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# THE REVENUE ACT OF 1950

CHARLES L. B. LOWNDES\*

The Revenue Act of 1950, which was signed by the President on September 23, 1950, started out as a bill to reduce excise taxes. In the form in which it left the House it provided for substantial excise tax relief. It also contained provisions designed to ease some of the inequities of the income and estate taxes, and, to offset the loss of revenue from the other parts of the bill, a number of so-called loophole-closing provisions. When the bill reached the Senate the country was in the middle of the Korean War and talking about a major defense program. Upon the recommendation of the President, the Senate eliminated the excise tax reductions and raised the rates of the individual and corporate income taxes. Most of the other provisions of the bill were retained, although some of the more controversial loophole-closing and relief provisions were deferred for further study.

In its final form the new Act is admittedly a stop-gap measure. The new rates are not stiff enough to sustain the defense program. Inevitably, new and tougher tax bills will soon be on their way. But although the new bill is an interim measure, its importance should not be underrated. The 1950 Act makes far-reaching changes in the law, particularly in connection with the loop-hole closing provisions, which merit careful study and analysis.

## PART ONE: THE INCOME TAX

### I. RATES

#### *A. Individuals*

The rates of the individual income tax have been raised by eliminating the percentage reductions of the tentative tax provided for by the prior law in the case of taxpayers returning their income on the basis of calendar years starting with 1951, and fiscal years commencing after September 30, 1950.<sup>1</sup> For these years the tentative 3 percent normal tax and the tentative graduated surtax rates provided for by the prior law will be the final rates. The maximum overall rate of tax for these years is 87 percent.<sup>2</sup>

For the calendar year 1950 the percentage reductions of the tentative tax allowed by the prior law have been lowered by approximately

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<sup>1</sup> §11(a), IRC, added by §101(a), 1950 Act; §12(b)(1), IRC, added by §101(b)(1), 1950 Act.

<sup>2</sup> §12(f), IRC, as amended by §101(b)(4), 1950 Act.

one-fourth in order to reflect the higher rates of the new Act for the last quarter of 1950 when the new Act was in force. Under the prior law the tentative normal tax and surtax were reduced by the following percentages:

- 17 percent of the first \$400 of the tentative tax.
- 12 percent of that part of the tentative tax in excess of \$400 and not in excess of \$100,000.
- 9.75 percent of that part of the tentative tax in excess of \$100,000.

Under the 1950 Act the reductions in the case of taxpayers using the calendar year are:

- 13 percent of the first \$400 of the tentative tax.
- 9 percent of that part of the tentative tax in excess of \$400 and not in excess of \$100,000.
- 7.3 percent of that part of the tentative tax in excess of \$100,000.<sup>3</sup>

The maximum overall rate of tax for the calendar year 1950 is 80 percent.<sup>4</sup>

In the case of taxpayers using fiscal years ending before October 1, 1950, the rates of the prior law apply.<sup>5</sup> The maximum overall tax under the prior law of 77 percent also applies to these taxpayers.<sup>6</sup>

Taxpayers who use a fiscal year which began before October 1, 1950, and which ends on any date after September 30, 1950, except December 31, 1950, will compute a tax on their entire income under the rates prescribed by the prior law, and another tax on their entire income under the rates prescribed by the 1950 Act for taxable years beginning after September 30, 1950. The final tax will be a part of the tax computed under the rates of the 1948 law proportionate to the number of calendar months in the taxable year prior to October 1, 1950, plus a part of the tax computed under the rates of the 1950 Act proportionate to the number of calendar months in the taxable year after September 30, 1950. In making this apportionment a calendar month, only part of which falls within the taxable period, will be disregarded if less than fifteen days of the month are included in that period.<sup>7</sup>

Ordinarily the taxable year of a decedent closes at the date of his death. Therefore, if a decedent died before October 1, 1950, his tax will be computed under the rates of the prior law. If, however, a joint return is filed for a deceased and a surviving spouse, the tax year of the decedent for the purpose of determining the applicable rates will be

<sup>3</sup> §12(c) (1), IRC, added by §101(b) (3), 1950 Act.

<sup>4</sup> §12(c) (1), IRC, added by §101(b) (3), 1950 Act.

<sup>5</sup> §12(c) (2), IRC, as amended by §101(b) (3), 1950 Act.

<sup>6</sup> §12(c) (2), IRC, as amended by §101(b) (3), 1950 Act.

<sup>7</sup> §108(e), IRC, added by §131(a), 1950 Act.

deemed to end on the date of the close of the tax year of the surviving spouse.<sup>8</sup>

Thus, for example, suppose that a husband and wife both file their returns on the basis of a calendar year. The wife dies on September 1, 1950. If separate returns are filed the wife's income will be taxed under the rates of the 1948 Act, because her taxable year ended before October 1, 1950. If, however, a joint return is filed covering the income of both spouses, the tax will be imposed at the rates prescribed under the 1950 Act for the calendar year 1950 upon the aggregate income shown by the return, because the taxable year of both spouses will be deemed to end on December 31, 1950.<sup>9</sup>

### B. Corporations

The 1950 Act abolishes the graduated normal and surtaxes and the so-called "notch provision" of the prior law and substitutes a flat normal tax and surtax, with a surtax exemption of \$25,000.

For fiscal years starting after June 30, 1950, and for calendar years commencing with 1951, the rate of the normal tax is 25 percent<sup>10</sup> and the rate of the surtax (starting with surtax net income in excess of \$25,000) is 20 percent.<sup>11</sup>

<sup>8</sup> §103, 1950 Act.

<sup>9</sup> The withholding tax tables and percentages which must be withheld have been changed to reflect the new rates. §1622(c)(1), IRC, as amended by §142, 1950 Act.

Changes have also been made with respect to the withholding provisions to reflect new methods of taxing:

- (1) Compensation of members of the armed forces in combat zones. §1621(a)(1), IRC, added by §202(b), 1950 Act. See also, §1625(a), IRC, as amended by §202(c), 1950 Act and §1633(a), IRC, as amended by §202(c), 1950 Act.
- (2) Payments made to an alien resident in Puerto Rico as an employee of the U. S. or its agencies. §1621(a)(6), IRC, as amended by §221(f), 1950 Act.
- (3) Payments made to citizens of the U. S. resident in Puerto Rico. §1621(a)(8), IRC, as amended by §221(f), 1950 Act.
- (4) Payments for services performed for the U. S. or its agencies in a possession of the U. S. §1621(a)(8), IRC, as amended by §221(f), 1950 Act.
- (5) Citizens of Puerto Rico. §252(a), IRC, as amended by §221(b), 1950 Act.
- (6) Alien residents of Puerto Rico. §143(a)(1), IRC and §143(b), IRC, as amended by §221(e), 1950 Act.
- (7) Rent paid to certain tax-exempt organizations and trusts. §143(h), IRC, added by §301(c)(4), 1950 Act.

Under the prior law withholding returns in the case of payments made to non-resident aliens and foreign corporations had to be filed on March 15 following the year in which the payments were made, but the tax did not have to be paid until June 15. Under the 1950 Act the tax will be due on the due date of the return, March 15. §143(c), IRC, as amended by §219, 1950 Act.

<sup>10</sup> §13(b)(1), IRC, added by §121(a), 1950 Act.

<sup>11</sup> §15(b)(1), IRC, added by §121(c), 1950 Act.

For the calendar year 1950 the normal tax rate is 23 percent<sup>12</sup> and the surtax rate is 19 percent.<sup>13</sup>

For taxable years ending prior to July 1, 1950, the rates of the prior law apply.<sup>14</sup>

If a corporation uses a fiscal year which started prior to July 1, 1950, and ended after June 30, 1950, on any date except December 31, 1950, it must compute a tax on its entire income under the rates of the prior law, and another tax on its entire income under the rates of the new law applying to taxable years starting after June 30, 1950. The tax due is the sum of that part of the tax computed under the 1948 rates proportionate to the number of days falling into the taxable period prior to July 1, 1950, plus a part of the tax computed under the 1950 law proportionate to the number of days falling into the taxable period after June 30, 1950.<sup>15</sup>

Oddly enough, although one of the purposes of the 1950 Act was to raise the rates of the corporation tax, many corporations because of the elimination of the so-called "notch provision" will find that their tax has actually been reduced by the new law.<sup>16</sup>

## II. CREDITS AND EXEMPTIONS

### A. *Individuals*

No change was made by the 1950 Act with respect to the personal exemptions and credits for dependents allowed by the prior law. Moreover, the system of splitting the income of married taxpayers introduced by the 1948 Act is retained under the new law.

### B. *Corporations*

In order to close a loophole in the prior law, a new restriction is imposed on the credit for corporate dividends in kind, by which the

<sup>12</sup> §13(b)(2), IRC, added by §121(a), 1950 Act.

<sup>13</sup> §15(b)(2), IRC, added by §121(c), 1950 Act.

<sup>14</sup> §13(b)(3), IRC, as amended by §121(a), 1950 Act; §15(b)(3), IRC, as amended by §121(c), 1950 Act.

<sup>15</sup> §108(f), IRC, as amended by §131(a), 1950 Act.

<sup>16</sup> Other changes in the corporate rates were made by the 1950 Act to apply the new rates to special classes of taxpayers:

(1) Mutual insurance companies other than life or marine. §207(a)(1), IRC, as amended by §121(d)(1), 1950 Act.

(2) Interinsurers or reciprocal underwriters. §207(a)(3), IRC, as amended by §121(d)(2), 1950 Act.

(3) Regulated investment companies. §362(b)(3) and (4), IRC, as amended by §121(e), 1950 Act.

(4) Life insurance companies. §201(a), IRC, as amended by §121(g)(3), 1950 Act.

(5) Insurance companies other than life or mutual. §204(a)(1), IRC, as amended by §121(g)(4), 1950 Act.

A slight change was made by the 1950 Act with respect to the 2 percent additional tax required for the privilege of filing a consolidated return. If the affiliated group includes a Western Hemisphere corporation, the additional 2 percent is only applied to the surtax net income in excess of the surtax net income attributable to the Western Hemisphere corporation. §141(c), IRC, as amended by §121(f), 1950 Act.

credit is limited to 85 percent of the adjusted basis of the property distributed in kind in the hands of the distributing corporation.<sup>17</sup>

Suppose, for example, that X Corporation purchased stock for \$10,000 and distributed the stock as a dividend in kind to Y Corporation when the stock had a fair market value of \$100,000 and Y Corporation promptly sold the stock for that amount. Under the prior law, since the Y Corporation would be entitled to a dividend received credit of 85 percent of the amount of the dividend or \$85,000, it would pay a tax upon only \$15,000 upon the receipt of the dividend. Moreover, since the basis of the stock in the hands of Y Corporation would be \$100,000, no further gain would be realized upon the sale of the stock at that figure. The result was, of course, that most of the gain on the stock went untaxed under the prior law. To close this loophole the 1950 Act limits the credit for a dividend received in kind to 85 percent of the adjusted basis of the property in the hands of the distributing corporation, plus any gain realized upon the distribution. Since no gain was realized on the distribution in the hypothetical situation, under the new law the dividend received credit would be limited to \$8,500 (85% of the adjusted basis of \$10,000) and the Y Corporation would pay a tax on \$91,500 when it received the stock.

In this connection, however, it is well to note that if a corporation distributes a dividend in kind in depreciated property the credit is limited to 85 percent of the fair market value of the stock at the time of the distribution, if this is lower than the adjusted basis. Thus, for example, in the foregoing hypothesis, if the adjusted basis of the stock had been \$100,000 and its fair market value \$10,000 at the date of distribution, the credit would have been limited to \$8,500.

In addition to the change in the credit for dividends received in kind the 1950 Act made various technical changes in connection with the credits allowed corporations in order to facilitate the computation of the tax.<sup>18</sup>

### III. RETURNS AND PAYMENT OF TAX

The 1950 Act grants estates and trusts an additional month to file returns and pay the tax.<sup>19</sup> Thus, for example, under prior law the

<sup>17</sup> §26(b), IRC, as amended by §122(a), 1950 Act.

<sup>18</sup> The technical changes in connection with corporation credits made by the 1950 Act include:

- (1) Dividends received from other domestic corporations. §26(b), IRC, as amended by §122(a), 1950 Act.
- (2) Preferred stock dividends received from a public utility company. §26(b), IRC, as amended by §122(a), 1950 Act.
- (3) Dividends paid by a public utility company on its preferred stock. §26(h)(1), IRC, as amended by §122(b), 1950 Act.
- (4) Normal tax net income of a Western Hemisphere corporation. §26(i), IRC, added by §122(c), 1950 Act.

<sup>19</sup> §53(a)(1), IRC, as amended by §205(b)(1), 1950 Act.

return of a trust or estate using a calendar year was due on March 15 following the close of the taxable year. Under the new law the return will not be due until April 15, and the tax will not be due until that date.

However, the 1950 Act takes away the privilege of paying taxes in four equal installments in the year following the close of the taxable year in the case of non-resident aliens<sup>20</sup> and trusts,<sup>21</sup> although this is still allowed in the case of an estate.<sup>22</sup>

Under the prior law corporations were allowed to pay their tax in four equal quarterly installments commencing with the due date of the return. The 1950 Act provides that starting with returns due in 1951, installment payments by corporations shall be speeded up over a period of five years, until in the fifth and succeeding years the entire tax will be due in two installments, one of which will be payable on the due date of the return and the other of which will be payable at the end of the first quarter following the due date of the return.<sup>23</sup>

For example, a corporation using a calendar year could pay its 1949 tax in four quarterly installments: on March 15, June 15, September 15, and December 15, 1950. In 1951 the corporation will have to pay 30 percent of the tax when each of the first two installments are due and 20 percent of the tax when each of the last two installments are due. The law provides for increasing the first two installments and decreasing the last two over a period of five years until finally in 1955 and the succeeding years the corporation will have to pay 50 percent of the tax on March 15 and 50 percent of the tax on June 15.

#### IV. EXCLUSIONS FROM GROSS INCOME

The 1950 Act grants a new exclusion from gross income and extends an old one. Under the new law, members of the armed forces are permitted to exclude pay for active service for any month, during any part of which they served in an area designated by the President as a combat zone, after June 24, 1950, and before January 1, 1952.<sup>24</sup> Enlisted personnel (including commissioned warrant officers) exclude all of their pay received for any month during any part of which they served in a combat zone. Officers, however, may only exclude the first \$200 of such compensation.

Unlike the allowance made for service pay in World War II, the exclusion provided by the 1950 Act is limited to pay for active service in a combat zone and is a monthly rather than an annual exclusion. In order to exclude compensation for any month, a member of the

<sup>20</sup> §205, 1950 Act.

<sup>21</sup> §205, 1950 Act.

<sup>22</sup> §56(b)(1), IRC, added by §205(a), 1950 Act.

<sup>23</sup> §56(b), IRC, added by §205(a), 1950 Act.

<sup>24</sup> §22(b)(13), IRC, as amended by §202(a), 1950 Act.

armed forces must serve in a combat zone at some time during that month. He need not, however, serve during the entire month. Thus, a soldier who served in Korea from November 29, 1950, to December 3, 1950, would be entitled to exclude all of his November and December pay from taxable income.

Under the prior law, corporations and railroads could elect to exclude income from the retirement of their bonds from gross income, provided they complied with certain conditions specified by the statute. This privilege which was limited to taxable years beginning before January 1, 1951, has been extended by the 1950 Act to taxable years beginning before January 1, 1952.<sup>25</sup>

## V. CAPITAL GAINS AND LOSSES

Although the proposal made by the Committee on Ways and Means of the House of Representatives to reduce the holding period of capital assets required to realize a long-term gain or loss from six to three months<sup>26</sup> failed of enactment, several interesting changes in the treatment of capital gains and losses are made by the new law.

### A. *Non-resident Aliens*

Under the prior law capital gains and losses of non-resident aliens who were not engaged in trade or business in the United States were not taxed. Although this is still the rule in the case of a non-resident alien who is not engaged in trade or business in the United States and is not physically present in this country during the taxable year, the 1950 Act adopts a new rule in other situations.

Non-resident aliens who were physically present in the United States (residence is not required) for ninety days or more (which need not be consecutive) are taxable upon all capital gains effected here during the taxable year. Moreover, a non-resident alien who was present in the United States for less than ninety days during the taxable year is taxable on the capital gains from transactions effected here while he was actually present in this country.<sup>27</sup>

In determining the taxability of capital gains of the non-resident alien who was present in the United States, capital losses may be offset under the same circumstances that capital gains are taxed. For example, since the capital gains of the non-resident alien who is not engaged in trade or business in the United States and is not physically present here during the taxable year are not taxed, his capital losses are ignored. On the other hand, since all of the capital gains of the non-resident alien who is not engaged in trade or business in the United

<sup>25</sup> §22(b)(9) and §22(b)(10), IRC, as amended by §201, 1950 Act.

<sup>26</sup> H. R. REP. No. 2319, 81st Cong., 2d Sess. (1950).

<sup>27</sup> §211(a)(1)(B), IRC, as amended by §213(a), 1950 Act.



States, but is here for ninety days or more are taken into account, all of his capital losses are also taken into account and only the net gain is taxed. In the case of the alien who is present in the United States for less than ninety days and is not engaged in trade or business here, only his gains from transactions effected while he is in the United States are taxed. Consequently, only his capital losses from transactions effected while he is here may be offset against his taxable gains.

The capital gains of a non-resident alien who is not engaged in trade or business in the United States are taxed according to the same rules which govern the other income of this class of taxpayer. If the taxpayer's fixed and determinable income plus his net capital gains (which are taken into account without applying the percentages for long-term capital gains and losses) amount to less than \$15,400, he is required to pay a tax of 30 percent of this gross aggregate. If, however, the taxpayer's fixed and determinable income plus his net capital gain (without applying the percentages) amounts to \$15,400 or more, two taxes must be computed. One tax is computed at the 30 percent rate on the gross aggregate. The other tax is computed on the taxpayer's net income at the regular rates for residents. In making this computation long-term capital gains and losses of the non-resident alien are reduced to the percentages ordinarily applied to long-term capital gains and losses and the tax is computed just as it would be in the case of a resident taxpayer. An alternative tax on capital gains is also computed and the final tax is the lower of the taxes computed under the regular or alternative methods. The only difference in the way in which the tax on net income is computed in the case of the non-resident alien who is not engaged in trade or business in the United States and the resident taxpayer is that in computing the non-resident's tax no provision is made for any net capital loss carry-over, although it is permissible to deduct a net capital loss from ordinary income up to \$1,000. When the two taxes have been computed the tax which is actually due is the higher of the 30 percent tax on gross income or the tax on net income at the regular rates.

#### *B. Gains from the Sale of Artistic and Literary Creations*

The 1950 Act excludes artistic, musical and literary creations from the definition of capital assets in order to make gains from the sale of such property taxable as ordinary income.<sup>28</sup> Under the prior law, if a professional author, composer or artist sold a literary, musical or artistic creation, his gain was taxed as ordinary income because it came from the sale of property held primarily for sale in the course of his trade or business and was not classified as a capital asset. An amateur who

<sup>28</sup> §117(a) (1), IRC, as amended by §210(a), 1950 Act.

sold a literary, musical or artistic product, however, could treat this as a capital asset and return any gain as a capital gain. The 1950 Act makes all income from the sale of such property ordinary income by excluding this type of property from the definition of capital assets. Moreover, to prevent any avoidance of the new rule by the author or composer or artist giving away his production and letting the donee sell it, the 1950 Act also provides that any gain from a sale by a donee shall be taxed as ordinary income.

It may be worth noting that the strictures of the new law do not apply to inventors. The amateur inventor may still sell the products of his ingenuity and return the gain as a capital gain.

### C. Short Sales of Capital Assets

Under the prior law it was possible to convert a short-term capital gain into a long-term capital gain and a long-term capital loss into a short-term capital loss by means of short sales or an option to sell, commonly called a "put." The 1950 Act seeks to close this loophole by taxing gains from the sales of stocks and securities and commodity futures, which it regards as in substance short-term, as short-term gains, and by treating losses, which are viewed as in substance long-term, as long-term losses. The statute lays down three rules which can be illustrated more clearly by concrete examples.

*Rule 1:* If a taxpayer makes a short sale (or buys a "put" which is treated just like a short sale for this purpose) and at the time of the short sale he has held "substantially identical property" for not more than six months, or, if a taxpayer after making a short sale acquires substantially identical property before closing the short sale, any gain from the sale will be a short-term gain.<sup>29</sup>

For example, A bought a share of stock for \$50. Five months later the stock was selling for \$100 a share and A wished to sell the stock and take his profit. However, he also wished to realize the gain in the form of a long-term capital gain only 50 percent of which would be taxable. Under the prior law A would sell a share of X stock short for \$100 to insure his profit. Several months later, after he had held the X stock for more than six months, he would cover the short sale with the X stock which he owned, and since the stock which he delivered to close out the short sale would have been held more than six months, his gain would be a long-term capital gain only 50 percent of which would be taxable. Under the 1950 Act, however, A's gain from the short sale will be taxed as a short-term, rather than a long-term gain.

*Rule 2:* The time of holding any "substantially identical property" acquired under the circumstances described in Rule 1 will be deemed to

<sup>29</sup> §117(1) (1) (A), IRC, added by §211(a), 1950 Act.

start on the date of closing the short sale or the gift or other disposition of such property, whichever occurs first.<sup>30</sup>

For example, on January 1, A bought one share of X stock for \$50. On June 1, A sold one share of X stock short for \$100. On July 15, A closed the short sale by buying one share of X stock for \$150 and delivering it to the lender. On July 16, A sold the share of X stock which he had purchased on January 1 for \$150. Under the prior law A would have a long-term capital gain from the sale of the original share of stock on July 16 of \$50 (50% of \$100), and a short-term capital loss of \$50 from the short sale on July 15. Consequently, although A would have a net gain of \$50 from the overall transaction, he would show no tax gain. Under the 1950 Act, however, A's gain from the sale on July 16 will be deemed to be a short-term gain, since the time of holding of the original stock purchased on January 1 will be deemed to start with the short sale on July 15. He will, therefore, have a short term gain of \$100 from the sale on July 16 and a short-term loss of \$50 from the short sale on July 15. This will give him a net tax gain of \$50, which corresponds with his actual gain from the transaction.

*Rule 3:* If at the time the taxpayer makes a short sale he has held substantially identical property for more than six months, any loss from the short sale will be treated as a long-term capital loss.<sup>31</sup>

For example, on January 1, A buys a share of X stock for \$50. On July 15, he sells a share of X stock short for \$75. On August 15 he buys a share of X stock for \$100 and delivers it to the lender closing out the short sale. On August 16 he sells the share of X stock, which he purchased on January 1, for \$100. Under the prior law, A would have a long-term gain from the sale on August 16 of \$25 (50% of \$50) and a short-term loss of \$25 from the short sale on August 15. The result would be that although his actual net gain from the overall transaction is \$25, he would show no tax gain. Under the 1950 Act, however, A's loss from the sale on August 15 will be treated as a long-term loss of \$12.50 (50% of \$25). He will have a long-term gain of \$25 (50% of \$50) from the sale on August 16, so that he will show a net tax gain of \$12.50, which is the same taxable gain which he would have had if he had not made the short sale, but had sold the stock acquired on January 1 for \$75 after he had held it more than six months.

The new rules are limited to sales of stocks and securities and commodity futures. Moreover, for the purpose of applying the rules the acquisition of a "put," or an option to sell, is treated like a short sale.

The new rules do not apply to "arbitrage" or "straddle" transactions.

<sup>30</sup> §117(1)(1)(B), IRC, added by §211(a), 1950 Act.

<sup>31</sup> §117(1)(2), IRC, added by §211(a), 1950 Act.

Thus, if a taxpayer enters into two commodity future transactions on the same day in different markets and both transactions require delivery of the same commodity in the same calendar month and are closed out on the same day, the new rules apply only to the extent that the quantity of the commodity dealt with on one market exceeds that dealt with on the other.<sup>32</sup>

For the purpose of determining whether a taxpayer has made a short sale or acquired a "put" and holds "substantially identical property," the taxpayer's spouse is treated like the taxpayer.<sup>33</sup> Thus, for example, if A owns a share of X stock and his wife sells a share of X stock short, the transaction will be treated for the purpose of determining whether any gains or losses are short or long-term as though A himself had made the short sale.

#### *D. Collapsible Corporations*

Under the prior law taxpayers attempted to convert ordinary income into capital gains by means of what the 1950 Act calls "collapsible corporations." Although the enthusiasm of the Treasury for collapsible corporations was naturally restrained, there appears to be no decision outlawing the device under the prior law.<sup>34</sup> The 1950 Act seeks to prevent taxpayers from converting ordinary income into capital gains by means of this device by providing that any gain realized upon the liquidation of a collapsible corporation shall be taxed as ordinary income.<sup>35</sup>

The nature of a collapsible corporation and the point at which it is attacked by the 1950 Act may be illustrated by a simple example drawn from the motion picture industry, since this appears to be where the scheme originated, although in recent years it has been adapted to other enterprises. Several men wish to produce motion pictures. If they carry on the business as partners, any income which they make will be taxed as ordinary income.<sup>36</sup> Moreover, if they form a corporation to produce motion pictures any income from the pictures will be taxed to the corporation as ordinary income, and again to the stockholders as

<sup>32</sup> §117(1)(3)(B)(ii), IRC, added by §211(a), 1950 Act.

<sup>33</sup> §117(1)(3)(B)(iii), IRC, added by §211(a), 1950 Act.

<sup>34</sup> The 1950 Act explicitly provides that the validity of collapsible corporations under the prior law shall be determined without reference to the provisions of the Act. §212(b), 1950 Act.

<sup>35</sup> §117(m), IRC, added by §212, 1950 Act.

<sup>36</sup> Although it would seem to be possible to achieve the desired tax consequences of a collapsible corporation even under the 1950 Act by forming a partnership to produce a motion picture and, after the picture was completed but before it had been sold or leased, having the partners sell their interests in the partnership. Under recent decisions the gains of the partners from the sale of their interests in the partnership would be capital gains. *Commissioner v. Lehman*, 165 F. 2d 383 (2d Cir. 1948); G. C. M. 26, 379, 1950 INT. REV. BULL. No. 10 at 4 (1950).

ordinary income when it is distributed to them in the form of dividends. To minimize their taxes, therefore, the group creates a collapsible corporation; that is, they form separate corporations for each picture which they produce. After the picture is completed but before it is sold or leased (that is, before the corporation has realized any income), the stockholders liquidate the corporation and have it distribute the picture to them. The stockholders realize a long-term capital gain on the distribution of the picture to them to the extent of the difference between the fair market value of the picture and the basis of their stock, the maximum tax upon which is 25 percent. If the fair market value of the picture has been estimated correctly, this is all the income which they will realize, because when the picture is subsequently sold or leased by the stockholders, any income from the picture will be offset by amortizing the basis of the picture in their hands.

To seal this loophole, the 1950 Act provides that any gain from the sale or exchange of stock in a collapsible corporation (whether or not in connection with a liquidation of the corporation) shall be taxed as ordinary income. Thus, the gain on the liquidation of the corporation in the foregoing example would be taxed not as a capital gain, but as ordinary income of the stockholder.

There are, however, various limitations on the taxation of gain from a collapsible corporation which may be so rigid that they may possibly create new loopholes. The gain will only be taxed as ordinary income of the stockholders where *all* of the following conditions are met:

(1) The gain must be realized by a stockholder owning more than 10 percent of the company's stock. Stock is deemed to be owned by a stockholder if it is owned actually or constructively according to the rules of ownership applied in the case of personal holding companies,<sup>37</sup> and in addition, if the stock is owned by the spouses of the taxpayer's brothers and sisters and the spouses of his lineal descendants.<sup>38</sup>

(2) More than 70 percent of the gain realized during the taxable year must be attributable to property manufactured, constructed or produced by the corporation.<sup>39</sup>

(3) The gain must be realized within three years following the completion of the manufacture, construction or production of the property.<sup>40</sup>

<sup>37</sup> §503(a)(1)-(6), IRC.

<sup>38</sup> §117(m)(3), IRC, added by §212, 1950 Act. It would appear that ordinary income may still be converted into a capital gain if a collapsible corporation is formed by at least ten totally unrelated individuals, none of whom own more than 10 percent of the company's stock.

<sup>39</sup> §117(m)(3), IRC, added by §212, 1950 Act.

<sup>40</sup> §117(m)(3), IRC, added by §212, 1950 Act.

## VI. TRANSACTIONS INVOLVING CORPORATE STOCK

*A. Purchase of Stock in a Parent Corporation by a Subsidiary*

Ordinarily the redemption of stock by a corporation is treated as a sale of the stock to the corporation by the stockholder and any gain realized by the stockholder is taxed as a long-term capital gain, provided, of course, that the stock represents a capital asset in the hands of the stockholder and has been held for more than six months. Section 115(g) of the Code provides, however, that the distribution will be taxed to the stockholder as an ordinary dividend if it is "essentially equivalent" to an ordinary dividend. Consequently, if a subsidiary corporation had surplus profits which it distributed to its parent and which the parent corporation in turn distributed to its stockholders in redemption of some of their stock, the distribution to the stockholders would be taxed as an ordinary dividend, if it was essentially equivalent to an ordinary dividend. Taxpayers discovered a loophole under the prior law to get around Section 115(g) by having the subsidiary use its surplus to purchase part of the stock of the stockholders of the parent corporation. In *Commissioner v. Wannamaker*<sup>41</sup> it was held that the gain realized upon the sale by the stockholders was taxable as a capital gain and could not be treated as an ordinary dividend. To close this loophole, the 1950 Act amends Section 115(g) of the Code<sup>42</sup> to provide that the amount paid by the subsidiary to the stockholders of the parent corporation shall be taxed as a dividend from the parent corporation to the extent that the amount would have been considered essentially equivalent to a taxable dividend if it had been distributed by the subsidiary to the parent corporation and applied by the parent to redeem its stock.

*B. Redemption of Stock to Pay Death Taxes*

Under the prior law a serious income tax problem faced the representative of an estate who wished to redeem stock held by the estate to get cash to pay death taxes, because of the possibility that the redemption would be treated as a distribution of an ordinary dividend under Section 115(g) of the Code. The 1950 Act amends Section 115(g) to provide that sufficient stock may be redeemed to meet death taxes and that the redemption will be treated as a sale of the redeemed stock to the corporation and not as an ordinary dividend.<sup>43</sup>

However, the relief afforded by the 1950 Act only applies where:

- (1) The value of the stock in the corporation which redeems the stock comprises more than 50 percent in value of the net estate;

<sup>41</sup> 178 F. 2d 10 (3rd Cir. 1950).

<sup>42</sup> §115(g) (1) and (2), IRC, added by §208(b), 1950 Act.

<sup>43</sup> §115(g) (3), added by §209(a), 1950 Act.

- (2) The redemption occurs within the period of the statute of limitations for the assessment of the estate tax, or ninety days thereafter; and
- (3) The amount of stock redeemed does not exceed the liability for death taxes of the estate, including any interest on such taxes. Any distribution in excess of the amount of death taxes is subject to the general rule laid down by Section 115(g) and may be taxed as an ordinary dividend.

### C. *Restricted Stock Options*

According to the Regulations<sup>44</sup> under the prior law, an employee upon the exercise of a stock option which he received from his employer realized additional compensation to the extent of the difference between the fair market value of the stock which he received and the price he paid to exercise the option. By the same token the difference was deductible by the employer as additional compensation paid the employee. The 1950 Act provides that in the case of "restricted stock options," an employee will not realize any income when he receives or exercises the option. Upon the sale of the stock acquired under the option, he may realize ordinary income or capital gain depending upon the circumstances. Moreover, since the restricted stock option is no longer regarded as additional compensation to the employee, the corporation which issues the option will not be allowed any deduction when it distributes the stock, nor will it be deemed to have received any consideration for the stock other than the option price.<sup>45</sup>

The favorable treatment afforded stock options under the 1950 Act only applies, however, where (1) the option is a restricted stock option, (2) which is exercised within the time limits set by the statute, and (3) where the stock acquired by the exercise of the option is not disposed of within the period prescribed by the statute for holding the stock.

A restricted stock option is an option granted after February 26, 1945, to an individual, for any reason connected with his employment, to acquire stock in the employer corporation or a parent or subsidiary of the employer corporation which complies with the following conditions:

- (1) The option price must be at least 85 percent of the fair market value of the stock at the time the option is granted;
- (2) The option must not be transferable except by will or inheritance, and during the lifetime of the optionee must be exercisable by the optionee alone;

<sup>44</sup> U. S. Treas. Reg. 111, §29.22(a)-1 (1948).

<sup>45</sup> §130 A, IRC, added by §218(a), 1950 Act.

- (3) At the time the option is granted the employee must not own more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation. For the purpose of determining such stock ownership the employee will be deemed to own stock owned by his brothers and sisters, spouse, ancestors, lineal descendants, and any corporation, partnership, estate or trust, in which he owns an interest, proportionately to such interest.

In order to get the benefits of the provisions for restricted stock options the employee must exercise the option while he is employed by the corporation granting the option or by a parent or subsidiary of such corporation, or within three months after the termination of such employment.

Moreover, the employee will be deprived of the benefits of the new provisions relating to restricted stock options if he sells the stock acquired through the exercise of the option within two years from the date of the grant of the option or within six months from the acquisition of the stock under the option. For example, if an employee got a restricted stock option which he exercised exactly two years after the option was granted and he sold the stock acquired under the option five months later, he would be taxed on any gain he made from the exercise of the option, even though (because it was not known when he would dispose of the stock acquired by the exercise of the option) the gain was apparently not taxable at the time the option was exercised.

If there is a restricted stock option and the option price amounts to 95 percent or more of the value of the stock called for by the option at the time the option is granted, any gain from the sale of the stock will be taxed as a capital gain.<sup>46</sup> If, however, the option price is between 85 and 95 percent of the value of the stock, the new law provides that upon the sale or other disposition (such as inheritance) of the stock acquired under the option, that part of the gain equal to the amount by which the lesser of (1) the fair market value of the stock at the time the option was granted, or (2) the fair market value of the stock at the time of its disposition, exceeds the option price, shall be taxed as ordinary income.<sup>47</sup> The income thus taxed is added to the basis of the stock and any additional gain is taxed as a capital gain.

For example, on January 1, 1951, an employee receives a restricted

<sup>46</sup> SEN. REP. No. 2375, 81st Cong., 2d Sess. (1950) explicitly states that the gain from the sale of the stock acquired under the stock option shall be taxed as a capital gain and apparently eliminates any uncertainty upon this point which may have existed heretofore.

<sup>47</sup> §130 A, IRC, added by §218(a), 1950 Act.



stock option to purchase a share of stock of X Corporation, by whom he is employed, for \$85. The fair market value of the stock at that time is \$100. On January 1, 1952, the employee exercises the option and acquires a share of X stock for \$85. On February 1, 1953, the employee sells the stock for \$125. The employee realizes ordinary income of \$15 from the sale, since this is the difference between the lower fair market value of the stock (\$100) at the time the option was granted and the option price. This income is added to the basis of the stock to make the basis \$100 (\$15 plus the option price of \$85). The difference between the selling price of the stock (\$125) and its basis (\$100) results in a long-term capital gain of \$12.50 (50% of \$25).

#### *D. Limited Tax-free Liquidations*

Section 112(b)(7) of the Code, before amendment, provided a special rule for complete liquidations which took effect in one month. The last time this provision applied was in 1944. Section 206 of the 1950 Act revives this provision for 1951 and provides that a corporation which is completely liquidated in one calendar month in 1951 may have the benefit of Section 112(b)(7).

In general the benefit derived from liquidating under Section 112(b)(7) is that a corporation may distribute property which has appreciated in value without the realization of any gain by the stockholders, who, instead of realizing an immediate gain, will take as the basis of the assets the substituted basis of their shares of stock. Of course, this simply postpones the realization of gain until the stockholders sell the assets, but it offers a convenient means of escape from a heavily taxed corporation, like a personal holding company.

Section 117(b)(7) provides for an immediate tax upon that part of the distribution to the stockholder, which represents accumulated profits of the corporation, as an ordinary dividend. It also taxes as a capital gain any gain represented by the value of any property distributed to the stockholder, which the corporation acquired after August 15, 1950, along with any cash distributed to the stockholder, to the extent that such property and cash exceeds the amount already taxed as an ordinary dividend. The basis of the property of the corporation distributed to the stockholder is adjusted by adding any gain taxed on the liquidation and subtracting any cash distributed in connection with the liquidation.

### VII. AMORTIZATION AND DEDUCTIONS

#### *A. Amortization of Bond Premiums*

The 1950 Act contains a new provision requiring dealers to amortize the premiums paid for "short-term municipal bonds."<sup>48</sup> An investor who buys a tax-exempt bond at a premium is required to amortize the

<sup>48</sup> §22, IRC, as amended by §203(a), 1950 Act.

premium and reduce the basis of the bond on the theory that since the interest from the bond is not taxable, he should not be able to deduct a loss represented by the premium on the bond when it is sold or redeemed. Thus, for example, if A purchases a ten-year \$1,000 bond for \$1,100, he will be required to reduce the basis of the bond by \$10 each year, so that if he holds the bond until maturity and redeems it at \$1,000, he will show no tax loss. Prior to the 1950 Act, however, dealers in state and municipal bonds were not required to amortize premiums paid for such bonds. The 1950 Act extends the amortization requirement to dealers who purchase "short-term municipal bonds" at a premium.

A short-term municipal bond is defined as an obligation issued by a state or other political subdivision of a state, the interest from which is not taxable, and which is held by the dealer for more than thirty days and whose earliest maturity or call date is not more than five years from the date on which it was acquired by the taxpayer. If the dealer inventories his securities on the basis of cost, he must subtract the amortization for each bond from the cost of the bond. If he uses some other basis for his inventory, such as market value, he is required to reduce the cost of securities sold during the year by the total amortization for that year.

A taxpayer who purchases a taxable bond at a premium may amortize the premium on the basis of the earlier call or maturity date and in the case of the taxable bond, unlike the tax-exempt bond, may deduct the amortization from gross income. In *Commissioner v. Korrell*,<sup>49</sup> the Supreme Court held that premium due to a conversion privilege contained in a bond could be amortized just like premium due to a high interest rate. Section 217(a) of the 1950 Act amends Section 125(b) of the Code to reverse this rule and to provide that premium due to conversion privilege cannot be amortized. If a premium is due both to a conversion privilege and a high interest rate, however, the part of the premium referable to the high interest rate may be amortized and deducted, which will obviously call for some skillful apportionment.

#### *B. Amortization of Emergency Facilities*

During World War II, Section 124 of the Code allowed taxpayers to amortize the cost of emergency facilities over a period of sixty months, instead of recovering their cost through the usual depreciation allowances. Section 216 of the 1950 Act adds Section 124A to the Code to extend similar treatment for emergency facilities during the current crisis, although there are significant differences between the 1950 Act and the World War II legislation.

<sup>49</sup> 70 S. Ct. 905 (1950).

Under the 1950 Act an emergency facility which is certified as necessary for national defense may be amortized over a period of sixty months. However, unlike the World War II legislation, the President is to designate the certifying authority. In World War II this function was vested in the Secretaries of the Army and Navy and the Chairman of the War Production Board.

The 1950 Act provides that part of a facility may be designated as an emergency facility and amortized while the cost of the remainder is recovered by means of depreciation. This was allowed in World War II, although there was no explicit provision for it.

A taxpayer may begin amortizing an emergency facility with the month following the acquisition or completion of the facility, or with the taxable year following its acquisition or completion. At any time, by appropriate written notice, he may elect to discontinue amortizing the facility and recover the remaining cost through depreciation.

The period during which emergency facilities may be certified will terminate upon a Presidential proclamation that the emergency is over. Unlike the World War II legislation, however, there is no provision in the 1950 Act by which the taxpayer upon the termination of the emergency may go back and recompute the amortization of the facility over the period ending with the termination of the emergency.

Under the 1950 Act upon the sale or taxable exchange of an emergency facility, any gain due to amortization will be taxed as ordinary income, without the benefit of Section 117(j) of the Code. For example, A acquires an emergency facility for \$100,000 which he elects to amortize. When the adjusted basis of the facility is \$50,000, but its adjusted basis would have been \$80,000 if A had elected to depreciate the facility instead of amortizing it, A sells it for \$110,000. The difference between what would have been the adjusted basis of the property if it had been depreciated (\$80,000) and the actual adjusted basis (\$50,000) or \$30,000 is taxed as ordinary income without the benefit of Section 117(j).

### *C. Net Operating Loss Deduction*

For taxable years beginning after 1949, Section 215(a) of the 1950 Act amends Section 122(b) of the Code to substitute for the two year carry-back and the two year carry-over of net operating losses, a one year carry-back and a five year carry-over.

### *D. Circulation Expenses*

In order to clear up a doubtful point under the prior law, the 1950 Act explicitly provides that publishers of newspapers, magazines and other periodicals may deduct expenditures to maintain, establish or in-

crease circulation, except those incurred in purchasing land or depreciable property or in acquiring any part of the business of another publisher.<sup>50</sup> Publishers may also elect to capitalize such expenditures as are deemed properly chargeable to capital account according to regulations to be prescribed by the Secretary of the Treasury.

#### *E. Depletion of Mines*

Section 207(a) of the 1950 Act amends Section 114(b)(4)(B) of the Code to provide that for the purpose of computing percentage depletion in the case of mines, any value added to minerals by transportation to the plants or mills in which the ordinary treatment processes are applied shall be included in gross income. If, however, the transportation exceeds fifty miles, this may only be done where the Treasury finds that the minerals must be transported greater distances than fifty miles for the ordinary treatment processes.

### VIII. PROVISIONS AFFECTING SPECIAL CLASSES OF TAXPAYERS

#### *A. Residents of Puerto Rico*

The 1950 Act institutes a new system of taxing income of residents of Puerto Rico by extending the federal income tax to Puerto Rico.<sup>51</sup> Citizens of the United States including those who are citizens of the United States because of the Organic Acts of Puerto Rico as well as citizens born or naturalized in the United States), who are resident in Puerto Rico, will be taxed upon their entire income, regardless of whether or not it comes from United States sources.

However, a citizen who is a bona fide resident of Puerto Rico for the entire taxable year is allowed to exclude his income from Puerto Rican sources from the federal tax, with the exception of compensation received as an employee of the United States. Moreover, a citizen who has been a bona fide resident of Puerto Rico for two or more taxable years may exclude his Puerto Rican income during a subsequent year, even though he was not a resident of Puerto Rico for the entire taxable year.

Aliens who are residents of Puerto Rico are taxed in the same way as aliens resident in the United States. Their income is taxable regardless of source. However, if an alien is a bona fide resident of Puerto Rico for the entire taxable year he may exclude his Puerto Rican income from the federal tax, except any amounts paid to him as an employee of the United States.<sup>52</sup>

Although aliens resident in Puerto Rico are taxed like aliens resid-

<sup>50</sup> §23(bb), IRC, added by §204(a), 1950 Act.

<sup>51</sup> §§251(d) and 252(a), IRC, as amended by §221(a) and (b), 1950 Act; and §116(1), IRC, added by §221(c), 1950 Act.

<sup>52</sup> §220, IRC, added by §221(d), 1950 Act.

ing in this country, withholding upon their fixed or determinable income from United States sources is required at the 30 percent rate applied to non-resident aliens.<sup>53</sup> The amounts withheld will, however, be credited against their final tax.

#### *B. United States Employees in Possessions of the United States*

Under Section 251 of the Code, a citizen of the United States who derives 80 percent of his gross income from a possession of the United States and 50 percent from the active conduct of a trade of business there, is taxed only on his income from United States sources. The prior law treated compensation for services performed in a possession as an employee of the United States as income from the possession for the purpose of Section 251, with the result that military and civilian personnel stationed in United States possessions paid little or no federal income tax. To correct this situation, the 1950 Act provides that for taxable years beginning after December 31, 1949, compensation paid to an employee of the United States for services in a possession will no longer be treated as income from the possession for the purpose of determining whether the taxpayer is entitled to the benefits of Section 251.<sup>54</sup>

#### *C. Regulated Investment Companies*

Regulated investment companies are the tax equivalent of what are popularly called investment trusts. The statutes tax the income of such companies to the shareholders rather than to the companies themselves by providing that regulated investment companies shall only be taxed upon their undistributed income, if they distribute 90 percent or more of their income during the taxable year. In the past regulated investment companies have experienced difficulty in meeting this requirement, since they have found it hard to determine just how much they would have to distribute to fall within the 90 percent limitation until the taxable year was over. The 1950 Act, therefore, provides that regulated investment companies may elect to treat dividends paid after the close of the taxable year as a distribution of their earnings during the taxable year.<sup>55</sup> Such dividends must, however, be paid within twelve months of the close of the taxable year and not later than the first regular dividend after they are declared. Moreover, as far as the shareholders are concerned, they must report the dividends as income when they are received, rather than as income of the preceding taxable period.

#### *D. Personal Holding Companies*

For taxable years ending after 1945 and before 1950, rents from

<sup>53</sup> §§143(a) (1) and 143(b), IRC, as amended by §221(e), 1950 Act.

<sup>54</sup> §251(j), IRC, added by §220, 1950 Act.

<sup>55</sup> §362(b) (8), IRC, added by §222, 1950 Act.

property leased to a stockholder owning 25 percent or more of a personal holding company's stock will not be classified as personal holding company income, provided the property was used by a stockholder in a bona fide commercial, industrial or mining enterprise.<sup>56</sup> It should be noted, however, that for taxable years ending after December 31, 1949, the general rule applies and such income will be treated as personal holding company income.

#### *E. Life Insurance Companies*

The formula adopted by the Revenue Act of 1942 for determining the net taxable earnings of life insurance companies resulted in relieving such companies from the federal income tax for 1947, 1948 and 1949. The 1950 Act amends this formula retroactively to provide for a tax for 1949 and subsequent years.<sup>57</sup> Congress is still undecided about what to do about 1947 and 1948.

#### *F. Exempt Organizations*

Perhaps the most important, and certainly the most complex, provisions of the new law are those which institute a new system for taxing the income of certain trusts and tax-exempt organizations. Congress felt that the exemptions granted to certain organizations have been used to avoid taxes, rather than to promote the purposes for which the exemptions were granted. The 1950 Act seeks to prevent the misuse of tax-exemptions without crippling the legitimate functions of exempt organizations. The complexities of the new system grow out of this legislative effort to catch the goats without shearing the sheep. The best way to approach them is to keep clearly in mind the alleged abuses which the new Act seeks to curb. The 1950 Act generally strikes at five types of tax avoidance in connection with trusts and tax-exempt organizations: (1) The exemption of unrelated business income; (2) the exemption of feeder corporations; (3) the exemption of leaseback income; (4) the unlimited deduction for charitable contributions of trusts; and (5) certain aspects of charitable foundations.

##### *(1) Taxation of Unrelated Business Income*

Although the matter is in dispute,<sup>58</sup> there is at least a strong possibility that under the prior law an exempt organization could carry on a business unrelated to its exempt function without paying any tax upon the income from the business. Thus, for example, a university might operate a spaghetti factory, either directly, or through the medium of

<sup>56</sup> §502(f), IRC, as amended by §223, 1950 Act.

<sup>57</sup> §202(b), IRC, as amended by §401(a), 1950 Act.

<sup>58</sup> *Trinidad v. Sagrada Orden De Predicadores*, 263 U. S. 578 (1924); *Universal Oil Products v. Campbell*, 181 F. 2d 451 (7th Cir. 1950); *Commissioner v. Orton*, 173 F. 2d 483 (6th Cir. 1949); *Roches Beach, Inc. v. Commissioner*, 96 F. 2d 776 (2d Cir. 1938); *C. F. Mueller Co. v. Commissioner*, 14 T. C. No. 111-½ (1950).

a "feeder" corporation, which would be exempt because all of its revenues went to the university, without paying any tax upon the income from the business. The general approach adopted by the 1950 Act to close this loophole is to classify the business income as "unrelated business income" or "Supplement U income" and subject it to a tax.<sup>60</sup> Moreover, "feeder" organizations which conduct a business and claim exemption because all of their revenues are paid over to an exempt organization are denied exemption.<sup>60</sup>

The tax on the unrelated business income of exempt organizations is, however, limited to the following organizations:

- (1) Labor, agricultural and horticultural organizations exempt under Section 101(1);
- (2) Charitable, scientific, literary, educational or religious organizations (excluding churches and associations of churches) and organizations for the prevention of cruelty to children or animals, exempt under Section 101(6);
- (3) Business leagues, chambers of commerce, real estate boards and boards of trade, exempt under Section 101(7);
- (4) Section 101(14) corporations organized to hold title to property and to collect income therefrom for any of the organizations, *including* churches and associations of churches.

The first \$1,000 of unrelated business income is exempt from tax. Amounts in excess of \$1,000 are taxed at the rates applied to corporations, if the exempt organization is the type of organization which is classified as a corporation under the income tax. Amounts in excess of \$1,000 are taxed at the individual rates applied to trusts, if the organization is classified for tax purposes as a trust.

Unrelated business income which is the subject of the tax includes any income from a business "regularly" carried on by the exempt organization, which is not "substantially" related to the function upon which the organization's exemption is based. It does not include income from an unrelated trade or business, however, (1) if substantially all of the work in carrying on such trade or business is performed for the organization without compensation; or (2) if the trade or business is carried on primarily for the convenience of the members, students, patients, officers or employees of an organization exempt under Section 101(6); or (3) if the unrelated business consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

<sup>60</sup> §421, IRC, added by §301, 1950 Act.

<sup>60</sup> §101, IRC, as amended by §301(b), 1950 Act.

Certain items are explicitly excluded from unrelated business income. They are:

- (1) Dividends, interest (including interest paid in connection with an unrelated business), and annuities;
- (2) Royalties;
- (3) Rents from real property (except rents from long-term leases connected with lease-back arrangements);
- (4) Gains and losses from the sale or exchange of property, except stock in trade or property held primarily for sale in the course of the taxpayer's trade or business;
- (5) Income from work done under a contract with the United States or a state;
- (6) Income of a college, university or hospital from research performed for any person;
- (7) Income from research for the United States or any of its agencies or for a state or political subdivision of a state;
- (8) Income from research performed for any person by an organization operated primarily for the purpose of carrying on fundamental research, the results of which are freely available to the public.

In computing "unrelated business net income," the taxpayer is allowed to deduct the deductions provided for by Section 23 which are directly connected with the unrelated business income. Deductions which are directly connected with income from unrelated business income are not deductible. A net operating loss deduction may be taken in determining an exempt organization's unrelated business net income. The net operating loss will be computed without taking into account the income and deductions of the organization which are excluded from its unrelated business income, and any such loss cannot be carried back to a year in which the organization was not subject to the new tax. An exempt organization which is taxed as a corporation may deduct up to 5 percent of its unrelated business net income (computed before the deduction) for charitable contributions; and an organization taxed as a trust may deduct up to 15 percent of its unrelated business net income (computed before the deduction) for charitable contributions.

## (2) *Feeder Organizations*

The 1950 Act provides that an organization which is operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from the income tax, even though it pays over all of its profits to an organization which is exempt under Section 101.<sup>61</sup>

<sup>61</sup> §101, IRC, as amended by §301(b), 1950 Act.



(3) *Income from Lease-backs*

Through sale and lease-back arrangements, exempt organizations have been using their tax exemptions to acquire property. For example, a university borrows money and uses it to purchase a factory, which it leases back to the seller under a long-term lease. The university then uses the tax-exempt rents to liquidate the indebtedness incurred in connection with the purchase of the property. To close this loophole, Congress provided in the 1950 Act that income from lease-backs should be taxed as unrelated business income in the case of those exempt organizations which are subject to the "Supplement U" tax on such income.<sup>62</sup>

There are, however, a number of statutory limitations on the taxation of lease-back income. The most important are: (1) The tax is only applied to those exempt organizations which are subject to the Supplement U tax, that is, the tax on unrelated business income; (2) it only applies where the exempt organization purchases the property which is leased with borrowed funds, that is, where at the end of the taxable year there is a Supplement U indebtedness against the property; and (3) only the income from long-term or Supplement U leases is subject to the tax.

If an exempt organization purchases property with its own funds and leases it under long-term leases, the rent from the leases is ordinary rent, which is excluded from unrelated business income. Moreover, where an exempt organization acquires property with borrowed funds, which it leases on long-term leases, only a part of the rentals proportionate to the ratio between the unpaid debt on the property at the close of the taxable year and the adjusted basis of the property is subject to the tax.

For example suppose that a university purchases a department store for \$300,000, using \$100,000 of its own funds and raising the remaining \$200,000 by a mortgage on the property. It leases the property for fifty years. The university collects \$30,000 in rents under the lease during the taxable year. At the end of the year none of the indebtedness has been paid off, so that the Supplement U indebtedness is \$200,000 and the adjusted basis of the property is \$300,000.<sup>63</sup> The income from the lease which is taxable is \$20,000, computed according to the following formula:

$$\frac{\$200,000 \text{ (Supplement U indebtedness)}}{\$300,000 \text{ (adjusted basis)}} \times \$30,000 \text{ (annual rental)} \\ = \$20,000 \text{ taxable income.}$$

In computing the net income from a Supplement U lease which is subject to the tax, the taxpayer is allowed the following deductions *in*

<sup>62</sup> §423, IRC, added by §301(a), 1950 Act.

<sup>63</sup> Depreciation should be taken into account to reduce the adjusted basis of the property, but it is disregarded for the purpose of the illustration.

*the same proportion* as that used to determine the part of the rent which is taxable:

- (1) Taxes and other expenses paid or incurred during the taxable year with respect to the property subject to the Supplement U lease;
- (2) Interest paid or accrued during the taxable year on the Supplement U indebtedness;
- (3) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to the lease.

Although in terms the 1950 Act only taxes rents from long-term leases of real property, the statute provides that "the term 'real property' and the term 'premises' include personal property of the lessor leased by it to a lessee of its real estate if the lease of such property is made under, or in connection with, the lease of such real property."<sup>64</sup> Moreover, although the statute was designed primarily to tax rents from sale and lease-back arrangements, the tax applies even though the property is leased to one other than the seller.<sup>65</sup>

Only rents from what the statute calls Supplement U leases, or long-term leases, are subject to the tax. A long-term lease is defined as a lease for a term of more than five years.<sup>66</sup> A lease for less than five years will be regarded, however, as a lease for longer than five years, if there is an option to renew the lease and the term of the original lease plus the period for which it may be renewed amount to more than five years. If the lease provides for renewals for a period which added to the original term of the lease does not aggregate more than five years, the lease will not be regarded as a long-term lease, until by repeated exercise of the right of renewal it has been in effect for more than five years. For example, if a three year lease with a privilege of renewing the lease for an additional year is renewed in the fourth, fifth and sixth years from the date of the original lease, it will not become a long-term lease until the sixth year. If property is acquired subject to a lease, the lease will be treated as a long-term lease if it has more than five years to run from the date when the property is acquired. Otherwise, it will be a short-term lease. Thus, if a university acquired property subject to a ten year lease which still had three years to run, this would be a short-term lease.

If part of the property subject to the lease-back arrangement is leased for more than five years and part is leased for less than five years, the leases for more than five years will only be considered as long-term leases, if:

<sup>64</sup> §423(c), IRC, added by §301(a), 1950 Act.

<sup>65</sup> §423(a), IRC, added by §301(a), 1950 Act.

<sup>66</sup> §423(a), IRC, added by §301(a), 1950 Act.

- (1) More than 50 percent of the rented area is leased for more than five years, or more than 50 percent of the total rents from the property comes from such leases;
- (2) Or, a particular tenant or group of affiliated tenants or partners occupy more than 10 percent of the total rented area under a lease for more than five years, or pay more than 10 percent of the total rents under such a lease.<sup>67</sup>

Even though property is leased for more than five years, the lease will not be treated as a long-term lease, if it is entered into for a purpose substantially related to the exempt function of the exempt organization, or if it involves the lease of part of a building primarily designed for and occupied by the exempt organization.<sup>68</sup>

The income from Supplement U leases is taxed only when the rented property is subject at the end of the taxable year to a Supplement U indebtedness, because the tax does not apply to property acquired by exempt organizations with their own, as distinguished from borrowed, funds.<sup>69</sup> Property will be treated as subject to a Supplement U indebtedness, however, even though the indebtedness was incurred prior to or after the acquisition of the property, if it was incurred for the purpose of acquiring or improving the property. For example, a university pledges its bonds to buy a store which it leases back under a long-term lease to the seller. Later it mortgages the store to redeem the bonds. The store is subject to a Supplement U indebtedness and the rents from the store are taxable as unrelated business income. Property will also be subject to a Supplement U indebtedness if it is subject to a mortgage when it is acquired, even though the exempt organization does not assume the mortgage.<sup>70</sup>

#### *(4) Denial of Unlimited Charitable Deduction to Certain Trusts*

Section 162(a) of the Code allows a trust an unlimited deduction for any income which is paid or permanently set aside for charitable purposes pursuant to the terms of the will or deed creating the trust. In the absence of some preventive provision in the 1950 Act, the unlimited charitable deduction could be used to circumvent the tax on unrelated business income by giving a business to a trust and providing that all the income of the trust should be paid over to or permanently set aside for charitable purposes. To prevent this the new law provides that the unlimited charitable deduction under Section 162(a) shall be denied to the extent that income paid or permanently set aside for deductible pur-

<sup>67</sup> §423(a), IRC, added by §301(a), 1950 Act.

<sup>68</sup> §423(a), IRC, added by §301(a), 1950 Act.

<sup>69</sup> §423(a), IRC, added by §301(a), 1950 Act.

<sup>70</sup> See, however, §423(b), IRC, added by §301(a), 1950 Act for certain retroactive exceptions to this rule.

poses is traceable to income which would be taxed as Supplement U income in the case of an exempt organization.<sup>71</sup>

*(5) Charitable Foundations*

By a variety of complex provisions, the 1950 Act seeks to put an end to tax avoidance by means of "charitable foundations." Charitable foundations differ and they are used in diverse ways. However, as a tax avoidance device a charitable foundation usually functions somewhat along these lines: A wealthy man creates a charitable corporation or trust and transfers his business or estate to the foundation. The income from the property will no longer be taxable because of the exemption enjoyed by the organization if it is an exempt organization, or because of the unlimited deduction for income paid to or permanently set aside for charity, if it is a non-exempt trust. Moreover, if the foundation qualifies as an exempt charity, any contributions to it will be deductible under the income and gift taxes, and at his death the creator of the foundation can pass the residue of his property along to it by his will without incurring any liability under the estate tax. There is, of course, no objection to a man dedicating his estate to charity. Usually, however, the creator of what might be called a private charitable foundation manages to keep various strings on his bounty which will assure him and his family of substantial personal benefits. By vesting control of the foundation in himself and his nominees, he can not only direct its benevolences, but he can assure himself and his family lucrative employment in various capacities in connection with the foundation. Thus, for example, a man might convey his business to a charitable foundation and arrange for his future employment as the manager of the business at a substantial salary. Or he might use a charitable foundation to accumulate tax-free capital for other enterprises. For example, the executives of a corporation might set up tax-exempt trusts and give them title to most of the corporate assets in order to accumulate tax-free risk capital for the corporation.

The 1950 Act attempts to curb misuse of charitable foundations in three ways: (1) If a trust or exempt organization engages in certain "prohibited transactions," that is, transactions which result in a private benefit to the creator of the trust or organization, rather than the advantage of the charitable beneficiaries, a trust will lose its unlimited deduction for charitable contributions,<sup>72</sup> while an exempt organization will forfeit its exemption.<sup>73</sup> (2) The same results will follow if a trust or exempt organization accumulates income under circumstances which indicate that the accumulation is for the benefit of the creator of the

<sup>71</sup> §162(g), IRC, added by §321(a), 1950 Act.

<sup>72</sup> §162(g)(2), IRC, added by §321(a), 1950 Act.

<sup>73</sup> §3813(e), IRC, added by §331, 1950 Act.

trust or organization, rather than the furtherance of its charitable purposes.<sup>74</sup> (3) Finally, the deduction for contributions to charitable organizations, which are allowed under the income, estate and gift taxes, will be denied in the case of contributions to trusts or organizations which have engaged in "prohibited transactions."<sup>75</sup>

All trusts which engage in prohibited transactions or improperly accumulate income are denied the unlimited deductions for charitable contributions and limited to a charitable deduction which cannot exceed 15 percent of the net income of the trust.<sup>76</sup> However, the statute does not strip the exemption from all exempt organizations which engage in prohibited transactions or improperly accumulate income, but is limited to organizations which are exempt under Section 101(6), and does not apply even to the following Section 101(6) organizations, which are more apt to be public charities than private family foundations:

- (1) Religious organizations (but not trusts);
- (2) Educational organizations with a regular faculty and curriculum and regularly enrolled student body in attendance at a place where the educational activities are carried on;
- (3) Organizations which normally receive a substantial part of their support from the United States or a state or contributions from the general public;
- (4) Organizations operated by religious organizations (other than trusts) which are not themselves subject to the new law;
- (5) Organizations which provide medical or hospital care, education or research.<sup>77</sup>

Two elements must co-exist for a "prohibited transaction" which will cause a trust to lose its unlimited charitable deduction or an exempt organization to lose its exemption and will also lead to a denial of income, estate and gift tax deductions for contributions to such organizations: (1) The transaction must be entered into between the trust or organization and certain interdicted persons; and (2) the transaction must involve a specified kind of dealing set forth in the statute.

The persons with whom the trust or exempt organization is forbidden to deal are:<sup>78</sup>

<sup>74</sup> §162(g)(4), IRC, added by §321(a), 1950 Act and §3814, IRC, added by §331, 1950 Act.

<sup>75</sup> §162(g)(2)(E), IRC, added by §321(2)(a), 1950 Act and §3813(e), IRC, added by §331, 1950 Act.

<sup>76</sup> §162(g)(2)(A), IRC, added by §321(a), 1950 Act and §162(g)(4), IRC, added by §321(a). In the case of trusts improperly accumulating income, there is the further limitation that the deduction for charitable contributions cannot exceed the amount actually paid out during the taxable year.

<sup>77</sup> §3813(a), IRC, added by §331, 1950 Act.

<sup>78</sup> §162(g)(2), IRC, added by §321, 1950 Act and §3813(b), IRC, added by §331, 1950 Act.

- (1) The creator of the trust, or a member of his family;
- (2) A person who has made a substantial contribution to the trust or organization, or a member of his family;<sup>79</sup>
- (3) A corporation controlled by the creator of the trust or organization or a substantial contributor thereto, through ownership, directly or indirectly, of 50 percent or more of the voting power of the corporation.

The transactions in which the trust or exempt organization are forbidden to engage are defined by the statute<sup>80</sup> as follows:

"Prohibited transaction" means any transaction after July 1, 1950, in which any trust [or exempt organization covered by the prohibition] while holding income or corpus which has been permanently set aside or is to be used exclusively for charitable or other purposes . . .

- "(i) lends any part of such income or corpus, without receipt of adequate security and a reasonable rate of interest, to;
  - "(ii) pays any compensation from such income or corpus, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;
  - "(iii) makes any part of its services available on a preferential basis to;
  - "(iv) uses such income or corpus to make any substantial purchase of securities or any other property, for more than an adequate consideration in money or money worth, from;
  - "(v) sells any substantial part of the securities or other property comprising such income or corpus, for less than an adequate consideration in money or money's worth, to; or
  - "(vi) engages in any other transaction which results in a substantial diversion of such income or corpus, to;
- [any person with whom the trust or exempt organization is forbidden to deal as set forth above]."

Ordinarily, a trust or exempt organization which engages in a prohibited transaction will lose its unlimited deduction or exemption only for those years following the taxable year in which it is notified that it has engaged in a prohibited transaction.<sup>81</sup> However, if there has been an intentional diversion of income or corpus, the unlimited deduction or exemption will be denied from the time when the diversion occurred. After a trust or exempt organization has lost its unlimited deduction or exemption it may have these privileges restored by convincing the

<sup>79</sup> Family in both (1) and (2) is defined to include the same persons who are treated as members of the same family under §24(b)(2)(D), IRC (dealing with the disallowance of losses between related taxpayers).

<sup>80</sup> §162(g)(2)(B), IRC, added by §321(a), 1950 Act and §3813(b), IRC, added by §331, 1950 Act.

<sup>81</sup> §162(g)(2)(C), IRC, added by §321(a), 1950 Act and §3813(c)(2), IRC, added by §331, 1950 Act.

Commissioner that it will not knowingly engage in prohibited transactions in the future.<sup>82</sup>

Contributions made after December 31, 1950, to a trust which has lost its unlimited deduction or to an exempt organization which has lost its exemption are not deductible under the income, estate or gift taxes.<sup>83</sup> Ordinarily such deductions will be denied only where the trust or organization has been formally notified of the loss of these privileges. However, if the trust or exempt organization lost its unlimited deduction or exempt status because it intentionally diverted a substantial part of its income or corpus, the privilege of deducting contributions may be forfeited for contributions made in the taxable year in which the diversion occurred or in a prior year. However, the denial of a deduction in this situation is limited to the donor or a member of his family who participated in the prohibited transaction.

The 1950 Act in addition to the strictures against "prohibited transactions" seeks to prevent tax avoidance by a trust taking a deduction for income permanently set aside for charitable purposes, and then using the income for the private ends of the creator of the trust, rather than the designated charity. Trusts which accumulate income for charitable purposes either for too long a time or in excessive amounts, or which use such income for purposes other than their charitable purposes, or invest it in a manner which jeopardizes the interests of the charitable beneficiaries, will be denied a deduction for income which is permanently set aside for charity and not actually paid out. Moreover, the deduction for amounts actually disbursed to charity will be limited to 15 percent of the net income of the trust.<sup>84</sup> A similar limitation is imposed upon exempt organizations. Exempt organizations which engage in the same practices will forfeit their exemptions.<sup>85</sup>

The final weapon which the 1950 Act relies upon in its campaign against the abuse of charitable foundations is publicity. Trusts which claim an unlimited deduction for charitable contributions and those organizations which are exempt under Section 101(6) and which are required to file information returns, must file statements setting forth their receipts, expenses, disbursements of income and principal, accumulations of income within the year and accumulations of income in prior years, which will be available to the public.<sup>86</sup>

<sup>82</sup> §162(g)(2)(D), IRC, added by §321(a), 1950 Act and §3813(d), IRC, added by §331, 1950 Act. It is not entirely clear from the wording of these sections whether a trust which has intentionally participated in a prohibited transaction may apply to have these privileges restored.

<sup>83</sup> §162(g)(2)(E), IRC, added by §321(a), 1950 Act and §3813(e), IRC, added by §331, 1950 Act.

<sup>84</sup> §162(g)(4), IRC, added by §321(a), 1950 Act.

<sup>85</sup> §3814, IRC, added by §331, 1950 Act.

<sup>86</sup> §153, IRC, added by §341(a), 1950 Act.

## PART TWO: THE ESTATE TAX

Although the 1950 Act was principally concerned with the Income Tax, there were several important amendments to the Estate Tax.

Section 501 of the 1950 Act amends Section 811 of the Code to provide that transfers made more than three years before the death of the transferor shall not be treated as transfers in contemplation of death. The same rule applies to the relinquishment of a power to revoke or modify a trust and to the release of a power of appointment. Transfers within three years of the transferor's death are presumed to be made in contemplation of death. The presumption, however, is rebuttable.

Section 502 of the 1950 Act amends Section 812(b) of the Code to eliminate the deduction allowed under the prior law for support of dependents.

Section 503(a) of the 1950 Act lays down new conditions which must be complied with before a possibility of reverter will be treated as an incident of ownership in life insurance. The amendment is somewhat technical and because of its complexity, rather than its intrinsic importance, merits a word of explanation.

Section 811(g) of the Code, as amended by the 1942 Act, provides that life insurance payable to beneficiaries other than the estate of the insured shall be taxable to the insured's estate where the insured either (1) paid the premiums for the policy, or (2) at the time of his death had incidents of ownership in the policy. A reversionary interest is not regarded as an incident of ownership for the purpose of determining the taxability of insurance under the incidents of ownership test. However, it is regarded as an incident of ownership for the purpose of determining whether the insured has paid premiums in certain situations. When the new system of taxing life insurance was adopted by the 1942 Act, Section 404(c) of that Act provided that if an insurance policy was irrevocably assigned so that the insured had no incidents of ownership after January 10, 1941, only that part of the proceeds of the insurance proportionate to the premiums paid by the insured after that date should be taxed to his estate. However, if the insured retained incidents of ownership after January 10, 1941, then a part of the insurance proceeds proportionate to all the premiums he paid (whether before or after January 10, 1941) should be taxed to his estate. For the limited purpose of determining whether an insured had incidents of ownership after January 10, 1941, a reversionary interest was regarded as an incident of ownership.

The Technical Changes Act of 1949 amended Section 811(c) of the Code to provide that a transfer with a reservation of a possibility of



reverter occurring prior to October 8, 1949, should not be taxed as a transfer taking effect at death, because of the reversionary interest, unless immediately prior to the death of the transferor the value of the possibility of reverter exceeded 5 percent of the value of the transferred property and arose as the result of an express reservation rather than by operation of law. Section 503(a) of the 1950 Act amends Section 404(c) of the 1942 Act to conform the definition of a reversionary interest which will constitute an incident of ownership in life insurance with the new definition of a reversionary interest which will make a transfer taxable as a transfer taking effect at death. Under Section 503(a) a reversionary interest will not be considered as an incident of ownership (for the purpose of determining whether the insured retained incidents of ownership after January 10, 1941) unless *at some time* after January 10, 1941, the value of the reversionary interest exceeded 5 percent of the value of the policy and the reversionary interest arose because of the express terms of the policy or some other instrument and not by operation of law.<sup>87</sup>

<sup>87</sup> Although the excise tax reductions which were originally planned when the 1950 Act was introduced in the House were dropped when the bill reached the Senate, there were several changes in connection with excise taxes:

- (1) The manufacturer's excise tax of 10 percent was extended to quick-freeze units. §§3403(c) and (e), 3442, 3443(a)(1), IRC, as amended by §605(a)(b) and (c), 1950 Act.
- (2) And to television sets and apparatus. §3405, IRC, as amended by §606, 1950 Act.
- (3) The tax on slot machines was raised from \$100 to \$150. §3627(a), IRC, as amended by §603(a), 1950 Act.
- (4) A provision, which is, perhaps, of particular interest to lawyers settling up decedent estates, extended the 20 percent retail excise tax on sales of furs and jewelry to sales of such articles by an auctioneer or other agent, even though the furs and jewelry belong to an owner, or deceased owner, who is not engaged in the business of selling furs and jewelry. If the sales are made from the home of the owner or deceased owner of the furs and jewelry, however, the first \$100 of the proceeds from the sales is exempt from the tax. §2412, IRC, added by §601, 1950 Act.
- (5) The various occupation (§3283, IRC, added by §604, 1950 Act) and retail excise taxes (§2413, IRC, added by §602, 1950 Act) are applied to agencies of the United States Government.
- (6) Under the prior law one way of avoiding the transportation taxes was to pay outside of the United States for transportation in the United States. The 1950 Act provides that where transportation begins and ends in the United States, the taxes shall apply even though payments therefor are made outside the United States. §3469(a)(c) and (d), IRC, as amended by §607(a), 1950 Act and §3475(a), IRC, as amended by §607(b), 1950 Act.
- (7) Section 608 of the 1950 Act amends Sections 2103(c) and 2112(c) of the Code to permit an importer of tobacco, snuff and cigars manufactured in a foreign country to attach United States revenue stamps to these products in the foreign country.
- (8) Section 609 of the 1950 Act amends Section 3443(a)(3)(A)(ii) of the Code to provide for refunding taxes paid on certain sales to aircraft engaged in foreign trade.