

Tax Pitfalls

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TAX PITFALLS

GEORGE J. LAIKIN

In the case of the "misplaced decimal point," the taxpayer was trapped by the innocent error of an employee. In preparing a capital stock tax return for the Lerner Stores Corporation, the decimal point was inadvertently placed so that the value of its capital stock was declared to be \$25,000 instead of \$2,500,000 as intended. An amended capital stock tax return was proffered for filing as soon as the error was discovered. It was rejected, however, because the period of limitations had expired. The Supreme Court of the United States recognized¹ that "the hardship resulting from the misplaced decimal point was plain," but held that "Congress not the Court is the source of relief." That decimal point cost the taxpayer dearly.

A misplaced decimal point is comparatively easy to detect. Most pitfalls are so concealed that only eternal vigilance can prevent entrapment. Ignorance of the law and mistake have been rejected as excuses. While the Supreme Court has declared that "it is not the purpose of the law to penalize frank difference of opinion or innocent errors made despite the exercise of reasonable care,"² what is "reasonable care" involves a test which is subjective, elusive, and speculative. The Bureau of Internal Revenue is now asserting a 25% penalty against corporate taxpayers who did not file excess profits tax returns believing that they were not subject to the tax.³

PROBLEMS AFFECTING LAWYERS

Tax complexities are present in every phase of the practice of the law. Some involve the lawyer himself. Thus, attorneys frequently receive substantial fees at the conclusion of litigation pending for several years. Considerable income is pyramided in one year and a disproportionate amount thereof would be paid in taxes were it not for the relief provided by Section 107 of the Internal Revenue

¹ *Helvering v. Lerner Stores Corporation*, 314 U.S. 463 (1941).

² *Spies v. United States*, 317 U.S. 492, 496 (1942).

³ *Southeastern Finance Co. v. Commissioner*, 4 T.C. 1069 (1945) *aff'd*, *Southeastern Finance Company v. Commissioner*, 153 F(2d) 205 (CCA 5th 1496); *Dougherty Co. v. Commissioner*, (CCA 4th) decided December 23, 1946 (1947 P. H. Par. 72,298). See dissents in *Economy Savings and Loan Company v. Commissioner*, 5 T.C. 543 (1945) and *P. Dougherty Co. v. Commissioner*, 5 T.C. 79 (1941), *aff'd* CCA 4th, *supra*.

Code. It provides that if 80% of the total compensation for services which have been rendered over a period of more than thirty-six months is received in one year, the tax shall not be greater than the aggregate of the tax which would have been paid had the compensation been received ratably over the entire period during which the services have been performed. The attorney may recompute his income and his taxes as if he had received a proportional amount of the fee during each year services were rendered with obvious savings in income taxes. Upon being engaged in a matter of substance, the attorney should be careful not to receive more than 20% of the anticipated fee before his services are concluded;⁴ and that the services will be completed within the same year when at least 80% of the compensation is finally paid.⁵

Section 107 does not require the attorney to lump together all fees received from a client for services rendered for him in a variety of matters. Each matter may be treated separately.⁶ Adequate records should, therefore, be kept with respect to all matters to which Section 107 may be applicable.

Attorneys who entertain clients at home or who have home law libraries should not overlook the possibility of depreciation deductions. Thus, in *Beaudry v. Commissioner*⁷ the Tax Court ruled that depreciation deductions were allowable with respect to a rug, radio, cocktail table and other items which were part of the equipment of an attorney's home library used exclusively for business purposes.

Some attorneys claim deductions for dues to golf and other clubs. This may be done only if it can be established that such expenditures are necessary in the conduct of the attorney's practice and that business benefits may be expected therefrom.⁸ The attorney should recognize that he may be required to give the names of new clients or the amount of new business derived from contacts made through the clubs. That club memberships are generally helpful in obtaining clients is not a sufficient ground for allowing the deductions.⁹

⁴ Cf. *rIanna v. Commissioner*, 156 F(2d) 135 (CCA 9th 1946).

⁵ Treasury Regulations 111, Sec. 29.107-1.

⁶ Cf. *Nast v. Commissioner* 7 T.C. 432 (1946).

⁷ *Beaudry v. Commissioner*, decided March 25, 1943 (1943 P-H Memorandum Decisions Service, Par. 43,156), aff'd, 150 F (2d) 20 (CCA 2nd 1945), and on remand, *Beaudry v. Commissioner*, decided February 6, 1946 (1946 P-H Memorandum Decisions Service, Par. 46,030).

⁸ *Boehm v. Commissioner*, 35 BTA 1106 (1937):

⁹ *Boehm v. Commissioner*, supra; *Lellyett & Rogers, Inc. v. Commissioner*, decided October 18, 1946 (1946 P-H Memorandum Decisions Service, Par. 46,250).

DOMESTIC RELATIONS

The field of domestic relations has not escaped its share of tax pitfalls. Every party to a divorce proceeding involving alimony or property will find it advantageous to consider tax implications.

Under the Internal Revenue Code¹⁰ the amount paid periodically by a husband to his wife under a "decree of divorce or separate maintenance" in discharge of a "legal obligation which, because of the marital or family relationship is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation" are deductible from the husband's income and taxable to the wife.

In *Kalchthaler v. Commissioner*¹¹ the taxpayer had deserted his wife and failed to provide for her support. Proceedings were instituted by the wife in the Pennsylvania courts to compel support. She obtained a judgment requiring the husband to pay a weekly sum for her support. When the tax consequences were reviewed, the Tax Court pointed out that judgment for support was not a decree of divorce or legal separation; that the taxpayer's wife was not legally separated from him; that the deduction is available to the husband only if the payments were made to a "wife who is divorced or legally separated from her husband under a decree of divorce or of separate maintenance." As a consequence, it held that the taxpayer was not entitled to deductions for amounts paid to his separated wife.

In *Brown v. Commissioner*¹² the Tax Court denied a husband any deduction for sums paid in accordance with a separation agreement entered into without court proceedings, pointing out that such payments were not made under a decree as required by the Internal Revenue Code. Private agreements do not qualify.

Temporary alimony is not deductible by the husband. To be deductible the payments must be made after a decree has been entered.¹³

Payments made by a husband for the support of his children are not deductible under the Internal Revenue Code. Even though such payments are received by the wife, they are not taxable to her if she merely received them on behalf of the children. A judgment in a divorce matter should, therefore, clearly differentiate between the amounts paid as alimony and as support money.¹⁴ The consequence of failing to do so is illustrated by *Moitoret v. Commissioner*.¹⁵ Here

¹⁰ Sec. 22(k) and Sec. 23(w) I.R.C.

¹¹ 7 T.C. 625 (1946).

¹² 7 T.C. 715 (1946).

¹³ *Wick v. Commissioner*, 7 T.C. 723 (1946).

¹⁴ *Budd v. Commissioner*, 7 T.C. 413 (1946) Regs. 111, Sec. 29.22(k)-1.

¹⁵ 7 T.C. 640 (1946).

the taxpayer was a divorced wife. The decree provided for payments to the wife for the support and maintenance of herself and the minor children, but did not allocate any specific sum for the children. The wife contended that to the extent that the payments were made to support the children, they should not be taxable to her. The Tax Court, however, interpreted the decree of the divorce court literally and taxed the whole amount to her.

To be deductible by the husband, the payments under a divorce decree must be periodic; they must be on an installment basis. Section 22(k) of the Internal Revenue Code provides that "an installment payment shall be considered a periodic payment for the purposes of this sub-section if the principal sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument . . ." A lump sum settlement does not qualify as a deduction to the husband. It is not income to the wife.¹⁶ If under a divorce settlement the husband is required to pay \$10,000 at the rate of \$1,000 a year for ten years, the first payment to be made as of the date of the judgment of the divorce, the payments would not be deductible to the husband, or taxable to the wife, because the full amount of the settlement will have been paid *prior* to the end of ten years after the date of the divorce judgment. If divorce settlement payments are to be deductible, the installments must extend over a period sufficiently long so that the last installment will be made *more* than ten years from the date of the judgment.

The impact of the Federal tax law upon divorce and legal separations is now so great that one writer suggested that the marriage vow be revised to conclude "until death or taxes do us part."¹⁷

INTER-FAMILY TRANSACTIONS

Transactions between members of a family are full of tax pitfalls. A wife's substantive rights to property acquired from her husband may have little bearing upon tax consequences.¹⁸ It has been

¹⁶ Regs. 111, Sec. 29.22(k)-1. A lump sum divorce settlement is not a taxable gift to the wife. *Converse v. Commissioner*, 5 T.C. 1014 (1945).

¹⁷ Weisbard, *Taxation of Family Liquidation*, *Taxes*, November 1946, page 1055.

¹⁸ The attempt to tax a husband upon the income received by members of his family on the theory that he exercised control over their property or incomes has reached the point that Circuit Judge Learned Hand in *Kohnstamm v. Pedrick*, 153 F(2d) 506 (CCA 2nd 1945) was forced to declare: "We cannot understand on what conceivable theory the income from the investments made by the children's mother is to be taken as the (father's). The (Collector) suggests nothing to support this extraordinary position except that she (the wife) uniformly consulted her husband about what she should do. It would indeed add terror to marital confidences if, whenever a woman asked her husband's advice, sporadically or uniformly, about what to do with their children's money, she took the chance that their income would be added to his for purposes of taxation. It may be that for tax purposes the jural indissolubility of the family will in the end be restored to the position it occupied in archaic law; but so far that has not happened."

aply said that "bed chamber arrangements" between a husband and wife will be viewed with suspicion. The courts refuse to recognize "concepts of ownership . . . fashioned out of legal niceties which may have little or no significance in . . . household arrangements."¹⁹ The current attack on husband and wife partnerships illustrates the divergence between tax law and the substantive law. Yet there are situations where tax consequences are governed by "legal niceties."

Notwithstanding the assault on family partnerships, if title to real estate is held in joint tenancy by a husband and wife under the laws of a state which give the wife an equal vested interest in the real estate and to the income therefrom,²⁰ the Bureau of Internal Revenue has consistently ruled that the income is divisible between them.²¹ Under these rulings, it is apparently of no significance that the wife's interest in the jointly held property was acquired through gift.²²

Typical of special provisions relating to family transactions are those prohibiting deductions for losses arising from sales or exchanges of property directly or indirectly between members of a family.²³ To illustrate:

Suppose A owns securities which have fallen in market value. He wishes to sell and claim a loss. Yet he has sufficient faith in the securities that he would like to retain them for his family. If he sells the securities directly to his wife, he is precluded from claiming a loss even though she pays him the current market value.²⁴ If the securities are listed and A sells them with the thought of having Mrs. A repurchase them immediately through the exchange, A's loss may nevertheless be disallowed.²⁵ There are conflicting decisions with respect to this. In *Commissioner v. McWilliams*,²⁶ the Sixth Circuit, and in *Commissioner v. Kohn*,²⁷ the Fourth Circuit, held that a loss could not be taken by a husband on the securities repurchased by the wife, even though such sale and purchase took place through the medium of a public exchange. The Second Circuit Court of Appeals, in *Commissioner v. Ickelheimer*,²⁸ took a contrary view and allowed the loss. No doubt, the Supreme Court will resolve this conflict.

¹⁹ *Helvering v. Clifford*, 309 U. S. 5331 (1940).

²⁰ This is the situation in Wisconsin. Sec. 246.01; 246.03; 234.21, Wis. Stats, 1945.

²¹ I.T. 3754, C.B. 1945, p. 143.

²² As distinguished from "typical" family partnership cases such as *Commissioner v. Tower*, 327 U.S. 280 (1946) and *Lusthaus v. Commissioner*, 327 U.S. 293 (1946).

²³ Sec. 24(b) (1) (A), I.R.C.

²⁴ Sec. 24(b) (1) (A), I.R.C.

²⁵ See Sec. 118, I.R.C. relating to wash sales.

²⁶ Decided by CCA 6th, Dec. 3, 1946 (1946 P-H par. 72,659).

²⁷ Decided by CCA 4th, Nov. 13, 1946 (1946 P-H par. 72,647).

²⁸ 132 F(2d) 660 (CCA 2nd, 1943).

Special tax considerations affecting the family may be further illustrated by the provisions relating to personal holding companies wherein an individual is considered as owning the stock of a corporation although title to such stock is held by a member of his family.²⁹ Also by the provisions requiring the immediate payment of salaries and interest to stockholders owning directly or indirectly 50% or more of the outstanding shares.³⁰

Clearly, before transactions between members of a family are consummated, the tax implications should be thoroughly investigated.

GIFTS

A owned 100 shares of X Corporation stock which he purchased at \$100. The shares dropped to \$20, at which price he sold them to his son. Later, the market having risen, the son sells them at \$40. While A is precluded from claiming a loss because the sale was made to a member of his family, the son, nevertheless, will be required to pay a tax upon the gain he realized when the stock he purchased from his father at \$20 is sold at \$40.³¹

If A had made a gift of the shares to his son, the situation would have been different. The son would not be required to pay any tax upon sale of the stock at \$40. His basis, as the recipient of the gift, would have been \$100 — the donor's basis.³² Moreover, since the 100 shares were worth only \$2,000 as of the date of the gift, the transfer would have been free of any gift taxes. Under the circumstances, a gift rather than a sale would have been better tax-wise.

It should be noted that while the measure of gain is the difference between the donor's basis and the amount realized by the recipient upon sale, if a loss is incurred, the loss is measured by the difference between the value as of the date of the gift and the amount realized by the recipient upon sale.³³ This distinction must be borne in mind if it is intended that the recipient will sell at a loss in order to offset other taxable gains which he may have.

Under the Internal Revenue Code a person may make a gift of \$3,000 a year to as many individuals as he chooses without paying a gift tax.³⁴ Thus, Jones may each year make a gift of \$3,000 to each of his children without paying a tax. But, if the gift involves a future interest, if the recipient does not receive immediate rights to that which is given away, the \$3,000 annual exclusion does not apply. A gift made in trust with income to be accumulated is a

²⁹ Sec. 503, I.R.C.

³⁰ Sec. 24(c) (3) I.R.C.

³¹ Because Sec. 113 I.R.C. provides no exception to basis in this type of situation.

³² Sec. 113(a) (2) I.R.C.

³³ Sec. 113(a) (2) I.R.C.

³⁴ Sec. 1003 (b) (3) I.R.C.

gift of a future interest and does not qualify for the annual exclusion. This may be true even though the Trustee is given authority to use income for the support of a beneficiary if in the Trustee's discretion it is necessary.³⁵

Frequently gifts are made for the purpose of dividing an estate during the lifetime of the owner. Items to be given away for this purpose should be those which have not appreciated greatly in value while held by the donor. Assume A owns stock in X Corporation, which he has held for many years. He bought the shares for \$10. They are now worth \$100. If those shares are given away, the gift tax will apply to a valuation of \$100. If the recipient later sells the shares at \$100, he will pay a tax upon a gain of \$90. The sum of the gift tax and the capital gains tax may actually exceed the amount of the estate tax that would have been paid with respect to the shares if they had remained in the estate and passed at death through a testamentary disposition. A beneficiary receiving these shares at A's death would have paid a tax upon the gain measured only by the difference between the value as of the date of death and the amount realized upon sale. These factors should be given careful consideration before a person of advanced age effectuates gifts. There is, of course, always the danger that a gift may be held to be in contemplation of death and defeat any estate tax minimization purpose.

JOINT TENANCIES

Gifts creating joint tenancies can prove very expensive tax-wise. Title to real estate is frequently held by a husband and wife in joint tenancy. Depending upon the amount involved, the joint tenancy may cause the property to be subjected to the gift tax as well as double estate taxes.

The creation of a joint tenancy is a taxable event under the gift tax laws.³⁶ The value of a gift will be determined on the basis of actuarial principles. Upon death of the husband title to the entire property automatically vests in the wife, but his half is subject to tax in his estate. If the wife retains the property until her death, the share she received from her husband will again be subject to estate taxes. Hence, consideration should be given to the use of a trust instead of a joint tenancy. The trust permits tax economies and provides for the continuity of title. Individuals with taxable estates should avoid joint tenancies.

³⁵ *Fondren v. Commissioner*, 324 U.S. 18 (1945); *Commissioner v. Disston*, 325 U.S. 442 (1945).

³⁶ Regs. 108 Sec. 86.2; Regs. 108, Sec. 86.19.

WILLS AND TRUSTS

The will and testamentary trust, so important in the disposition of an individual's estate, are replete with tax difficulties and uncertainties. A few of the pitfalls will be illustrated.

A good will cannot be drawn unless the attorney has sufficient knowledge concerning his client's financial affairs and family situation. For example: Suppose A, a man of considerable means, engages an attorney to draw a will. A is advised as to the desirability of creating a testamentary trust, and as to the possible estate tax economies. A agrees to this program. However, A fails to disclose, and the attorney fails to discover, that A has substantial amounts of life insurance from which his wife is to receive stated monthly payments. The will as drawn contains no specific provision for the payment of estate or inheritance taxes. Upon the death of A, Mrs. A is the beneficiary under a testamentary trust and the recipient of fixed payments from life insurance. The Executor of A's estate is faced with the duty of collecting from Mrs. A the proportionate amount of Federal estate tax which the face amount of life insurance bears to A's entire net estate.³⁷ Mrs. A is thus in the very difficult position of having to raise money to pay the estate taxes attributable to life insurance proceeds which she will not receive except in installments over a period of many years. Clearly, this is not what A had in mind when he made his estate plans.³⁸

Every well drawn will should contain specific directions covering payment of the estate and inheritance taxes. Without such a provision, it is impossible to plan with certainty for the support and maintenance of dependents and beneficiaries.

Many wills are drawn leaving the whole of a substantial estate to the surviving spouse. The fact that upon the death of the spouse another set of estate taxes and death charges will be payable is not considered. Often a will is drawn leaving the entire estate to a wife and expressing the hope that she will take care of the children. This, too, subjects the entire estate to a second tax at the death of the wife. Such double taxation can be avoided. Present high estate tax rates make it necessary to postpone as long as possible the vesting of title to an estate in heirs and beneficiaries. The trust medium should be used for this purpose.

Where a number of beneficiaries are involved, consideration should be given to the creation of several separate, rather than a single, testamentary trust. Separate trusts make for greater ease in planning and administering an estate. Income tax economies are possible. If

³⁷ Sec. 826(c) I.R.C.

³⁸ The same problem is also present with respect to property passing pursuant to a power of appointment. Sec. 826 (c) I.R.C.

only one trust is created, and the income therefrom is to be accumulated, such income will be subject to tax in higher brackets than if the same amount were divided amongst several trusts. Multiple exemptions will be available. Lower tax brackets will be applicable.

The provisions of a testamentary trust must be flexible so as to provide for the needs of beneficiaries as conditions change. Great care must, however, be exercised lest the provisions designed to provide flexibility subject the estate to a second tax at the death of a beneficiary.

Provision is frequently made in a testamentary trust for the payment of the income to a widow plus such additional amounts of principal as she may from time to time demand. The effect of such a provision is to give the widow complete control over the estate left in trust for her and the entire amount thereof would be subject to estate taxes at her death. If, however, the right to invade corpus is vested in someone other than the widow, such invasion can take place for her benefit without double estate tax consequences. Such discretion may be exercised by a Trustee, provided the widow is not the Trustee.³⁹

Frequently an estate is to be devoted to charitable purposes after the death of certain life beneficiaries. Charitable bequests are not subject to the estate tax.⁴⁰ However, if the right to invade principal is given, the amount to be devoted to charitable purposes becomes uncertain and the deduction for the charitable bequest may be lost.⁴¹ The right to invade should be sharply circumscribed, if not entirely eliminated, lest the hoped for estate tax minimization fail to materialize.

REAL ESTATE TRANSACTIONS

Many problems arise in connection with real estate transactions. One of them relates to the deductibility of real estate taxes adjusted as of the time of closing. The general rule is that real estate taxes are deductible when paid or accrued depending upon the accounting method employed.⁴² Assessments for local benefits, however, are not deductible.⁴³ The distinction depends upon whether the levy is imposed to pay for some local improvement which benefits only a limited number of property owners and is collectible only from them. When it is, there is no deduction.

When real estate transactions are closed, the purchaser customarily reimburses the seller for the portion of any taxes already paid

³⁹ Regs. 105, Sec. 81.24(1); Sec. 811(f) I.R.C. See also as to the income tax, Reg. 111, Sec. 29.22(a)—22, as added by T.D. 5488; *Jergens v. Commissioner*, 136 F(2d) 497 (CCA 5 1943), cert. den. 320 U.S. 784.

⁴⁰ Sec. 812(d) I.R.C..

⁴¹ *Industrial Trust Co. v. Commissioner*, 151 F(2d) 592 (CCA 1st 1945).

⁴² For date of accrual under Wisconsin Law see G.C.M. 24599, 1945 C.B. 110.

⁴³ Regs. 111, Sec. 29.23(c)-3.

which is allocable to the period following the closing. When the taxes for the current period are not yet payable, the seller credits the purchaser with the portion allocable to the period during which he (the seller) held title.⁴⁴ This common practice does not, however, determine which of the parties is entitled to a deduction for income tax purposes. The rule is that if the tax is a personal obligation of the seller or a lien on the property prior to the closing date, the purchaser may not deduct the tax even though it is paid by him. The tax is treated as a part of the cost of the property.⁴⁵ If, however, the tax is neither a personal obligation of the seller, nor a lien prior to the closing date, the purchaser may deduct the entire tax paid. The amount which he received from the seller at the closing is treated as a reduction of the selling price. These rules operate regardless of the closing method employed.

If an owner of real estate, operating on a cash basis, were to pay 1948 real estate taxes on December 31, 1947, such taxes would not be deductible in 1948 even though the taxpayer paid them for and intended to claim them in 1948. They must be deducted in the year in which they were paid or accrued.⁴⁶ Hence, the income for both 1947 and 1948 would be distorted. Such distortions can prove expensive.

Under long term or valuable leases, the payment of advance rentals or the deposit of security create tax problems. Care must be exercised lest advance payments or the deposit of security constitute taxable income to the landlord in the year in which such advance payments were made or the security was deposited. The general rule is that advance rentals paid upon the execution of a lease without restriction as to the disposition or enjoyment thereof by the landlord are taxable in full in the year received and cannot be apportioned over the term of the lease.⁴⁷ This rule applies whether the landlord is on a cash basis or on the accrual basis.⁴⁸ Sums deposited with the landlord solely for the purposes of security, which are to be kept intact and refunded to the lessee upon termination of the lease, do not ordinarily constitute income to the lessor.⁴⁹

A security provision in the lease whereby the lessee deposits a sum of money to be applied against the rental for the last period of

⁴⁴ This is now the rule in Wisconsin by statute. Sec. 74.62, Wis. Stats, as amended by c.495, Laws of 1945.

⁴⁵ *Magruder v. Supplee*, 319 U.S. 394 (1942); *Commissioner v. LeRoy*, 152 F(2d) 936, CCA 2d 1945).

⁴⁶ Sec. 43 I.R.C.

⁴⁷ *O'Day Investment Co. v. Commissioner*, 13 B.T.A. 1230; *Renwick, et al. v. United States*, 87 F(2d) 123 (CCA 7th 1937).

⁴⁸ Cf. *C. H. Mead Coal Co. v. Commissioner*, 31 BTA 190 (1934); *Scott v. Commissioner*, 27 BTA 951 (1933).

⁴⁹ *Estate of Barker v. Commissioner*, 13 BTA 562; *Clinton Hotel Realty Corp. v. Commissioner*, 128 F(2d) 968 (CCA 5th 1942).

the lease in the event all other conditions have been performed is vulnerable on the ground that there are no restrictions against the use of the funds by the landlord. Such a deposit actually constitutes an advance payment of rental.

Although the lessor must pay income taxes on advance rentals in the year of receipt, the lessee is required to amortize the advance payments over the term of the lease.⁵⁰

Where a lessee makes extensive improvements, he may amortize the cost thereof over the period of the lease. If the lease contains an option to renew, amortization must nevertheless be based upon only the principal term of the lease without taking into consideration the renewal period.⁵¹ Unless this is done, the loss of some amortization deductions may occur in the event the lease is not renewed or extended.

Where a closely held corporation pays rent to a major stockholder, the question may arise as to whether a portion of the rent should not be disallowed on the ground that it is excessive — that it is in part a distribution of corporate profits. This occurred in *Limericks, Inc. v. Commissioner*.⁵² Here the majority stockholder and his wife owned all but one qualifying share. They also owned the real estate, which they purchased for \$50,000 and rented to the corporation at \$18,000 a year. The Tax Court held that a fair rental for the property was only \$8,400 a year and treated the rest of the payments as a distribution of corporate profits not deductible by the corporation, but taxable to the recipients.

One of the factors contributing to the Tax Court's ruling in the *Limerick's* case was that the corporation had advertised extensively through printed media and on the radio that their business had moved "out of the high rent, high tax district," and that the customers would "save the difference." This prompted the Tax Court to say:

The payment by petitioner corporation of \$8,400 per year rental will give at least a color of verity to the petitioner's advertisement that it had moved into 'a low rent' district. While it is regrettable from the undisputed evidence in this case that petitioner's customers did not 'save the difference,' the law will permit the government to 'tax the difference.'

Many corporations and stockholders have unnecessarily been subject to double taxes upon the sale of real estate. If the corporation sells its real estate at a profit, it is required to pay a tax thereon. Later, upon distribution of the profit as dividends, or upon liquida-

⁵⁰ Regs. 111, Sec. 29.23(a)-10; *Main & McKinney Building Co. v. Commissioner*, 113 F(2d) 8 (CCA 5th 1940), cert. den. 311 U.S. 688; *Southwestern Hotel Co. v. United States*, 115 F(2d) 686 (CCA 5th 1940) cert. den. 312 U. S. 703.

⁵¹ Regs 111, Sec. 29.23(a)-10.

⁵² 7 T.C. 1129 (1946).

tion, another tax is paid by the stockholders. Where a corporation wishes to sell all of its assets, and will realize a profit on such sale, careful consideration should be given to the dissolution and the distribution of the assets of the corporation to the stockholders prior to any sale. The stockholders could then negotiate and arrange for a sale. The danger in this procedure, however, is pointed out in *Commissioner v. Court Holding Co.*⁵³ Here the corporation desired to sell certain property. It negotiated for a sale but prior to the consummation thereof, negotiations were broken off. The corporation was dissolved; the assets were distributed to the stockholders. Then the stockholders resumed negotiations with the same prospective purchasers and consummated the sale. The Supreme Court held that the sale by the stockholders under such circumstances was a sale by the corporation and it subjected the corporation to a tax on the gain.

If a corporation is to be dissolved and stockholders are to make the sale, the dissolution and distribution of the assets should take place before a prospective purchaser is found and negotiations for the sale undertaken. Under such circumstances the *Court Holding Co.* case will not apply.

The stockholders, upon the dissolution of the corporation, will be required to pay a gains tax measured by the difference between what they paid for their stock and the fair market value of the property received upon liquidation.⁵⁴ The fair market value will probably be the same or reasonably close to the price at which the stockholders will later sell the property. Thus, only one tax on the gain will be payable.

CORPORATE PROBLEMS

The field of corporate activity is replete with tax problems, dangers and pitfalls. Some problems are simple; others defy comprehension.

A simple situation may be illustrated by the unwary owner of all of the stock of a corporation owning real estate. He dissolved the corporation and personally took title to the property. However, he failed to consider that the market value of the property at the time of dissolution is much more than he paid for his shares. Equities had been built up over a period of years; indebtednesses had been paid off through earnings. The taxpayer was subjected to a gains tax upon the difference between the cost of his stock and the present market value of the real estate — a result as undesirable as it was unanticipated.

⁵³ 324 U.S.331 (1945).

⁵⁴ Sec. 111; Sec. 115(c) I.R.C.

A great many problems arise under Section 115 of the Internal Revenue Code with regard to the liquidation of corporation either in whole or in part. The problem frequently arises where a corporation has accumulated substantial surplus. The stockholders do not want to receive dividends because of their own high tax brackets, but would be anxious to have the accumulated profits if it could be received by way of a partial liquidation and redemption of their shares on a capital gains basis.

The Internal Revenue Code provides⁵⁵ that if a corporation cancels or redeems its stock at such time and in such manner as to make the distribution and cancellation or redemption, in whole or in part, essentially equivalent to the distribution of a taxable dividend, the amount paid in redemption shall be treated as a taxable dividend. Thus, if there are earnings and profits, accumulated after February 28, 1913, available for use in connection with a partial redemption and cancellation of stock, there is grave danger that such redemption will be construed as the payment of a taxable dividend and taxed to the stockholders as ordinary income rather than at capital gains rates. This will be true unless there is a sound business reason requiring the reduction of capital or unless the redemption and cancellation takes place at a time and in a manner clearly evidencing no purpose of distributing corporate profits.⁵⁶

The tests for determining whether or not a partial liquidation shall be treated as a distribution of earnings may be summarized as follows:⁵⁷ (1) Capitalization largely represented by earnings capitalized through the issue of stock dividends; (2) Relatively poor dividend paying record; (3) Proportional ownership of shareholders unchanged; (4) No need for the corporation to adopt a policy of contraction; (5) Initiative for distribution came from stockholders who need the cash; (6) Corporation continues to operate at a profit.

It should be noted, however, that the ultimate criterion of the application of Section 115(g) is "the net effect of the distribution rather than the motive and the plans of the taxpayer or his corporation."⁵⁸

One method of distributing earnings without having stockholders incur surtax liability on dividends is, of course, through a complete liquidation of the corporation. Amounts received in complete liquidation will be treated as having been received in payment for

⁵⁵ Sec. 115(g) I.R.C.

⁵⁶ *Commissioner v. Bolson*, 70 F(2d) 304 (CCA 7th 1934); *Upham v. Commissioner*, 4 T.C. 1120 (1945); *Manning v. Commissioner*, 3 T.C. 853 (1944).

⁵⁷ *Flanagan v. Helvering*, 116 F(2d) 937 (App. D.C. 1940).

⁵⁸ *Flanagan v. Helvering*, *supra*.

the stock. The transaction would result in a capital gain or loss.⁵⁹ Such a step, however, means "going out of business."

Sometimes a redemption, in whole or in part, takes place in connection with a recapitalization involving an exchange of the redeemed stock for other securities of the corporation. Common stock might be surrendered in exchange for other common stock and debenture bonds. If such exchange takes place under circumstances not reflecting a sound business purpose, it might be construed as involving a taxable dividend. Two recent cases illustrate the problem. These are the *Bazley*⁶⁰ and the *Adams*⁶¹ cases. In both a closely owned corporation following the recapitalization provisions of the Internal Revenue Code⁶² issued common stock and long term debenture bonds in exchange for its common stock. The recapitalization provisions were adhered to in all formal respects but the Treasury nevertheless contended successfully that the transactions were essentially equivalent to the distribution of a taxable dividend and that they served no legitimate corporate purpose as to recapitalization.⁶³

The position of the Commissioner of Internal Revenue in the *Bazley* and *Adams* cases illustrates the principle that formal adherence to the provisions of the Internal Revenue Code or to the requirements of state law do not absolutely control tax liability. The classic case, of course, is *Gregory v. Helvering*,⁶⁴ where a series of transactions which followed the reorganization provisions of the Internal Revenue Code in every technical respect were nevertheless held by the Supreme Court not to be entitled to the benefits of the reorganization provision because their sole and admitted purpose was tax avoidance. Tax avoidance is not a sufficient business purpose.

Problems relating to partial liquidations or redemptions are not unrelated to Section 102 of the Internal Revenue Code which provides a penalty upon corporations accumulating surplus beyond reasonable business needs. Stockholders of many close corporations have difficult choices to make. If dividends are paid, their personal high tax rates will consume most of them. If dividends are not paid, Section 102 may impose a penalty of at least 27½%. In approaching a Section 102 situation, a careful analysis should be made of the history of the business, its present and future needs and plans. Such an analysis may reveal sufficient need for the accumulated surplus.

⁵⁹ Sec. 115(1) I.R.C.

⁶⁰ 155 F(2d) 237 (CCA 3rd 1946).

⁶¹ 155 F(2d) 246 (CCA 3rd 1946).

⁶² Sec. 112(g)(1)(E) I.R.C.

⁶³ The *Bazley* and *Adams* cases are now pending on certiorari before the United States Supreme Court.

⁶⁴ 293 U.S. 465 (1935).

If reasons are not uncovered, it might nevertheless, under certain circumstances, be cheaper to pay the penalty imposed by the section than pay dividends to stockholders in whose hands the distribution would be taxed at rates substantially higher than the corporate rate plus the penalty.

Section 102 should be considered in organizing new corporations. The capital structure should be such as to make necessary the accumulation of working capital out of profits. The corporation may thus be placed in a position where it will be unable to pay dividends until such time when adequate working capital has been accumulated.

When a corporation pays dividends in kind rather than in money, the question arises whether such payment results in a taxable gain or deductible loss to the corporation. Much depends upon the wording of the resolution declaring the dividend.

Where the property which is to be paid as a dividend has increased in value, the resolution should declare the dividend in terms of the assets themselves, i.e., dividends payable in Y Company stock, or in X Company bonds. In such case, the difference between basis and fair market value would not be taxable to the corporation. If a loss resulted, such loss would likewise not be deductible by the corporation.⁶⁵

Where property to be used for dividend purposes has depreciated in value and the corporation wants to realize a loss, then the resolution declaring the dividend should declare it in terms of dollars and after that the property should be distributed. Then the corporation can claim the difference between basis and fair market value, at which value it was distributed, as a loss.⁶⁶

Where a salary is voted for an officer of a closed corporation, and such officer owns directly or indirectly fifty per cent or more of the stock of the corporation,⁶⁷ the salary must actually be paid within two and one-half months after the close of the corporation's fiscal year.⁶⁸ The same rule applies with respect to interest which may be due a stockholder. It applies even though the salary or interest is accrued on the books of the corporation as a liability. Payment by note of the amount due a principal officer and stockholder will not be considered sufficient to meet the requirements of the statute,⁶⁹

⁶⁵ *General Utilities & Operating Co. v. Commissioner*, 27 BTA 1200, 29 B.T.A. 934, rev'd, 74 F(2d) 972 (CCA 4th 1935), but in effect aff'd by Supreme Court, which reversed CCA 4th in part, 296 U.S. 200; *Commissioner v. Columbia Pacific Shipping Co.*, 77 F(2d) 759 (CCA 9th 1935).

⁶⁶ Note 65, *supra*. *Callanan Road Improvement Co. v. Commissioner*, 12 B.T.A. 1109; A.R.R. 435, C.B. June 1921, p. 27.

⁶⁷ Sec. 24(b)(1) I.R.C.

⁶⁸ Sec. 24(c)(3) I.R.C.

⁶⁹ *Miller v. Commissioner*, 7 T.C. 729 (1946). But see *Musselman Hub-Brake Co. v. Commissioner*, 139 F(2d) 65 (CCA 6th 1943).

and will result in the disallowance of the salary or interest deduction claimed.

MISCELLANEOUS PROBLEMS

In selling a business, specific arrangements are often made for the seller not to compete. If the amount paid for the agreement not to compete is to be deducted by the purchaser, the agreement should specifically state the consideration paid for this covenant and should fix the period during which it will be in effect.⁷⁰ If the amount paid for such a covenant is not specifically stated, the amount to be amortized cannot be ascertained. The cost of eliminating the competition must then be treated as a capital expenditure, as part of the cost of acquiring the business. Unless a definite period of non-competition is provided, there would be no basis for determining the time over which the consideration paid for the covenant should be amortized and deducted.⁷¹

Some interesting problems arise in connection with the repayment of debts. Suppose A owes B \$10,000. B is willing to take stock in the X Company, which is owned by A, in payment. This stock, now worth \$10,000, cost A only \$3,000. If A transfers the stock in payment of his \$10,000 debt, he realized a capital gain of \$7,000 and has subjected himself to a capital gains tax.⁷² If, however, he had simply paid the debt in cash, he would not have fallen into the trap of incurring a taxable gain by paying a debt.

The same principle applies in the case of a fiduciary who makes a distribution to a legatee or beneficiary in kind rather than in cash. The fiduciary is taxed with the difference between the basis of the assets distributed and the value at which they are distributed to the legatee or beneficiary.⁷³

An analogous situation relates to the payment of interest. Assume A owes a debt and accumulated interest thereon. The debt and the interest are cancelled by the execution and delivery of a new note to cover both the principal and the accumulated interest. If A is on the cash basis, he is not entitled to an interest deduction because there actually was no payment of interest. It would be deductible only when finally paid.⁷⁴ On the other hand, if A had borrowed money to pay the interest from someone other than his present creditor, he would be entitled to a deduction for the interest paid.⁷⁵ The same

⁷⁰ *A. Levy & J. Zentner Co. v. Commissioner*, 31 B.T.A. 38, 1934.

⁷¹ *J. I. Case Co. v. United States*, 32 F Supp. 754 (Ct. Cls. 1940). *B. T. Babbitt, Inc. v. Commissioner*, 32 B.T.A. 693 (1935).

⁷² *Huberman v. Commissioner*, decided June 30, 1943 (1943 P-H Memorandum Decisions Service Par. 43,323).

⁷³ *Kenan, Jr. v. Commissioner*, 114 F(2d) 217 (CCA 2nd 1940).

⁷⁴ *Eckert v. Burnet*, 283 U.S. 140 (1931); *Helvering v. Price*, 309 U.S. 409 (1940); *United States v. Collier*, 104 F(2d) 42 (CCA 5th 1939).

⁷⁵ *Cf. Humphrey v. Commissioner*, 91 F(2d) 155 (CCA 9th 1937).

principle would apply in the case of interest on life insurance loans. The interest, if not paid, is added to principal. It is not deductible when added to the principal.⁷⁶ However, when payment on the renewed loan is made, either in full or in part, the interest is deductible.⁷⁷

CONCLUSION

Tax pitfalls are as many and as varied as the variety of transactions that occur between people. No transaction involving money or property should be consummated until the tax implications have been fully explored and evaluated.

⁷⁶ *Alsberg v. Commissioner*, 42 B.T.A. 61 (1940); *Prince v. Commissioner*, 39 B.T.A. 487 (1939).

⁷⁷ G.C.M. 2861, C.B. June 1928, p. 255; Bureau ruling, July 12, 1946, 1946 P-H Par. 76,300; *Estate of Bowen v. Commissioner*, 2 T.C. 1 (1943).