MONTHLY

STATE-MENTS

AN INSURANCE AND TAX LETTER

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Dear Sir:

One of the greatest tax saving opportunities coming out of the 1974 Pension Reform Act is the increase in the ceiling for contributions to self-employed pension plans from $2,500 to $7,500. This means that if you are a sole proprietor, a partner or a shareholder-employee of a Subchapter S corporation you can set aside up to 15% of your compensation with a ceiling of $7,500 a year. The typical money purchase pension plan can build a beautiful pension at almost any age from an annual $7,500 premium.

The price for this, of course, is that every employee of your organization who has three years of service must be included in the plan and his interest must be 100% vested. In the alternative, if you wish graduated vesting, you must include every employee age 25 with one year of service. Depending, of course, on the total compensation of other employees, this may be a small price.

If you are an executive in a corporation you might also be one of that growing group of individuals who owns a small business on the side. If you do and have only a few employees, you could create a self-employed plan and salt away 15% of your compensation every year.

But this is not all. Do you know that the $7,500 ceiling does not apply where you adopt a "defined benefit" self-employed pension plan? This is provided for the first time in the 1974 Pension Reform Act and is carried into Section 401(j) of the Internal Revenue Code. It does not become effective, however, until taxable years commencing after December 31, 1975. A formula is provided in the law as a guide to the Treasury in drafting detailed Regulations which should be published before the year's end.

Contributions to other types of self-employed plans, however, may be made this year.

Would you like us to work up some figures for you?

Cordially,

Henry Newman

RECENT CASES AND RULINGS

Tax Court Values Minority Interest in Personal Holding Company. Trying to place a value on a minority interest in an unlisted closely held investment company can be difficult, particularly if there is no similar publicly held company with which it can be compared. Usually, even after an exhaustive analysis, the final valuation is a compromise by the Court somewhere within the extremes presented by the taxpayer and the Commissioner, as in *Estate of Heckscher v. Commissioner*, 63 TC No. 44. The decedent owned 2,500 out of 108,000 shares of an unlisted closely held personal holding company. The executor returned the shares for estate tax purposes at $50 each. The underlying asset value of the stock was $193 per share, about 40% of which was represented by unimproved Florida land. The Commissioner's valuation expert applied "minority interest" and "lack of marketability" discounts to asset value to arrive at $113 a share. The executor's expert suggested $60 a share based on income expectations.

The Tax Court after weighing the various factors held the fair market value to be $100 per share, based on an assumed yield of 6%, or approximately 50% of net asset value.

Expenses of Rental Pool Condominium Held Deductible. In a case of first impression a District Court holds that a condominium purchased for rental income is to be treated the same as any other rental property. *Wachter v. U.S.*, USDC, Wash., December 13, 1974. In 1968, after investigation by their investment advisor, taxpayers purchased a 3-bedroom condominium for $39,500 in a marina complex called The Admiralty. The condominium was designed as three separate rental units. At the time of purchase a management arrangement was entered into with the developer of the complex whereby taxpayers placed their units in a rental pool along with 37 other condominiums as part of a resort-hotel operation. Due to completion delays and other start-up costs the taxpayer's units were rented for only 41 days in 1969. Taxpayers received $356 as their share of the pooled rentals against which they charged net expenses of $5,337, including depreciation, interest, insurance and maintenance. Although the taxpayers withdrew their units from the rental pool for personal use only 8.2% of the total available time, the Commissioner, nevertheless, disallowed taxpayer's deductions, except for part of the interest, on the ground that the condominium was acquired and used primarily for personal reasons and not to realize a profit.

The Court upheld taxpayers' deductions as a business expense and as expenses incurred to conserve income producing property. The Court found from the facts that taxpayers acquired their unit with the expectation of realizing profit from participating in a rental pool and later disposing of their investment. Personal use was minimal.

Individual Retirement Account Forms Now Available. Four new forms have just been released by the IRS for use in the establishment of Individual Retirement Accounts under the Pension Reform Act of 1974. This Individual Retirement Account is a brand new instrumentality which permits individual employees who are not participants in qualified employee trusts to set aside and deduct contributions up to 15% of his compensation but not more than $1,500.

Model individual retirement trust account. Form 5305 is a model trust agreement that meets the requirements of Code Sec. 408(a) for persons wishing to adopt an individual retirement program. The agreement is between the individual and the trustee and is not to be filed with the IRS. Specifically, the agreement provides for the acceptance of additional cash contributions from the grantor. However, only cash is acceptable and contributions in excess of $1,500 will not be accepted. The grantor's interest is non-forfeitable; and no part of the trust funds may be invested in life insurance contracts, which *are* authorized investments under a different section. Provision is made for distributions on retirement, either in a lump sum or periodically.

Model individual retirement custodial account. Form 5305-A, which is also not to be filed, closely follows Form 5305 and the trust agreement described therein. The owner's interest must be non-forfeitable; the account must be nontransferrable, and the annual receipt must not exceed $1,500.

Applications for approval of individual retirement accounts. Form 5304 is an application for approval of an individual retirement account established by an employer or employee association. In addition to Form 5304, copies of all instruments making up the trust must be filed in duplicate with the Director for the District in which the employer's or association's principal place of business is located. Form 5306 is an application for IRS approval of a prototype individual retirement account to be submitted by a bank, savings and loan association, federally insured credit union, and IRS-approved trustee or custo-

dian, insurance company, regulated investment company or trade or professional association.

Stock Selling Expenses, But Not Underwriting Discount, Allowed as Administration Expenses. A constant area of controversy between the Commissioner and representatives of decedents' estates revolves around the question of what expenses are estate tax deductible where securities must be sold to raise cash requirements for taxes and administration expenses. The Commissioner ordinarily disallows such expenses. Fortunately, the Courts take a more positive view, as shown by *Estate of Joslyn v. Commissioner* 63 TC No. 43. It was necessary for the decedent's executor to sell 250,000 shares of decedent's interest in Joslyn Mfg. Co. in order to pay taxes and expenses of administration. The stock was traded over the counter and was a sufficiently large block to require registration with the SEC. The block was sold by means of a secondary offering through an underwriting agreement. The estate paid incidental expenses of $70,000 incurred in connection with the sale for which it took an estate tax deduction. Also, the estate took a deduction for the underwriters' discount of $1.15 per share, which was the difference between $18.10 per share received by the estate and the $19.25 paid by the public. The Commissioner disallowed all selling expenses for the reason that the fair market value of the stock on the applicable valuation date did not exceed the proceeds of the sale.

The Tax Court held that the incidental expenses of underwriting incurred by the estate were deductible administration expenses. But it upheld the disallowance of the underwriters' discount, on the ground that the underwriting agreement constituted a bona fide sale of the stock to the underwriters rather than an agency agreement.

Lack of Current Accumulations No Bar to Accumulations Tax. Any closely held corporation whose officers believe it has no accumulations tax problem because it is not accumulating income in the current year should review their position in light of *GPD, Inc. v. Commissioner*, CCA-6, December 6, 1974. Taxpayer was a corporation engaged in the sale and distribution of Ford automobile parts. From its incorporation in 1954 to 1968, the taxable year in question, taxpayer's stock was owned by one shareholder except as modified below. Taxpayer's net income after taxes varied from $82,000 in 1959 to $279,000 in 1968. It paid no dividends until 1967 when it paid cash dividends of $46,300 and $67,400 in 1968. During the years 1959 through 1967 the sole shareholder made stock gifts to various Catholic charities totaling 7,190 shares. These were redeemed by taxpayer at different times for $900,000 of which $434,000 was paid out in 1968. The 1968 redemption was charged to earnings and profits with the result that there was a net decrease in 1968 earnings as compared to 1967. The Commissioner disregarded the 1968 redemption and assessed accumulated earnings penalties of $79,400 for 1967 and $84,600 for 1968. The Tax Court upheld the Commissioner for 1967 but denied his 1968 deficiency determination, because taxpayer had no increase in its earnings and profits for that year.

The Court of Appeals disagreed with the Tax Court's reasoning and held that taxpayer could not avoid imposition of the accumulated earnings tax for 1968 merely because it did not accumulate earnings and profits during that year. Congress intended that the tax apply in any year in which a corporation had accumulations from any years, prior or present. The case was remanded to the Tax Court to determine whether taxpayer was availed of for the proscribed purpose and whether at the end of 1968 its total accumulations were beyond the reasonable needs of the business.

Executor Wins Marital Deduction Victory in Community Property Case. An interesting community property case which deals with the purchase and use of discount bonds in payment of Federal estate taxes is *Estate of Ray v. U.S.*, USDC, Texas, November 16, 1974. Approximately 10 days before his death decedent's business partner, as decedent's agent, borrowed $1 million to purchase in decedent's name, $1,270,000 of discount treasury bonds. The loan agreement with the bank stipulated that the proceeds of the loan were his separate property and that the bank would look only to decedent's separate property for repayment of the loan in the event of default. The Commissioner disallowed a marital deduction on the ground that the bonds were community property and not decedent's separate property.

The Court disagreed and held that the bonds were decedent's separate property which entitled the estate to a marital deduction. The reason was that the bonds were acquired by borrowed funds which had become separate property by virtue of the security agreement. The fact that decedent lacked a significant amount of separate property before the loan transaction is not evidence of his intention to avoid tax by repaying the loan from community funds. The community estate was not diminished since the bonds provided their own source of revenue for repayment of the debt.

THE EMPLOYEE STOCK OWNERSHIP TRUST— HOW IT OPERATES AND ITS ADVANTAGES

The long neglected "stock bonus trust" has now come into its own. Here are some of the reasons: (1) it provides a new and very useful method for the employer to raise capital, (2) the loss of popularity of the qualified stock option as a method of compensating executives and, (3) the highly favorable treatment the stock bonus trust, now called the Employee Stock Ownership Trust, received from the Pension Reform Act of 1974. There are now only about 600 qualified stock bonus plans in existence, as contrasted with over 100,000 profit sharing plans, but we predict this number will increase materially during the next several years. We shall first describe how the plan works and then outline three of its uses. The principles evolved can be applied to a variety of comparable situations.

An Employees Stock Ownership Plan (called ESOT for short) is very much like a qualified profit sharing plan with these differences:

1. The corporation can contribute stock or cash to an ESOT plan but only cash to a profit sharing trust (hereafter designated P-S trust).
2. The ESOT trust can invest all or any part of the trust fund in the corporation's stock, whereas a P-S trust cannot invest more than 10% of its funds in such stock (subject to a complex exception).
3. The ESOT trust must distribute *stock* to the employee on his retirement or termination of service or to his estate in case of his death, while the P-S trust can distribute cash or other assets.

Like the P-S trust, contributions are limited to 15% of total compensation of the participants, with the same carry-over of any unused deductions.

Heretofore, stockholders of closely held corporations have been reluctant to part with a fraction of their stockholdings. But the provision of a new, reliable market for the corporations' stock financed by before-tax dollars carries much interest and persuasion. A frequently recurring example is the purchase by an ESOT trust of stock from the estate of a deceased stockholder, either all of it or enough to provide the necessary funds to pay estate taxes and expenses of administration.

Likewise, if any employee retired or left the company, the trust could buy his stock. And this could be done without violating the attribution rules of Section 318 of the Code. This means that any member of the principal stockholders' family could sell as much or as little stock as he wished to the ESOT trust at capital gains rates, while any such sale to the corporation could result in ordinary income (unless a wife or child sold all of his or her stock).

The Treasury so far will not permit a binding stock purchase agreement, because one of the basic requirements of the ESOT trust is that stock *must* be distributed to the employee on retirement, etc. But it will approve a stock purchase agreement that gives the employee the *option* to sell his stock to the Trust.

In this era when capital financing is so difficult, the stock bonus trust offers a unique opportunity. If a corporation were to borrow $500,000, it would take $1,000,000 of earnings before taxes to pay off the loan. But if it created an ESOT trust, the trust could borrow the $500,000 on a note guaranteed by the corporation and use it to purchase $500,000 of the corporation's stock. Each year the corporation would contribute and deduct an amount sufficient to pay the principal and interest due on the loan.

This letter, prepared with the help of a nationally recognized tax authority, is sent to you in the interest of more comprehensive Financial Planning. The broad field of financial planning involves the joint services of an Attorney, Accountant, Trust Officer, Investment Counsel and Life Underwriter.

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