TAX DOINGS

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Contents

I. a. Real Estate Taxation Course - July 6 - 8 at Boyne Mountain Lodge.
You will be receiving further information on this later in the spring.

b. Tax Executives Institute, Inc. will be holding a meeting on the Michigan tax program on March 28 at the Pitt-Ft. Shelby Hotel, Detroit. The speaker will be Lt. Gov. William G. Millikin.
Members of the Tax Section are invited.
Cocktails @ 5:30 P.M. Dinner @ 6:30 P.M.
$8.00 per person
If interested contact: Brian T. O'Keefe, Chrysler Corp., Detroit

II. Federal Taxation

a. Acquiescence in the Gutchess Case, (1966) 46 T.C. 554:A., C.B. 1967-6, 6

The commissioner has reversed his position regarding the includability of a family residence in the estate of a husband who transfers the residence to his wife prior to his death. In that case, the husband continued to live in the home until the time of his death, but the Court ruled that there had been no oral or written agreement that the decedent was to retain the right to occupancy and that none could be implied.

b. U. S. vs. McKay, (C.A.-5th 1967) 1967-1 U.S.T.C. par. 12449
Attorney-Client Privilege

An appraisal report obtained by an executor who was also the attorney for the decedent's estate was held not to be protected from disclosure under the attorney-client privilege, or as the work product of the executor-attorney by the Fifth Circuit in U.S. vs. McKay, decided 2-3-67. In essence, the Court held that IRC Section 7602 permits the Commissioner to examine such appraisals, in connection with determining the estate tax liability and enforced the Commissioner's summons issued under Section 7604.

c. Correll vs. U. S., (C.A.-6th 1966) 66-2 U.S.T.C. par. 9778
Overnight Rule

Our Circuit, the Sixth, in Correll vs. U.S., November 29, 1966, joined the Eighth Circuit and the Tax Court in flatly rejecting the Commissioner's rule that the taxpayer must be away from home overnight (or for a sufficiently long period of time to require sleep or rest) before he can deduct meal expenses.

POINTS TO REMEMBER

d. The Service has announced that the $3.00 per month payments made by senior citizens beginning July 1, 1966 for supplementary medical insurance benefits under Medicare are deductible as medical expenses on the 1966 Federal Income Tax Return--IRS Release dated February 7, 1967.

e. The cost of liquor is not deductible as a charitable contribution on the ground that is was consumed in response to a municipality's plea to conserve water--Standard Federal Tax Report No. 14 CCH.

f. If you picked up an unusually large fee in 1966, you may wish to take advantage of the averaging provisions of the Code. You may do this by totaling your 1962-1965 taxable income, dividing the total by three and adding $3,000.00. If your taxable income for 1966 is more than the result obtained from the foregoing steps, you will have an average income of more than $3,000.00 and the income averaging rules will apply. Whether you will gain a tax benefit may then be readily determined by reference to tables set out in Citation 677 CCH Standard Federal Tax Reports, Paragraph 8579.

g. The new Federal Tax Lien Act of 1966 says that lenders, sureties and others who advance funds to meet an employer's payroll will be liable for withholding taxes attributable to the wages if the employer fails to pay them beginning in 1967. It would appear that this statutory provision would reverse the holding in United States vs. Hill, CA-5, 1966.

h. Senator Magnuson has introduced a bill in the U. S. Senate, 90th Congress, to establish a Small Tax Division within the Tax Court of the United States.

III. State and Local

a. For purposes of Code Section 164 (d) (1), on the apportionment of Real Property Taxes between seller and purchaser, the "Real Property Tax Year" in Michigan is the calendar year, according to Revenue Ruling 67-31, I.R.B. 1967-5, 7.

REVIEW OF IMPORTANT TAX DECISIONS DURING 1966

By: John J. Raymond

A. MATTERS AFFECTING INDIVIDUALS

Installment Sales Problem:

In an installment sale, is the buyer's assumption of liabilities added to the downpayment and principal payments in computing 30% limitation? In the Irwin case, 45 T.C. No. 53, the Tax Court held that the liabilities of the seller which were assumed by the buyer and paid by him in the year of sale constituted payments to the seller in the year of sale. The Commissioner attempted to include all of the assumed liabilities as part of payments in the year of sale. On the other hand, in the Ninth Circuit, in the Marshall case, 357 F. 2d 294, the Government argued that only the liabilities assumed and paid in the year of sale should be included. The Court held that no part of the liabilities, assumed or paid, should be taken into consideration, otherwise the seller would never know how to report the sale since the buyer would be in control of such payments. However, the problems highlighted by the Irwin decision should never be treated lightly.

How Not To Exchange Property Expecting Tax-free Status:

In the Carlton case, 17 A.F.T.R. 2d 1051 (S.D. Fla.), the taxpayer was approached by a corporation who wanted to buy his land. He granted the corporation an option and then he offered to buy certain other properties. The corporation then contracted to purchase these other properties and assigned this contract to the taxpayer. The Court held that since the replacement property never vested in the corporation, there was not an exchange of property and, therefore, the transaction was taxable.

Raffle Tickets Not A Charitable Contribution:

This is a question that all of us have feared would some day be decided and it was decided in the case of Dr. Goldman, 46 T.C. No. 10. The Court held that since he had a chance to win, he received full consideration.

How To Win At The Track:

Keep your losing tickets at the race track as well as the winning tickets. Merely keeping a book record of losses is not sufficient and just in case you might some day win that twin-double, it is suggested that you keep the losing tickets also, Donovan v. Comm., 359 F 2d 64, CCA-1

Payments To A Parochial School As Tuition Not A Charitable Contribution:

So holds the Court in Casey, T.C.M. 1965-282. The answer is obvious because there is consideration in the form of education for the child. However, some pastors have stated that they will not charge tuition provided there is sufficiently increased contributions to take care of the cost of running the school. If this is done without any requirement that a parent with children in the school pay a definite minimum amount, then these amounts would be contributions and deductible.

"Primarily For Sales" in Section 1221(1) Means "Of First Importance" or "Principally":

In the Malat case, (Malat v. Riddell, 383 U.S. 569) the taxpayers acquired a 45-acre parcel of land which they claim they intended to develop and operate as an apartment project. Difficulties were encountered in obtaining the necessary financing and the interior lots were subdivided and sold. Profits therefrom were reported as ordinary income. Additional frustrations were encountered in the form of zoning restrictions and the taxpayers decided to terminate the venture and sell the property. The District Court ruled that the taxpayers had failed to establish that the property was not held primarily for sale to customers. The Government took the position that "primarily" also means "substantial". The Supreme Court held "the words of statutes-including revenue acts-should be interpreted where possible in their ordinary every-day sense" and that "primarily" means "of first importance" or "principally". Upon remand, the lower Court decided in favor of the taxpayer. This opinion may have great impact with respect to the term "held primarily for sale" as it appears in the other sections of the Code such as Section 337 with reference to the sale of inventory type assets. It might also apply to the same term as it is used in Section 1231.

When An Accountant Gives His Client His Working Papers At The Client's Request, Are Such Papers Subject To Internal Revenue Service Summons?

In the Cohen case, 250 F. Supp. 472, in Nevada the District Court held "no" under the facts in this case. Cohen told the agents that his accountant had all of his tax records. Cohen then called his accountant and asked for and received all of his working papers, documents, etc. The agents later went to see the accountant who told them what he had done. Cohen was then served with a summons. The Court held that Cohen had legitimate and personal possession of these records and therefore the constitutional guarantee against the self-incrimination protected him against the summons. Compare the case of U.S. v. Joseph P. Pizzo, Dist. Ct. S.D. N.Y., 11-2-66, where the court distinguished the Cohen case from its own facts, observing that in Cohen there was at least an ex post facto disclaimer of ownership of the working papers by the accountant.

Bias of Special Agent Grounds For Reversal:

In Reuben G. Lenske v. U.S., CA-9, 10-5-66, the Ninth Circuit reversed the conviction of a lawyer for tax evasion on several grounds including the fact that the Special Agent's report recommended prosecution on the basis, among other things, that the taxpayer had left wing political and social ideas and activities. In wording that finds no equal for its scathing criticism of the Special Agent, the Court said, "the judgment which the Special Agent formed and embodied in his recommendation that Lenske be criminally prosecuted can only be described as grotesque."

Can The Government Snoop On The Conversations Between Lawyer And Client?

In Black v. United States, 87 S.Ct. 190, the Supreme Court had for its

consideration the question of whether or not the monitoring of conversations between taxpayers and their attorneys would be grounds for reversal of a conviction for tax evasion. In this case the Solicitor General maintained that nothing in the monitoring was relevant to the taxpayer's case, yet the Supreme Court held that only a new trial would remove all doubt as to whether the taxpayer had received a fair trial in the first instance.

Innocent Husband Liable For Tax But Not Fraud Penalties Where Funds Were Embezzled By His Wife:

In the Bonner case, T.C.M. 1966 - 96, the wife embezzled approximately $20,000.00 from a hospital where she was employed. The evidence showed that she spent only a few hundred dollars on her husband and the rest was spent on a daughter by a prior marriage. The taxpayer had no knowledge of the embezzlement. The Court held that the Commissioner had not established fraud against the innocent spouse. This appears to be the better rule although there are cases to the contrary.

Expenses Of Unsuccessful Defense Of Criminal Prosecution Arising From Business Actions Deductible:

In the Tellier case, 383 U.S. 687, the taxpayer was convicted and sentenced for violation of the Federal Securities Law, his deduction for legal expenses were disallowed by the Tax Court. The Second Circuit reversed and the Supreme Court affirmed the Second Circuit. The Court, in determining whether the expenditure was personal or business, applied the "origin and character of the claim" doctrine of Gilmore, 372 U.S. 39. The Court held that the Federal income tax law is not concerned with the lawfulness of the income it taxes. Section 1 65(d) is an example of this. It also referred to its decisions in Sullivan, 356 U.S. 27 and Heininger, 320 U.S. 467. The Court concluded that no public policy was violated by the expense. It is a man's constitutional right to engage a lawyer.

When Is An I.R.S. "Expert" Not an Expert?

The Court of Claims in Garstin, 352 F. 2d 537, had to decide between the taxpayer's witness and the Service's witness. In the Garstin case the Court held that the government's witness who attempted to appraise the land in question, located in Delaware, had never previously appraised any real estate in that State except for some property located about 100 miles away. Furthermore, the same expert whose testimony was rejected in this case was previously declared not qualified to express an opinion in another tax case on real estate values in Pennsylvania!

Recapture of Bad Debt Reserve:

In the Schmidt case, 355 F. 2d 111, the Ninth Circuit had to deal with the question of when a taxpayer incorporates his business and transfers his receivables to the corporation at book value, has he realized income to the extent of the reserve for bad debts? The Ninth Circuit said that the Tax Court and the I.R.S. have disregarded the economic realities of the transaction. The government holds that when receivables are disposed of on a non-taxable transaction, the need for the reserve ceases and it must be restored to income. The Court held that whether the receivables are sold for cash or for stock no income is received unless the sales price exceeds the net amount of the receivables.

Irrevocable Trust Corpus And Income Taxable To Grantor Who Reserves The Right As Trustee To Distribute Or Accumulate:

In the O'Malley case, 383 U.S 627, the Supreme Court so held. In this case,

the settlor established a series of irrevocable trusts naming himself and two others as trustees. The trustees were authorized in their discretion to pay out income currently or to accumulate it and add it to the trust principal. Over the years, most of the income was accumulated so when the settlor died the principal had a value of $276,000.00 of which $186,000.00 represented income accumulations. The Commissioner taxed the entire value of the trust in the Estate of the deceased settlor. The District Court and Seventh Circuit held that only the date of death value of the property originally transferred to the trusts was includible. The problem with the Supreme Court's decision is at what point did the settlor own and transfer the income? This is necessary because the statute states that it applies to property "of which the decedent has at any time made a transfer." Another question which may arise from this case is, does the settlor-trustee make a gift and a transfer every time he exercised the power to pay out income or accumulate it? (See "Loopholes and Ambiguities of Section 2036" - Mich. Law Review, Jan. 1967, Comments, for some other problem areas in this statute.)

Depreciation Allowed In Year Of Sale:

On March 7, 1966, the Supreme Court handed down its decision in Fribourg Navigation Co., Inc. v. Commissioners, 383 U.S. 272. The Court rejected the Commissioner's theory that an asset costs nothing in the year of sale where its sales price exceeds the adjusted basis at the beginning of the year. The Court quoted from the Regulations, Section 1.167 (a)-1(c), stating that salvage value is the amount estimated at the time of acquisition and is not changed merely because of changes in price levels but may be changed if useful life is redetermined; useful life, in turn, is redetermined only where there is a clear and convincing basis for a significant change. In Fribourg, the Commissioner did not challenge the original estimates of useful life or salvage value.

B. MATTERS AFFECTING CORPORATIONS

New Subchapter S Provisions:

New Section 1375 (f) provides a look-back rule whereby distributions made by a corporation to its shareholders after the close of its taxable year, but within 2 1/2 months thereof, are treated as non-dividend distributions of its undistributed taxable income of the previous year. This will permit stockholders to avoid locked-in income in the corporation.

Another important change arises out of the enactment of Section 1378 which eliminates "one-shot" capital gain elections. This arose where corporations expecting a large amount of capital gains did elect to be taxed under Subchapter S, thereby passing through the capital gain to the shareholder.

Shareholder Loans In Pseudo Corporations Are Equity Contribution:

Recent cases have refused to accept the government's position that loans by shareholders in Subchapter S corporations constitute a second class of stock. (See Gamman, 46 T.C. 1; Lewis Building & Supplies, Inc., T.C.M. 1966-159; compare Catalina Homes, Inc., T.C.M. 1964-225; Henderson, 245 F. Supp. 782.) On December 27, 1966 the Service appeared to capitulate to the holdings of Gamman and Lewis by amending their Regulations 1.1371-1 (g). The amendment in essence holds that if loans are made to the corporation in substantially the same proportion as the number of shares held by the lenders, such purported debt obligations will be treated as contributions to capital rather than second class of stock, but there is a catch to this capitulation. The amendment goes on to say that if the stock issued results in a change of

a shareholder's proportionate share of stock or his proportionate share of such purported debt, a new determination will be made as to whether the corporation has more than one class of stock. Thus, if loans are not made in substantially the same proportion as stock is owned, the Service may claim that the loans do constitute a second class of stock.

Interest Paid By Shareholder On Corporate Loan:

Quite a furor was caused by the decision of Murphy Logging Co., 239 Fed. Supp. 794, where the Commissioner was successful in the theory that guaranteed loans, i.e. corporate loans guaranteed by a stockholder, were in reality loans to the stockholder. Therefore, when the corporation paid interest on such loans, it constituted a dividend to the shareholder individual. In a more recent case, Fors Farms, Inc. v. United States, 17 A.F.T.R. 2d 222 (W.D. Wash. 1966), the District Court found that the parties intended a genuine debt from the corporation to the bank. The debt was not subordinated and the proceeds were used for the intended purpose. Under these circumstances, the interest payments were held not to constitute a dividend.

New Section 531 Approach:

During the last few years, there has been developing a new defense against the application of Section 531 by the government to accumulated earnings in closely held corporations. This new approach utilizes the so-called operating cycle test. This is the period of time during which raw materials are purchased, manufactured and in inventory; such inventory being sold and outstanding accounts receivable generated. The period of time necessary to collect the accounts receivable usually completes the operating cycle. In Bardahl Manufacturing Corporation, T.C.M. 1965-200, and again in Apollo Industries, Inc., 358 F. 2d 867, the Courts have held that a corporation should be allowed to accumulate sufficient working capital to meet operating expenses during this operating cycle. This new approach to the 531 penalty tax problem could result in lessening the impact created by the less sophisticated approach of the former cases which seemed to be impressed by the excess of current assets over current liabilities. An excellent article on this problem is that of "The New Accumulated Earnings Tax; A Surevey Of Recent Developments" by Stephen S. Ziegler, Tax Law Review of November, 1966.

Business Purposes In Spin-Offs:

The Ninth Circuit has reversed the Tax Court in Commissioner v. Wilson, 353 F. 2d 184, and requires that a business purpose is necessary to take advantage of the spin-off provision of Section 355. In the Wilson case, the taxpayer's corporation was in the retail business selling a substantial quantity of furniture under conditional sales contract. It decided that the business should form its own finance company. This was accomplished by transferring to a new corporation all new additional sales contracts and certain additional contracts in exchange for stock which was then distributed to its shareholders. The Commissioner claimed that the transaction was used principally as a device to distribute the corporation's earnings and profits. The Tax Court held that since the parties intended to continue the financing of the business and were not planning to liquidate, siphen off its assets, or sell its stock, the transaction complied with Section 355. The Ninth Circuit held that it could see no business purpose for the transaction and held that the stock received on incorporation was a taxable dividend.

Use Of Operating Loss By Acquiring Profitable Business:

A corporation which had incurred losses in the shipping business was merged

in 1956 with a corporation in the dairy and grocery store business. The shipping corporation was dormant for several months prior to the merger. The District Court found that the principal purpose of the merger was tax avoidance under Section 269. The Fifth Circuit reversed and remanded since immediately before the merger taxpayer's shareholders controlled both corporations. The Court held that Section 269 applies when the loss corporation "acquires" a profitable corporation to use an otherwise unusable loss. Southland Corp. v. Campbell, 385 F. 2d, 333.

Revived Tire Company Allowed Net Operating Loss Carryover:

In Clarksdale Rubber Company, 45 T.C. No. 22, the taxpayer suspended operations after suffering losses. It leased its plant to another rubber company and the lease contained an option to purchase the taxpayer's capital stock. The option was exercised and production of tires resumed. The Court held that the principal purpose was not tax avoidance but market expansion and the term during which the taxpayer leased its assets was not a period of inactivity.

Multiple Sales Corporations:

In V. H. Monette & Co., Inc., 45 T.C. No. 2, the taxpayer was a manufacturer's representative selling brand named products to military commissary stores for pricing purposes. The manufacturers recognized six delivery zones. On the advice of the counsel, separate corporations were established for each zone of delivery. One corporation performed all financial and accounting functions for the group, but each corporation had a branch office in its zone. Home office expenses were allocated on the basis of commission income. The Court allowed the separate surtax exemptions since the profits and risks in selling in the various zones differed.

Dividend Can Result From Transfer Of Profits From Corporation:

In Equitable Publishing Company v. Commissioner,, 356 F. 2d 514, CA-3, the Internal Revenue Service used a new approach towards transactions in related corporations. There was a transfer of business from a profitable corporation to a corporation operating at a loss, both being controlled by the same stockholders. The Court taxed the income to the profitable corporation and then went one step further and agreed with the Commissioner that the transferred income was a constructive dividend to the shareholders. Thus, Section 482 was not the only arrow in the bow of the Service.

How Not To Sell Real Estate:

Taxpayer corporation owned an interest in land; its sole stockholder owned an interest in an adjoining piece. When a publicly held corporation became interested in the land, both interests were transferred to a new corporation in exchange for stock. The stock of the new corporation was exchanged for stock of the publicly held corporation. After that, the new corporation was dissolved. The Court held the exchange was taxable since it was not a bona fide reorganization. Since the new corporation had no business purpose, the Court ignored its existence. West Coast Marketing Corp. v. Comm., 46 T.C. No. 4.

* * *

The foregoing analysis is not intended as all inconclusive of the many tax decisions, rulings and regulations issued during 1966. Only the more important matters have been included. However, there were also amendments and changes in the Federal tax statutes.

Thus, in addition to the changes mentioned with respect to Subchapter S corporations, we recommend review of the following:

1. Foreign Investors Tax Act of 1966

2. Changes in rules for withholding and estimated tax payments

3. Suspension of investment credit and accelerated depreciation

4. Removal of limitation on amount of deduction which owners may take in self-employed retirement plans

5. No further deductions for political purposes even when connected with seemingly business motive

6. Federal Tax Lien Act of 1966