profession. He claimed as deductions both his travel and moving expenses; the travel expenses under Section 162(a)(2) while he was temporarily away from home, and the moving expenses under Section 217 because he was involved in the commencement of employment at a new principal place of work.

The Tax Court allowed only the travel expense deductions, relying on Robert J. Schweighardt.79 The court was quick to note the taxpayer's inconsistent position. The taxpayer's employment at the new location must be permanent or of an indefinite time period to qualify as the new principal place of work under Section 217.80 Therefore, if the taxpayer

claimed moving expenses he could not claim travel expenses because while in Washington, he would have to be at home. In the alternative, inconsistencies would exist if the taxpayer was allowed to deduct moving expenses to a new principal place of business, because when he has claimed travel expenses, he would be returning to his previous home.

The court also decided that unreimbursed moving expenses are not ordinary and necessary business expenses or travel expenses while away from home. If the taxpayer could prove the cost of moving expenses to be ordinary and necessary business expenses then his deductions under Section 162 would be precluded.

The Internal Revenue Service has recently arrived at the same conclusion in Revenue Ruling 74-242. On approximately the same set of facts as in Goldman, the Service, relying on the Schweighardt case, denied the taxpayer simultaneous deductions under both Sections 162 and 217. However, the Service did allow him deductions for his travel expenses, which were one and one-half times greater than his moving expense. The taxpayer’s allowable deductions in both instances were greater than the disallowed deductions and thus he did not suffer a total loss. However, in many instances the opposite may be true; the moving expenses may exceed the travel expenses. If the taxpayer fails to meet the 39-week requirement of Section 217(c)(2), the moving expenses will be disallowed and the taxpayer will thus be left on the losing side. However, if the taxpayer meets the 39-week requirement, it is possible that he will be allowed to claim deductions under either Section 162 or 217, whichever will give the greater deduction.

4.04 Sale or Exchange of Residence. Section 1034(a) provides for the nonrecognition of gain realized from the sale of a taxpayer’s residence if a replacement residence is purchased within one year of that sale at a cost in excess of the adjusted sale price of the old residence. The Treasury Department, in addressing itself to this section, has held in Revenue Ruling 74-411 that Section 1034(a) does not provide for an extension of the time limitation for replacing a principal residence due to an absence from the United States. Thus where a taxpayer sells his American residence pursuant to a tour of duty abroad, he must purchase and use a replacement residence abroad within one year after the sale of his old residence, and not within a year of his return to the United States, to qualify for the nonrecognition provisions of 1034(a).

cerning temporary nature of employment at one location, if anticipated actual duration is less than one year, for the purposes of deducting travel expenses under Section 162.

81 See Wilson v. Comm’r, 412 F.2d 314 (6th Cir. 1969); Comm’r v. Dodd, 410 F.2d 132 (5th Cir. 1969).
82 Id.
4.05 Travel Expenses. In *Charles G. Gustafson*, the Tax Court allowed Gustafson, a traveling salesman from Des Moines, Iowa, a deduction for the entire amount of his traveling expenses. He traveled 52 weeks a year, but voted and paid state income taxes in Iowa. Also, his sister had a home in Iowa where he kept his personal belongings, which he did not carry on his trips, and to where he returned periodically on weekends. The court held this was enough to establish his home at his sister's house and thus allow deduction of his traveling expense.

In order to qualify for a deduction of traveling expenses, an individual must incur the expenses while away from home. *Gustafson* was just one in a long series of cases defining what is a "home" and where it is located. It has long been recognized that a taxpayer may not have a home to be away from for the purposes of calculating traveling expenses for tax purposes. The Revenue Service defines home as the taxpayer's principal place of business, employment or post of duty, regardless of where his family residence is located. Some courts have rejected this definition and construed home to be the taxpayer's family residence.

Throughout a long period of judicial indecision the Service has agreed to go along with *Gustafson*, thereby making a determination of the word "home" difficult if not impossible. However, in Revenue Ruling 73-529, the Service has withdrawn its acquiescence of *Gustafson* and has developed a new three-part test for traveling salesmen. This new test establishes whether a salesman has a regular place of abode in a real and substantial sense and may settle the problem existing between the courts and the Service on the meaning of home. The new test consists of three objective factors:

1. Whether the taxpayer performs a portion of his business in the vicinity of his claimed home and uses the abode while he performs business in the vicinity;
2. Whether the taxpayer's living expenses are duplicated because his business requires him to be away; and
3. Whether the taxpayer still lives in the area where his historical place of lodging and claimed residence are located, or does a member of his lineal or marital family live there, or does the taxpayer use the claimed home frequently.

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85 3T.C. 998 (1944).
86 Relying on Chester D. Griesemer, 10 B.T.A. 386 (1928).
87 INT. REV. CODE OF 1954 § 162(a) (2).
88 Joseph W. Powell, 34 B.T.A. 655 (1936); Charles E. Duncan, 17 B.T.A. 1088 (1929).
90 Six v. United States, 450 F.2d 66 (2d Cir. 1971), remanding 322 F. Supp. 547 (S.D.N.Y. 1971); Wallace v. Comm'r, 144 F.2d 407 (2d Cir. 1943).
The Service states that a yes answer to all of the above factors means deductions are allowable, and that two out of three yes answers means a good chance for deductions.

4.06 Mileage Allowances. Advanced Revenue Procedure 74-23 has increased the automatic mileage deduction from 12 cents to 15 cents for the first 15,000 business miles traveled and from 9 cents to 10 cents for mileage thereafter. Under the provision, an employee or a self-employed person may deduct the operating cost of his automobile used in trade or business. When such operating costs are in conformance with the new mileage allowances and substantiated as to time, place and business purpose, the substantiation requirements of Section 274 are met.

This allowance includes gas (including all taxes), oil repairs, license tags, insurance, and depreciation. But it does not include interest deductions allowable under Section 163, local taxes (except those included in the cost of gas) allowable under Section 164, parking fees, and tolls. If the standard mileage rate is used, straight-line depreciation must be used and the basis of the automobile reduced by this amount. Taxpayers using other types of depreciation or who have taken additional first-year depreciation may not use the standard rate.

Advanced Revenue Procedure 74-24 has increased automatic allowances for medical and charitable travel from 6 cents to 7 cents per mile, while Advanced Revenue Procedure 74-25 has increased the automatic allowance for travel connected with a job-related move the same amount. Parking fees and tolls are not included in this mileage allowance; and, again, interest under Section 163 and taxes under 164 (except those included in the gasoline costs) are not included. As depreciation is not allowed for travel related to medical, charitable or moving, no reduction in basis is required for those who use these rates.

Advance Revenue Ruling 74-433 has increased the amount of reasonable employer reimbursement for business meals and lodging from $36 to $44. This increase will also apply to the entire year of 1974. If an employer reimburses his employee for subsistence, or as a per diem allowance and the amount does not exceed $44 or the maximum per diem rate authorized to be paid by the Federal Government, the requirements of 1.274-5(c) substantiation are sustained if the employer...
reasonably limits travel expenses to ordinary and necessary business expenses and if the time, place and business purpose of the travel are recorded. Items included in the allowance include meals, lodging, laundry, fees for services and tips. It does not include taxi fares or costs of telephone calls or telegrams.

The per diem allowance is not available to employer and employee if they are related. This exists where the employee owns more than 10% of the employer. Mileage allowances are specifically excepted.

When the employee feels he will lose on the per diem or mileage allowances, he can write the Commissioner with full facts of any special circumstances which account for the variation and the special rates. The employee has the burden of convincing the Internal Revenue Service that special circumstances exist, and if he does, he will be accorded the same treatment as the taxpayers taking advantage of the fixed rates and allowances.

4.07 Medical Expenses—Special Education. Section 213 provides for deductions of medical care expenses, which are described by Section 213(3) as the diagnosis, cure treatment, or the prevention of disease. These include the cost of attending a “special” school for mentally or physically handicapped, if the alleviation of such handicaps is the principal purpose for being there. This includes “the cost of ordinary education furnished which is incidental to the special services furnished by the school.”

Lawrence D. Greisdorf was allowed to deduct educational expenses under Section 213 when he showed that the school attended by his child had been established for children having an emotionally caused learning disability. In Greisdorf, the evidence showed the educational aspects of the school were secondary. Helping the emotional causes of its students were its principal goal, and children were sent to the school for this reason. However, in C. Fink Fischer, the court stated that where the school served a dual purpose, providing normal education and solving mental problems, only that portion of the tuition which could be allocated to medical services was deductible.

In Jack W. Reiff, the taxpayer’s daughter attended a school concentrating primarily on academic training. Although the school she attended accepted youngsters with learning disabilities, the court did not classify it “special” because none of the staff had special training in the

100 See generally Treas. Reg. § 1.213-1.
101 Treas. Reg. § 1.213-1(e) (1) (V) (a).
102 Id.
104 50 T.C. 164 (1968), the court not finding the school a “special” school, but allowing deductions of medical expenses related proximately to the prevention of the child’s emotional problems (in the form of fees to psychiatrists).
105 43 P-H TAX CT. MEM. ¶ 74,020 (Jan. 1, 1974).
handling of emotionally disturbed children and no psychiatrists were employed by the school. The fact that her therapist sent her to the school because it might have a positive effect on her problems did not sway the court. Also, although the classes were small and tutoring of individual students a standard practice, the court noted there was nothing more involved here than at many other good academic schools. Perhaps the most influential factor was that the school considered the student's problem incidental to his academic training. The court found the school neither a "special" school nor one serving a dual purpose, and denied any medical deductions.

The Tax Court has by this case divided the medical care deductions for special education into three distinct classes: one where the educational facility is termed a "special school" and all tuition is deductible; the second being a school serving a dual purpose where those expenses allocated to medical care can be deducted, and the final classification being the type treating the student's emotional problems incidental to academic learning, where no medical care deductions are allowed.

4.08 Medical Expenses—Capital Expenditure. Treasury Regulation 1.213-1(e)(iii) authorizes a medical expense deduction for a capital expenditure to the extent the expenditure exceeds the increase in the value of the property. Treasury Decision 7317106 has amended the regulation. Expenditures made for the operation and maintenance of the capital asset are now deductible as medical expenses if their primary purpose is that of medical care. Thus, if a capital expenditure qualifies as a medical expense, costs of its maintenance or operation qualify as medical expenses if the medical reason for the expenditure still exists.

4.09 Medical Expense—Contact Lens Insurance. Section 213(e)(1)(c) allows deductions for insurance covering medical care. By way of Revenue Ruling 74-429,107 the Internal Revenue Service has extended this deduction to insurance for contact lenses. As amounts paid for the contact lenses to correct vision are a medical expense within Section 213(e)(1)(A), the insurance payments to protect against loss or damage to contact lenses are also deductible. It appears from the ruling that the insurance payments qualify as medical insurance deductions and can be combined with other medical insurance payments. The taxpayer can deduct one-half of them up to $150, the remainder going into the 3% pool.

4.10 Theft Losses. Section 162(a) allows deductions for all ordinary and necessary expenses paid during the taxable year in carrying on a trade or business. However, Section 162(c) disallows deductions for illegal bribes and kickbacks, and Section 162(f) disallows fines and penalties paid for violation of a law. Nevertheless, since the income tax was

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to tax net income, it is generally held that ordinary and necessary business expenses of an illegal business are deductible. But where the allowance of such a deduction would frustrate a sharply defined public policy, a deduction may be disallowed.

Section 165(c)(2) allows deductions to individuals for "losses incurred in any transaction entered into for profit, though not connected with a trade or business." Section 165(c)(3) provides that theft losses are deductible.

In Jerry Rossman Corp. v. Commissioner, the court put forth public policy reasons for disallowing certain penalty payments as expense deductions. The Supreme Court has recognized that a business expense deduction may be disallowed if its allowance would contravene a sharply defined state or federal statute. However, the general law has been to disallow deductions only where a taxpayer deliberately and intentionally patronized an illegal business and by participation there was a severe and immediate frustration of state law. These principles have been applied to claimed losses as well as expenses.

The decision in all cases is dependent on the particular fact situation. Although depending on the facts, the deductibility of both losses under Section 165 and expenses under 162 must be treated equally and with some uniformity. But the Tax Court has expanded on the theory of what constitutes public policy and what is a severe frustration of statutory law in Raymond Mazzii. Mazzii suffered a $20,000 loss in a counterfeiting scheme with the facts as outlined below.

After some prior negotiations, Mazzii was told by two men to bring $20,000 in one hundred dollar denominations to a hotel room for reproduction. The reproduction was to be done in a small black box. After a small amount of time and a buzzing noise, two bills, the original and a counterfeit copy, were emitted. Actually, the box was not capable of reproducing the money. While at the hotel room two strangers

110 See, e.g., Comm'r v. Heiningen, 320 U.S. 467, 473 (1943), which disallowed tax deductions where a taxpayer violated a state statute and incurred a fine or penalty.
111 175 F.2d 711 (2d Cir. 1949).
112 Id. at 713, where Judge Learned Hand stated the "Revenue Act does not declare that penalties may not be deducted; the doctrine is a judicial gloss" and that when acts are condemned by law and punishable by fines or penalties, allowing business expense deductions defeats, in part, the punishment.
115 See, e.g., Fuller v. Comm'r, 213 F.2d 102 (10th Cir. 1954), aff'g G. E. Fuller, 20 T.C. 308, 317 (1953).
117 61 T.C. No. 55 (Jan. 28, 1974).
entered, impersonating policemen; they left with the money and their two partners, leaving petitioner without any money or any black box.

Petitioner deducted $19,900 from his tax claiming the money lost was a theft loss. In the Tax Court the government alleged no loss was proved and if proved, allowing the deduction was contrary to public policy, as there had been actual involvement by petitioner. The court admitted no limitation is imposed by Section 165 on deductibility of such a loss, but disallowed a deduction using Luther M. Richey as their basis. In Richey, the taxpayer was involved in an actual counterfeiting scheme and the process had begun with taxpayer helping in the operation. In Mazzi the taxpayer attempted to distinguish Richey by stating there was no real plan to counterfeit, as there was no device which could do the job. Also, petitioner noted he knew nothing about the process and had not participated. The majority of the court was not swayed by these arguments and held petitioner's conduct no less violative of public policy. It is this public policy argument which caused the split in the court and raised questions for discussion.

The dissent in Mazzi expounds on the fact that Congress has set forth categories of expenditures under Section 162 to be denied deductions on grounds of public policy. These areas were to be all inclusive, and determination of what is deductible is to be determined by Congress. In its opinion in Commissioner v. Tellier the Supreme Court seemed to agree with this policy.

It is submitted that perhaps whether the facts vary or not, the decision of this type case should not rest on fact distinction. A more consistent judicial interpretation of Sections 165 and 162 and/or a clearer rule by the Congress is needed to settle the point of argument.

It is felt that congressional intent in disallowing certain deductions is to be all inclusive and should not rely to any great extent on judicial interpretation. Congress has set forth categories of expenditures under Section 162 to be denied a deduction on the grounds of public policy, and Congress should be the power to alter, amend or add to these non-deductible expenditures. Of course, in similar cases, the public policy argument may be avoided entirely, since a theft does not involve payments voluntarily made and a theft loss can be said never to occur. This may be the best avenue, as it will prevent the Tax Court from

120 Raymond Mazzi, 61 T.C. No. 55 (Jan. 28, 1974).
121 Id.
grading criminal activity and from determining tax liability in terms of the seriousness of the crime.

4.11 Casualty Losses. Section 165(c)(3) allows deductions for casualty losses. The amount deductible is the lesser of (1) the actual loss—the difference between the value of the property just before the loss and that immediately thereafter, or (2) the adjusted basis of the property for determining loss on a sale.\(^\text{124}\) A casualty is defined as an event due to some sudden, unexpected, or unusual cause and not due to the deliberate or willful action of persons claiming the loss.\(^\text{125}\) Generally, this means an accident or a sudden invasion by a hostile force and not the progressive deterioration of property through a steady and constant action.

In *Cox v. United States*,\(^\text{126}\) the petitioners were denied casualty loss deductions even though the loss sustained met the criteria outlined above. The petitioners had bought certain property as a long-term investment and when oil was subsequently discovered on the land, increasing its value, a lease was given by an oil company to drill and develop any oil on the property. One well began producing at the rate of 250 barrels a day, but after only one month of operation, a massive intrusion of underground salt water invaded the oil-producing zone. This intrusion could not be controlled. Petitioner claimed a casualty loss deduction on the decrease in land value caused by this intrusion. He argued that the decline represented a portion of the appreciation over the original purchase price and should, therefore, be an allowable casualty loss.

The government relied on *Jones v. Smith*\(^\text{127}\) and *Squirt Co. v. Commissioner*\(^\text{128}\) in its arguments to deny a casualty loss deduction. The court noted that the facts of *Cox* were unique and that there was no controlling authority.\(^\text{129}\) Hence, the court sought the congressional intent. The plain and literal meaning was analyzed initially to determine the legislative purpose. When this offered no assistance the court looked beyond the meaning of the words to the purpose of the legislation. The *Cox* court took the position that the casualty loss deductions were allowed because Congress recognized that some purely fortuitous events

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124 Treas. Reg. § 1.165-7(b).
127 193 F.2d 381 (10th Cir. 1951).
128 423 F.2d 710 (9th Cir. 1969).
129 The court distinguished *Jones* (oil well cave-in) on the grounds that that decision was based on the interpretation of a contract and taxpayer's accounting practices, and that the drilling expense loss there was not sudden, unusual, and wholly unexpected. It distinguished *Squirt Company* (freeze of citrus land) because it held only that the threat of a future injury to land (future freezes), which causes a present decline in land values, is not a casualty loss.
might impair the taxpayer's financial position so as to make it difficult for him to pay current income taxes.\(^{130}\)

In *Cox*, however, the taxpayer's ability to pay his income tax was not impaired in any way because there was no loss affecting his cash flow. The most the petitioner had lost was unexpected and unrealized appreciation collateral to his original investment. No financial hardship had been experienced. If the taxpayer had been permitted to succeed, he would have converted his ordinary income into capital gains and thereby obtained lower tax rates on such gains.

Construing the casualty loss provision against these factors, the court denied the taxpayer a deduction. It appears that a taxpayer will need to show at least one of the following circumstances to claim casualty loss deductions: (1) injury to the surface of the land; (2) impairment to potential surface uses; (3) inability to pay federal income taxes; or (4) out-of-pocket expenditures by taxpayer. If the taxpayer can show any of the above this court infers that a casualty loss deduction may be allowed.

Another recent case involving a casualty loss deduction involved a property loss of a child of majority age while she lived in the home of her parents. In *Howard Scharf*,\(^{131}\) the court denied casualty loss deductions claimed by the parents for the loss of property belonging to their 21-year-old son. The loss was caused by a fire which practically destroyed the petitioner's home. The fire caused loss of property to the husband and wife and two children; one aged 20, the other 21. At the time of the fire, the age of majority was 21 in Maryland—the state where the loss occurred. Under Maryland law, once a child reaches 21 years of age the parents no longer have a duty to support them.

The court relied on *Thomas J. Draper*\(^{132}\) to disallow the casualty loss deduction for the property of Scharf's 21-year-old son. In *Draper*, the court stated that the adult daughter could not legally compel her parents to make replacements for her casualty loss. As to Scharf's 20-year-old child, the petitioners were allowed to claim the casualty loss deductions, since the petitioner had a legal obligation to support this child and thus, to replace possessions destroyed by the fire. The deductibility of a loss does not hinge on whether the parents actually support their children, but whether they have a legal obligation to do so. This is of particular interest in these times as many states have reduced the age of majority from 21 to 18 years of age.

Husband and wife may incur the same problem with property owned separately or as tenants by the entireties. With property owned separately, the husband will be denied casualty loss deductions on losses to the wife's


\(^{132}\) Thomas J. Draper, 15 T.C. 135 (1950).
property. In property owned by the entireties the loss will be divided equally between the owners. Therefore, when claiming casualty loss deductions in family situations, the legal owner of the property must be determined before the loss can be claimed.

4.12 Prepaid Feed Expenses. In Cattle Feeders Tax Committee v. Schultz, the district court enjoined the Internal Revenue Service from enforcing its three-part test concerning a cash basis taxpayer’s deductions of prepaid feed expenses. Cattle Feeders was an unincorporated association whose members sponsored investment programs for farmers, which programs included the prepaying for feed that was to be delivered in the next year. The court found Cattle Farmers would suffer irreparable economic injury if the ruling was published and enforced. The court held that the ruling was substantive rather than an interpretative rule or general statement of policy. As such, it was subject to the notice requirements of the Administrative Procedure Act. In addition, the court found the Service had extended its statutory authority beyond its limits and usurped legislative authority contrary to the Constitution. Cattle Feeders’ victory in the district court was short-lived, as the Tenth Circuit reversed the lower court’s holding. The Tenth Circuit found Section 7421 to be a bar to the taxpayer’s injunction suit. Citing Enochs v. Williams Packing & Navigation Co., Inc., the court stated that the taxpayers had not met the two-part test put forth in that case. The circuit court held that to obtain an injunction the taxpayer must show (1) that the government would not prevail under any circumstances because the Service’s actions were clearly without a legal basis and (2) that a basis for equity jurisdiction exists.

Relying on these factors, the Tenth Circuit found that the ruling was not without legal basis because Sections 461 and 466 implicitly give the Commissioner the right to require the taxpayer to compute his taxable income on a basis which clearly reflects income.

136 Proposed Rev. Rul. 73-530, T.I.R. 6 P-H 1973 FED. TAXES ¶ 55,628 requires the taxpayer to show (1) the expenditure is a payment for purchase of feed rather than just a deposit; (2) the payment is for a business purpose and not just for the avoidance, and (3) the deduction does not distort income to deduct the amount paid for the feed.
137 33 Am. Fed. Tax R.2d 74-428, 431 (W.D. Okla. 1973), where the court held the ruling “null, void, of no force and effect and unenforceable.”
141 370 U.S. 1 (1962).
This, although the ruling may destroy Cattle Feeders' business the association has no remedy through the courts. However, any investor in Cattle Feeders' business may litigate the validity of the ruling in a suit for refund in the Tax Court.

4.13 Convention Advertising. Section 276(c) allows a deduction for expenses incurred for advertising in a convention program of a national political party if the proceeds are used solely to defray convention costs and if the amounts paid or incurred for advertising are reasonable in light of the business the taxpayer may expect to receive as a result of the advertising. Recently, however, the President has signed the Campaign Reform Law eliminating any tax deduction for amounts paid for advertising in a convention program, regardless of the business benefit or the use of the advertising fund. Section 406(d) of the new law repeals Section 276(c), effective January 1, 1975.

4.14 Premature Deposit Withdrawal Penalties. Although Revised Ruling 73-511 treated premature withdrawal interest penalties as deductible from gross income, the taxpayer obtained no benefit unless he itemized his deductions. However, Congress has now seen fit to allow these losses as deductions in arriving at adjusted gross income. This new law is retroactively effective for taxable years beginning after 1972. Thus, the change allows taxpayer to deduct the interest forfeited while using the standard deduction or low-income allowance in arriving at taxable income.

4.15 Unreasonable Compensation. Corporate taxpayers are allowed a deduction under Section 162(a)(1) for wage and salary payments which do not exceed a "reasonable allowance for personal services actually rendered." Corporations will normally want to claim as large an amount as possible for reasonable salaries and bonuses, since the deduction of these items will reduce gross income. For closely held corporations, this area has been highly litigated.

The Regulations view percentage or contingent compensation employment contracts with great care. The two leading cases in this area are Robert Rogers, Inc. v. United States, and Harolds Club v. Commissioner. In Rogers, Inc., the Court of Claims upheld as reasonable a 1939 contract with a non-shareholder employee for a base salary plus 1% of the net profits, which led to a salary of $175,000 when the company prospered during World War II, because the agreement was reasonable when entered into. In Harolds Club, a non-shareholder father was employed by his sons as manager of a Nevada casino for a base salary

146 93 F. Supp. 1014 (Ct. Cl. 1950).
147 340 F.2d 861 (9th Cir. 1965),
plus 20% of the net profits. The court of appeals upheld the principle of the contingent contract, but reduced the salary deduction to 15% on the grounds that the original contract was not the result of a "free bargain" between the father and his sons as required by the regulations.

In Miller Box, Inc. v. United States,\textsuperscript{148} a company president contracted with his brother to manage two companies, which were created the following year, for a base salary plus 20% of its net profits. The formula resulted in a total annual salary in excess of $500,000, due to the expected further escalation of the Vietnam War. The Fifth Circuit ruled that nearly 90% of the salary was unreasonable compensation because (1) the contracts were between related parties, (2) the reasonableness of contracts should be viewed at the time they were adopted (1966) by the corporation, and (3) this salary was four or five times higher than that paid to managers of competing companies. In Pepsi-Cola of Salina, Inc.,\textsuperscript{149} a 65-year-old woman was the president and sole shareholder of the corporation. She received a base amount plus a fixed percentage of the net profits as her salary, which exceeded $100,000 after 1968. The Tax Court, noting that the company had never paid any dividends and that the woman did not testify as to any active duties she performed as president, held that about 40% of her salary was unreasonable compensation and represented dividends.

A related case (and a taxpayer victory) is Tulia Feedlot, Inc. v. United States.\textsuperscript{150} The shareholders charged the corporation a 3% fee for guaranteeing a bank loan made to the corporation. The court rejected the Service's argument that the 3% fee was really a dividend, and agreed with the taxpayer that it was a deductible business expense since the individual shareholders were personally liable on the loan in the event of a corporate failure. A notice of appeal by the Service to the Fifth Circuit has been filed.

4.16 Charitable Contribution. In Haverly v. United States,\textsuperscript{151} the principal of a Chicago elementary school received free samples of school books from local publishing firms who hoped to convince the principal to purchase their books for the school. Haverly gave the books, which had a fair market value of $400, to the school's library and claimed a charitable deduction for the donation. The Commissioner conceded that the taxpayer was entitled to a charitable contribution deduction under Section 170 for the fair market value of the books as of the date of gift.

However, the Commissioner contended that when the recipient of unsolicited samples manifests an intent to accept the property, it

\textsuperscript{148} 488 F.2d 695 (5th Cir. 1974).
\textsuperscript{149} 61 T.C. No. 61 (Jan. 29, 1974).
\textsuperscript{150} 366 F. Supp. 1089 (D. Tex. 1974).
\textsuperscript{151} 374 F. Supp. 1041 (N.D. Ill. 1974).
becomes income and that deducting the contribution was evidence of the necessary intent.

The court distinguished *Commissioner v. Duberstein*,\(^{152}\) wherein the taxpayer realized income upon receipt of an automobile given to him as compensation for services previously rendered. Here taxpayer could not be forced to realize income by receiving unsolicited samples. In granting taxpayer's motion for summary judgment, the court determined that unsolicited samples did not fit within the categories of income as set forth in Section 61(a).\(^{153}\)

### 5.00 Tax Credits

#### 5.01 Investment Credit
In 1966, the Internal Revenue Service ruled that a building structure used as a hog-raising facility did not qualify as Section 38 property for the purposes of investment credit.\(^{154}\) In effect, the Service ruled that the structure was not tangible personal property. Tangible personal property is defined as any tangible property, except land and improvements thereto, such as buildings or other inherently permanent structures and their structural components. Included in this classification of tangible property is all property contained in or attached to the building.\(^{155}\)

In *Melvin Satrum*,\(^{156}\) the Tax Court refused to follow the 1966 ruling in allowing an investment credit for amounts expended on the units to house chickens. In so doing, the court relied on the fact that the henhouse was used as an integral part of the activity and would have to be expected to be replaced when the property it houses is replaced. In addition, the court referred to the amount of working space and the utilization of space.\(^{157}\) Believing the work done in taxpayer's henhouse to be for the maintenance and collection of eggs, the house was analogized to a storage area or processing chamber.\(^{158}\) Finally, the court relied on a Senate Finance Committee Report\(^ {159}\) which used the hog-raising structure as an example of property eligible for an investment credit.

The decision was not unanimous, four judges dissenting. The dissent emphasizes that the activity in the house which was relied on by the majority was indistinguishable from prior cases\(^ {160}\) disallowing investment credits.

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\(^{152}\) 363 U.S. 278 (1960).

\(^{153}\) 374 F. Supp. at 1044.


\(^{155}\) Treas. Reg. § 1.48-1(c).

\(^{156}\) 62 T.C. No. 47 (June 27, 1974).

\(^{157}\) *See generally* Sunnyside Nurseries, 59 T.C. 113 (1972); Central Citrus Co., 58 T.C. 365 (1972); Robert E. Catron, 50 T.C. 306 (1968), discussing amount of working space and its uses.

\(^{158}\) Sunnyside Nurseries, 59 T.C. 113, 121 (1972); Central Citrus Co., 58 T.C. 365 (1972).


\(^{160}\) Arnie Therrip, 59 T.C. 122 (1972); Sunnyside Nurseries 59 T.C. 113 (1972), holding greenhouses were buildings and disallowing an investment credit on them.
Although both dissent and majority state a building is to be given its commonly accepted meaning, there seems to be much more to the determination of what is or is not a building under Sections 38 and 48. Subsequent cases will have to determine when a structure is entitled to an investment credit. Whether Satrum will set a precedent for future cases in this area must be pure speculation.

5.02 Investment Credit Recapture. Under Section 38, taxpayers are entitled to a tax credit for investment in certain types of property (generally depreciable tangible personal property other than buildings and their structural components) in the year such property is placed in service. The credit is 7% of the qualified investment, except for certain public utilities where only 4% is allowed. The credit does not reduce the property's basis and is in addition to any depreciation deductions.

The amount of the qualified investment depends on the useful life of the property. If the property's life is less than three years there is no tax credit; if the useful life is from three to five years, then only one-third of the investment qualifies; for a five- to seven-year life, two-thirds qualifies. If the useful life is longer than seven years the entire amount of the investment qualifies for the tax credit.

However, if the qualified property is disposed of or ceases to be qualified before its useful life ends, Section 47(a) requires part or all of the credit to be recaptured. The difference between the credit taken and credit allowed for the period of actual use is added to the tax due in the year of disposition. However, Section 47(b) provides that property will not cease to be Section 38 property where there is a "mere change in form of conducting the trade or business so long as the property is retained in such trade or business and the taxpayer retains a substantial interest in such trade or business." Thus, where property is transferred from a partnership to a newly formed corporation doing identical business, and taxpayer retains substantial interest in the property, recapture is not triggered.

In W. Frank Blevins, taxpayer retained the same interest in a newly formed corporation as he had in the partnership (45%). However, before the useful life of the property had ceased, taxpayer reduced his interest in the corporation by 53% (retaining 21% total interest in the

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162 Int. Rev. Code of 1954, §§ 46(a) (1), 46(c) (3); Treas. Reg. § 1.46-1.
163 Int. Rev. Code of 1954, § 46(c) (2); Treas. Reg. § 1.46-3 (b).
164 Int. Rev. Code of 1954, § 46(c); Treas. Reg. § 1.46-3.
165 See James Soares, 50 T.C. 909 (1968), when taxpayer had 48% interest in the partnership and only 7.6% interest in the newly formed corporation, the court held he had not retained substantial interest in the exchange of partnership interest for stock interest.
166 61 T.C. No. 59 (Jan. 29, 1974).
corporation) by making a gift to his sons. As noted, recapture was not triggered by the partnership's Section 38 property being transferred to the corporation. Instead, the question for the court was whether the gift would trigger a recapture of the credit earned.

Without finding it necessary to determine whether 21% was a substantial interest under Section 47(b), the court held that 53.3% (the amount of the gift) of the investment credit shall be the amount of recapture.

To determine the amount of recapture, the court states since the taxpayer obtained his investment credit as a partner, petitioner's interest must be traced from the time he received the credit as a partner through the incorporation. Thus, the court first applied Treasury Regulation 1.47-3(f)(5)(iv) and then Treasury Regulation 1.47-6(a)(2) to determine if the reduction of taxpayer's interest warranted recapture. Treasury Regulation 1.47-3(f)(5)(iv) provided that in the case of a mere change in the form of a trade or business, if the interest of the taxpayer in the trade or business is reduced but the taxpayer retains a substantial interest, the reduction in interest must be tested under Section 1.47-6(a)(2) (relating to partnerships) to determine if recapture is warranted.

Although taxpayer argued that 1.47-3(f)(5)(iv) applies only at the change of form, the court disagreed. Section 1.47-3(f) is applicable to the time of change as well as the period thereafter. Applying the percentage test of 1.47-6(a)(2) the court found recapture was warranted. In so doing, the court noted Section 47(b) provides that property does not cease to be Section 38 property with respect to the taxpayer by reason of a mere change in form of conducting the trade as long as taxpayer retains a substantial interest, but this does not preclude recapture upon the occurrence of a reduction in the interest. They noted where a reduction of interest is involved, 1.47-3(f)(5)(iv) is controlling. Thus, they rejected taxpayer's argument that this section applies only during the change in form by holding it applicable to any reduction in interest occurring thereafter.

6.00 Depreciation

6.01 Public Utility—Construction Equipment. The Supreme Court firmly established the validity of Revenue Ruling 59-380\(^{168}\) by reversing the Ninth Circuit's decision in Commissioner v. Idaho Power Co.\(^{169}\) The taxpayer was a public utility which used its own equipment and employees in the construction of improvements and additions to its capital facilities.

\(^{167}\) See generally Treas. Reg. § 1.47-3(f)(1)(ii).

\(^{168}\) Rev. Rul. 59-380. 1959-2 CUM. BULL. 87. Depreciation sustained on construction equipment owned by a taxpayer and used in the erection of capital improvements for its own use is not an allowable deduction, but shall be added to and made a part of the cost of the capital improvements. So much thereof as is applicable to the cost of depreciable capital improvements is recoverable through deductions for depreciation over the useful life of such capital improvements.

In 1962 and 1963 the taxpayer claimed a deduction from gross income for all of the year’s depreciation on such equipment, including that portion related to its use in constructing the company’s capital facilities. The construction-related depreciation was therefore based on the shorter life of the equipment (10 years) instead of the longer life of the capital facilities constructed (30 years). The Commissioner did not question the deduction of that portion of the transportation equipment’s depreciation allocable to the operation and maintenance of the taxpayer’s facilities, however, the Commissioner contended that Section 263(a) precluded any deduction for depreciation on the equipment which was attributable to the construction of the company’s capital facilities.

Section 167 allows a depreciation deduction on property used in a taxpayer’s trade or business or for the production of income. Revenue Ruling 59-380 provides that where the taxpayer is not in the construction business any equipment it owns and uses in the construction of its capital facilities is not “property used in the trade or business” of the taxpayer and thus is not depreciable property under Section 167. Instead, such portion constitutes a cost of construction and should be added to the basis of the asset constructed as a capital expenditure. This revenue ruling was also followed by the Court of Claims in Southern Natural Gas Co. v. United States, holding that the portion of depreciation on automotive equipment used in the construction of a corporation’s new facilities was a cost giving such asset value and should therefore be included in that asset’s depreciable basis. The court rejected the “a trade or business” approach in favor of the analysis that equipment, to the extent used by the taxpayer in constructing new facilities, was not used in “the trade or business” of the natural gas company.

On appeal, the Ninth Circuit concluded that the equipment used in the construction of the taxpayer’s own capital improvements was used in the trade or business of the Idaho Power Co. The court reasoned that:

The continuity and regularity of the taxpayer’s construction activities, the number of employees engaged in construction and the amounts expended on construction all point to the conclusion that construction of facilities is a major aspect of the taxpayer’s trade or business.

170 Int. Rev. Code of 1954, § 263. Capital Expenditures. "(a) General Rule. No deduction shall be allowed for—(1) any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

171 Int. Rev. Code of 1954, § 167(a). "General Rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence). (1) of property used in the trade or business. . . ."

172 Treas. Reg. § 1.263(a)(2)—"Examples of capital expenditures (a) The cost of acquisition, construction, or erection of buildings. . . ."

173 412 F.2d 1222 (Ct. Cl. 1969).

174 Id. at 1265.

175 477 F.2d at 696.
The court believed that the activities involved fell within the meaning of Section 167 and that therefore Revenue Ruling 59-380 was an improper and incorrect interpretation of the law. The Ninth Circuit also agreed with the taxpayer's second contention that Section 263 did not preclude a deduction for depreciation since that section only applied to amounts "paid out" for new buildings or for permanent improvements. The court concluded that depreciation is a "decrease in value" not a "payment, or expenditure, or an out-of-pocket expense."

The Supreme Court, however, overruled the Ninth Circuit's decision in Commissioner v. Idaho Power. As to the taxpayer's first contention, the Court did not have to reach the issue whether the Court of Appeals had given the phrase "used in the trade or business" a proper construction. Because the Commissioner had appeared to have conceded that point, the Supreme Court assumed, without deciding, that Section 167 has a "literal application to the depreciation of the taxpayer's transportation equipment used in the construction of its capital improvements."

Nevertheless, the Court agreed with the Commissioner's contention that Section 263 takes precedence over Section 167 and any deduction for an amount "paid out for new buildings or for permanent improvements" is therefore disallowed. Section 263 takes precedence over Section 167 by virtue of the priority-ordering terms contained in Section 161. That section provides that deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code are subject to the exceptions provided in Part IX. Part VI includes Section 167 and Part IX includes Section 263. Since Section 263 barred the deduction, it was immaterial to the decision whether the deduction qualified under Section 167 as "used in the taxpayer's trade or business."

The Court also disagreed with the taxpayer's contention that the depreciation of construction equipment represents merely a decrease in value and not an amount "paid out" within the meaning of Section 263(a). The Court saw no reason to treat construction related depreciation differently than the cost of the transportation equipment itself and held that: "Depreciation—inasmuch as it represents a using up of capital—is as much an 'expenditure' as the using up of labor or other items of direct cost." The Court also looked to accepted accounting practices and established tax principles requiring the capitalization of the cost of acquiring a capital asset to add further reasoning for the conclusion that

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176 A revenue ruling does not have the force of law and to the extent it conflicts with a statute it is ineffective.


180 94 S. Ct. at 2762 n.5.


182 94 S. Ct. at 2764 n.8.
depreciation of the equipment should be capitalized as a cost of the self-constructed asset. The Court also noted that the non-capitalization of construction-related depreciation could lead to disparate treatment among taxpayers. Such treatment would allow firms which constructed their own facilities to obtain a current deduction but require those without sufficient resources to capitalize their entire cost of construction, including the depreciation charged to it by the contractor.

The Supreme Court's decision in *Idaho Power* obviously strengthens the Commissioner's position regarding other expenditures that might also be capitalized. Areas which could be affected are legal and accounting work on mergers and acquisitions, evaluation studies in connection with the acquisition, renovation, and sale of residential properties, and the expansion of sales outlets and change in methods of distribution.

6.02 Land Improvements. Section 167(a) allows a depreciation deduction for the exhaustion and wear and tear of property used in the taxpayer's trade or business and for property held for the production of income. Depreciation is not allowed on land because land is incapable of wearing out or becoming obsolete. But what about depreciation on certain expenditures for land improvements? The question arose in *Tunnell v. United States* in which the district court distinguished those improvements which become an integral part of the land and those which only relate to the taxpayer's specific trade or business project. In *Tunnell*, the plaintiffs claimed depreciation on all their land improvement expenses in developing a waterfront mobile home park. These improvements included not only the landscaping and grading of the land but also dredging and bulkheading of lagoons which were to provide waterways for potential tenant-boatowners. The plaintiffs based their claims on the ground that these improvements were features of a total complex and thus they derived their useful life expectancy from the limited life of the whole project.

The government contended that since the useful life of the lagoons would continue whether or not the project itself might become obsolete, no depreciation could be allowed for their dredging and bulkheading because their useful life was indeterminate. The court felt that this interpretation was inconsistent with the regulations. Treasury Regulation 1.167(a)-1(b) provides that an asset's useful life should be measured over the period the asset is useful to the taxpayer in his trade or business or in the production of his income. Therefore, another use which the lagoons might serve after the taxpayer's original project becomes obsolete was irrelevant. Furthermore, the court compared the lagoons to private roads

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185 Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775 (2d Cir. 1973).
which are depreciable when their useful lives are peculiarly tied to that of the entire project to which they provide access.\textsuperscript{188}

The court also allowed a recovery on the clearing, thinning and landscaping expenses because of their integral relationship to the park. Such improvements formed a unique design which could only be used for the mobile home project. However, except for the grading of roads, general grading expenses could not be recovered. In \textit{Trailmont Park, Inc.},\textsuperscript{189} depreciation deductions on such grading expenses were allowed because the several levels of terraces on a mountainside which were specifically landscaped to hold trailer pads were only usable for a mobile home park. On the other hand, the graded marshland in \textit{Tunnell} could easily be adapted to uses other than the taxpayer's and therefore increased the value of the land.

The plaintiffs also argued that the government was estopped from asserting non-depreciable of the expenditures because the Guidelines for Depreciation\textsuperscript{190} had led them to believe that the expenditures were depreciable. The court disagreed with the plaintiff's rationale. The Guidelines had no relevance to whether a particular expenditure could be recoverable through depreciation.\textsuperscript{191} They simply provided advance assurance of the useful lives of assets which could initially be depreciated, not assurance that the assets listed would be depreciable in every instance.

\textbf{6.03 Customer Lists.} Although Section 165(a) provides for a deduction on losses sustained during the taxable year not compensated by insurance or otherwise, there is no specific provision in the law that permits a deduction for partial loss of an intangible capital investment. To claim a loss deduction, the loss must be evidenced by closed and completed transactions, fixed by identifiable events actually sustained during the taxable year. In addition, only a bona fide loss is allowable.\textsuperscript{192}

Proving a bona fide loss has been a problem to taxpayers who have lost customers after purchasing customer lists. For example, in \textit{Anchor Cleaning Service, Inc.},\textsuperscript{193} the Tax Court held that the customer accounts acquired by the cleaning service were a single capital asset composed of a list of customers and were not a composite of separate individual capital assets. Thus, the court disallowed loss deductions when some customers discontinued the service. The reasons behind this decision included: (1) the cleaning service acquired the list, along with the goodwill, furniture and office goods, and accounts receivable for one purchase price; (2) no valuation was placed on any particular contract, and

\textsuperscript{191} 367 F. Supp. at 565.
\textsuperscript{192} Treas. Reg. § 1.165-1(b).
\textsuperscript{193} 22 T.C. 1029 (1958).
(3) the cleaning service allocated part of the purchase price to the entire customer list.

In Revenue Ruling 69-311,194 the Service reaffirmed this position where the taxpayer purchased the accounting practice of a deceased accountant and the clients of the deceased were recommended to go to the taxpayer for all work formerly handled by the decedent. In denying the loss, the Service advanced what is called the single unitary assets doctrine or indivisible asset doctrine. As the lost contracts were constantly being replaced by new ones, the indivisible asset was not exhausted by the passage of time or the loss of a contract.

However, where a taxpayer purchased only an account of a single customer, a loss deduction was allowed when the client died.195 The Service ruled that when a sole account transferred in a single transaction does not lead to other accounts, and the time of its loss of usefulness can be established, the loss is deductible. In addition, the Seventh Circuit allowed a loss deduction in *Super Food Service, Inc. v. United States*,196 after the purchaser of a customer list had assigned a value to each individual contract by a specified formula. The court stated the indivisible asset doctrine did not apply when a specific value is given to each contract.

In *Sunset Fuel Co. v. United States*,197 the taxpayer obtained certain assets of the seller (Dwyer), the single biggest asset being Dwyer's customers. The price paid for Dwyer's customer list was computed on an individual basis by use of a specific formula. As in *Anchor* and *Super Foods* the government argued that the customer list was a mass, indivisible asset and could not be separated for a loss deduction. Furthermore, the government argued the purchaser had acquired the "customer structure" of the business; that is, they acquired a new level of operation and an opportunity to make inroads into markets already opened by the acquired business, in addition to the income from the particular customer who dealt with the previous owner. The court held that since the taxpayer had a going business and was operating in the same area as Dwyer, they did not assume Dwyer's customer structure. All that was acquired was an additional flow of capital from Dwyer's customers, not a new level of operation. Since the taxpayer had valued each customer as a capital asset, taxpayer was able to deduct its unrecovered basis on the loss or death of one of the customers. Each customer was held to constitute a single unitary asset, not the entire contract as in *Anchor Cleaning*.

However, in future cases of this nature, the taxpayer may not always prevail. In the Oregon District,198 at least, the question of whether a

196 416 F.2d 1236 (7th Cir. 1969).
purchaser of a customer list purchased a single mass asset or a group of single unitary assets will be a factual question depending on the method of treating the acquired list. It appears that when the purchaser places a valuation on an individual contract, a reasonable method of reaching this valuation figure, and a reasonable method of establishing the remaining value, he will be able to claim a loss deduction.

7.00 Capital Gains

7.01 Non-Recognition of Gain. Does the death of a taxpayer terminate the availability of the non-recognition of gain provisions under Section 1033? Both the Third and Fourth Circuits have agreed that the requirements of Section 1033 are met if the testamentary trustee of the taxpayer’s estate reinvests the proceeds in other property similar or related in use to that taken.199 In Estate of George W. Jayne,200 however, the Tax Court did not permit the wife of the taxpayer to defer the gain which the taxpayer could have received from the sale of property under threat of condemnation. The reason was not the subsequent death of the wife, but that the wife used her own money when buying suitable replacement property. Had she merely acted as executrix of the taxpayer’s estate and used estate funds to purchase the similar property, Section 1033 would then have been available to her. The Internal Revenue Service is still at odds with such an interpretation of Section 1033. Revenue Ruling 64-161201 specifically refused to follow the decision in In re Goodman’s Estate v. Commissioner,202 where the deceased taxpayer’s representatives were allowed to qualify under the replacement requirements. The ruling interprets Section 1033 to require the taxpayer to put himself in the same investment position as he was in before the involuntary conversion in order to receive the nonrecognition benefit. If the taxpayer dies before procuring the replacement property, the continuation of his investment cannot be completed. However, the refusal of both the Tax Court and the Fourth Circuit to follow Revenue Ruling 64-161 puts that ruling’s interpretation of Section 1033 in doubt.

7.02 Transfer of Patent Rights. Section 1235 provides that a transfer of all substantial rights to a patent constitutes the sale or exchange of a capital asset held for more than six months. However, Treasury Regulation 1.1235-2(b)(1)(iii) denies this treatment for those patent transfers “in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant.” In Mros v. Commissioner,203 the Tax Court agreed with the plaintiff’s contention that Treasury Regulation 1.1235-2(b)(1)(iii)
was too narrow an interpretation of the law. In that case the taxpayer had granted exclusive rights in his gear reduction device patent to another party but the agreement restricted their use to certain specified areas of manufacture. The Commissioner argued that any advance payments to Mros which arose from this limited field of use agreement were royalties and thus not entitled to capital gain treatment. The Tax Court disagreed and stated that as long as the transfer was a grant of the exclusive right to a patented invention in a particular field of use, it would therefore qualify as a transfer of "all substantial rights" under Section 1235. The Ninth Circuit, on the other hand, reversed and held that such a limited field of use patent transfer did not qualify for capital gains treatment if it was restricted to a geographic or industrial use area.

In holding the regulation a valid interpretation of Section 1235, the court applied a twofold test which the Sixth Circuit had outlined in *Fawick v. Commissioner.* In *Fawick,* the taxpayer had granted exclusive rights to another person of his patent relating to assemblies suitable for use in driving clutches. This grant limited the patent's field of use to the marine service industry. In order to determine whether *Fawick* was entitled to Section 1235 benefits, the Sixth Circuit outlined two requirements that any grant must satisfy to qualify for capital gain treatment. First, there must be an actual transfer of the monopoly rights in a patent. Second, the taxpayer must not retain any substantial rights after the transfer has taken place. Since the *Fawick* patents had known value outside the marine service industry at the time of the grant, that value constituted a substantial right causing the transaction to fail to qualify under Section 1235.

In applying this test to the present case, the Ninth Circuit disallowed capital gain treatment because the Mros patent had potential value in areas other than the limited field of use for which it was sold. Therefore Treasury Regulation 1.1235-2(b)(1)(iii) was applied and any advance payments made to Mros constituted royalties under Section 1235.

7.03 Lessee's Payment to Update Restoration Clause. Payment to a lessor to relieve the lessee of a contractual duty to restore the premises to its original condition upon termination of the lease constitutes additional rent and therefore ordinary income. In *Sirbo Holding, Inc.*, the taxpayer-lessee had leased the property for use as a theater or broadcast studio on the condition that the lessee restore the property to its original condition. The liability of the lessee encompassed both the replacement of the curtains and seats as well as the removal of walls, partitions, and other installations which the lessee had made to convert

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204 436 F.2d 655 (6th Cir. 1971).
205 436 F.2d at 662.
207 57 T.C. 530 (1972).
the property to its intended use. In the negotiations for a new lease, however, the lessee paid an amount to "update" the restoration clause. This updating thereby relieved the lessee of its liability to account for the damages which had occurred during the period covered in the original lease.

The taxpayer claimed that this payment should be considered as a capital gain under Section 1231. That section provides that gains on sales or exchanges of property, plus gains from the compulsory or involuntary conversion of property, used in the trade or business shall be treated as gains from sales or exchanges of capital assets held more than six months. The Tax Court disagreed with the taxpayer's contention and held that the payment was ordinary income. Where a payment represents compensation for damages, the amount received is first charged to the taxpayer's basis and only the amount received in excess of basis is taxable. To the extent that the obligation to restore related to the seats and curtains which had been removed by the lessee, that cost had long since been recovered by the taxpayer through the composite depreciation claimed on the property as a whole. Furthermore, Sirbo Holdings offered no proof of damages or economic loss due to the cost of removal of the walls and other installations made by the lessee. If anything, the value of the property had been enhanced.

On appeal, however, the Second Circuit remanded the case for reconsideration of the decision that the payment did not constitute an amount realized from the sale or exchange of property under Section 1231. The circuit court was concerned over the decision, which went unchallenged by the Commissioner, in Boston Fish Market Corp., where, in a similar situation, the landlord received capital gains treatment. On remand, the Tax Court reaffirmed its position that consideration received in the updating of a restoration clause did not constitute an amount realized from the sale or exchange of property or from the compulsory or involuntary conversion of property within the meaning of Section 1231. The words "sale" and "exchange" must be given their ordinary meaning and the payment for updating the restoration clause related to new terms upon which the lessee would continue to occupy the property. Nothing was sold and nothing was exchanged, the lessee was merely released from a contract obligation. The Commissioner, upon request by the Second Circuit to justify its inconsistent position in Boston Fish Market and Sirbo Holdings, stated that its concession in the former case was an error.

7.04 Covenant Not to Compete. If a payment on a contract for the sale of a business is designated for goodwill, it is considered capital gain to the seller and is nondeductible by the buyer. If, on the other hand, the

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209 57 T.C. 884 (1972).
210 Commissioner v. Killian, 314 F.2d 852 (5th Cir. 1963).
payment is for a covenant not to compete, it is ordinary income to the seller but is deductible by the buyer over the term of the covenant. Where the contract does not specifically allocate these payments the court will determine how much of the consideration received is for each. Furthermore, if there has been an allocation agreed upon in the contract for sale, the taxpayer will be precluded from treating it differently for tax purposes.

In Servicemaster of Memphis, Inc. v. United States, the parties contracted for the sale of a business for $45,000 and allocated $30,000 to a covenant not to compete and $3,000 to goodwill. The court refused to accept such a distribution and noted that a covenant's value rarely exceeds 50% of the purchase price. Accordingly, the court reduced the covenant's value to $22,500. While it is unusual for a court to upset a specific allocation without strong proof that the true substance of the agreement is not reflected, if it is clearly beyond the economic realities of the transaction, a court will not hesitate to adjust it.

7.05 Severance Damages. When land or other property is involuntarily converted into money, Section 1033 provides that no gain will be recognized if that money is used in acquiring other property which is similar or related in service or use to the property so converted. There seems to be little difficulty when applying Section 1033 to compensation received for condemnation which has been reinvested into suitable replacement property. The Service, however, has been reluctant to grant the same treatment to compensation for severance damages relating to the lessening of value of the property which is retained by the taxpayer. Just such a situation arose in McKitrick v. United States. There the Service disallowed Section 1033 treatment on a taxpayer's severance damages after part of his property was taken for highway purposes and after the taxpayer had reinvested all of the compensation and severance damages into similar property.

The Service based its position on two Revenue Rulings which allow the deferral of severance damages only where the taxpayer purchases property adjacent to his remaining land or where the gain is used to restore the usability of the retained land. The court disagreed with this narrow interpretation and noted the inconsistency of the Service's position since Revenue Ruling 72-433 did not limit the availability of

211 Nelson Weaver Realty Co. v. Comm'r, 307 F.2d 897 (5th Cir. 1962).
212 Karan v. Comm'r, 319 F.2d 303 (7th Cir. 1963).
218 Rev. Rul. 72-433, 1972-3 CUM. BULL. 35.
Section 1033 treatment to the two exceptions delineated. That ruling noted the similarity between severance damages and condemnation proceeds received for an involuntary grant of flowage easement rights on a farm. The ruling made no mention that the proceeds had to be reinvested in adjacent farmland in order to qualify under Section 1033.

The court also commented on the fact that no other statutory language or treasury regulation had been shown to support the Service's position. Furthermore, the only case on point specifically held that severance damages are deferrable under Section 1033. Section 1033 was designed to give relief to taxpayers who have involuntarily realized gain through condemnation and has therefore been liberally construed to accomplish that purpose. Since that section makes no distinction for the character of the condemnation award, the relief provisions of that section are available even though part of an award may be attributable to severance damages.

7.06 Sale of Rental Equipment. Section 1231(b)(1)(B) precludes capital gains treatment on the sale of property which a taxpayer holds "primarily for sale to customers in the ordinary course of his trade or business." A problem arises, however, in determining when certain property is "primarily held" for such use. In International Shoe Machine Corp. v. United States, the plaintiff was in the business of leasing shoe machines to its customers. International did not solicit any sales but still found it necessary to sell a number of the machines upon request in order to maintain a competitive position. Even though International had set up procedures for such transactions, it reported long-term capital gain on the sales contending that the machines were not held primarily for sale. The Internal Revenue Service disagreed and taxed the gain on the sales as ordinary income.

In the suit for a refund, International argued that since its policy had consistently been to lease, and not to sell its machines, any machines which were sold could not have been held primarily for sale in the ordinary course of business within the meaning of Section 1231. The district court disagreed and pointed out that the test as to whether an asset was primarily held for sale was not a comparison between rental and sales activity but rather a determination as to whether such sales formed a predictable part of the corporation's business activity. Thus, as soon as International decided to sell its machines and set up procedures to accommodate such sales, the plaintiff operated a business in which selling...
was an accepted and predictable part. Even though the sales did not constitute a major portion of the plaintiff's business, the machines were held and sold in the ordinary course of business under Section 1231.

The court also struck down the plaintiff's final contention that the transactions fell within the scope of the "rental obsolescence" cases.225 Those decisions allowed capital gains treatment on sales of rental equipment which had become obsolete for rental purposes since the sales represented a liquidation of an investment. In International's case, however, while all the machines had been rented out for several years before their sale, their useful rental lives had not yet terminated. Any sale price would have then had to include the present value of the machine's potential ordinary rental income which could not then be transformed into capital gain.

7.07 Insider's Profits. Once again a Circuit Court has found the Tax Court's construction of transactions involving the treatment of repayments of funds previously taxed at capital gains rates unpersuasive. The taxpayer in Cummings v. Commissioner226 was a member of the board of directors of a movie company who sold a portion of his stock at a gain, and within six months repurchased the same stock. Since Section 16(b) of the Securities Exchange Act of 1934227 requires that any profit made under the above circumstances must inure to the corporation, the taxpayer remitted his profit from the transaction to the corporation in order to protect his position against possible liability for insider's profits. However, while the taxpayer had originally treated his profits as long-term capital gains, he deducted his repayments as ordinary business losses and thereby realized a tax gain on the overall transaction.

The basis of the Second Circuit's decision to disallow just such a tax gain was Arrowsmith v. Commissioner.228 In that case, the Supreme Court held that an expenditure made for a business purpose could not be deducted as an ordinary business expense if it is sufficiently related to an earlier capital gains transaction. The Tax Court, however, has consistently refused to find that relationship in situations concerning Section 16(b) violations. In previous cases,229 as in Cummings, the taxpayer had claimed that the repayments were made to protect his business reputation. Because


227 15 U.S.C. § 78 (1934). Section 16(b) of the Act provides:

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reasons of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer.

228 344 U.S. 6 (1952).
the taxpayer had realized capital gains in the capacity of a shareholder while paying the alleged insider's profits as an officer of the corporation, the Tax Court has found no connection and has therefore refused to follow the Arrowsmith rule in those situations.

In Cummings, however, the Second Circuit joined two other circuit courts in reversing the Tax Court's construction of such transactions.200 The court reasoned that the nexus between the repayment and the earlier capital gains was obvious since the repayment was made solely because of the earlier sale, itself a prerequisite for liability under Section 16(b). Thus, with no distinction between the status of the taxpayer in the two transactions, the Arrowsmith rule controlled and Cummings was limited to a capital loss. To decide otherwise would be to defeat the policy of Section 16(b) in removing the incentive for short-term trading by corporate insiders. The court held that: "Without good reason, we are unwilling to interpret the Internal Revenue Code so as to allow this anomalous result which severely and directly frustrates the purpose of Section 16(b)."231 In view of the Second Circuit's decision in Cummings, as well as the holdings of the Sixth and Seventh Circuits, it seems unlikely that the remaining circuits will follow the Tax Court's adamant position.232

7.08 Hedging. Section 1233(b)(1) treats any gain upon the closing of a short sale as short-term capital gain to the extent property substantially identical to that sold short is acquired after the short sale and on or before the date the sale is closed. However, under Section 1233(g) this rule does not apply to hedges in commodity futures and, therefore, gains and losses arising out of hedging transactions result in ordinary gains and losses. In International Flavors & Fragrances, Inc.,233 the corporation, fearing a possible currency devaluation, sold British pounds short in order to protect its interest in a British subsidiary. When the currency was subsequently devalued, the corporation upon closing contract realized a large profit which would have resulted in short-term capital gain under Section 1233(b)(1). However, International Flavors decided to sell its currency contract to a bank in order to report the gain on the sale of the contract as long-term capital gain. The Commissioner argued that the sale of the contract was either a sham resulting in a short-term capital gain under Section 1233(b)(1) or that the contract itself was a hedge resulting in ordinary income under the Corn Products234 doctrine.

The majority of the Tax Court agreed with the Commissioner's

200 Id.
231 480 F.2d 1304, 1308 (7th Cir. 1973).
232 62 T.C. No. 26 (May 16, 1974).
234 Corn Products Refining Co. v. Comm'r, 350 U.S. 46 (1955). The Supreme Court held that where the purchase and sale of futures is related to the operation of the taxpayer's business, a hedge occurs and ordinary income rather than capital gain or loss is incurred.
contention that the gain resulted in ordinary income. The court felt that the short sale of British pounds was not an investment but rather a hedge against the risk of future losses of income. Since such protection constitutes an integral part of a multi-national corporation’s business, the short sale contract of currency could not then be considered a capital asset under the Corn Products rationale. It should be noted, however, that even though the taxpayers in this case had to treat its currency gains as ordinary income, had the results been a loss they would have been given ordinary business loss treatment.

7.09 Collapsible Corporation Sale of Stock. Section 341(b)(1) sets forth a definition of a collapsible corporation which may be summarized as a corporation which is formed or availed of for the construction of property with a view towards selling its stock before it realizes a substantial part of the taxable income to be derived from the constructed property. If a corporation is collapsible, Section 341(a)(3) precludes its shareholders from taking capital gains on a sale of stock which takes place within three years from the date of completion of the property if the corporation has not yet realized a substantial part of the income to be derived from such property. One of the key aspects in determining whether Section 341 applies is the extent to which the stockholder has the proscribed view towards selling out his stock interest prematurely.

In Joseph M. Crowe, the petitioner sold his stock in a land development corporation before the corporation realized a substantial part of the income expected from the property. Even though Crowe owned 50% of the stock, the Tax Court found that his sale was a capital gains transaction. The court’s decision rested on the fact that Crowe lacked the

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235 350 U.S. at 51.
236 Chemplast, Inc., 60 T.C. 623 (1973). (An appeal by the Commissioner to the Third Circuit is pending.)
   For purposes of this section, the term “collapsible corporation” means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in paragraph (3), or for the holding of stock in a corporation so formed or availed of, with a view to—
   (A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the taxable income to be derived from such property, and
   (B) the realization by such shareholders of gain attributable to such property.
238 There is some dispute as to whether it is necessary that there be the requisite view at the time the corporation is formed. See Sidney v. Comm’r, 273 F.2d 928 (2d Cir. 1960); Burge v. Comm’r, 253 F.2d 765 (4th Cir. 1958). But see Jacobson v. Comm’r, 281 F.2d 703 (3d Cir. 1960).
240 Int. Rev. Code of 1954, § 341(3) provides relief from collapsible treatment when the sale is by a non-professional stockholder and there are no professional stockholders owning more than 20% of the stock.
necessary tainted "view" under Section 341.\textsuperscript{241} Time, Inc., the other 50% stockholder, had demanded an option to buy back Crowe's interest within a five-year period as a necessary prerequisite to the formation of the corporation. After a year, Crowe ran into disputes over policy and asked Time, Inc., to give him discretion over policy matters, let him buy out Time's interest, or exercise its option to buy him out. Because Crowe intended his initial purchase of the stock to be a long-term investment and was only compelled to sell his interest by circumstances beyond his control,\textsuperscript{242} the court felt that the proscribed "view" under Section 341 was missing. Time, Inc., also lacked the proscribed "view" even though the possibility existed at the time of formation that Time, Inc., might eventually exercise the option. Since neither party intended nor wanted the option possibility to be realized, Time, Inc., therefore, lacked a purpose and the tainted "view" to buy out Crowe. Time's subsequent exercise of the option was thus only a remote possibility which could not have been expected to materialize.

7.10 Bootstrap Sales to Tax-Exempt Organizations. There were two cases decided in 1974 involving the bootstrap sale of a business to a Section 501 tax-exempt religious organization. Both transactions were patterned after the successful bootstrap sale achieved in \textit{Commissioner v. Brown}.\textsuperscript{243} The Supreme Court there found a bona fide sale and allowed the seller capital gain treatment for the $1,300,000 sale of his company's stock where the proceeds were to be paid out of the company's earnings over the next 10 years. The Court rejected the Service's argument that the transaction was not a sale or exchange of a capital asset, within the meaning of Section 1222(3), and that the proceeds should be considered ordinary income since the purchasing charity assumed no business risks and the individual sellers retained their management positions.

In \textit{Aaron Kraut},\textsuperscript{244} the only variation from \textit{Brown} was that there was a flexible purchase price for the company between $500,000 and $3,500,000, payable primarily out of 75% of the business' net income for the ensuing 10 years. In denying capital gains treatment for the $600,000 payment made in 1967, the Tax Court emphasized the excessive and flexible sales price which prevented the transaction from being a bona fide sale within the meaning of Section 1222(3). \textit{Brown} was distinguished since the fixed purchase price "had a reasonable relationship to the subject matter of the sale,"\textsuperscript{245} and that the "transaction had effected a real change

\textsuperscript{241} INT. REV. CODE OF 1954, §§ 341(b) (1) (A), (B).
\textsuperscript{242} Commissioner v. Lowery, 335 F.2d 680 (3d Cir. 1964). The court determined that in order to have the requisite view, freedom of choice is necessary in making a decision to sell the stock, and that when a sale is compelled by circumstances beyond the control of the stockholder, that view does not exist.
\textsuperscript{243} 380 U.S. 563 (1965).
\textsuperscript{244} 62 T.C. 420 (1974). The tax-exempt purchaser in this case was the Reverend Rex T. Humbard's Cathedral of Tomorrow, Akron, Ohio.
\textsuperscript{245} Id. at 426.
of economic benefit” for the tax-exempt purchaser, since it would obtain outright control over the business after the purchase price was paid.

A similar situation occurred in Berenson v. Commissioner, but with a slightly different result. The taxpayers had sold their business, which had a fair market value of $3,000,000, to a Section 501 tax-exempt religious organization for $6,000,000 with the money to be paid out of the company's earnings over the next 13 years. The Second Circuit partially reversed the Tax Court but did not distinguish this transaction from the transaction in Brown as far as $3,000,000 of the sales price was involved (the company's fair market value), and allowed the capital gains treatment for this amount. To this extent there was a bona fide sale within the meaning of Section 1222(3). The balance of the purchase price was deemed to be excessive, making it distinguishable from Brown, and the court ruled that this excess amount had to be treated as an ordinary income payment.

Section 514, enacted in the 1969 Tax Reform Act, repealed the preferred tax-exempt status of religious organizations for their unrelated business income. Thus, the effects of, and tests imposed by, Brown, Kraut and Berenson on debt-financed purchases have been mooted. Since all Section 501 organizations are now subject to tax on their unrelated business income, the tax advantages of this type of bootstrap sale have been minimized.

8.00 Procedure

8.01 Withdrawal of Tax-Exempt Status. The Anti-Injunction Act, Section 7421(a), reads in part: “... no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.”

Determination of this Act's purpose and applicability has not been consistent and only recently has the Supreme Court decided to abandon an uncertain pattern of interpretation of the Act in favor of looking to its plain meaning. In Bob Jones University v. Simon, the Court refused to grant an injunction to prevent the withdrawal of the university's tax-exempt status under Section 501(c)(3). The Court reasoned that since the injunction would restrain the collection of taxes, Section 7421(a) was a clear bar to the action.

Until the early 1920's, the courts had applied literal force to the Act

246 Id. at 425.
248 INT. REV. CODE of 1954, § 7421(a). This portion of the Act is identical to § 10 of the Act of March 2, 1867, but for the first “any” which was added to the Revised Statutes version in 1878.
implying that only unspecified extraordinary and exceptional circumstances would justify a pre-enforcement injunction suit. In 1922, the Supreme Court found just such a circumstance and allowed a pre-enforcement injunction action against tax statutes that were really penalties in disguise. However, the court was soon to note that such an interpretation had no application to truly revenue-raising tax statutes. The first major deviation came in Miller v. Standard Nut Margarine Co., in which the court applied a new definition to the "extraordinary and exceptional circumstances" test. The decision equated the test with the traditional equitable requirements for issuance of an injunction. Thus if literally applied, the test would require nothing more than what equity had demanded before the Act's passage.

This interpretation was rejected in Enochs v. Williams Packing and Navigation Co. involving a taxpayer-corporation that furnished its own boats to various captains of its own choice. These captains then hired the crews and later sold back the catch to the corporation. The government contended that the corporation was an employer of fishermen and, therefore, was liable for social security and unemployment taxes. The Court held that in order to avoid the literal terms of Section 7421(a), the taxpayer must satisfy a two-part test. The injunction would be refused unless (1) it was clear that under no circumstances could the government ultimately prevail and (2) equity jurisdiction was also found to exist. Since the Court felt that the government's claim was not without foundation, the Court refused to enjoin the collection of the disputed taxes.

The question presented in Bob Jones University v. Simon was whether, prior to the assessment or collection of any tax, a court may grant an injunction prohibiting the Service from revoking a letter ruling declaring the petitioner qualified for tax-exempt status under Section 501(c)(3). Bob Jones University is devoted to a religious belief that God intended segregation of the races and, as a result, does not allow blacks as students. In 1970 the Service announced that it would no longer allow tax-exempt status for private schools maintaining racially discriminatory

253 284 U.S. 498 (1932).
255 Id. at 7. This decision switched the focus of the "extraordinary and exceptional circumstances" test from merely equitable considerations to a requirement that the action called for by the Service be totally without legal merit.
256 Rev. Proc. 72-39, 1972-2 CUM. BULL. 818. Such a letter ruling leads to inclusion in the Service's Cumulative List of tax-exempt organizations and assures potential donors in advance that contributions to such an organization will qualify as charitable deductions under the Code. INT. REV. CODE OF 1954, § 170(c)(2).
admissions policies. Upon request, the university advised the Service that it did not admit blacks and further stated that it had no intention of altering this policy. The Commissioner then instructed the District Director to revoke the letter ruling affecting Bob Jones University's Section 501(c)(3) status. The university filed suit for preliminary and permanent injunctive relief in order to prevent the Service from revoking the university's tax-exempt status. While the district court granted the preliminary injunction requested, the Fourth Circuit reversed on the ground that the university’s action was barred by Section 7421(a) as interpreted in Williams Packing.

The university contended that Section 7421(a) was inapplicable because the suit was not one “for restraining the assessment or collection of any tax...” but was for the purpose of compelling the Service to refrain from withdrawing its tax-exempt status under Section 501(c)(3). The Court, however, looked to the underlying purpose of the suit and reasoned that since the revocation of the university’s letter ruling would result in substantial tax liability, the case fell within the scope and purpose of Section 7421(a). That purpose is the protection of the Service's need to assess and collect taxes as expeditiously as possible with a minimum of pre-enforcement judicial interference, “and to require that the legal right to the disputed funds be determined in a suit for a refund.”

In the companion case to Bob Jones, the Supreme Court refused to distinguish Alexander v. “Americans United” Inc. from Williams Packing for purposes of Section 7421(a) or to exempt that suit from the two-part test. Americans United is a non-profit educational institution whose purpose is to defend and maintain religious liberty through the dissemination of knowledge concerning the separation of church and State. In 1969 the Service issued a letter ruling revoking the organization’s tax-exempt status on the ground that it had violated Sections 501(c)(3) and 170(c)(2)(D) by devoting a substantial part of its activities to attempts to influence legislation. Although revocation of Americans United’s tax-exempt status did not result in any tax liability, the 1969 letter ruling caused a decrease in its contributions because it destroyed the taxpayer’s eligibility for tax-deductible contributions under Section 170.

The court of appeals reversed the district court and held that the taxpayer’s suit was not within the scope of Section 7421(a) and rested its decision on three factors. First, the proscriptions against efforts to

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259 370 U.S. at 7.
261 Although the corporation’s § 501(c)(3) tax-exempt status was revoked, it still qualified for tax-exempt status under § 501(c)(4).
influence legislation found in Section 501(c)(3) were unconstitutional. Second, the suit was not brought to enjoin the assessment or collection of the taxpayer's own taxes, and third, any restraint on the assessment or collection of the taxes of its contributors was only a "collateral effect" of the suit.\textsuperscript{263}

The Supreme Court disagreed with the court of appeals' interpretation stating that under the two-part test in \textit{Williams Packing}, "the constitutional nature of a taxpayer's claim, as distinct from its probability of success, is of no consequence under the Anti-Injunction Act."\textsuperscript{264} Since the Court felt that the government's action was not without foundation, the suit was barred. Furthermore, even though the suit would not affect Americans United's own tax liability, that fact made little difference, since Section 7421(a) speaks of a suit restraining the collection or assessment of "any tax" and "by any person, whether or not such person is the person against whom such tax was assessed." Thus a suit to enjoin any tax collection or assessment of the taxpayer's contributors triggered the literal terms of Section 7421(a). Finally, the Court dismissed the claim that the tax question was at best a "collateral effect" and refused to grant an injunction requiring the reinstatement of the taxpayer's Section 501(c)(3) letter ruling. Because the primary objective of the suit was to restore advance assurance that donations to the corporation would qualify as charitable deductions, the Court held that Section 7421(a) precluded relief since the injunction would never have been requested unless it also effectively restrained taxation of its contributors.

8.02 Anti-Injunction Act. While Section 7421(a)\textsuperscript{265} precludes a taxpayer's suit that seeks to restrain the collection of taxes, is that section broad enough to cover actions which challenge only the method of collection and not the collection itself? In reversing a Pennsylvania district court decision, the Supreme Court held in \textit{United States v. American Friends Service Committee}\textsuperscript{266} that the anti-injunction provision posed an absolute bar to the taxpayer's claim for injunctive relief. The controversy arose when two practicing Quakers asked their employer, American Friends, not to withhold 51.6\%\textsuperscript{267} of their wage withholding taxes.\textsuperscript{268} Since both taxpayers were conscientiously opposed to participation in war in any form, they argued that to contribute their portion of taxes used for war or defense without bearing witness to their religious beliefs

\textsuperscript{263} \textit{Id.} at 1177-79.

\textsuperscript{264} 94 S. Ct. at 2058.

\textsuperscript{265} Anti-Injunction Act, 26 U.S.C. § 7421(a) (1966).


\textsuperscript{267} This figure represents the taxpayers' estimate of the percentage of the federal budget which is allocated for defense.

\textsuperscript{268} 26 U.S.C. § 3042 (1966), which states in part: "... every employer making payment of wages shall deduct and withhold upon such wages (except as otherwise provided in this section) a tax determined in accordance with the following tables..."
would violate their right to exercise freely their religion as guaranteed by the first amendment. The district court agreed with the taxpayer's contention and enjoined the United States from enforcing Section 3402 as against American Friends with respect to the disputed portion of the tax. Even though the government was able to show that the interest and penalties on the tax deficiencies would not offset the cost to the Service of collecting the disputed taxes through the levy process, the court found that the minor additional cost and inconvenience which would result was not a sufficient reason to overcome the taxpayers' first amendment privilege.\textsuperscript{269}

In reversing this decision, the Supreme Court relied on the test espoused in \textit{Enochs v. Williams Packing & Navigation Co.}\textsuperscript{270} There the Court held that the assessment or collection of taxes could be enjoined only if it was clear that the government could in no circumstances ultimately prevail on the merits.\textsuperscript{271} Since the taxpayers both conceded that they did not fall within the \textit{Williams Packing} exception, the injunctive relief granted by the district court was plainly at odds with the objectives of the section: "efficient and expeditious collection of taxes with 'a minimum of preenforcement judicial interference,' and protection of the Collector from litigation pending a refund suit."\textsuperscript{272}

The dissent distinguished the taxpayers' position from that in \textit{Williams Packing} where there was an adequate legal remedy in a suit for a refund. In the instant case, however, the withholding method itself was attacked on the grounds that it violated their right to exercise their religion. The relief sought did not restrain the collection of taxes but merely required that a different method of collection be used.

\textbf{8.03 Joint Return Liability.} Section 6013(d)(3) provides for joint tax liability between a husband and wife if they file joint returns. However the Treasury has issued new regulations which will relieve an innocent spouse from liability where there has been a significant underpayment in the joint return by the other spouse.\textsuperscript{272} In order for the new Treasury Regulation 1.6013-5 to apply, the spouse must show that: (1) he or she filed a joint return with the other spouse; (2) the amount improperly omitted exceeded 25\% of the gross income stated in the return; (3) he or she did not know or have any reason to know of the omission, and, (4) it would be inequitable to hold the innocent spouse liable for the deficiency attributable to the other spouse's omission.\textsuperscript{274} In determining whether it would be inequitable to hold the innocent spouse

\textsuperscript{269} Sherbert v. Verner, 374 U.S. 398 (1963). The Supreme Court held that only the gravest abuse which would endanger a paramount interest of the state could allow a limitation in this highly sensitive constitutional area.

\textsuperscript{270} 370 U.S. 1 (1962).

\textsuperscript{271} See text accompanying notes 249 to 264, supra.

\textsuperscript{272} 95 S. Ct. at 16.

\textsuperscript{273} T.D. 7320, 1974 INT. REV. BULL. No. 35, at 15.

\textsuperscript{274} Treas. Reg. § 1.6013-5(a).
liable, the new regulations require that all relevant facts and circumstances must be considered, especially the degree to which the innocent spouse has benefitted from the items omitted.275

Similar relief has also been given to protect the innocent spouse from fraud penalties imposed for the underpayment of taxes under Section 6653. Now a spouse filing a joint return is not held liable for a fraud penalty unless it is due to his own personal fraudulent conduct. Therefore, an innocent spouse will not be assessed for a fraud penalty solely because he has filed a joint return with a defrauding spouse.276

8.04 Determination of State Law. Is a federal court conclusively bound by a state trial court adjudication of property rights where the United States is not made a party to the action? This question was answered in the negative by the Supreme Court in Commissioner v. Estate of Bosch.277 However, while a federal court may not be conclusively bound, absent a judgment by the state's highest court, proper regard must still be given to relevant rulings of other courts of the state in order to adequately determine the applicable state law.278 In Pirrie v. United States,279 the Ninth Circuit Court of Appeals reversed a district court's ruling which had disallowed a marital deduction on a bequest left to the plaintiff. The district court read the bequest as passing a terminable interest to the plaintiff and barred the deduction under Section 2056(b). The court reasoned that under the Bosch rule, even though a state probate court had construed the bequest as passing a nonterminable interest, it was not bound by the decree absent a judgment by the state's highest court.

The Ninth Circuit Court of Appeals interpreted the holding in Bosch differently. That court has held that it is only when there is persuasive data showing that the state's highest court would decide otherwise could a federal court disregard a state court's determination of state law.280

8.05 Standing—Injury in Fact. In Tax Analysts and Advocates v. Schultz,281 the district court for the District of Columbia held that a non-profit corporation organized for the purpose of promoting tax reform had sufficient standing to challenge the validity of Revenue Ruling 72-355.282 This ruling declared that gifts of up to $3,000 to multiple finance committees organized to receive contributions for the campaign of one political candidate are to be treated as gifts to the individual

275 Treas. Reg. § 1.6013-5(b).  
276 Treas. Reg. § 301.6653-1(f).  
278 Id. at 465.  
280 Id. at 74-1361.  
committees and not to the candidate. Contributors were thus allowed to take a $3,000 exclusion under Section 2503(b) for each such donation, even though the separate contributions would simply be funneled to the central finance committee of the candidate. Individual donors contributing more than $3,000 to a candidate's campaign could thereby escape the gift tax which would have been imposed had all the contributions been made directly to the candidate's central campaign committee.

The Service argued that Tax Analysts and Advocates lacked standing because they failed to show any "injury in fact" or that they were within the "zone of interest" which was sought to be protected. The court disagreed with the government's contention and stated that the two-pronged test for standing had come under considerable criticism and that the decisions in Sierra Club v. Morton, and United States v. SCRAP were controlling on the issue of standing. Accordingly, the "zone of interest" test is now only a "collateral area of inquiry.

In United States v. SCRAP, the plaintiff was a group of law students formed for the purpose of enhancing the quality of the environment for its members and all citizens. The organization brought suit to enjoin the enforcement of a general railroad freight increase which would have applied to both recyclable and non-recyclable goods. SCRAP argued that since the government had not prepared a detailed environmental impact statement, the rate increase was therefore illegal. SCRAP's alleged injury, for standing purposes, was that the increased use of non-recyclable goods caused by the modified rates meant a drain on the Washington area's natural resources as well as more refuse, all of which adversely affected the area's national parks which SCRAP members used. The Supreme Court accepted this line of causation between the allegedly illegal conduct and the complained-of injury even though the plaintiffs had only a "small stake" in the outcome of the litigation.

In Tax Analysts, a member of the organization alleged that Revenue Ruling 72-355 injured him by "dismissing his ability to affect the electoral process and to persuade elected officials to adopt policies and programs he favors." Because the ruling allowed contributions of more than $3,000 to the same candidate to escape the gift tax, the influence of persons making large contributions would be increased while diminishing the impact of those persons making smaller contributions. The district court concluded that: (1) The alleged dilution of the taxpayer's ability to affect

284 376 F. Supp. at 897.
287 376 F. Supp. at 897.
289 376 F. Supp. at 898.
the electoral process was a judicially recognizable wrong; (2) even though others are similarly injured, that fact did not preclude standing; (3) the causal link between Revenue Ruling 72-355 and the alleged injury while strained, was more persuasive than that upheld in SCRAP, and, (4) the alleged harm gave the taxpayer a sufficient stake in the outcome of the case in order to qualify as a case or controversy under article III of the United States Constitution.

The court also dismissed the government's contention that Section 7421(a) barred the suit as a restraint on the collection of taxes. That section had no application to the present suit because Tax Analysts was not seeking to restrain the Commissioner from collecting taxes, but rather was seeking to require him to collect additional taxes required by law.

The district court awarded summary judgment to Tax Analysts on the basis of Helvering v. Hutchings, in which the Supreme Court held that the beneficiary of a trust and not the trust itself is the person to whom the gift is made and therefore for which the deduction will be allowed. Otherwise the donor could avoid the limitation upon allowed exemptions by creating a number of trusts for the benefit of a single beneficiary. The district court found that the Hutchings "benefit theory" was broad enough to cover the situation in Tax Analysts and that Revenue Ruling 72-355 was, therefore, not a lawful interpretation of Section 2503(b).

8.06 Disclosure of Tax Information. A recent Treasury Decision has clarified the circumstances under which it is permissible for tax return preparers to disclose or use the tax return information of their customers under Section 7216. Treasury Regulation 301.7216-2 permits disclosure by a tax return preparer when it is done pursuant to other provisions of the Code, to court orders, or in order to prepare state and local tax returns. In cases involving related taxpayers whose interest is not adverse to each other and in those cases concerning disclosure to a taxpayer's fiduciary, the tax return preparer may give return information without the formal consent of the taxpayer.

Treasury Regulation 301.7216-3 prohibits disclosure or use of such information in other situations unless it is done with the formal consent of the taxpayer. Thus, these regulations preclude a tax return preparer from selling his customers' names and information to those interested in forming mailing lists.

8.07 Access to Private Rulings. Can the Internal Revenue Service
be compelled to release private letter rulings? Generally, such disclosure is prohibited without the Commissioner's approval, however the Treasury has established a procedure which must be followed by the Service when such disclosure is requested or demanded. In Queen's-Way To Fashion, Inc. v. United States the Service notified the plaintiff that its distributors were to be considered as employees and therefore the corporation was required to withhold taxes as well as make employer contributions. Queen's-Way alleged discrimination and in order to prove that the Service's national position was to treat such distributors as independent contractors, it demanded access to all private rulings issued individuals engaged in the business of direct selling on a commission basis. The Service contended that the private rulings were tax returns and, therefore, Section 7213(a)(1) restricted their disclosure. Relying on Tax Analysts and Advocates v. Internal Revenue Service, the court disagreed and stated that except for certain information furnished by the individual taxpayers, the release of the rulings is not barred by the restriction on disclosure of tax returns. In Tax Analysts the Court held that such rulings were not returns submitted by the taxpayers, but rather documents generated by the agency.

In a similar case, Fruehauf Corp. v. Internal Revenue Service, the Service again tried to bar the access to private rulings requested by taxpayers. The plaintiffs there alleged that the rulings were essential for their defense of a conspiracy charge. The Service resisted disclosure under the Freedom of Information Act by pointing to one of its exceptions. Section 552(b)(3) of the act provides that: "This section does not apply to matters that are—(3) specifically exempted from disclosure by statute." The statute relied on by the Service was Section 6103 of the Code which provides for the confidentiality of tax returns. However, the district court held that the Code section had no application to the private rulings sought by Fruehauf, and, to the extent any material included might constitute an invasion of privacy, safeguards could be taken to prevent its disclosure.

The Service itself is having second thoughts on the rules regarding the availability of private tax rulings. The Service has announced a plan

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295 A "private" or "letter" ruling is a written statement issued to a taxpayer by the Office of Assistant Commissioner (Technical) in which interpretations of the tax laws are made and applied to a specific set of facts. The function of a "letter" or "private" ruling is to advise the taxpayer in advance of the tax treatment that he can expect from the Service under the specified circumstances. Treas. Reg. § 601.201(a)(2).
299 362 F. Supp. at 1308.
which would open up private rulings for public inspection.\textsuperscript{304} The plan would require taxpayers to submit waivers of confidentiality when seeking a private ruling on their special facts. Such a plan, however, would not affect previous rulings and until the Service resolves certain problems involving the disclosure of trade secrets, it will resist disclosure unless forced to do otherwise.

8.08 Self-Incrimination—Attorney-Client Privilege. A taxpayer may not invoke the constitutional privilege against self-incrimination to prevent the production of his tax records unless they are in his possession.\textsuperscript{308} Furthermore, a taxpayer's privilege does not extend to his accountant's work papers which the accountant has transferred directly to the taxpayer's attorney.\textsuperscript{306} The issue arises as to whether this privilege extends to a taxpayer's tax records which he has received from his accountant and personally transfers to his attorney. This question was decided in the affirmative in United States v. Kasmir,\textsuperscript{307} in which the Fifth Circuit stated that since the taxpayer could have asserted his fifth amendment rights had he held on to the papers, the subsequent transfer to his attorney did not affect his right to raise the fifth amendment privilege.

In Kasmir, a taxpayer was visited by two special agents of the Internal Revenue Service who were investigating the taxpayer's previous tax returns and had asked to see the taxpayer's personal books and records. Before complying with the request, the taxpayer called his accountant who then advised him not to produce any of the requested material. The next day, the accountant delivered an assortment of records and documents to the taxpayer which had up to that time been in the accountant's possession. The taxpayer immediately turned the documents over to Kasmir as his attorney. Kasmir refused to comply with a subpoena ordering him to give up the material. The district court then granted the government's petition for enforcement on the grounds that the records had been owned by the accountant. On appeal, Kasmir contended that enforcement of the subpoena for the production of the records would violate the taxpayer's self-incrimination privilege.

The Fifth Circuit agreed with Kasmir and cited Couch v. United States\textsuperscript{308} as controlling. In Couch, the taxpayer had instructed her accountant to deliver her financial records directly to her attorney after a subpoena had been issued and served upon that accountant to produce the material. The Supreme Court held that the taxpayer had no fifth amendment privilege in the documents. Since the documents had been in continuous possession of the accountant for over 10 years, the taxpayer

\textsuperscript{304} Press Release, INT. REV. 1409 (Aug. 9, 1974).
\textsuperscript{307} 499 F.2d 444 (5th Cir. 1974).
\textsuperscript{308} 409 U.S. 322 (1973).
could not show any legitimate expectation of privacy. This is so since the accountant's own need for self-protection would often require the right to disclose the information given him. The Court in *Couch* held that actual possession, rather than ownership, was determinative for fifth amendment purposes. The Court, however, did note that actual possession was not necessarily the *sine qua non* for successful assertion of the self-incrimination privilege: "... situations may well arise where constructive possession is so clear or the relinquishment of possession is so temporary and insignificant as to leave the personal compulsions upon the accused substantially intact..."³⁰⁹

The court focused on two factors: first, the party in possession of the evidence and second, in situations where the actual possessor is not the taxpayer, the taxpayer's legitimate expectation of privacy with regard to that evidence.³¹⁰

In *Kasmir*, however, the Fifth Circuit reasoned that since the taxpayer had first received the records back from his accountant his possession then came within his "private enclave" and therefore was covered by fifth amendment rights. In transferring these papers to his attorney the taxpayer retained an expectation of privacy through the attorney-client relationship. The Fifth Circuit also rebuked the government's contention that the attorney lacked standing to assert the taxpayer's claim of privilege, because "the realities of tax litigation require that the attorney be allowed to press his client's claim," and here his client could have successfully done so.³¹¹

8.09 Failure to File Return. An attempted extension of the privilege against self-incrimination³¹² was reversed by the Fourth Circuit in *Higginbotham v. United States*.³¹³ Assessments were made for federal wagering excise taxes³¹⁴ against the taxpayer after the three-year limitations period had expired. The Service contended that since the taxpayer had failed to file a return the applicable statute of limitations did not apply.³¹⁵ The taxpayer successfully asserted at the district court level that since he could not file a return without incriminating himself, denial of the advantages of the limitations period constituted an impermissible punishment.

The Fourth Circuit refused to accept the taxpayer's interpretation and reversed the district court's decision. According to the rule set forth

³⁰⁹ *Id.* at 336.
³¹⁰ 499 F.2d at 449.
³¹¹ *Id.* at 452-453.
³¹³ 491 F.2d 432 (4th Cir. 1974).
³¹⁵ INT. REV. CODE OF 1954, § 6501(c). "Exceptions.—(3) No return.—In case of failure to file a return, the tax may be assessed, or a proceeding in a court for the collection of such tax may be begun without assessment, at any time."
in United States v. United States Coin & Currency, the self-incrimination privilege merely precludes the government from punishing the taxpayer for his failure to file a return, however, the government is still free to collect any taxes which are proved to be due. In the instant case, the taxpayer was not being prosecuted for either his failure to pay the occupational tax or his failure to file a return. Since the statute of limitations makes no distinction between those owing gambling taxes and those owing ordinary taxes, a denial to toll the statute of limitations for the taxpayer was not an unconstitutional fetter upon the exercise of his fifth amendment right. To decide otherwise would give Higginbotham an advantage over other taxpayers who are required to file a return in order to take advantage of the limitation period.

8.10 Notice of Disallowance of Refund Claim. Section 6532(a)(3) provides that a taxpayer who waives the requirement that he be mailed a notice of disallowance of a refund claim has two years from the execution of waiver in which to sue for a refund. Otherwise, under Section 6532(a)(1), the statute of limitations begins to run when the Service mails its formal notice of disallowance. In Miller v. United States, however, the Service sent the taxpayers a formal notice of disallowance 18 months after the Millers had executed a waiver of such notice. Since the taxpayers waited more than two years from execution of their waiver before filing suit, the court had to decide whether the formal notice extended the original two-year statute of limitations period. The government contended that the earlier date should control and based its argument on Section 6532(a)(4). That section provides that any reconsideration after a notice of disallowance or waiver has been mailed or executed shall not extend the period for bringing suit. Since the Service itself was unable to produce the original waiver of notice, the Millers' reliance on the formal notice of disallowance to extend the statute of limitations was found to be justified.

8.11 Notice of Tax Sale and Adjournment. While it is clear that the Service must give a taxpayer notice of the date his property is to be sold at a tax sale, both the Code and the regulations are silent as to whether notice of adjournment and a new sale date are required. In United States v. Conry, a California district court held that such notice must be given. In that case, the date of sale was twice postponed before the sale was finally held. Because the taxpayer failed to exercise his right of redemption within the allotted time, a quitclaim deed was recorded in

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317 Id. at 717.
318 500 F.2d 1007 (2d Cir. 1974).
319 Treas. Reg. § 301.6532-1(d).
320 INT. REV. CODE OF 1954, § 6335(b).
322 INT. REV. CODE OF 1954, § 6337(b)(1).
favor of the United States. The government then brought an action to acquire possession of the property still occupied by the taxpayer.

The taxpayer contended that since Section 6335(b) requires that notice of a tax sale be given to the property owner, notice of the adjournments must also be given. In the absence of such notice, the sale could not operate to convey title. The court agreed with the taxpayer. Since Section 6335(b) demonstrated congressional concern to protect the rights and interest of the property owner through the notice requirement, the grant of authority to adjourn, under Section 6335(e)(2)(F), must be read as “subject to an implied restriction that any regulations concerning the adjournment of tax sales must provide for reasonable notice of adjournment to the property owner.” Treasury Regulation 301.6335-1(c)(2) fails in this respect, and therefore, the court held that it was deficient in that it did not comply with the statutory grant of authority.

Nevertheless, the government still maintained that the court had no jurisdiction over the case because Section 7421(a) disallows a suit brought for the purpose of restraining the assessment or collection of any tax. Since a court action voiding the tax sale would constitute such a restraint of collection or assessment of taxes, the government argued that the court must dismiss the suit as prohibited by Section 7421(a). The court did not accept this argument, reasoning that a taxpayer must have the right to challenge the government's failure to comply with the notice requirement. Several cases have allowed such challenges to the validity of title to property acquired from the government by third-party purchasers. However, the government and Section 7421(a) were not directly involved because the government's collection of taxes, already realized through the tax sale, was not disturbed. In Conry, however, the taxpayer's only recourse would have been to permit the government to sell the property and then seek to reacquire it from the subsequent purchaser. Such a prospect would cast a serious cloud over the title of any property conveyed by the government in this way, since an innocent third-party purchaser might eventually be required to reconvey title back to the taxpayer. To preclude just such a situation the court held that, where “the suit is initiated by the government and the taxpayer seeks to raise the notice issue simply as a defense to the government’s action, Section 7421 should not be read to bar assertion of that defense.”

8.12 Notice of Tax Lien. In United States v. Peoples Bank of

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323 Infr. Rev. Code of 1954, § 6335(e)(1). Since there were no bids, the property passed to the United States for the minimum price.
325 Treas. Reg. § 301.6335-1(c)(2).
Stafford, an Internal Revenue Service agent served the bank with notice of levy upon a taxpayer's bank account the day after he had telephoned the bank inquiring as to the existence of the account. The bank, suspecting that a tax lien would be placed upon the taxpayer's account, set off a loan of the taxpayer against his account immediately after receiving the telephone call. The Service brought suit to compel the bank to pay over the amount which it had charged against the taxpayer's account. The Service contended that the telephone call to the bank was sufficient notice under Section 6323(f) to impose the tax lien upon the account. In the resulting litigation, the court dismissed the government's suit, holding that something more than a telephone call was needed to file notice of a tax lien with a holder of a security interest in the subject property.

8.13 Deficiency Notice—Jeopardy Assessment. The Sixth Circuit held in Rambo v. United States, that the Internal Revenue Service must send a taxpayer a deficiency notice before assessing and collecting any tax due as part of a short-year jeopardy assessment under Section 6851. This section provides for the termination of the taxpayer's tax period, and authorizes the Secretary to demand payment of the tax due for the short year when the possibility exists that the taxpayer may do something to render the collection of the tax ineffectual. Both the Second and the Seventh Circuits agree that notice is not needed. In Rambo, the taxpayer was found with a supply of drugs whereupon the Service, pursuant to Section 6851, terminated his tax year and determined the amount of income tax due for the short tax period. Upon assessment of the tax, the Service filed a tax lien and served notices of levy upon the taxpayer's bank and property. Rambo contended that since the Service had failed to send him a deficiency notice within 60 days after the jeopardy assessment, he was denied the procedural safeguards mandated under the law. The Sixth Circuit agreed with the district court which had ordered the Internal Revenue Service to return all of the seized property and to remove its liens from Rambo's property.

The Service contended that the government's assessment authority

331 375 F. Supp. at 344.
332 492 F.2d 1060 (6th Cir. 1974); petition for cert. filed 43 U.S.L.W. 3017 (U.S. July 10, 1974).
333 Laing v. United States, 496 F.2d 853 (2d Cir. 1974); Williamson v. United States, 31 Am. Fed. Tax R.2d 800 (7th Cir. 1971).
335 Such a deficiency notice is a jurisdictional prerequisite to the right to petition the Tax Court for a redetermination of the tax. Int. Rev. Code of 1954, § 6213(a). Otherwise, the taxpayer must pay the full tax and then bring suit in a federal district court for a refund. Flora v. United States, 362 U.S. 63 (1958).
under Section 6851 came from the general assessment power under Section 6201 which does not require notice of deficiency. The Sixth Circuit disagreed with this contention, stating that the statutory authority for assessing the short-year tax is conferred by Section 6861. This section immediately follows Section 6851 and appears in the Code under the heading "Jeopardy Assessment." Section 6861(b) requires that such notice of deficiency be made within 60 days after the making of the assessment, and if the Service fails to issue the notice, then pursuant to Section 6213(a), the tax collection may be enjoined.

Recently, however, the Second Circuit in Laing v. United States, rejected the Sixth Circuit's interpretation, and reaffirmed its prior position denying the deficiency notice requirement in Section 6851 situations. In Irving v. Gray, the Second Circuit had agreed with the Seventh Circuit which held that the deficiency notice requirement cannot be read into Section 6851 because the assessment is not a deficiency as defined under Section 6211. Since a deficiency is defined as the amount by which the tax imposed exceeds that shown on the tax return when no return has been filed, a deficiency could not, therefore, be determined. The Sixth Circuit disagreed with this distinction and concluded that the short-year tax assessment was in fact a deficiency. The court noted that the regulations provide that where no return is filed or if a return is filed which lists no tax, "the deficiency is the amount of tax imposed by Subtitle A, Chapter 11, or Chapter 12." Therefore, the tax imposed by the Service became a deficiency when Rambo refused to pay the imposed tax or file a return.

Both the government in Rambo and the taxpayer in Laing have sought Supreme Court review to clarify this issue. Unless this conflict is resolved by the Supreme Court the procedural safeguards in the jeopardy assessment area will be greater in the Sixth Circuit than in either the Second or Seventh Circuits.

8.14 Head of Household. The head of a household, under Section 2(b)(1)(B), must pay over 50% of the household expenses. In an opinion which sought out substance over form, the Tax Court ruled, in Estate of Jean Foster Fleming, that there could be a household within a household.

337 492 F.2d at 1062.
338 496 F.2d 853 (2d Cir. 1974).
340 Id. at 24.
341 31 Am. Fed. Tax R.2d 73-800.
342 INT. REV. CODE OF 1954, § 6211(a).
343 492 F.2d at 1064.
344 Treas. Reg. § 301.6211-1(a).
345 492 F.2d at 1064.
346 43 P-H TAX CT. MEM. ¶ 74,137 (May 29, 1974).
Mrs. Fleming, her unmarried daughter, her married daughter and son-in-law built their own house. One floor of the house was for the exclusive use of Mrs. Fleming and her unmarried daughter, another floor was exclusively for married daughter's family, and the remainder was used by all. Mrs. Fleming paid over 50% of the expenses related to the floor used by herself and her daughter, but less than 50% of the entire household expenses. The court rejected the “one house, therefore one household” argument used by the Commissioner. The floor for the exclusive use of Mrs. Fleming and her daughter operated independently from the remainder of the house in many matters, thereby qualifying as a separate household for tax purposes.

8.15 Bankruptcy—Income Tax Refund. Section 70(a)(5) of the Bankruptcy Act vests title in the trustee of the estate of a bankrupt to all alienable property which the bankrupt may possess at the time he files his petition. Because the thrust of Section 70(a)(5) is to secure for the creditors everything of value that the bankrupt owns, the Supreme Court has given the term “property” a broad definition. This interpretation is tempered, however, by the fact that the bankrupt is then free to make a fresh start, unencumbered by his past debts.

In *Kokszka v. Belford,* the petitioner filed a voluntary petition in bankruptcy out of which the sole asset claimed by the trustee in bankruptcy was an income tax refund check for $250.00. The Referee in Bankruptcy directed the petitioner to turn the check over to the trustee upon receipt. The petitioner complied with the order but filed a petition for review contending that the tax refund was not “property” under Section 70(a)(5).

The term “property” has never been given a precise or universal definition. In *Lines v. Frederick,* the Supreme Court held that vacation pay which had accrued prior to the time of filing for bankruptcy was not “property” within the meaning of Section 70(a)(5). The Court reasoned that vacation pay was a substitute for wages and that to deprive the petitioner of this income would hamper his ability to make a fresh start. Wages pose “distinct problems in our economic system,” since they provide the basic means for the economic survival of the debtor, and therefore should not be included within Section 70(a)(5) property.

Relying on the *Lines* decision, the petitioner in *Kokszka* contended that since his tax refund was solely derived from wages it should also be

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249 Id. at 380. See also Burlington v. Crouse, 228 U.S. 459, 473 (1913).
251 Id. at 2433.
253 Id.
exempt from Section 70(a)(5). The Supreme Court disagreed with petitioner's contention stating that while both the vacation pay and petitioner's tax refund were wage based, the vacation pay was substituted for future weekly income which would be necessary for the debtor's basic support. The tax refund, on the other hand, was sufficiently rooted in the bankrupt's past and therefore related to those debts which brought on the bankruptcy. To allow the refund to pass to the trustee would not hinder a fresh start for the petitioner but would supply more incentive to begin anew.

In the alternative, the petitioner argued that even if the tax refund was Section 70(a)(5) property, 75% of the refund should still be exempt under the provisions of the Consumer Credit Protection Act. The Act provides that 25% of a person's aggregate disposable earnings for any pay period may be subject to garnishment. The petitioner contended that his tax refund, being solely derived from wages, was "disposable earnings" and that the vesting of the same in the trustee was a "garnishment" under Section 1672(a)(b) and (c). The Court, however, held that the Consumer Credit Protection Act must be read in light of and in connection with the Bankruptcy Act. Since the Consumer Credit Protection Act was passed in part to prevent personal bankruptcies, if despite its protection a bankruptcy did occur, any protection or remedy must then fall within the scope of the Bankruptcy Act.

9.00 Inventory

9.01 Unit Livestock Price Method. Treasury Regulations 1.471-6(e) authorizes the use of a "unit livestock price method" when valuing the inventories of livestock raisers and other farmers. The regulation provides that if animals purchased are not mature at the time of purchase, the cost must be increased at the end of each tax year in accordance with established unit prices. However, no increase has to be made on animals purchased in the last half of the year.

In Auburn Packing Co., the Tax Court determined the unit-livestock price method of valuing inventory was not limited to taxpayers who breed herds but could also be used for cattle held for fattening and slaughter. Auburn Packing Co. purchased feeder cattle, fed them grain feed for 60 to 120 days and then either sold or transferred them to their slaughter plant. The Tax Court held the Service could not upset Auburn Packing's consistent use of the unit-pricing method. The Service was...
found to have no power to make taxpayer switch to the lower of cost or market inventory valuation method.

By way of Revenue Ruling 74-505, the Service has agreed to follow the taxpayer's victory in *Auburn Packing*. However, the Service stated that the decision in the Tax Court was correct only because the inventory method in dispute was one authorized by the regulations and had been consistently used by the taxpayer. But if the method has not been used consistently, the Service has the authority under Section 446 to deny the use of the unit-price method.

9.02 LIFO Inventory Valuation. The year 1974 saw a tax development which is not attributable to any court decision, statutory enactment or Internal Revenue Service pronouncement. This is the unprecedented number of firms that have converted to the LIFO method of accounting for inventory. A review of the financial pages at times makes it appear that the Commissioner is virtually being inundated by Forms 970 (the form which must accompany the tax return for the year in which LIFO is first used). The recent changes will probably result in future litigation and official pronouncements, but currently the phenomenon has not had such an effect. In this section we wish to briefly review LIFO, the reasons for its adoption and why we haven't seen greater adoption in the past.

Section 471 requires the use of inventories whenever they are necessary to determine income, stating only that the method employed must as nearly as possible conform with the best practice in the trade or business and clearly reflect income. The inventory is costed either under specific identification or using a flow assumption. Keep in mind that regardless of the method employed the physical quantity is the same. The most popular flow assumption is FIFO, which stands for first-in, first-out. FIFO assumes that the ending inventory is comprised of the items which were most recently acquired. LIFO, which is specifically allowed by Section 472, is an abbreviation of last-in, first-out. Under the latter flow assumption, the ending inventory is considered to consist of items with the earliest costs of the period.

To illustrate, assume a company does not have a beginning inventory and during 1974 makes the following purchases:

<table>
<thead>
<tr>
<th>DATE</th>
<th>QUANTITY</th>
<th>UNIT PRICE</th>
<th>TOTAL COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>2,000</td>
<td>$10.00</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>March</td>
<td>8,000</td>
<td>12.00</td>
<td>96,000</td>
</tr>
<tr>
<td>May</td>
<td>7,000</td>
<td>15.00</td>
<td>105,000</td>
</tr>
<tr>
<td>August</td>
<td>5,000</td>
<td>16.00</td>
<td>80,000</td>
</tr>
<tr>
<td>October</td>
<td>4,000</td>
<td>18.00</td>
<td>72,000</td>
</tr>
<tr>
<td>December</td>
<td>4,000</td>
<td>20.00</td>
<td>80,000</td>
</tr>
</tbody>
</table>

$453,000

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If the units on hand at year's end are 6,000, the value of such an ending inventory under FIFO would be $116,000 calculated as follows: 4,000 units at $20.00 each from the December purchase ($80,000) and 2,000 units at $18.00 from the October purchase ($36,000). The same quantity under a LIFO flow assumption would result in an ending inventory value of $68,000 consisting of 2,000 units at the January purchase cost of $10.00 each ($20,000) and 4,000 units with the March cost of $12.00 per unit ($48,000). The $48,000 smaller ending LIFO inventory ($116,000 minus $68,000) will result in a net income before taxes which is also $48,000 lower, and assuming a 50% tax rate, $24,000 less taxes would be currently payable.

This last statement can be proven by assuming that our fictitious company has annual “Sales” of $800,000 and “Expenses” other than “Cost of Goods Sold” at $400,000:

<table>
<thead>
<tr>
<th></th>
<th>LIFO</th>
<th>FIFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$800,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Cost of Goods Sold:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>$453,000</td>
<td>$453,000</td>
</tr>
<tr>
<td>Less Ending Inventory</td>
<td>68,000</td>
<td>385,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$415,000</td>
<td>$463,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Net Income Before Tax</td>
<td>15,000</td>
<td>63,000</td>
</tr>
<tr>
<td>Income Taxes (50%)</td>
<td>7,500</td>
<td>31,500</td>
</tr>
<tr>
<td>Net Income</td>
<td>$ 7,500</td>
<td>$ 31,500</td>
</tr>
</tbody>
</table>

As the above illustrates, the “Net Income” before taxes and after taxes would be lower under LIFO by $48,000 ($63,000 v. $15,000) and $24,000 ($31,500 v. $7,500) respectively.

As the illustrations should make perfectly clear, LIFO will result in a lower dollar value of ending inventory whenever the company is experiencing a period of inflation. The minimized inventory causes an increase in cost of goods sold with a resulting reduction in net income and current tax liability. If prices are declining rather than increasing the exact opposite result will occur. LIFO only has a tax benefit during inflationary periods and the tax effect is a delaying of the tax payment rather than an avoidance. Ignoring the possibility of different tax rates, over a complete cycle of proceeding from zero inventory back to zero inventory, the total taxable income for the period would be the same under either LIFO or FIFO. To illustrate, assume that the company in our example for 1975 experiences “Sales” of $900,000, has other “Expenses” of $400,000 and purchases $370,000 of merchandise during the period, but has a zero ending inventory:
The LIFO "Net Income Before Tax" for the two years would total $77,000 ($15,000 plus $62,000), "Net Income" would be $38,500 ($31,000 plus $7,500). The aggregate "Net Income" before and after tax under the FIFO method would likewise amount to $77,000 ($63,000 plus $14,000) and $38,500 ($31,500 plus $7,000) respectively.

Thus far we have seen that the use of LIFO during periods of rising prices will result in a reduction of current tax liability, therefore allowing the company to hold on to the related tax dollars longer. Since inflation has in differing degrees been a fact of economic life for many years, why haven't firms been using LIFO throughout these inflation years? The reason is that Section 472 which specifically allows use of the method also requires that when it is used for tax purposes it must also be used in the preparation of reports to shareholders and reports used for credit purposes, in other words financial statements. Since the tax return data also appears on the financial statements, the shareholders will be shown a net income under LIFO that is lower than could have been shown under FIFO (assuming constantly increasing costs). Using the figures of the 1974 comparative income statements and assuming outstanding stock is 1,000 shares, under LIFO the $7,500 net income would result in an earnings per share (EPS) of 75 cents, and under FIFO, a net income of $31,500 would result in an EPS of $3.15. Considering the strong correlation between EPS and the market price of a share, it is understandable why the managers of a company were reluctant to change.

Another reason often cited for not using LIFO for financial statement presentation is that it is theoretically unsound. Actually there is a theoretical basis for the LIFO method, but let us briefly consider the basis of FIFO. It is argued that FIFO results in an inventory value which nearly reflects current costs because the inventory is recorded at its most recent prices and the cost flow assumption more closely approximates the physical flow of goods. LIFO considers measurement of income more important than the valuation of assets. Since items sold are sold at the current selling prices which reflect inflationary increases, the cost of the goods sold that is charged against these revenues should also reflect
these inflationary increases by recording inventory at the oldest costs. LIFO in effect changes current operations with the more recent inflated costs. This analysis is in no way a complete discussion of the theoretical principles underlying the methods but is merely intended to illustrate from an accounting standpoint that either method can be rationalized when the major factor in deciding to change is the potential tax benefit.

We know why the changes are being made, but why now? It is a combination of factors, none of which can be singled out as the culprit. Certainly high on any list of factors would be that inflation became sufficiently severe to outweigh the disadvantages of making the change. Another contributing factor is that economic conditions have been such that inventories in many cases are at low levels which can soften the impact of the change on net income. Also, since many companies have already made the change, the psychological impact on shareholders may not be as pronounced as it would have been a few years ago. This writer predicts that unless there is a drastic curtailment in inflationary pressures, the trend to convert to LIFO will continue. Due to the complicated valuation and adjustments required by the change, the area is potentially a source of much future litigation.

10.00 Pension Reform Act

On Labor Day, 1974, President Ford signed a pension reform bill into law. The Act, officially titled The Employee Retirement Income Security Act of 1974,\(^{361}\) has been described as the most significant change in government regulation of private pension plans in the last 30 years. As the title of the act implies, the legislation is intended to afford pension plan members a greater degree of security than they have previously enjoyed. In signing the bill the President described it as "a landmark measure that may finally give the American worker solid protection in his pension plan." Our chief executive's comment contained a well-placed may, because whether or not the employee receives "solid protection" is dependent on many factors. One thing that can be said with certainty is that in attempting to protect the worker the Act has several significant tax effects. The most obvious of these is that the minimum vesting and participation standards must be met if the plan is to be a qualified plan under the Internal Revenue Code.

10.01 Participation Requirements. The general rule is that an employee must be allowed to participate in the plan after completing one year of service, but this can be extended to three years where the plan provides for 100% vesting upon commencing participation. A year of service represents a 12-month period, typically beginning with the date of commencing employment, in which the employee completes at least 1,000 hours of service. The Secretary of Labor can be expected to issue regulations defining hour of service and year of service to be used in

\(^{361}\) Pub. L. No. 93-406 (Sept. 2, 1974).
unusual situations and by seasonal or special industries. Exceptions to the general participation rule are that employees may be excluded from the plan until they reach age 25. Those who begin employment within five years of the normal retirement age set by the plan may be completely excluded. Exempt educational organizations with plans that provide for 100% vesting after one year of service may have a minimum participation age of 30.362

Where a plan sets 25 or less as the age of eligibility, service with the employer prior to becoming eligible is not completely lost. The Act requires that all of the years of service with the employer after attaining age 22 be counted in determining the employee’s vested rights in the plan.363 To illustrate, assume that Able, Baker and Carr begin full-time employment with a firm at ages 20, 22 and 24 respectively, and that the firm’s covered pension plan requires an employee to attain the age of 25 to be eligible to participate in the plan. After 10 years of continuous full-time service both Baker and Carr would have 10 years of service while Able would only have eight, the difference being the two years of service he performed prior to becoming 22. A plan by its provisions could provide that the age for counting service years be less than 22.

In counting years of service all employers who contribute to a multi-employer plan would be considered as one employer, whether it be a plan covered by a collective bargaining agreement, one by a controlled group of corporations (within the meaning of Internal Revenue Code Section 1563) or one by unincorporated businesses under common control. Where a company is taken over by another all of the service with the prior company will count if the successor continues the predecessor’s plan. If the plan is not continued, the amount of service credit will be calculated under regulations to be issued by the Secretary of the Treasury.

The effect of an employee leaving and later being rehired or working part-time then returning to full-time employment depends on the vesting and participation provisions of the plan and whether the break constitutes a one-year break in service. A one-year break in service means a 12-month period designated by the plan in which the employee completed 500 or less hours of service. If the plan requires three years of service or attainment of age 25 prior to becoming eligible, all service prior to the one-year break in service which occurred before the employee became eligible to participate can be ignored. When an employee leaves prior to attaining any vested benefits as to his employer’s contributions and is later rehired, if the amount of his years of service prior to the break in service, but subsequent to a previous break, is less than or equal to the aggregate of the consecutive one-year breaks, they also may be ignored.364 Assume

363 Id. § 411(a)(4).
364 Id. § 410(a)(5).
that Ralph works four years under a plan whose provisions meet the minimum requirements of the Act, leaves without any vested benefits derived from his employer's contributions and is rehired five years later. All of his prior service could be ignored in determining his participation, vesting and benefits. A plan may also provide that the employee work one year before applicable years of prior service be counted.\textsuperscript{365}

Once an employee has satisfied the service and/or age requirements, he must become a participant on the earlier of the first day of the plan year beginning after the date he satisfies the requirements or the day six months after the date of satisfying the requirements. The Act provides that this participation provision must be specifically provided for in the trust if it is to maintain or acquire qualified status.\textsuperscript{366}

The Act tends to closely follow the rules of the prior law as to antidiscrimination. In addition to the foregoing requirements, a trust and/or annuity plan will be qualified only if it

a. benefits either 70% or more of all employees, or 80% of all eligible employees, if at least 70% of the employees are eligible, and

b. the plan is found by the Secretary of the Treasury not to discriminate in favor of officers, shareholders or highly compensated employees.\textsuperscript{367}

Prior law included supervisory employees in its enumeration of those people in whose favor the plan could not discriminate. This omission is probably of little significance in that supervisory personnel will most likely be included in the term "highly compensated employees."

The Act remedies a problem that occasionally existed under the prior law. The problem would arise where the company's union employees would reject pension benefits in favor of increased wages, and the Internal Revenue Service would insist on considering the voluntarily excluded union personnel in determining whether a plan covering the non-union employees met the percentage and nondiscrimination tests. The Act amends prior law, providing that for purpose of these tests employees whose retirement benefits are determined by a collective bargaining agreement, and nonresident alien employees without earned income from sources within the United States, may be excluded.\textsuperscript{368}

10.02 Vesting Requirements. The Act establishes minimum vesting standards which must be followed by a qualified plan. This is accomplished by adding Section 411 to the Internal Revenue Code. The most obvious requirement is that the plan must provide that the accrued benefits derived

\textsuperscript{365} Id. § 410(a) (5) (C).
\textsuperscript{366} Id. § 410(a) (4).
\textsuperscript{367} Id. § 410(b) (1).
\textsuperscript{368} Id. § 410(b) (2).
from the employee's contributions be completely vested. The intent of this provision is clearly stated in the House Floor Explanation, "to grant covered employees nonforfeitable rights with respect to their own contributions." The section as enacted refers to "accrued benefits derived from his own contributions," rather than merely his "own contributions" as used in the committee report. This reference to accrued benefits may confuse some into believing they have a right in more than merely their contributions, prior to the time of complete vesting. I believe the extent of accrued benefits attributable to the employee's contributions will depend on the vesting provisions of the plan and in most cases this will mean that the employee's accrued benefits for at least the first five years of employment will be limited to his contributions. The determination of the definite effect of the wording will have to await issuance of a Treasury Regulation.

The new section also requires that the employee's normal retirement benefits vest once he has reached normal retirement age. The plan must provide for the eventual complete vesting of all accrued benefits arising from the employer's contributions. The Act provides a choice of three methods that can be used to accomplish the eventual complete vesting. The simplest procedure that will satisfy the requirement is to have 100% vesting after 10 years of service. A second possibility is a graduated system of vesting whereby the employee after five years of service has a vested right in at least 25% of the accrued benefits derived from his employer's contributions. The vested percentage must then increase by five percentage points for each of the sixth through tenth years of service (a minimum of 50% vested at the end of the tenth year of service) and 10 percentage points for each of the 11th through 15th years of service, attaining 100% vesting after the 15th year of service. The third method requires that the employee with at least five years of service have a vested right in at least 50% of the accrued benefits derived from the employer's contribution when the sum of his age and his total years of service equal 45. For each succeeding year the required minimum percentage of vesting must increase by 10 percentage points until the employee has a completely vested interest in the accrued benefits. Notwithstanding the provisions of this last alternative, an employee after 10 years of service must have a right to at least 50% of his accrued benefits derived from his employer's contributions and this vested percentage must increase by at least 10 percentage points for each additional year of service.

To illustrate the last option, assume that Carr, Dowd, and Estes begin full-time employment with a firm at ages 24, 31 and 35 respectively. After five years of continuous service, Carr would be 29 years old and have an age/service total of 34, Dowd would be 36 years old and have an age/service total of 41, while Estes would be 40, and have an age/service

369 Id. § 411 (a) (1).
370 Id. § 411 (a).
371 Id. § 411 (a) (2).
combination of 45. At this point neither Carr nor Dowd need have any vested rights as to the accrued benefits derived from the employer's contribution, but Estes must have a 50% vested right as to these accrued benefits. Estes' percentage of vested right must increase by at least 10 percentage points for each of the next five years becoming completely vested after 10 years of service and at an age of 45. After another five years of continuous service, Carr would be 34 and have an age/service total of 44; Dowd would be 41 with an age/service total of 51. Dowd at this time must have at least an 80% vested interest in the accrued benefits derived from his employer's contribution, calculated as follows: at age 38 Dowd would have attained an age/service total of 45 having completed seven years of service, therefore qualifying for a 50% vested interest in the accrued benefits derived from the employer's contribution, for each of the next three years of service his percentage of vested rights would increase by 10 percentage points, totaling 80% at the end of the 10th year of service. Even though Carr would not currently have an age/service total of 45 he would have a vested right to 50% of the accrued benefits derived from the employer's contribution because he has completed 10 years of service. For each succeeding year of service his share in such benefits would increase by 10 percentage points until completion of his 15th year of service, at which time his rights to accrued benefits would be completely vested, even though Carr would only be 39 years old.

Each of the methods that can be used to provide complete vesting are minimum standards. If the 10-year 100% vesting method is used, the only requirement is that the employee's rights to accrued benefits be 100% vested after 10 years' service, he need not have any right to the accrued benefits derived from the employer's contribution prior to that time. Similarly under the 15-year graduated vesting method the employee's rights in the accrued benefits derived from the employer's contribution may be zero until five years of service are completed. Under the "Rule of 45," the vested rights related to the employer's contribution can also be nonexistent until the magic age/service total is reached, with the exception of the required provision for 50% vesting after 10 years and the related increments in such vested rights through the 15th year of service.

The plan must present a vesting schedule which meets the minimum standards of one of three statutory options for accomplishing eventual complete vesting. An employer may change the vesting schedule, provided that the new schedule does not reduce the nonforfeitable percentage of the accrued benefit derived from employer contribution of any participant in the plan as compared to such nonforfeitable percentage that would have been computed under the original vesting schedule. Any participant in the plan who has at least five years of service may,

372 Id. § 411 (a).
373 Id. § 411 (a) (10) (A).
within a reasonable period of time after the adoption of the new vesting schedule, elect to have his nonforfeitable percentage computed under the schedule existing prior to the change.\textsuperscript{374}

An exception to the vesting requirements is provided for so-called "class year plans." The vesting requirements are considered met if the plan provides that the employee's right to the employer's contribution or benefits derived from such contribution are completely vested not later than the end of the fifth plan year following the plan year for which the contribution was made.\textsuperscript{375} "The term class year plan means a profit-sharing, stock bonus, or money purchase plan which provides for the separate nonforfeitability of employees' rights to or derived from the contributions for each plan year."\textsuperscript{376} Under this provision a profit-sharing plan will meet the vesting requirements if it provides that the contribution for each employee for a particular plan year is 100% vested within five years. To illustrate, if the employee's rights to an employer's contribution to a profit-sharing plan for calendar (or fiscal) year 1975 is completely vested by the end of calendar (or fiscal) year 1980 the vesting requirements are met. The requirements will be met whether the employee's rights vest at the rate of 20% per year, 25% per year beginning in the second year, vests 100% at the end of the fifth year or any other combination so long as their right to the employer's contribution is completely vested by the end of the fifth year.

The term nonforfeitable benefits is somewhat a misnomer, at least as applied to the accrued benefits derived from the employer's contribution. A plan may of course provide that benefits derived from the employer's contribution cease upon the death of the participant, even though the former employee did not receive substantial benefits as a result of his untimely death.\textsuperscript{377} Death, though, cannot result in a forfeiture of qualified joint and survivor annuities provided by the plan.\textsuperscript{378} A retiree's benefits may also be suspended during the period that he is reemployed by the employer who maintains the plan under which he was receiving benefits. If the plan is a multi-employer plan, his return as an employee to the same industry, trade or craft which the plan covers will also result in suspension of benefits. The Secretary of Labor can be expected to issue regulations (including a definition of the term "employed") for the implementation of this provision.\textsuperscript{379}

Certain retroactive plan amendments with respect to funding made within two and one-half months of the close of the plan year (two years for multi-employer plans), which do not result in a reduction of the

\textsuperscript{374} \textit{Id.} § 411(a) (10) (B).
\textsuperscript{375} \textit{Id.} § 411(d) (4).
\textsuperscript{376} \textit{Id.}
\textsuperscript{377} \textit{Id.} § 411(a) (3) (A).
\textsuperscript{378} \textit{Id.} § 401(a) (11).
\textsuperscript{379} \textit{Id.} § 411(a) (3) (B).
employee's accrued benefits determined on the first day of the plan year to which the amendment applies, are not to be considered a forfeiture. An amendment which results in a reduction of the accrued benefits of participants may take effect if the plan administrator obtains the timely agreement of the Secretary of Labor that the result of not allowing the amendment would result in a substantial business hardship, and that waiver of funding requirements would not be an adequate remedy. The Secretary of Labor in ruling on a proposed retroactive amendment that will adversely affect participants' accrued benefits must consider (though other factors may also be considered) whether the employer is operating at an economic loss, the relative unemployment, underemployment, sales and profits in the particular industry and the likelihood that the plan will be discontinued if the amendment is not granted.

It is acceptable for a plan to provide that an employee who does not have a nonforfeitable right to at least 50% of the accrued benefits derived from his employer's contribution, to forfeit such benefits upon the withdrawal of his (the employee's) mandatory contributions. A plan may not contain such forfeiture provision unless it also provides for the restoration of the forfeited benefits upon the repayment by the employee of the full amount withdrawn (plus interest in the case of a defined benefit plan). The plan may restrict the repayment provision by requiring the employee to make such repayment before he has a one-year break in service.

A possible exception to the above is that accrued benefits derived from employer contributions which accrued prior to the enactment of the Employee Retirement Income Act of 1974 may be forfeited because of withdrawal by the employee of mandatory contributions (or benefits derived therefrom) which he made prior to enactment, providing the amount thus forfeited is proportional to the amount withdrawn.

Each full-time year of employment for the employer which the employee performed after attaining the age of 22 is considered in determining his nonforfeitable percentage of vested rights to benefits derived from employer contributions. Years of service prior to age 22 must be considered where the plan provides a "Rule of 45" vesting schedule and the employee was a participant prior to his 22nd birthday. To illustrate we will again assume that Able begins employment with a firm which has a qualified pension plan. If the plan provides that the minimum age of participation is 25 (the maximum acceptable age), at age 30, after 10 years of continuous full-time service, Able would have eight years of service (years of employment since age 22) for purposes

380 Id. § 411(a)(3)(C), § 412(c)(8) & (d)(1).
381 Id. § 412(d)(2).
382 Id. § 411(a)(3)(D).
383 Id.
384 Id. § 411(a)(4).
of determining his vested rights to benefits derived from employer contributions, regardless of the vesting schedule provided in the plan. The results would have been the same had the plan provided for a minimum participation age of 22. But had the plan provided that an employee become a participant after one year of service regardless of age the results could have been different. Where the plan's vesting schedule was of either the 10- or 15-year vesting type, Able would again have eight years of service for purposes of the calculation. If the plan used the "Rule of 45" to meet the minimum vesting requirements, Able would have nine years of service for purposes of determining his vested rights to accrued benefits derived from his employer's contributions, because under the "Rule of 45" the plan may not disregard any year of service during which the employee was a participant. After completing one year of employment Able would have become a participant, this would have occurred when he was 21, therefore at age 30 Able would have been a participant in the plan for nine years.

There are further exceptions to the general rule that all years of service with the employer after the employee reaches age 22 are counted in determining his vested rights. Years for which the employee declined to make a mandatory contribution and years for which the employer did not maintain the plan (or a predecessor plan) need not be considered.\(^3\) It also might be possible to ignore certain years of service which occurred prior to breaks in service if they fit within the statutory provisions; even if the service prior to the break is to be considered it need not be taken into account until the returning employee has completed an additional year of service.\(^3\) When an employee does not complete three years of service after 1970, years of service previously completed may be ignored. Years lost due to breaks in service before the effective date of the Act need not be reinstated.\(^3\)

The plan's vesting schedule tells us what percentage of the accrued benefits an employee has at a particular time. What those accrued benefits in fact are depend on the type of plan and who made the contributions. The plan could be a profit-sharing, money-purchase or defined benefit plan. Under a profit-sharing plan each employee would contribute an annual amount based on an agreed formula and the employer contributes a portion of the profits for the year. The profits are then divided among participating employees in a manner which does not discriminate in favor of highly compensated employees. Under a purchase-money type of plan the employer agrees to contribute a fixed amount each year for each employee. At retirement all the money thus contributed is used to purchase the employee an annuity. Defined Benefit plans promise the

\(^{385}\) Id.

\(^{386}\) See discussion of participation requirements \textit{supra}, and \textsc{Int. Rev. Code of 1954}, § 411(a)(6) at ¶ 10.01.

\(^{387}\) \textsc{Int. Rev. Code of 1954}, § 411(a)(4)(E) & (F).
employee a fixed pension upon retirement. If the plan is any type other than the defined benefit (fixed pension) plan the employee’s accrued benefit is merely the balance of his account.\textsuperscript{388}

The defined benefit plan must provide a method of accruing benefits which meets one of three tests.\textsuperscript{389} A plan would be acceptable if it provides that each employee’s accrual is at least 3\% of the maximum benefit he would have received had he become a participant at the earliest possible age and continued in the plan until age 65.\textsuperscript{390} A plan will also qualify if the accrual rate, expressed in dollars or in a percentage, for any later year is not more than one-third greater than the rate for the current year.\textsuperscript{391} The third possible way of qualifying is to provide that the accrued benefit payable on leaving the employment is a ratable portion of what he would have received at normal retirement age had he continued at his present salary until that date.\textsuperscript{392} In practice the calculation may be much more complicated than the above indicates. A few examples of complicating factors are the valuation of ancillary benefits, the effect of employee withdrawals and consideration of social security benefits in determining plan retirement benefits.

Since benefit attributable to the employee’s contribution is always completely vested, it is necessary to allocate the accrued benefit between the employer and employee contributions. In plans other than defined benefit plans which require mandatory employee contributions, the accrued benefit attributable to the employee’s contributions is the balance in the separate account maintained for the employee’s contribution. If both employer and employee contributions are accumulated in a single account, then a pro rata portion of the account determined on the basis of relative net contributions would be the accrued benefits applicable to each. To illustrate, assume that an employee has made a total net contribution of $2,000 to a profit-sharing plan while his employer has contributed $18,000 and the account balance is currently $30,000. The employee’s contribution would represent 10\% of the total contribution, therefore $3,000 (10\% of the account balance) would represent the accrued benefits derived from the employee’s contribution.\textsuperscript{393}

A defined benefit plan which provides for mandatory employee contributions requires a rather technical and confusing calculation to determine the accrued benefits applicable to these contributions. The accrued benefit derived from an employee’s contribution at a particular date is the employee’s accumulated contribution multiplied by the

\textsuperscript{388} Id. § 411(a) (7).

\textsuperscript{389} Id. § 411(b) (1).

\textsuperscript{390} Id. § 411(b) (1) (A).

\textsuperscript{391} Id. § 411(b) (1) (B).

\textsuperscript{392} Id. § 411(b) (1) (C).

\textsuperscript{393} Id. § 411(c) (2) (A).
conversion factor appropriate for the plan’s normal retirement age. The conversion factor for a normal retirement age of 65 years is 10%, factors for other normal retirement ages will be prescribed in regulations to be issued. The accumulated contribution for an employee is the aggregate of his mandatory contribution and interest (if any) under the plan for the years prior to the effective date of the Act plus interest at a rate of 5% compounded annually from the first plan year covered by the Act to the normal retirement age. To illustrate assume that an employee is a participant in a defined benefit plan which has a normal retirement age of 65 and his accrued benefits are currently $3,000. If his accumulated contributions total $9,000 the application of the 10% conversion factor would result in $900 of the accrued benefits derived from the employee’s contribution. Therefore, of the total $3,000 of accrued benefits, $2,100 would be applicable to the employer’s contributions. If we assume further that the employee in our illustration is 50% vested, his total vested accrued benefits would be $1,950 ($1,050 applicable to employer contributions plus his own $900).

10.03 Funding Requirements. Under prior law the employer was only required to make annual contributions sufficient to cover normal pension costs (amounts earned during the year by the participants) and interest on unfunded past service costs. The new law, with certain exceptions, requires the employer to contribute, in addition to the normal cost, an amount sufficient to amortize the past service cost over a 40-year period (30 years for plans created after January 1, 1974). The funding requirements do not apply to profit-sharing or stock bonus plans and certain plans which are funded exclusively by the purchase of individual insurance contracts. Technically money purchase pension plans are included in the funding requirements, but as long as the employer makes the contribution as required by the plan’s formula, the minimum is met.

The most difficult funding situation is where the plan is of the fixed benefit type, in which eligible employees are promised a fixed pension at retirement. In such a situation the employer must make sufficient annual contributions to allow the trustee to pay the promised pensions. The factors that must enter into such a calculation are too numerous and complex for the scope of this article. Such a calculation is also beyond the expertise of most attorneys, accountants and even plan administrators, therefore requiring the use of a professional actuary. In determining the dollar contribution in the year that is required to assure that the plan is adequately funded, the actuary must consider the probable number of employees that will leave without vested rights, the number that will retire, the average age of retirement, the life expectancy of a retiree, the expected future yield on plan assets and the current value of those assets, to mention only a few factors.

394 Id. § 411(c) (2) (B). 395 Id. § 411(c) (2) (C). 396 Id. § 412(h) & (i).
Most of the factors that the actuary considers must be estimated. These estimates are termed actuarial assumptions. If the results of the assumptions are to be acceptable they must be reasonable taking into account the plan's past experience and reasonable future expectations.\textsuperscript{397} No matter how carefully the actuarial assumptions are made the actual experience can be different. If the actuary underestimated a cost factor or overestimated an income factor an actuarial loss will be experienced. On the other hand, if the actuary is too conservative, in that he has overestimated cost factors or underestimated income factors, the plan will experience an actuarial gain. The determination of these experience gains or losses is made by comparing the actual current value of the plan assets with value of the desired value of the assets. Such valuation must be made every three years, though it can be done more frequently.\textsuperscript{398}

The existence of significant experience gains or losses will probably require the actuary to revise his assumptions and change the method of funding. Any change in funding method or plan year requires prior approval of the Secretary of the Treasury.\textsuperscript{399} When an experience gain is determined the employer is not allowed to take the full benefit of it in the year of determination, nor is he required to absorb the full impact of experience losses in a single year. Gains and losses are instead spread (amortized) over the next 15 years (20 years for multi-employer plans).\textsuperscript{400} This amortization procedure could result in a complicated series of gain and/or loss amortization accounts. To limit the potential confusion, combining and/or offsetting of accounts will be allowed, though the mechanics of the combining/offsetting procedure will be prescribed by regulations to be issued.\textsuperscript{401}

The new law requires qualified plans to maintain a device for detecting underfunding; it is called the funding standard account.\textsuperscript{402} The account is charged (debited) annually with normal cost for the plan year and amounts sufficient to amortize in equal installments the following:\textsuperscript{403}

\begin{enumerate}
\item Past service costs (over 30-40 years);
\item Experience losses over 15 years (20 years if multi-employer plan);
\item Losses resulting from changes in actuarial assumptions over 30 years;
\item Any waived funding deficiency over 15 years;
\item Any excess debit arising from the plan having switched from the alternate funding method back to the basic method, over 5 years.
\end{enumerate}

\textsuperscript{397} Id. § 412(c) (3).
\textsuperscript{398} Id. § 412(c) (9).
\textsuperscript{399} Id. § 412(c) (5).
\textsuperscript{400} Id. § 412(b) (2)& (3).
\textsuperscript{401} Id. § 412(b) (4).
\textsuperscript{402} Id. § 412(b) (1).
\textsuperscript{403} Id. § 412(b) (2).
The account is credited each year with the amount the employer contributed to or under the plan for the plan year and an amount sufficient to amortize in equal installments the following: 404

1. Experience gains over 15 years (20 years if multi-employer plan);
2. Gains resulting from changes in actuarial assumptions over 30 years;
3. Net decreases in unfunded past service costs arising from plan amendments over 30 years (40 years if a multi-employer plan);
4. The amount of any waived funding deficiency for the plan year;
5. Any excess credit arising from the plan having switched from the alternate funding method back to the basic method, over 5 years.

If the account balances or shows a net credit balance the minimum funding requirements for the year have been met. When the account shows a net debit balance the minimum requirements have not been met; the employer has an accumulated funding deficiency. Where underfunding exists and a waiver is not obtained the employer will be subject to a 5% penalty on the accumulated funding deficiency. If the employer does not correct the deficiency within 90 days (with possibility of extension for cause) of the mailing of a notice of deficiency by the Internal Revenue Service he will be assessed a penalty equal to the accumulated funding deficiency. 405 As if the taxes alone were not a sufficient deterrent to underfunding, neither the initial nor additional tax is deductible. 406 The deficiency can be avoided if the employer can make a sufficient additional contribution within two and one-half months of the close of the plan year. 407

Where an employer can convince the Secretary of the Treasury that application of the minimum funding standards in a particular year would cause him substantial business hardships, he can have the requirements waived for such year, but such waiver is only available during five of any consecutive 15 years. 408 Employers may also obtain permission to extend the prescribed amortization periods by as much as 10 years, if such extension would not be contrary to the purpose of the Act or adversely affect the interests of plan participants in the aggregate. 409

An alternate minimum funding standard is also available. If it is used the plan must maintain an alternate minimum funding standard account. 410 This account is debited for normal cost, the excess of the present value of accrued benefits under the plan over the fair market value of the assets of the plan and any excess of credits to the account for all prior years.

404 Id. § 412(b) (3).
405 Id. § 4971.
406 Id. § 275.
407 Id. § 404(a) (6).
408 Id. § 412(d).
409 Id. § 412(e).
410 Id. § 412(g) (1).
over changes to the account for those prior years. The alternate account is credited for the amount of the employer's contribution for the year.\textsuperscript{411} Election of the alternate standard is an attempt to reduce the required employer contribution. Whether the attempt will be successful depends on the relative fair market value of the plan assets. If the value of the plan assets substantially decline the basic standard will prove to be the least expensive. A plan using the alternate standard must continue to maintain a basic funding standard account and when (and if) the plan elects to switch back to the basic standard, the difference is amortized over a five-year period.

There is a possible exception to the minimum funding rules. If market conditions were such that the current fair market value of the plan's assets exceeded the total accrued liability of plan under the basic funding standard, the plan would be considered fully funded and the employer would not have to make any contributions for that year. The employer could continue to meet the minimum funding requirements without making a contribution in each succeeding year that the condition persisted. The fair market value of plan assets may not exceed the accrued plan liabilities, but if the difference is less than the minimum funding requirement under the basic standard, the employer can pay the lesser of the two.\textsuperscript{412}

Thus far we have only discussed the minimum contribution an employer must make. Is there a maximum? The simple answer is that there is no limitation on what can be contributed, but the size of an annual deduction for tax purposes is limited. For all practical purposes all deduction limitations existing under the old law are left undisturbed.\textsuperscript{413} The change is that when the minimum funding requirement exceeds the deduction limitation the latter becomes inoperative.\textsuperscript{414} Therefore the employer may contribute and deduct the higher of the minimum funding requirement or deduction limitation. Even if his contribution exceeds both, the excess can be carried forward and deducted in future years.

\textbf{10.04 Plans for the Self-Employed.} The most obvious change is that the deductible contribution to plans for the self-employed (often referred to as HR 10 or Keogh plans) has been increased from 10% of the earned income derived from the trade or business to 15%. The former maximum deduction of $2,500 has also been increased to $7,500.\textsuperscript{415} Possibly more significant is the creation of a minimum deduction representing the lesser of $750 or 100% of the earned income derived from the trade or business.\textsuperscript{416} The new provision would appear to allow persons

\textsuperscript{411} Id. § 412(g) (2).
\textsuperscript{412} Id. § 412(c) (7) & (8).
\textsuperscript{413} Id. § 415.
\textsuperscript{414} Id. § 404(a) (7).
\textsuperscript{415} Id. § 404(e) (1).
\textsuperscript{416} Id. § 404(e) (4).
who are self-employed on a part-time basis, such as corporate directors and moonlighting professionals (i.e., attorneys and CPAs who are employed by a firm) to avoid paying taxes on at least the first $750 of their "self-employment" income. The opportunity would exist whether or not the moonlighter was covered by an employer plan. The minimum deduction is a desirable addition to tax law, but seems somewhat incompatible with Individual Retirement Savings plans (discussed infra) which require that the individual employee not be a participant in an employer plan.

The plan must cover all employees of the self-employed person, who have three or more years of service, though certain nonresident aliens and employees covered by collective bargaining agreements may be excluded.\textsuperscript{417} Regardless of the number of plans to which the self-employed person contributes, he is allowed only to deduct in total the lesser of $7,500 or 15\% of the earned income in any one taxable year.\textsuperscript{418} To further complicate matters only a single $100,000 contribution base can be used. The maximum contribution base coupled with mandatory employee coverage will mean that an owner-employee whose earned income exceeds $100,000 would be required, in order to take the maximum deduction, to make a contribution of 7\%\% of his eligible employee's wages.

A person may be able to exceed the $7,500 limit where his plan is of the defined benefit type. The law now provides a formula for the amount of a straight-life annuity that can be accrued each year beginning with his participation in the plan determined by the age at which the person commences participation. The amount of benefit that may be accrued is determined by multiplying his earned income, not in excess of $50,000, by the applicable percentage for the age at which his current participation in the plan began. The percentages currently provided are:\textsuperscript{419}

<table>
<thead>
<tr>
<th>Age at Participation</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 or less</td>
<td>6.5</td>
</tr>
<tr>
<td>35</td>
<td>5.4</td>
</tr>
<tr>
<td>40</td>
<td>4.4</td>
</tr>
<tr>
<td>45</td>
<td>3.6</td>
</tr>
<tr>
<td>50</td>
<td>3.0</td>
</tr>
<tr>
<td>55</td>
<td>2.5</td>
</tr>
<tr>
<td>60 or over</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Regulations to be issued will provide percentages for ages not currently prescribed and for the adjustment of the percentages in the case of plans providing other than a basic benefit. The amount of the contribution required to finance an annuity benefit, not exceeding

\textsuperscript{417} Id. § 401(d)(3).
\textsuperscript{418} Id. § 404(e)(2).
\textsuperscript{419} Id. § 401(f).
one determined by the above formula, would be deductible even if it exceeded the $7,500 limitation.

To illustrate, we assume we have two physicians, Drs. Jeckel and Hyde, who commence participation in a plan at ages 45 and 55 respectively. Assuming each meet or exceed the $50,000 limitation and can be expected to maintain these earnings, Dr. Jeckel would be allowed to accrue a right to a life annuity at age 65 of $1,800 ($50,000 times .036) for each year, while Dr. Hyde could accrue only $1,250 ($50,000 times .25) for each year, or life annuity incomes at age 65 of $36,000 ($1,800 times 20 years) and $12,500 ($1,250 times 10 years) respectively. The cost to provide Dr. Jeckel's annuity would be nearly $10,000 per year. Even though this amount exceeds the $7,500 limitation, the doctor would be allowed to deduct the whole amount in determining his taxable income for the year. If the annual amount required to provide Dr. Hyde with a $12,500 annuity income at age 65 was less than the $7,500 limit, he of course would still be allowed to make a deductible contribution to a qualified plan of up to the $7,500 limit. Any increase in the rate of accrual or compensation base is considered a new period of participation in the plan as to the increase. For example, if the plan is amended so as to cover the first $40,000 of earned income, rather than $30,000 as previously provided in the plan, and this change is made when the participant is 60 years old, the percentage applicable to this $10,000 increase in compensation base would be 2% and whatever percentage had been applicable to the original $30,000 would continue to be applicable.

The extent to which (if any) the new provision benefits self-employed individuals will depend on the age at which they began participation in the plan. Regardless of the result under the accrued benefit formula, the annual benefit under a defined benefit plan upon retirement may not exceed the lesser of $75,000 per year or the average of the participant's average earned income for the three highest years. We will have to await the issuance of regulations to answer many questions raised by this provision. For example, must the self-employed individual use the same percentage for his eligible employees as he uses for himself or must he use a percentage determined with respect to the employee's age, if this is how the employer determined his own percentage? Since the maximum for purposes of the calculation is earned income of $50,000, can an employer whose earned income exceeds the maximum proportionately reduce the employee's percentage?

The old law required that excess contributions to Subchapter S plans and plans for the self-employed be returned. Now, excess contributions to self-employed plans are subject to a non-deductible 6% penalty on the excess. The penalty is assessed for each year that the excess is

420 Id. § 401(j) (3) (B) (iii);
421 Id. § 415(b).
outstanding.\textsuperscript{422} Excess contribution made on behalf of more than 5% shareholders of a Subchapter S corporation are not subject to the penalty tax. Instead the excess is added back to the income of these shareholders.\textsuperscript{423} A penalty is also provided for premature distribution from a self-employed plan. The individual is subject to an additional tax equal to 10% of the premature distribution that is includable in his gross income for the year. A premature distribution is one which is made before the individual attains age 59$\frac{1}{2}$, made for any reason other than the individual becoming disabled.\textsuperscript{424}

10.05 Individual Retirement Savings Plans. Previously if a person was not self-employed or covered by a union or employer-sponsored retirement plan, any amount which he attempted to save for his retirement was by necessity done with after tax dollars. An employee not covered by a plan can now deduct from his gross income up to 15% of the first $10,000 of gross income. This maximum deduction of $1,500 can be taken each year until he reaches age 70$\frac{1}{2}$, and can be taken whether or not the taxpayer itemizes. Married taxpayers are not penalized. If both have earned income each can set up his or her own plan. The only requirement is that the amount of the deduction be actually paid in cash during the taxable year by or on behalf of the taxpayer to an individual retirement account, for an individual retirement annuity or individual retirement bonds. Not only may an employer contribute to an employee’s plan, he may be the one who set it up.\textsuperscript{425}

The maximum applies whether only the employer, only the employee or both contribute to the individual retirement plan. All that is important is that the combined contribution does not exceed the greater of 15% of the individual's gross income for the tax year or $1,500. Therefore if an employer were to contribute $1,000 for an employee earning more than $10,000, the employee could contribute an additional $500. If the employee for whom the $1,000 contribution was made earned only $8,000 exclusive of the employer's contribution, he could contribute only an additional $350. In the preceding example the employee's gross income would be $9,000 ($8,000 plus $1,000 of employer contribution), the maximum contribution would therefore be $1,350 ($9,000 times 15%) which would allow an additional contribution by the employee of $350 ($1,350 minus $1,000). As the example illustrates, the employer's contribution is included in the employee's gross income and he takes the applicable deduction in full on his own tax return. Even though a deduction is allowed for income tax purposes, the amount of the aggregate contribution remains subject to social security taxes.

\textsuperscript{422} Id. § 4972.
\textsuperscript{423} Id. § 1379.
\textsuperscript{424} Id. § 72(m)(5).
\textsuperscript{425} Id. § 219.
If contributions are made to an individual retirement plan in excess of those for which a deduction is allowed, a 6% excise tax is imposed on such excess, unless it is repaid to the employee by the due date for filing his return. The excise tax is assessed for each year that the excess exists. An excess is corrected by merely making a contribution in latter years which is less than that which is allowed. To illustrate, Jones earns $10,000 in 1975 and contributes $2,000 to his individual retirement plan, since his maximum deduction is $1,500 he has made an excess contribution of $500 and is subject to a penalty of $30 ($500 times 6%). If in 1976 his maximum deduction is again $1,500, but he only contributes $1,000, he will have removed the excess and not be subject to the penalty. However, if Jones makes the maximum contribution in 1976 of $1,500 he will again be required to pay the $30 penalty on the excess $500. An interesting situation would occur where a person who previously made an excess contribution becomes ineligible to contribute to an individual retirement plan by virtue of becoming a participant in a qualified employer plan. Since he cannot remove the excess by making contributions which are less than maximum, his only alternative would be to make a withdrawal from the plan, and if he is less than 59 1/2 pay the 10% penalty on premature distributions.

The individual retirement plan may use one of three funding vehicles. Individual retirement accounts (IRA) are domestic nonforfeitable trusts created exclusively for the benefit of an individual. With the exception of tax-free rollovers (discussed infra) the trustee cannot accept a contribution of more than $1,500 per year. Such contribution must be made in cash and distributions of or from the account must begin no later than the end of the year in which the individual reaches 70 1/2. In the event the individual dies prior to exhausting the account, its balance must be paid out within five years, or used to purchase an annuity for the named beneficiaries. The only commingling of the account assets allowed is with those of a common trust fund, and for purposes of diversifying investments the assets may be pooled with assets of a qualified trust. A bank is usually the trustee, though other persons can qualify. The assets of the IRA can generally be invested in any assets that would be acceptable investments for a qualified plan, including but not limited to savings accounts with credit unions and savings and loan associations, mutual fund shares and insurance annuity contracts. The assets may not be used to purchase life insurance contracts, though annuity contracts purchased with these assets may contain nominal life insurance features. The cost of the life insurance element of annuity contracts is not deductible. Trustee of the IRA and insurance companies issuing such annuity contracts are required to make annual reports to the Secretary of the Treasury.
Rather than use the IRA the deductible contribution may be made directly to an insurance company for the purchase of nonforfeitable individual retirement annuities which contain no more than an incidental life insurance feature. As stated previously the cost of such feature is not deductible. All refunds must either be applied toward future premiums or the purchase of additional benefits and as with the IRA the requirements applicable to premature death and commencement of distributions apply. The third possibility is to invest in special U.S. bonds. The bonds can only be purchased in the name of the individual. The bonds must cease to bear interest or otherwise provide an investment yield once the individual attains age 70½ or five years after the date the individual dies, but not later than the date the decedent would have attained age 70½. Bonds must be held for at least 12 months after they are issued and if they are redeemed before the individual reaches 59½ or becomes disabled, the premature distribution will be subject to the 10% penalty.

IRAs may be established by employers for the exclusive benefit of their employees or by unions for the exclusive benefit of their members. Separate accounts may be set up for each individual or one account may be created to cover all participants, with separate accounting for each individual's interest. The assets may be commingled for investment purposes. The employer-created accounts may not be used to avoid the nondiscrimination provisions applicable to qualified plans. Proceeds from individual retirement savings plans are taxed when received. Due to deductions being limited to the contribution and the contribution being limited to the deduction, the individual's basis will be zero resulting in the full amount received being taxed when received. Unfortunately the proceeds are not eligible for capital gains treatment or the special 10-year average provision applicable to lump sum distributions (discussed infra).

10.06 Tax-Free Rollovers. Portability was a much-discussed and very desirable concept that did not find its way into the Employment Retirement Income Security Act of 1974. In essence it would have allowed an employee who left one employer to bring with him and deposit into the retirement plan of his new employer the vested interest he had earned under his previous employer's plan. Considering the various types of plans and funding vehicles, compulsory portability proved unfeasible. Congress provided for a limited degree of portability by virtue of the Act allowing certain tax-free rollovers. If an employee withdraws his entire interest from an individual retirement savings plan or receives a lump sum distribution of his vested interest in a qualified plan upon separation, he may avoid immediate taxation on the sum by depositing it within 60 days, into either an individual retirement savings

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429 Id. § 408(b).
430 Id. § 409.
431 Id. § 408(c).
432 Id. § 408(d), § 409(b).
plan or the funding vehicle of another qualified plan.\textsuperscript{433} The effect of these provisions has been referred to as a system of “voluntary portability.”\textsuperscript{434}

The Act does not limit the number of tax-free rollovers a person can have during his lifetime, nor is there a particular sequence for the rollovers. The rollover can be made from one plan to either an employee plan, a plan for the self-employed, or an individual retirement savings plan. For example if an employee receives a lump sum distribution of $10,000 from his employer’s qualified plan he can avoid immediate taxation by placing it into an IRA and then later withdraw the balance of the account and invest it tax free in either a new employer’s plan (with the employer’s consent) or possibly in a plan for the self-employed. The only significant limitation on rollovers is that tax avoidance is not allowed for rollover of amounts which were received by an individual from an IRA or individual retirement annuity, if within the prior three years there has been a tax-free rollover of amounts received from an IRA, individual retirement annuity or retirement bonds.\textsuperscript{435} There exists a danger that amounts rolled over to an individual retirement plan that would have received the favorable lump sum treatment (discussed infra) had it been distributed from the original plan, will not receive the benefit of the favored treatment when distributed from the individual plan. However, the regular five-year averages provisions would be applicable.\textsuperscript{436}

\textbf{10.07 Lump-Sum Distributions.} Under the new law the portion of a lump-sum distribution (LSD) from a qualified plan attributable to years of participation prior to 1974 is to be considered a capital gain. Amounts considered accumulated after 1973 are treated as ordinary income. To soften the impact of the new rules, a special elective 10-year forward-averaging method has been provided for the calculation of tax on the LSD. The new law also provides for an exclusion of 50\% of the first $20,000, but unfortunately limited to $10,000 reduced by 20\% of the amount by which the LSD exceeds $20,000.\textsuperscript{437} To illustrate this minimum allowance, assume an employee receives an LSD at retirement at age 65 of $40,000, he would be able to exclude from income $6,000 calculated as follows: basic exclusion of $10,000 (50\% of first $20,000) reduced by $4,000 [($40,000 minus $20,000) times 20\%), representing 20\% of the amount by which the LSD exceeds $20,000. The minimum distribution allowance would be subtracted from the gross LSD to arrive at a taxable LSD of $34,000 ($40,000 minus $6,000).

To further illustrate the mechanics of the new provisions, assume that employee Smith retires at the end of 1978 upon attaining the age of

\textsuperscript{433} Id. \textsection 402(c) (5), \textsection 403(c) (4), \textsection 408(d) (3), \textsection 409(b) (3)(C).
\textsuperscript{434} 120 CONG. REC. 15739 (1974) (remarks of Senator Williams).
\textsuperscript{435} INT. REV. CODE OF 1954, \textsection 408(d) (3) (B).
\textsuperscript{436} Id. \textsection 1301.
\textsuperscript{437} Id. \textsection 402(a) (1), \textsection 403(a).
66. Smith elects to receive at retirement, according to the provisions of his employer's pension plan, an LSD in lieu of a life annuity. The LSD amounts to $90,000. Smith became a participant in the plan at the beginning of 1964 and remained a participant in good standing until his retirement. Smith expects to file a joint tax return with his wife who is also 66 years old. During 1978 the Smiths had salary and other income amounting to $23,000, their itemized deductions for the period total $5,000.

The first step in calculating Mr. and Mrs. Smith's tax liability is to consider whether a minimum distribution allowance is applicable to their situation. Unfortunately the allowance is not applicable, since 20% of the amount by which the LSD exceeds $20,000 [(\$90,000 minus \$20,000) times 20% equals \$14,000] exceeds the basic allowance (20% of first \$20,000 equals \$10,000). Having determined that all of the LSD is subject to tax our next concern is to determine the tax on the ordinary income portion of the LSD.

The total taxable LSD (\$90,000) including ordinary income and capital gains portion is divided by 10, the tax on the resulting \$9,000 is calculated using rates for single persons even though the taxpayer is married. The tax using current rates would be \$1,840. This is then multiplied by 10 resulting in a total tax of \$18,400. This is the amount that would be due if the distribution was all ordinary income, but since Smith's 15 years of participation involved five post-1973 years, only 5/15 or one-third the LSD represents ordinary income. Since one-third of the distribution is ordinary income, only one-third of the \$18,400, or \$6,133, is added by the taxpayer to the ordinary tax shown on his return.

Obviously if one-third the LSD was ordinary income the other two-thirds is taxable as capital gains. The capital gains of \$60,000 (\$90,000 times two-thirds) are reduced by one-half. One-half the capital gains or \$30,000 is added to Smith's salary and other income (\$23,000) for a total of \$53,000. After allowance for the itemized deductions (\$5,000) and four exemptions (\$3,000) their taxable income would be \$45,000. At current joint return tax rates the tax on this amount would be \$14,560. The Smiths' tax bill for 1978 would be \$20,693 (\$14,560 plus \$6,133 applicable to the ordinary income portion of the LSD). In addition, if the Smiths' taxable income of \$45,000 was sufficiently higher than their average income for the four years immediately preceding the current year they also would be eligible for general income averaging. To illustrate, assume that the regular taxes on the \$45,000 under the general income averaging provisions is \$13,500, the tax bill for 1978 would be \$19,633 (\$13,500 plus the \$6,133 applicable to the ordinary income portion of the LSD).

Had Smith's LSD been from a profit-sharing plan and contained securities of the employer (including its parent and/or subsidiaries) any unrealized appreciation (excess of market over cost to the plan) would
not be considered in calculating the minimum deduction allowance and applying the special 10-year averaging provisions.\textsuperscript{438} To illustrate, assume Smith's LSD consisted of $40,000 in cash and $50,000 in his employer's securities which cost the plan $30,000. The $20,000 unrealized appreciation in the stock would not be considered for purposes of calculating the special averaging and the minimum deduction allowance. For those purposes the LSD would be $70,000 ($90,000 minus $20,000). The unrealized appreciation is taxed at capital gain rates when (and if) the securities are sold.

The calculations are further complicated when the employee receives an annuity in addition to the LSD. Of course the annuity payments are not taxed until they are received, but the present value of a currently received annuity or an annuity received in the five years preceding the LSD must be taken into consideration in calculating the minimum deduction allowance and special 10-year averaging.\textsuperscript{439} To illustrate, if Smith had received an annuity with a present value of $10,000 in addition to the $90,000 LSD, $100,000 would be used to make the computations. The minimum deduction allowance again would not be applicable, therefore the tax would initially be calculated at single rates on one-tenth of $100,000. The resulting tax would be multiplied by 10 for a total of $20,900. From this is subtracted the portion applicable to the annuity, $2,090, because the value of the annuity represents 10\% of the $100,000 used to calculate the total tax, resulting in $18,810 ($20,900 minus $2,090 or 90\% of $20,900). Recalling that only one-third of Smith's participation occurred after 1973, $6,270 (one-third of $18,810) is the tax on the ordinary income portion of the LSD.

To elect special averaging the individual must have participated in the plan from which he receives the LSD for at least five years. An individual can only make one such selection for LSDs received after he attains age 59\frac{1}{2}.\textsuperscript{440} Therefore a person receiving three LSDs during his lifetime, but all after attaining age 59\frac{1}{2} could only make the election as to one of them. However if two or more of them were received before he reached 59\frac{1}{2}, all of them would qualify for the election.

\textbf{10.08 Other Provisions.} The Act has set up minimum vesting and funding standards for defined benefit plans. These standards would be meaningless, however, without provisions to assure that the ultimate benefits were paid. To provide this protection, plans with more than 25 participants and not otherwise excluded are required to purchase plan termination insurance.\textsuperscript{441} The insurance applies to vested benefits only and liability is currently limited to $750 a month or 100\% of average monthly wages during the highest-paid five consecutive years of participation. The

\textsuperscript{438} Id. § 402(a).
\textsuperscript{439} Id. § 402(e).
\textsuperscript{440} Id. § 402(a).
Pension Benefit Guaranty Corporation (PBGC), a public corporation, has been formed within the Department of Labor to administer the insurance provisions. The corporation will set premium rates payable by the plans to finance the coverage. The premiums are currently set at one dollar ($1.00) per plan participant for single employer plans and 50 cents ($ .50) per participant for multi-employer plans. The insurance is unique and also controversial in that employers are liable to the PBGC for benefits paid by it because of plan termination. The liability is limited to 30% of the employer's net work measured within 120 days prior to termination of the plan. There is some argument that the limit is not absolute, but on a per-plan basis. Consequently under certain circumstances 100% of a multi-plan employer's net worth could be subject to the PBGC's lien. Regulations to be issued will hopefully answer this question.

The Act also adds various reporting requirements. Within 120 days of a plan becoming subject to the Act, the Secretary of Labor must receive a description of the plan which is to be updated every five years. Plan participants and beneficiaries must also receive a plan description, though not as comprehensive as the Secretary's copy, and it also must be updated at 60-month intervals. Both the Secretary of Labor, participants and beneficiaries must be informed of material modifications within 210 days of the close of the affected plan year. The Secretary of Labor is also to receive a comprehensive annual report and the plan is required to annually provide participants with audited financial statements. The Act also places fiduciary responsibility on plan managers/administrators, defines liabilities for the breach of this responsibility, generally prescribes many administrative procedures and specifically prohibits certain transactions.

11.00 Corporations

11.01 Casualty Loss Prior to Adoption of Section 337 Liquidation Plan. Section 337, which provides for the nonrecognition of gain or loss at the corporate level when corporate assets are sold or exchanged subsequent to the adoption of a plan of liquidation and all assets are distributed to the shareholders within 12 months after the adoption of the plan, was enacted to resolve the confusion arising from the Supreme Court decisions in Commissioner v. Court Holding Co. and United States v. Cumberland Public Service Co. It is now recognized that an involuntary conversion due to a fire is a sale or exchange under Section 337.

In United States v. Morton, the Eighth Circuit dealt with the other aspect of Section 337(a), that is, when does the "sale or exchange" by

442 Id. § 1362 (1970).
444 324 U.S. 331 (1945).
447 387 F.2d 441 (8th Cir. 1968).
The fire involved in Morton occurred before the adoption of the liquidation plan. But the court held that the involuntary conversion was not completed until the policy proceeds were received, a settlement figure agreed on, or judgment obtained. The Sixth Circuit in *Central Tablet Mfg. Co. v. United States*,448 held that an involuntary conversion due to a fire before the adoption of a liquidation plan was not shielded under Section 337. The Supreme Court, in a five-to-four decision, affirmed the Sixth Circuit.

The majority of the Supreme Court held that the obligation to pay for a fire loss arises when the fire occurs and thus is unlike an executory contract, which would fall under Section 337 even though the sale had been negotiated by the corporation prior to the plan, but not finalized until after the plan was adopted. Executory contracts may be rescinded, while a casualty cannot. Although the amount of the liability and the question of liability have not been answered, the obligation itself is present and it is the point in time when the property is valued that is critical.

The majority found that a casualty loss is similar to a condemnation. Generally, when title has passed by condemnation before the plan of liquidation is adopted, the corporation does not escape taxation under Section 337.449 The Supreme Court held the date of the casualty is analogous to the passing of title in a condemnation proceedings.

The dissenting judges, relying on the casualty loss deduction procedures450 and the taxpayer's accrual method of accounting, found that the taxpayer had no clear right to the income and that the "quantum of the income" must be ascertainable within reasonable limits.451 They held the cash amount of the loss was not reasonably ascertainable until after the plan of liquidation—about seven months after the casualty. The rule in condemnation cases is not at odds with their dissent, because the recognition of income must be at the time of the transfer of title in a condemnation proceeding since, at that time, it creates a binding obligation in the condemning authority to pay just compensation which the condemnee is certain to recover. However, until the amount is reasonably ascertainable452 in a casualty loss situation, there is no need to recognize a gain using the normal rules of accrual accounting.

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449 Covered Wagon, Inc. v. Comm'r, 369 F.2d 629, 633-635 (8th Cir. 1966); Dwight v. United States, 328 F.2d 973 (2d Cir. 1964).
450 See Coastal Terminals, Inc. v. Comm'r, 25 T.C. 1053 (1956), stating where insurance recovery is uncertain, the loss is to be taken in the year of the casualty loss. But see Commissioner v. Harwick, 184 F.2d 835 (5th Cir. 1950), where the court said if there is reasonable certainty that the insurance will be paid, the loss deduction is postponed until the recovery question is resolved.
451 Taxpayer here used the accrual method of accounting unlike Morton where the taxpayer used the cash basis of accounting. In Kinney v. United States, 31 Am. Fed. Tax R.2d 73-528 (N.D. Cal. 1972), the taxpayer was on the accrual basis and the court followed Morton. However, the case is pending in the Ninth Circuit.
The majority of the Court noted that the taxpayer had a possible tax relief after suffering a casualty loss. They can use the insurance proceeds to replace the destroyed property and escape recognition of gain.\(^{453}\) Of course, this must be completed within the 12-month liquidation period.

The dissent noted another possible way to avoid the results stated by the majority. They stated that since the Service approves post-fire plan adoptions if made on the same day as the conversion on sale, the taxpayer could then have the liquidation plan begin at the time of the fire. Treasury Regulation 1.337-1\(^{454}\) provides that the sale or exchange can occur on the same day the plan of liquidation is adopted.

While it appears that for the present time, the date of the casualty loss will be treated as the "sale or exchange" date, the divided Court seems to be sufficient evidence that this is not the final case to be adjudicated under this factual situation. The effect of the taxpayer's accounting method, cash or accrual, the intent of Congress for enacting Section 337, whether to clean up formalistic distinctions or as a general relief provision, and the effect of Section 1033 on future actions of this type on the Court's decisions have not as yet been finally answered.

11.02 Deductions—Attorney's Fees in Section 337 Liquidation. Section 337(a) was directed at correcting a definite inequity,\(^{455}\) the inequity being the possible double taxation on liquidating corporations; once when the assets are sold by the corporation and once on distribution of the proceeds derived from the sale to the shareholders.\(^{456}\) Thus, Section 337 eliminated tax at the corporate level and imposed a single tax on the stockholders.\(^{457}\)

But what of the attorney's fees connected with the sale of Section 337 property. Are these deductible under Section 162(a) as business expenses or are they to be treated as capital expenditures? In *Pridemark, Inc. v. Commissioner*,\(^{458}\) the Fourth Circuit allowed business deductions for liquidation legal fees. The court held that profits and losses from normal operations during a Section 337 liquidation are to be calculated for tax purposes and as the legal fees were ordinary and necessary expenses in a Section 337 liquidation, they are deductible.

However, in *Of Course, Inc. v. Commissioner*,\(^{459}\) the Fourth Circuit reversed its prior decision. Their rationale was as follows: (1) Profits


\(^{454}\) Treas. Reg. § 1.337-1.

\(^{455}\) See Commissioner v. McDonald, 320 F.2d 109, 112 (5th Cir. 1963); Hawaiian Trust Co. v. United States, 291 F.2d 761, 762 (9th Cir. 1961).

\(^{456}\) See 65 Mich. L. Rev. 1508 (1967), discussing United States v. Mountain States Mixed Feed Co., 365 F.2d 244 (10th Cir. 1966).

\(^{457}\) Any gain realized on the sale of assets by the liquidating corporation is passed to the shareholders in the form of a reduction in basis.

\(^{458}\) 345 F.2d 35 (4th Cir. 1965).

arising from normal operations of a Section 337 liquidation are ordinary income; or, (2) if the liquidating corporation has expensed certain assets purchased in earlier years and sells them during a Section 337 liquidation, the proceeds of this sale do not qualify for capital gains treatment but are taxable as ordinary income in the year of liquidation; but, (3) attorney's fees directly incurred during disposition or acquisition of a capital asset are considered capital expenditures, to offset the selling price, and not deductible as a business expense or an expense under Section 212. The court noted that Section 337 does not intend to give expenditures which are consistently treated as capital expenditure offsets against selling price, the same treatment as ordinary income derived from sources unrelated to the liquidation. If this were not the effect, the liquidating corporation and its shareholders would obtain an unintended tax benefit, that being the right to deduct expenses related to the liquidation from unrelated income.

The petitioner argued that the reasoning in United States v. Mountain States Mixed Feed Co. should be controlling. The court accepted the argument that if the costs of distribution in kind are deductible as ordinary expenses, the legal costs of the sale of assets should likewise be deductible because this was all part of the liquidation—dissolution of the corporate entity.

The court in Of Course rejected this argument, stating the reason for allowing a deduction on the normal costs of liquidation as business expenses, has as a corollary, the disallowance of a business expense deduction for an expense qualifying as a capital expenditure. The court noted any other rule would give irrational results. For example, if the rule did not apply, money spent in repairing a capital asset could be deducted as a business expense incident to liquidating the asset.

Finally, the court refused to use this rule prospectively, because petitioner had not relied on the court's decision in Pridemark, and knew that as to its liquidation procedure, the Commissioner did not acquiesce.

11.03 Partial Liquidations. The removal of funds from a closely held corporation is a transaction which may trigger disastrous conse-

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460 See, e.g., Citizens Acceptance Corporation v. United States, 462 F.2d 751, 756 (3d Cir. 1972); Commissioner v. Anders, 414 F.2d 1283, 1287 (10th Cir. 1969).

461 INT. REV. CODE OF 1954, § 162(a).


464 365 F.2d 244 (10th Cir. 1966).

465 The court held the argument in Mountain States to be "sui generis," and cited Lanrao, Inc. v. United States, 422 F.2d 481, 484 (6th Cir. 1970), which held that although the dissolution costs of a corporation can be rationalized as business expenses, it did not follow that capital selling expenses are business expenses under either Section 162 or 212, if they occur during a corporate dissolution.
quences for the shareholder, since the Treasury may characterize the distribution as a dividend, hence creating ordinary income. Section 346 provides an avenue for distributing funds from an operating company if there is a partial liquidation. Under Section 346 the receipt of funds by a shareholder from his closely held corporation will be treated as both a return of capital to the extent of capital and capital gains income to the extent that the proceeds exceed his basis in the stock. A distribution will be treated as a partial liquidation of a corporation if: (1) it is one of a series of distributions in redemption of all of the stock of the corporation; (2) it is a distribution in redemption of part of the stock of the corporation which is "not essentially equivalent to a dividend," or (3) it is a distribution which terminates one of several businesses which has been engaged in by the distributing corporation.\footnote{\textit{INT. REV. CODE OF 1954}, § 346(a)(1), § 346(a)(2), § 346(b).}

To qualify under Section 346(a)(2) as a distribution "not essentially equivalent to a dividend" the test is whether or not there has been a "contraction" of a corporate business.\footnote{Ballenger v. United States, 301 F.2d 192, 195 (4th Cir. 1962); \textit{Treas. Reg.} § 1.346-1(a).} Regulation 1.346-1(a)(2)(iii) illustrates the concept of a "genuine corporate contraction" as being a distribution of unused insurance proceeds which were recovered as the result of a fire which destroyed a portion of the business premises and, as a result, that portion of the business was discontinued. This same illustration was upheld as a corporate contraction in \textit{Joseph W. Imler},\footnote{11 T.C. 836 (1948), \textit{acquiesced in} 1949-1 \textit{CUM. BULL.} 2.} in which fire proceeds were permitted to be distributed to shareholders under the theory of a partial liquidation. This Regulation also points out that a distribution of funds which were accumulated for an expansion program, which has now been abandoned, will not qualify as a corporate contraction. Revenue Ruling 60-322 held that a partial liquidation did not result where a corporation, due to a steady decline in demand for its products, distributed cash to its shareholders in redemption for a portion of their stock.\footnote{Rev. Rul. 60-322, 1960-2 \textit{CUM. BULL.} 118.} The source of the cash for the distribution resulted from the sale of the corporation's bonds and excess inventories. No change was made in its activities other than a reduction of inventory reflecting the decreased demand.

In 1974 the Commissioner issued Revenue Ruling 74-296\footnote{Rev. Rul. 74-296, 1974 \textit{INT. REV. BULL.} No. 25, at 15.} distinguishing Revenue Ruling 60-322. Here a department store's business was adversely affected by the construction of two shopping centers in the vicinity of their location. The department store changed its method of operation from a general department store to a small discount apparel store operation by eliminating 33 of its 40 departments, changing the type of merchandise sold, and eliminating credit. As a result of this
contraction the floor space was reduced by 85%, accounts receivable was reduced from 570x to 10x dollars, employees were reduced from 275 to 20 and sales declined from 4000x to 600x dollars per year. Fixed assets such as display counters and cash registers and excess inventory were sold thereby generating approximately 800x dollars in cash after the payment of all liabilities. Of this amount 600x dollars was paid to its shareholders pro rata in redemption of a portion of their outstanding common stock. This was treated to be a general contraction of the corporate business, thereby qualifying as a partial liquidation.

*Mains v. United States* held that distributions by a Columbus, Ohio-based amusement company engaged in the carnival business providing rides, entertainment, and concession to fairs and expositions did not qualify for a partial liquidation. Here the company had 10 units operating in different parts of the country at the same time. The southern route which generated 38.65% of the corporation's gross receipts was sold to another corporation for $350,000. The court found that while a large proportion of the corporation's revenues were generated as a result of the southern route, only 5.19% of the corporation's total assets were involved. The court also noted that the selling corporation had undistributed profits of $1,335,000 and that in the year of the sale an additional $100,000 was invested in new equipment.

**11.04 Gift of Closely Held Corporate Stock Followed by a Redemption.** The year 1974 continued to be an excellent year for taxpayers who have caused their stock in a controlled corporation to be donated to a charitable organization (thereby obtaining a charitable contribution deduction) which later redeems the stock or resells the stock to the taxpayer's controlled corporation. These cases point out that the courts are not concerned with what the donee of stock does with it once he has received it if at the time the donation is made the plan of redemption has not been entered into by the corporation or there is no agreement between the donee and the control corporation as to repurchasing the stock.

In *Dewitt v. United States*, the taxpayer, Dewitt, owned 100% of the stock of Mortgage Company, which in turn held two-thirds of the shares of Service, Inc., with the remaining one-third of Service, Inc. shares being held personally by Dewitt. When business reasons dictated that the two companies should be consolidated, Dewitt learned that he would be unable to obtain a step-up-in basis of Service, Inc.'s assets under

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Section 334(b), since he was the sole owner of the stock, and therefore a "related person." To obtain the benefits of the step-up-in basis under Section 334(b)(2) it would be necessary for Mortgage Company to purchase 80% of the stock of Service, Inc., within a one-year period. Since Dewitt was a related taxpayer, the purchase by Mortgage of the additional shares to meet the 80% requirement from him would not be sufficient. Therefore it was necessary to find some way that another individual or entity could own at least 13\(\frac{1}{3}\) % of the Service, Inc., stock which in turn could be purchased by Mortgage Company. After consulting with his attorneys, Dewitt decided to make a gift of eight shares or 13\(\frac{1}{3}\) % of the outstanding stock to a qualified Section 170(c) charitable organization, thus entitling Dewitt a charitable deduction as set forth in Section 170(a). In October of 1964, four shares were donated to the San Rafael Military Academy and again in early 1965, an additional four shares were donated. These shares were accepted by the board of trustees of the academy with no strings attached or any conditions set forth as to whether or not these shares had to be retained pending repurchase by Dewitt's controlled corporation. In April of 1965 Mortgage Company offered to purchase the eight shares for $25,800 per share or a total price of $206,400 and to give in return a promissory note bearing interest at the rate of 4% per annum. The principal was to be paid between the 20th and 30th years in monthly installments. The academy, desiring to obtain cash since it was not receiving dividends from the closely held corporation stock, accepted Mortgage Company's offer. Seventeen months later, a corporation which had acquired the assets and assumed the liability of Mortgage Company, repurchased the note from the academy for the sum of $206,400.

Hence, the question arose, was there a valid gift of the property which would permit the taxpayer to take a charitable deduction in the years 1964 and 1965? The government contended that there was an unwritten agreement between the academy and the shareholder, Dewitt, that the stock would be retained until such time as Dewitt's controlled corporation could repurchase the gift stock. Unable to substantiate the government's contention, the court of claims found that the taxpayer had both delivered the stock with donative intent and relinquished all control over the stock, and also that the decision to repurchase had been made after the donation. The court also found that the academy and their board of trustees was under no obligation to repurchase this stock nor were they obligated to sell it only to the taxpayer or his controlled corporation, Mortgage Company. Therefore, the element of risk involved with this donation was sufficient to support the view that a bona fide gift was made.\textsuperscript{474}

In \textit{Daniel D. Palmer},\textsuperscript{475} the Palmer College of Chiropractic was owned

\textsuperscript{474} \textit{Id.} at 74-1127-74-1128.

\textsuperscript{475} 62 T.C. No. 75 (Aug. 27, 1974).
and operated by a profit-making corporation. Seventy-two percent of the corporation stock was owned by a trust and the remaining 28% was owned by the taxpayer Daniel Palmer. In order to obtain donations from alumni and to participate in federal funding programs, Palmer sought to establish a tax-exempt, non-profit foundation to operate the college. Of the corporation's combined assets of $2,500,000, the assets of the college accounted for $2,000,000. Following the establishment of a tax-exempt foundation and a favorable ruling from the Internal Revenue Service qualifying it as an exempt Section 501(c)(3) organization, the foundation acquired the corporation stock from the trust in return for a note payable in annual installments over a 35-year period. The taxpayer then made a contribution to the foundation of corporation stock sufficient so that the foundation owned 80% of the stock of the corporation. On the following day, the corporation's board of directors voted to redeem the shares of stock which were held by the foundation and to pay for the shares by transferring to the foundation all of the assets of the college.

The Commissioner challenged the charitable contribution deduction, contending that the taxpayer had received a distribution essentially equivalent to a dividend. In *Humacid Co. v. Commissioner*476 the Tax Court held: "The law, with respect to gifts of appreciated property is well established. A gift of appreciated property does not result in income to the donor so long as he gives the property away absolutely and parts with title thereto before the property gives rise to income by way of sale." Relying on *Blair v. Commissioner*,477 the Tax Court in *Palmer* held that as long as the entire interest had been assigned and no incidence of control was retained, then any tax on the income accrued to the donee, not to the donor. The result would be different if the redemption had been arranged prior to the time of making the donation.478

11.05 Accumulated Earnings Tax. Sections 531 through 537 provide for the taxation of unreasonable earnings that have been accumulated by a corporation. Each corporation is permitted to accumulate $100,000 of earnings during its lifetime. The accumulated earnings tax, per Section 532, applies to every corporation formed or availed of for the purpose of avoiding income with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being distributed. The penalty tax is in addition to the ordinary corporate income tax, and is 27½% of the accumulated taxable income not in excess of $100,000, plus 38½% of the accumulated taxable income in excess of $100,000. Note that this tax is not upon the total accumulated earnings, but upon the income earned during the year or years in question which has not been distributed or divided. Section 533(a) provides that for the purposes of the penalty tax the fact that earnings and profits of a

476 42 T.C. 894, 913 (1964).
478 Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1972).
corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation is able to prove by the preponderance of the evidence to the contrary. Section 533(b) also states that it is prima facie evidence of a purpose to avoid income with respect to shareholders if the corporation is a holding company or investment company.

In United States v. D. Donruss Co. the Supreme Court finally resolved the conflict of decisions as to whether or not tax avoidance was to be one of the motives, or the primary motive. In agreeing with the government, the Supreme Court held that the penalty tax was applicable if tax avoidance of the shareholders was "one" of the purposes for accumulating the earnings. We should note at this point that the accumulated earnings tax is a tax which is applied primarily against the closely held corporation, not the large corporations with vastly held stock. The purpose of the tax is to force corporations to pay dividends to their shareholders which will again be subject to a tax, and to prevent buildups of earnings and profits in a corporation which could be passed out to shareholders at capital gain rates at a liquidation, or a sale, or perhaps even obtaining a stepped-up basis through the death of the primary shareholder.

Section 537, however, provides that income may be accumulated for the reasonable needs of business. Hence, we are confronted with the most difficult factual situation in the accumulated earnings area. What are the reasonable needs of the business?

In Starks Building Co. the taxpayer corporation owned a large office building which had been constructed in 1913 in Louisville, Kentucky. By 1963 the directors of the corporation realized that if they were to continue to attract the type of tenants which they had in the past, being in one of the prestige locations of Louisville, they were going to have to build a new building to compete with other new construction in the area. Discussions with financing institutions indicated that a strong anchor tenant was a prerequisite to obtaining the requisite financing. From 1963 until 1967 the court found that the taxpayer conducted serious negotiations with two different banks, neither of which resulted in leases due to the taxpayer's inability to obtain the necessary financing for a building which would be as large as the banks required. The corporate directors established in 1948 a capital items reserve fund, whereby during the years in question an amount of cash was deposited equal to the amount of the depreciation amortization deducted by the taxpayer on the federal income tax return. This fund grew from $1.8 million in 1962 to $3.3 million in 1967, hence the basis for the government's attack that earnings were being accumulated beyond the reasonably anticipated business needs of the corporation. Looking to Treasury Regulation

1.537-1 which requires that the corporation's plans must be specific, definite, and feasible, the court noted that it would not have been practical for the corporation to have had actual plans drawn until such time that a lease was entered into with the anchor tenant.

Evidence presented by one of the banks indicated that any building they would lease would have to be constructed to their specific requirements. *Faber Cement Block Co.* had previously held that specific, definite, and feasible plans do not demand that taxpayer produce meticulously drawn blueprints for the action, but merely that the contemplated expansion appears to have been of real consideration during the tax years in question. The court determined that the reasonable, anticipated future need to construct a new business did exist, and the taxpayer had exerted a sufficient effort to find a tenant, although such search had not yet been successful. The court did not say as to how many years would be able to pass before finding a tenant and to have the court arrive at the same holding.

In *Ivan Allen Company v. United States* the issue arose as to how appreciated securities should be valued for the purposes of determining whether or not earnings and profits had been accumulated unreasonably. The court held that they should be valued not at their original cost but at their fair market value at the date in question, less the cost of converting the securities into cash. In 1938, the Supreme Court held in *Helvering v. National Grocery Company* that the depreciation decreased the value of a corporation's assets and should be taken into consideration in determining whether or not earnings in excess of reasonable needs had been retained. Here the Court determined that the very liquid nature of the assets in question should be determined by their fair market value, and not cost, since they were readily convertible into cash for use in the business if so required. In reaching this result they relied upon the *Battelstein Investment Co. v. United States*, whereby a corporation which had sold a very valuable piece of land and had received a note secured by the land was allowed to have the discounted value of this land treated as an asset, due to its highly liquid nature. The Tax Court takes the same position as noted in *Starks Building Co.* wherein they held that the value of investment securities which are readily marketable must be included in the computation of total quick assets of petitioner and that their value should be determined by fair market value as of the end of the year in question.

*Inland Terminals, Inc. v. United States,* a 1973 case, held that a

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481 50 T.C. 317 (1968).
482 493 F.2d 426 (6th Cir. 1974).
483 304 U.S. 282 (1938).
484 442 F.2d 87 (5th Cir. 1971).
486 477 F.2d 836 (4th Cir. 1973).
subsidiary which was wholly owned could accumulate earnings for the business needs of a parent. Regulation 1.537-3(b) specifically permits a controlling corporation to accumulate earnings for its controlled subsidiary.

In *Alice Brown, Inc. v. Commissioner*, the Sixth Circuit affirmed the holding of the Tax Court that a corporation which sold its operating assets during the year, and then conducted no further business activity during the last five months of the year, became a holding or investment company and therefore the tax was imposed, since no showing of any plans or activities to enter a new business were presented.

11.06 Disallowance of Post-Acquisition Losses. Section 269 provides for the disallowance of deductions and losses if the principal purpose of the acquisition was to evade or avoid income taxes. The section was enacted in 1943 to prevent the acquisition of loss corporations to offset high profits which were subject to the “excess profits” tax. The offset was usually accomplished through tax loss carryovers and selling at a loss acquired assets with a high tax basis and a low market value.

Originally the disallowance was thought to apply only to benefits accruing to the acquiring corporation. Later the Fourth Circuit rejected this distinction in *Commissioner v. Coastal Oil Storage Co.* holding the disallowance applicable to the acquired as well as the acquiring corporation. In *James Realty Co. v. United States* the application of Section 269 was extended to newly formed corporations which were attempting to benefit from the corporate multiple surtax exemption.

The problem next arose as to whether or not Section 269 applies to post-acquisition losses and decreases in asset value. The deduction of post-acquisition losses was disallowed in three of the five circuits which considered the issue prior to 1973. During 1973 the Fifth Circuit, in *Hall Paving Co. v. United States*, joined the majority when they concurred with the analysis of the Second Circuit. The Second Circuit looked to the legislative intent of Section 269 and determined the application of Section 269 was not limited to the disallowance of losses occurring prior to acquisition.
After the holding by the Fifth Circuit in *Hall Paving Co.* that Section 269 was applicable to post-acquisition losses, that court remanded the case for a determination of whether or not the prohibited purposes were present. On remand the district court found that Hall Paving Company had prior to the end of its fiscal year in 1963 acquired five bowling alleys which had cumulative losses which exceeded the profit from the Paving Company. The Hall Paving Company filed a single consolidated income tax return offsetting the profit from the principal business with the losses from the bowling alleys. The jury determined that the principal purpose for the acquisition was tax avoidance purposes and therefore the Commissioner's disallowance of the losses from the bowling alleys was correct.

*Your Host, Inc. v. Commissioner* presents a situation where the Commissioner used both Section 482 to reallocate income and also Section 269 to disallow multiple surtax exemptions. This case involved an organization that commenced partnership in 1944 and grew by the mid-60's to a 16-corporation organization operating restaurants, commissaries, a bakery, and a vending machine and leasehold operation. The finding of the Commissioner, as related to Section 482 allocations, will not be set aside unless they are found to be "arbitrary, unreasonable or capricious." As related to Section 269, a denial of the multiple surtax exemption will be set aside only if the Commissioner's finding is clearly erroneous. In *Your Host, Inc.*, the Second Circuit affirmed the Tax Court's determination that there are different standards for applying Section 269 and Section 482. The Second Circuit determined that while four of the restaurant-operating corporations should be denied their surtax exemption because their acquisition was for the principal purpose of tax avoidance, there were sound business reasons for their separate corporate existence, so that no allocation of income was permissible under Section 482. The reason for this apparent inconsistency is that while a corporation may have originated out of the evil motive of tax avoidance, it may be operating on a day-to-day basis as a business, thereby not justifying any reallocation of income. Citing *Dorba Homes, Inc. v. Commissioner*, the court cautioned against:

[C]onfusing a purpose, the continued existence of which may be thought to eliminate an adverse determination under [Section] 482, with the principal purpose to evade or avoid the federal income tax, the initial presence of which governs [Section] 269 and which may exist along side other secondary reasons for the formation of the corporation.

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497 *Wisconsin Big Boy v. Comm'r*, 452 F.2d 137, 140 (7th Cir. 1971).
498 *Dorba Homes, Inc. v. Comm'r*, 403 F.2d 502, 505 (2d Cir. 1964).
499 *Id.* at 506.
In upholding the allocation of the profit derived from the bakery subsidiary to the parent corporation which sold the baked goods to the restaurants, the court held that if the taxpayer disputes the Commissioner's allocation of 100% of the income from one corporation to another, contending it should be a lesser percentage, the issue should be raised at the trial and not at the appellate level.

Canaveral International Corp. was contemplating the purchase of a 152-foot yacht for the purposes of leasing the yacht for oceanographic research and marine exploration. Further discussions with the owner indicated that the yacht was owned by a corporation and that the corporate basis of the yacht was $769,000. At this point Canaveral changed their intention to acquire the asset itself and negotiated an agreement whereby the stock of the corporation owning the yacht was to be acquired in exchange for 949 shares of no-dividend-bearing non-voting preferred stock which could be converted to 20,878 shares of common stock of Canaveral at a future date. At the date the transaction was concluded the Canaveral stock had a value of $177,500. The Commissioner determined the principal purpose of the acquisition of the stock of the corporation owning the yacht, rather than acquiring the asset itself, was for the avoidance of federal income tax. Hence when Canaveral later sold the yacht for $250,000 and deducted $519,632 as a Section 1231 loss (deduction against ordinary income), the loss was disallowed. In rebutting the taxpayer's argument that the yacht was acquired for a valid business purpose, the court relying on Treasury Regulation 1.269-3(a), stated that the presence of a valid business purpose in acquiring an asset will not override the absence of a tax avoidance motive. The only advantage which Canaveral could derive from acquiring the stock was the acquisition of the potential half-million-dollar loss.

11.07 Net Operating Loss Carrybacks and Carryovers. By enacting Section 172, Congress has attempted to ameliorate the tax consequences in those businesses and industries in which income tends to fluctuate from one year to another by permitting the profit years to be reduced by loss years. Net operating losses may be carried back to each of the three preceding years and carried forward to each of the five succeeding years, or until the loss is consumed. To illustrate this principle, let us assume that in 1974 the business incurred a $40,000 loss while in each year, 1971, 1972, 1973, and 1975 through 1979 the business incurred a $5,000 profit. The $40,000 loss from 1974 would be carried back to the earliest of the three preceding years, 1971, and the $5,000 loss would be wiped out, thereby leaving $35,000 of net operating loss to be carried to 1972, thereby wiping out that $5,000 profit and leaving $30,000 to be carried to 1973, thereby eliminating that $5,000 profit. The $15,000 of profit which will have been eliminated entitles the taxpayer to file for a refund

501 61 T.C. No. 58 (Jan. 29, 1974).
of the income tax paid in the years 1971 through 1973. The remaining $25,000 of loss may be carried forward to each of the succeeding five years.

Section 172(b) (2) provides:

Except as provided in subsections (i) and (j) [inapplicable here], the entire amount of the net operating loss for any tax year (hereinafter in this section to be referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph [1]) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.

Section 1201 (a) provides two methods of calculating the income tax for any year in which a corporation has a capital gain which is the lesser of:

1. the regular tax on all income, or
2. the regular tax on all income reduced by the amount of capital gain plus 30% of the capital gain. The latter is known as the alternative tax calculation. Since the corporation tax is 22% on the first $25,000 of taxable income, the regular method of calculation will, when income is below $36,000, be more beneficial than the alternative tax calculation. The alternative calculation is beneficial to a taxpayer with income in excess of approximately $36,000. Weil v. Commissioner held that where a taxpayer's ordinary operating deductions exceed his ordinary income, the excess of deductions over income does not reduce the amount of capital gain subject to the alternative capital gain calculation.

With these statutes and the Weil case as background, the stage is now set for one of the most important controversies to develop during the year 1974. At stake are over 100 pending cases involving 20 million dollars in taxes. Although the taxpayer has been successful in the First, Eighth, and Ninth Circuits, the Commissioner has recently been successful in the Fourth Circuit case of Mutual Assurance Society of Virginia Corp. v. Commissioner. During the year 1969 Mutual Assurance Society incurred a loss of $83,059.04. To obtain benefit from this loss Mutual would be required to carry this back to the earliest of the three preceding years or 1966. However, since the taxpayer incurred a loss in 1966, the $83,000 loss would be carried back to the year 1967. Next, the tax is calculated for the corporation under both the regular and alternative tax calculation methods. Under the regular method using Section 11, the taxable income of $281,828.70 for the year 1967 is reduced by the 1969

502 229 F.2d 593 (6th Cir. 1956).
503 Chartier Real Estate Co., 428 F.2d 474 (1st Cir. 1970), aff'g per curiam 52 T.C. 346 (1969).
504 Foster Lumber Co. v. United States, 500 F.2d 1230 (8th Cir. 1974).
loss carry-back of $83,059.04, leaving a recomputed taxable income of $198,769.66 or $8,909.44 in tax liability.

Under the alternative calculation of Section 1201(a) the ordinary income for the year 1967 of $72,575.10 is added to the capital gains of $209,253.60 for the total taxable income of $281,828.70. From this figure is deducted the capital gains of $209,253.60, thereby leaving a negative balance, which when multiplied by the corporation tax rate leaves a zero tax. The next step is to calculate the alternative tax on the capital gain by multiplying the capital gain by the alternative tax rate of 25%.

This results in a tax of only $52,303.40.

Now to the essence of the problem. How much of taxpayer's 1969 loss of $83,059.04 was consumed in recalculating the income for the year 1967? The taxpayer argues that only $72,575.10, the amount of the ordinary income was used in 1967, thereby leaving $10,483.94 to be used to reduce the tax for the year 1968. The Commission's position is that since there was still taxable income of $198,769.66 after the deduction of the 1969 loss, there is no loss to be carried to 1968.

The crux of this situation is the interpretation of Section 172(b)(2) which states: "The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried." We would note that this problem arises when two conditions are present: (1) the amount of the loss carried back or carried forward exceeds the amount of the ordinary income for the year to which the loss is being carried; and (2) the alternative tax calculation is being used to determine the tax on the capital gain.

Although Axelrod v. Commissioner involved the application of the loss carryback and alternative capital gains calculation for an individual, the Sixth Circuit held the net operating loss carryback was fully consumed in the carryback year as the loss did not exceed the total of the ordinary income plus capital gains, thereby upholding the validity of Treasury Regulations 1.72-4(b)(ii) and 1.172-5.

In Chartier Real Estate Co., Inc., the Tax Court looked to the legislative purpose of the net operating loss carryback and carryover provisions which, as they found, were intended "...to ameliorate somewhat the arbitrary nature of the annual accounting period, especially in the case of businesses with great fluctuations in income from year to year," thereby offsetting profit years with losses from other years. The Tax Court also determined that the taxable income meant "...taxable income to which the loss is actually applied in computing the actual tax liability." Therefore they arrived at the conclusion that a net operating

507 The current alternative tax rate is 30%.
508 75 USTC ¶ 9115.
510 Id. at 358,
loss, which exceeded ordinary income for the year to which it was carried back, could be again carried forward to a succeeding year since no tax benefit accrued to the taxpayer when the alternative capital gains tax calculation was utilized. The First Circuit in a brief per curiam opinion affirmed the Tax Court's decision with the now memorable quotation: "No useful purpose would be served by further elaboration on these unimportant and seldom-occurring questions." Courts which have subsequently dealt with this issue have uniformly followed the Tax Court's decision in Chartier.

The Eighth Circuit in Foster Lumber Co. v. United States, while affirming the opinion of the Tax Court primarily based on the weight of the previous decisions, noted that both the Commissioner's and the taxpayer's interpretation of the wording "taxable income" present plausible meanings of Section 172(b)(2). In answer to the arguments of both litigants that the plain meaning of the statute should be applied, the court came up with another memorable quotation: "As one would probably expect in the case involving the Internal Revenue Code, it is impossible to find any plain meaning in the statutory language that would dispose of this controversy." The Fourth Circuit in Mutual Assurance Society of Virginia Corporation v. Commissioner reasoned that since the phrase "taxable income" is not defined in Section 172, it should therefore be given the meaning as set forth in Section 63(a) which is "gross income minus the deductions allowed by this chapter." The Fourth Circuit, in a lengthy analysis of the meaning of the phrase "taxable income" found that the phrase could only have the meaning as set forth in Section 63(a). Therefore when a corporate taxpayer utilizes the alternative tax calculation, there can be no carryover to a succeeding year of a net operating loss until the loss exceeds both the capital gain and the ordinary income. In conclusion, the Fourth Circuit pointed out that nothing in the legislative history requires that a tax benefit be derived from every dollar of net operating loss which is carried back or carried forward, and if the congressional intent has not been fully implemented by these statutes it is up to Congress to change the wording of the statute to realize the full benefit of a net operating loss.

It is submitted by the writer that the Fourth Circuit's interpretation of Section 172(b)(2) is the better reasoned decision, although it probably does not give the result which Congress originally intended.


511 428 F.2d at 475.


513 500 F.2d 1230 (8th Cir. 1974).

514 Id. at 1232.


516 Id. at 74-6029.
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