

FEDERAL TAX LEGISLATION

The second session of the 87th Congress has enacted some significant tax legislation. By operation of Public Law No. 87-426,¹ an amendment to Section 165 of the Internal Revenue Code of 1954,² a taxpayer who, during the period following the close of the taxable year but on or before the time prescribed by law for the filing of the return for that year, has suffered a casualty loss in an area designated by the President as a disaster area, may elect to claim the appropriate deduction on that return. If such an election is made, the casualty resulting in the loss will be deemed to have occurred in the taxable year for which the deduction is claimed.

The effect of the amendment is to allow the taxpayer who has suffered the casualty loss in the early part of his tax year to treat his loss as having been incurred in the prior year. Thus, the taxpayer making the election will have funds for rebuilding at an earlier date, either from a lower tax payment made with the return or from a tax refund. The amendment was adopted March 31, 1962, and is effective with respect to disasters occurring subsequent to December 31, 1961.

On October 16, 1962, President Kennedy signed the Revenue Act of 1962,³ just four days short of one and one-half years from the time he proposed it. Although the act falls short of the tax recommendations originally submitted to Congress by the President, its passage does represent the first big revision of the Internal Revenue Code since 1954. The three major sections of the act provide for an investment credit, the treatment of transfers of depreciable property and the regulation of expense account deductions.

In a past issue of the Boston College Industrial and Commercial Law Review,⁴ the investment credit and the transfers of depreciable property provisions were noted. However, the investment credit provision has undergone several major changes since the publication of that issue. The purpose of this note is to set forth that provision as it was enacted. In addition, the expense account regulations will be discussed.

The investment credit that can be claimed by a taxpayer is seven per cent⁵ of the cost of the property which qualifies for the credit.⁶ The amount of credit taken is subject to a limitation in that it cannot exceed twenty-five per cent of the tax liability. However, this limitation does not apply to the first \$25,000 of tax liability.⁷ If a husband and wife are both entitled to the credit, but elect to file separate returns, only the first \$12,500

¹ Pub. L. No. 87-426, 76 Stat. 51 (1962).

² Subsection (h) of section 165 is redesignated subsection (i); the present amendment is designated subsection (h).

³ H.R. 10650, 87th Cong., 2d Sess. (1962).

⁴ Legislation, 3 B.C. Ind. & Com. L. Rev. 232-41 (1962).

⁵ The rate is 3% for public utilities since the stimulative effect is largely negated by lower rates to their consumers.

⁶ Section 38 of the Int. Rev. Code of 1954 will set forth the nature of the property that qualifies for the credit. Such qualified property is termed "section 38 property" throughout the act.

⁷ Thus, if the taxpayer has a tax liability of \$75,000, the maximum credit he can claim for the year is \$37,500 (\$25,000 plus 25% of \$50,000).

of each spouse's tax liability is exempt from the twenty-five per cent limitation.⁸

The credit to which the taxpayer is entitled, but which he is unable to use because it exceeds the limitation, may be carried back to each of three preceding tax years⁹ and carried forward to each of five succeeding tax years. In addition, a taxpayer may deduct any remaining unused credit in the first year after all carry forwards for the credit have expired.

All new "section 38 property" qualifies for the credit regardless of its cost. However, only \$50,000 of used property can qualify as "section 38 property" each year. If the taxpayer has purchased more than \$50,000 during the year, he may select which of the used assets qualify.

If the property has an estimated useful life to the taxpayer of four to six years, one-third of its cost is taken into account for purposes of determining the credit. Two-thirds or the entire cost is taken when the useful life is from six to eight years or eight years or more, respectively.¹⁰

The tax basis of "section 38 property" is reduced by the amount of the credit, whether or not it can be used immediately to reduce taxes. As stated by the Senate Finance Committee,¹¹ this downward adjustment was provided because there was no reason to allow a taxpayer a deduction for depreciation on that part of the property for which, in effect, the government had paid. The original House version of the act, passed on March 29, 1962, would have allowed the taxpayer to depreciate the full cost of the property. Senator Long of Louisiana sponsored the basis reduction amendment in the Senate. The Secretary of the Treasury, C. Douglas Dillon, pleaded before the Senate-House Internal Revenue Committee for the removal of the Long amendment, claiming that it would vitiate the purpose of the investment credit by weakening the taxpayer's incentive to modernize his equipment. But Senator Harry Byrd of Virginia and a majority of the Senate conferees insisted that, without the Long amendment, the investment credit would be a windfall for certain businessmen.¹²

The act provides for a credit recapture—an adjustment in past credits to guard against a quick turnover of assets by those seeking multiple credits.

⁸ However, if either the husband or the wife has no qualified investment, the one having the investment may make use of the entire \$25,000.

⁹ Unused credit may be a carryback only to taxable years ending after June 30, 1962.

¹⁰ The reader may find the following illustration helpful:

Property	Estimated life	Cost	Accountable
A	3 yrs.	\$ 5,000	-0-
B	5	90,000	\$ 30,000 (one-third of cost)
C	7	120,000	80,000 (two-thirds of cost)
D	20	340,000	340,000 (entire cost)
E (used)	10	160,000	50,000 (\$50,000 used property limitation)
			<u>\$500,000</u>

If the taxpayer has a tax liability of \$50,000, the maximum credit that he may use this year is \$31,250 (\$25,000 plus 25% of \$25,000). Since he is entitled to a tax credit of \$35,000 (\$500,000 $\times$ 7%), he may deduct the entire \$31,250 from his tax liability, and he has an unused credit of \$3750.

¹¹ S. Rep. No. 1881, 87th Cong., 2d Sess. (1962).

¹² Wall Street Journal, September 26, 1962, p. 1, col. 3.

CURRENT LEGISLATION

When property is disposed of or otherwise ceases to be "section 38 property," the credit that was taken when the asset was first put into use is recomputed by substituting the actual number of years the property was used for the useful life as originally estimated. If the recomputed credit is less than the credit as was taken, the difference is added to the current year's tax liability.¹³ The credit recapture does not apply if the property has been transferred because of the demise of the taxpayer, nor when there has been a mere change in the form of conducting a trade or business, so long as, (1) the property is retained in such trade or business as "section 38 property," and (2) the taxpayer retains a substantial interest in such trade or business.

Special provisions have been provided for mutual savings banks, co-operative banks, building and loan associations, regulated investment companies, real estate investment trusts, co-operatives and Subchapter S corporations.

The investment credit provision has met with strong opposition. Most criticism springs from the realization that the credit will result in a substantial revenue loss for the government. The provision has also been termed discriminatory in that it ignores the service, retail and distribution segments of the economy.¹⁴ Industry has not shown itself to be in favor of the investment credit. In a survey conducted by the Wall Street Journal, only one out of sixty-eight companies questioned believed that the provision would have any effect on major expansion programs.¹⁵ Opponents of the credit aver that the recent revision of the Bulletin F depreciation guidelines is an adequate stimulus to new investment. However, the Wall Street Journal reports that of the forty largest corporations, sixty per cent do not expect to change their depreciation schedules. The reasons set forth for this indifference are poor profits, surplus capacity and more liberal depreciation schedules reached through negotiation with the Internal Revenue Service.

Under the expense account provisions, which add section 274 to the Internal Revenue Code of 1954, expenditures for activities generally considered to be entertainment, amusement or recreation will not be deductible unless such expenditures are directly related to the active conduct of the taxpayer's trade or business.¹⁶ However, taxpayers seeking good will may continue to deduct costs of entertaining present or prospective customers, even though the expenditure is not directly related to the active conduct of the business, when the entertainment directly precedes or follows a

¹³ A special rule applies to property which has been stolen or destroyed or damaged by casualty, and to the property which is acquired to replace it. If the insurance proceeds received by the taxpayer exceed the reduction in the qualified investment, the credit recapture clause is not operative. However, the insurance proceeds will reduce the basis of the replacement property. On the other hand, if the reduction in qualified investment is greater than the insurance proceeds, the credit recapture applies. In that event, the basis of the replacement property is not reduced by the insurance proceeds.

¹⁴ H. Rep. No. 1447, 87th Cong., 2d Sess. B9 (1962).

¹⁵ H. Rep. No. 1447, 87th Cong., 2d Sess. B8 (1962).

¹⁶ Also the taxpayer must continue to establish that the expense was ordinary and necessary in the carrying on of his trade or business.

substantial and bona fide business discussion and when it is associated with the active conduct of the business. Taxpayers claiming deductions for good will expenditures will not have to prove that business was actually discussed or transacted during the entertainment, but a business connection must be present.

Expenditures for entertainment facilities¹⁷ will not be deductible unless the facility is used primarily¹⁸ for the furtherance of the taxpayer's trade or business and is directly related to the active conduct of the business. Deductibility of the use of facilities for the generation of good will is subject to the tests of the allowance of good will entertainment expenditures. All dues paid to social, athletic or sporting clubs are treated in the same manner as expenditures for entertainment facilities.

The maximum deduction that a taxpayer can claim for gifts is twenty-five dollars per year for each recipient.¹⁹ Since some expenditures may be thought of as both gifts and entertainment expenses, the Secretary of the Treasury has been given the authority to prescribe regulations in order to solve problems of classification.

The well-known *Cohan* case²⁰ held that where evidence indicates that a taxpayer has incurred deductible travel or entertainment expenses, although he is unable to substantiate them or to determine their exact amount, the deduction should not be disallowed entirely, and the court must make as close an approximation of them as it can. The act, however, provides that an expense item will be disallowed entirely unless the taxpayer is able to substantiate it. He must keep adequate records or have sufficient evidence proving the necessary elements of deductibility.

Some expenditures will be deductible even though proof is absent that they are directly related to or associated with the taxpayer's business. Among these are expenses of recreational and eating facilities maintained for employees and costs of food and beverages furnished under circumstances considered conducive to a business discussion.

When a taxpayer is traveling away from home in pursuit of his business, no deduction is allowable for travel expenses incurred which are not allocable to the business. However, if the travel away from home does not exceed one week or the time not allocable to the taxpayer's business is less than twenty-five per cent of the total time away, this provision does not apply. In any case, only those travel expenses which are not lavish or extravagant under the circumstances may be deducted.

Much of the testimony given before the House Committee on Ways and

¹⁷ A facility would be any item of personal or real property owned or rented by the taxpayer, such as a yacht, swimming pool, automobile and the like.

¹⁸ "Primarily" in this provision means greater than 50%. If the facility is used less than 50% for the furtherance of business, no deduction may be claimed for its operation.

¹⁹ Excluded from this limitation are: (1) items having a cost to the taxpayer not in excess of \$4 on which the taxpayer's name is imprinted, (2) a sign, display rack or other promotional material to be used on the recipient's premises, and (3) an item of tangible personal property having a cost to the taxpayer not in excess of \$100 which is awarded to an employee for length of service or for safety achievement.

²⁰ *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

Means in opposition to the expense account provisions dealt with their adverse effects upon the restaurant and theater business.²¹ But it can be effectively argued that these concerns are not entitled to the fruits of present expense account abuses. It was also urged at the Hearings that the existing laws are adequate and that the Internal Revenue Service should widen its audit coverage to detect possible violations.²² These views were not held by the Secretary of the Treasury, C. Douglas Dillon.

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SECURED TRANSACTIONS

In the area of secured transactions, legislation has been quite limited since its last treatment¹ in the *Boston College Industrial and Commercial Law Review*. Perhaps increased attention given by various states to the Uniform Commercial Code² is the reason. This article will not include any legislation dealing directly with the UCC.

Louisiana has enacted the Direct Vehicle Loan Company Act,³ the purpose of which is to regulate the lending of money secured by liens on motor vehicles. Loans may not be made until sixty days or more after the borrower is vested with title to the motor vehicle. The legislature later by resolution⁴ suspended certain portions of the act affecting loans made primarily for industrial and commercial purposes or loans made by licensed sales finance companies or companies licensed under the Small Loan Law of Louisiana. The Direct Vehicle Loan Company Act was approved in conjunction with Louisiana's Motor Vehicle Sales Finance Act⁵ which regulates the financing of motor vehicles by retail instalment agreements, the latter act also being amended.⁶

Several states have dealt with the question of whether the buyer should be entitled to a refund or credit on the finance and service charges when he pays in full before maturity the amount of the credit extended for the purchase. The Arizona legislature has amended its law⁷ by now allowing any borrower to prepay a loan at any time during the loan period. The Rule of 78⁸ is the prescribed method of computing the refund. Banks or trust com-

²¹ See particularly the statements of Vincent Sardi, Jr., Hearings on the President's 1961 Tax Recommendations before the House Committee on Ways and Means, 87th Cong., 1st Sess. 1616-24 (1961).

²² Hearings, *supra* note 21, at 1634; Frank V. Olds, Federal Tax Committee of the Controllers Institute of America.

¹ Legislation, 3 B.C. Ind. & Com. L. Rev. 248 (1962).

² Legislation and annotations dealing with the Uniform Commercial Code will be found elsewhere in this Review.

³ Acts 1962, Act No. 138, approved July 6, 1962, effective January 1, 1963.

⁴ House Current Resolution No. 126, adopted July 12, 1962.

⁵ La. Rev. Stat. § 6:951 (1950).

⁶ Acts 1962, Act No. 139, approved July 6, 1962, effective January 1, 1963.

⁷ Ariz. Rev. Stat. Ann. § 6-254 as amended by Laws 1962, ch. 210, approved March 13, 1962, effective June 21, 1962.

⁸ This method, sometimes referred to as the "sum of the digits" method, is based on the notion that the greater part of the finance charge is earned in the early period of the