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Capital Gains and Losses

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CAPITAL GAINS AND LOSSES

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The subject assigned for this morning is "Capital Gains and Losses" from the point of view of the Federal Income Tax. This is an important topic worthy of the most careful consideration by everyone who is to advise taxpayers these days.

Except for striking oil or gas and securing a 27½% allowance for depletion (limited to 50% of the net income from such property), long-term capital gain is about the only kind of taxable income today from which a taxpayer can retain and accumulate any substantial portion after paying his income taxes.

Such gain is distinguished for ordinary earned income and is set aside and taxed under the Federal statutes at a much lower rate, currently at a maximum effective rate of 26% for both individuals and corporations. Under the law as it now stands that rate is due to drop to 25% for individuals with taxable years beginning on and after November 1, 1953, and for corporations for return periods beginning on and after April 1, 1954.

In addition, by an amendment made in Section 315 of the Revenue Act of 1951, net long term capital gain is excluded from Section 102 net income. Thus such gain is not to be counted in computing the penalty surtax for accumulation of profits by corporations. Likewise such gain is in effect eliminated from the computation of the surtax on domestic personal holding companies.

As a consequence, it should be worth repeating that here is a special class of taxable income, from which the taxpayer, whether an individual or domestic corporation, can retain and accumulate at least 74% after Federal income taxes.

It should not be overlooked that capital gains and losses may also be of importance from the point of view of State income taxes. In this state, of course, capital gains and losses are treated under ordinary income rules, but in Maryland, for example, these are entirely excluded from tax irrespective of the holding period of the property sold. Maryland has evidently adopted the British and Canadian view that these are capital transactions which should not constitute current taxable income. In the District of Columbia both gains and losses are ignored upon the sales of capital assets held over two

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years. This appears to represent a combination of the British concept of trading in capital, with the old Federal rule that a holding of over two years before sale indicates a capital gain or loss type of transaction as distinguished from current income. A detailed discussion of the State laws would unduly extend the present paper. We shall have to conclude this part with the advice: Don't forget to check the State income tax statutes with reference to capital gains and losses.

A short history of the development of the concept of capital gains and losses under the Federal statutes should be helpful particularly in interpreting some of the older decisions. The principle that gain or loss upon the sale or exchange of "capital assets" should be distinguished for the purposes of the income tax from the usual current income of a taxpayer, was introduced in the Revenue Act of 1921, effective after December 31, 1921, for taxpayers other than corporations. That principle has been continued with modification and refinement in each succeeding Revenue Act.

The term "capital assets" contemplated, under the 1921 Act, property held essentially for investment and profit. Since 1924 the term has meant generally all kinds and classes of property, except stock in trade or inventories or property held primarily for sale to customers in the ordinary course of business.

In the statutes prior to 1934, there were the added requirements that to constitute capital assets the property had to be held for more than two years, the sale or exchange had to be consummated after December 31, 1921, and a capital loss had to be a "deductible loss". Those limitations were dropped in the 1934 Act, and capital assets have since been defined without reference to the holding period. Further, since 1934, there has no longer been a limitation of capital gains to dispositions after December 31, 1921, and no specific restriction that a capital loss must be a deductible loss.

In the Revenue Acts from 1921 to 1932 inclusive, all sales or exchanges of capital assets (held over two years) were grouped apart from the other ordinary transactions of a taxpayer other than a corporation and a capital net gain for the taxable year was taxed at a maximum rate of 12½%. Under the 1921 Act a capital net loss was treated no differently from an ordinary deductible loss; but in the statutes from 1924 through 1932, a capital net loss worked a reduction in tax not exceeding 12½% of such net loss (for a taxpayer other than a corporation).

Thus prior to 1934 corporate taxpayers received no benefit or detriment in reference to capital gains or losses. Under the 1934 and 1936 Acts a corporation was taxed in full on a net capital gain, while the deduction for a net capital loss was limited to $2,000 (except for investments of banks). For other taxpayers a percentage of each item of capital gain or loss ranging from 100% (for a one-year holding) down through five brackets to 30% (for a holding of over 10 years) was recognized and taken into account in computing net income. However, if the resultant was a net capital loss, the deduction was limited to $2,000.

In the Revenue Act of 1938 the provision as to corporations (and banks) was continued; but for other taxpayers the concept of separating short-term and long-term capital gains and losses was introduced, with a different method of treating a net gain or loss of each class.

Short-term gains and losses on capital assets held up to 18 months before sale or exchange, were considered in full and offset. If the resultant was a net short-term capital loss it was not deductible in the current year but could be carried forward for one year to apply against short-term gains. If the resultant with such carry-over was a net short-term gain it was taxed in full.

Long-term gains and losses were divided into two brackets: for assets held over 18 months up to 24 months, 66 2/3% of each item was taken into account, and over 24 months, 50% was recognized, and such reduced amounts were aggregated. If the resultant was a net long-term gain it was taxed at a limit of 30%; if it was a loss it worked a reduction of the tax up to 30% of such net loss.

In the 1939 Act (with an exception for personal holding companies) the situation was changed only as to corporations. They were permitted to deduct long-term capital losses in full, and were given a one year carry forward of a net short-term capital loss.

Beginning in 1940 long-term capital gains and losses (on the sale or exchange of capital assets held over 18 months) were generally excluded for purposes of computing the excess profits tax imposed upon corporations.

In the Revenue Act of 1942 the division between long-term and short-term capital gains and losses was reduced to a holding period of six months. For corporations generally all capital gains and losses were aggregated (including a carry-over from 1941) and if there was a net short-term gain it was taxed in full; if a net long-term gain, it was taxed at a maximum of 25%. If there was a net capital loss it was a carry-over as a short-term capital loss to the five succeeding years.

For other taxpayers short-term capital gains and losses (including a carry-over from 1941) were taken in full and long-term gains and losses were taken into account at 50%, and the amounts of each class were aggregated and then offset. If the excess was a net short-term gain it was taxed in full; if a long-term gain, it was taxed at 50% (an effective rate of 25%). If the net figure was a loss, it was deductible to the extent of the taxpayer's net income or $1,000, whichever was less, and any balance was a carry-over as a short-term capital loss to the five succeeding years. Under this statute it should be noted that for taxpayers other than corporations one dollar of short-term capital loss could wipe out two dollars of long-term capital gain.

The method set up in 1942 for taxing capital gains and losses of corporations generally has continued up to the present time, except that the rate of 25% applicable to a net long-term capital gain was increased by the 1951 Act to 26% for taxable years beginning after March 31, 1951, and before April 1, 1954. After that, under present law, the rate returns to 25%.

In the Revenue Act of 1950 a new provision[1] was inserted in regard to "collapsible corporations," eliminating what would otherwise be capital gain realized in connection therewith after December 31, 1949. This was revised in the 1951 Act, applicable to gains after August 31, 1951, and has since continued in the same form. We might as well cover this exception at this point.

In essence a "collapsible corporation" is one which is formed or availed of to produce or purchase stock in trade or property held primarily for sale to customers or to hold stock in such a subsidiary, with a view to the realization by the shareholders through liquidation or sale of their stock of gain attributable to such property. Gain on such stock would have been capital gain prior to 1950. Capital gain is still not precluded on such stock held over six months in three instances: (A) if the gain is realized by a shareholder who, with those related to him in the degrees specified, does not hold over 10% of the stock; (B) if the gain realized in a taxable year is at least 30% attributable to other sources than the type of property specified above; or (C) if the gain is realized after the expiration of three years following the completion of the manufacture, construction, production or purchase of the property. In all other cases the stockholder's gain with reference to a collapsible corporation is not capital gain.

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1. INT. REV. CODE § 117 (m). Further citations to the Internal Revenue Code in this article will be by Section number only.

For taxpayers other than corporations the method set up in 1942 was continued through 1950 and then was substantially changed in the Revenue Act of 1951 to the present form. In this the short-term holding period of six months is retained, and all capital gains and losses, including the carry-over from the prior years, are aggregated. If the net figure represents a long-term capital gain, 50% thereof is a deduction from gross income and the tax is computed on the resultant net income at regular rates; or, in the alternative, the whole net capital gain may be set aside and taxed at a rate of 25% (or 26% for taxable years beginning after October 31, 1951, and before November 1, 1953); and such tax is added to a partial tax computed upon the other net income at regular rates, if this results in a lower total tax. In the case of an estate or trust the 50% deduction applies after excluding any portion of the net capital gain reportable by the income beneficiaries.

If the net figure represents a short-term capital gain it is included in income in full and taxed at regular rates. If the net figure is a capital loss of either class, it is deductible to the extent of the taxpayer's net income or $1,000, whichever is less, and any balance is a carry-over as a short-term capital loss to the five succeeding years.

It would seem desirable to have a partial summary at this point. Thus far we have covered primarily the methods of taxing capital gains and losses. Since this is a special rate of tax upon a particular kind of income the specification is entirely within the grace of Congress. The benefit may be entirely withheld from a certain class of taxpayers as was the case with corporations under the earlier statutes. Also the factors may be changed at any time, and have been frequently changed in the past.

The holding period affecting the tax has ranged from two years up to ten and is now down to six months. Some think that this is too short a period of distinction and that it should be increased. The definition of "capital assets" has varied from time to time and in recent years has been expanded to cover more exceptional situations (but that is true of the income tax statute generally).

The only constitutional limitations in this area appear to be these: First, a gain to be taxed must in fact be a profit, "the difference between the buying and selling prices";[2] or the excess of the gross proceeds over an amount sufficient to restore the capital value;[3] in other words, the entire gross proceeds of a sale cannot normally be considered gain. Second, the gain must in fact belong to or be in some

2. Hayes v. Gauley Mountain Coal Company, 247 U. S. 189, 192 (1918).
3. Doyle v. Mitchell Bros. Co., 247 U. S. 179, 185 (1918).

manner attributable to the taxpayer taxed. One cannot be charged with income that clearly belongs to someone else.

While a loss on a sale or exchange is similarly computed, it is not income but in the nature of a deduction, which has been said to be merely an act of grace by Congress which may be changed or withdrawn in any new statute.[4] Hence, the allowance of a capital loss as an offset or deduction in whole or in part or not at all, must depend upon the terms of the statute as enacted by Congress.

Let us return to a discussion of some of the other factors of importance in the current determination of capital gains and losses. Under the Internal Revenue Code in its present form there are a number of basic provisions of relatively long standing which are generally applicable to the present subject.

We are dealing here, under Section 117 (a) of the Code, with gain or loss from the sale or exchange of capital assets. Gain from the sale or other disposition of property is defined in Section 111 (a) of the Code as the excess of the amount realized over the adjusted basis provided in Section 113 (b) for determining gain, and the loss as the excess of the adjusted basis provided in such section for determining loss over the amount realized. The amount realized is the sum of money plus the fair market value of the property received. Basis may be defined as cost or a figure to be used in lieu of cost. Thus there are brought into the computation of gain or loss all the provisions of Section 113 for basis, and where property is received in an exchange the ever-present question of valuation.

Then, by Section 111 (c), the extent to which the gain or loss is to be recognized is to be determined under Section 112. This brings into consideration all the provisions dealing with the so-called "non-taxable" transactions. This is necessarily so since only the amount taken into account in computing net income is considered as a capital gain or capital loss. Hence, for example, if we have an exchange of investment real estate for property of like kind, under Section 112 (b) (1), in which no gain or loss is recognized, there is no amount of capital gain or loss to be considered under Section 117 of the Code. Such examples could be multiplied, but the important point to remember here is that capital gain or loss contemplates only the taxable amount, and then only that which is includable for the taxable year under consideration.

Also, as you all know, the time for reporting income including gain depends in large part upon the method of accounting employed

4. Barber Coal Co. v. Commissioner, 74 F. 2d 163 (10th Cir. 1934).

by the taxpayer. Section 111 (d) of the Code specifically provides for reporting a portion of gain on the installment basis in the year in which a payment is received, and this has been held to apply equally to a capital gain. Since this is an elective method for other than regular dealers in personal property,[5] a capital gain may all be reported in the year of the sale or portions of gain spread over the years the payments are received.[6] There is no known precedent for reporting a loss by the installment method, and hence a capital loss must be taken up in the year the trade is consummated.

There is also authority for reporting gain, and hence capital gain, upon a cash basis of accounting, the method employed by most individual taxpayers operating with little more for records than a check book. While the decisions are somewhat confused, it seems clear that where the seller receives little more than an open account or the mere agreement of the buyer to pay the price in several amounts, the sums received may be applied first to liquidate the cost of the property sold and thereafter the payment constitutes clear gain.[7] That rule is particularly applicable where the further payments are subject to a contingency such as being based upon future production of ore, and would seem to apply even under an accrual method of accounting.[8]

Then there has been some controversy as to what constitutes a sale or exchange, since if there is neither, the capital gain and loss provisions do not apply. This may be advantageous where there is a deductible loss, but detrimental when there is a taxable gain.

In a recent case[9] petitioners had purchased a judgment from the residuary legatees of an estate, and later settled the judgment with the judgment debtor. It was held that this was not a sale or exchange, but a mere paying off of a debt, and hence the gain realized was not capital gain.

In another similar decision[10] it has been held that the mere paying off of an obligation such as a note which the taxpayer had bought at a discount was not a sale or exchange. Evidently because of this rule, Section 117 (f) of the Code specifically provides that payment in retirement of evidences of debt of a corporation, including

5. § 44.
6. This is true only providing, that the sale meets the requirements of § 44—that on a casual sale of personal property the price exceeds $1,000, and that on the sale of such property or of real estate, the down payment does not exceed 30% of the selling price.
7. Perry v. Commission, 152 F. 2d 183 (8th Cir. 1945), and cases cited therein.
8. Burnett v. Logan, 283 U. S. 404 (1931).
9. Galvin Hudson, CCH Tax Ct. Rep. 19,781 (R) (1953).
10. Bingham v. Commissioner, 105 F. 2d 971, 972 (2d Cir. 1939).

those of a government or political subdivision, with interest coupons or in registered form, shall be considered as amounts received in exchange therefor. Banks are given an exception from this in Section 117 (i) where the losses exceed the gains on such obligations. However, in the case of governmental obligations issued on a discount basis, the realization thereof on redemption is considered to be interest earned rather than gain. This rule would apply to E Series Defense Bonds, for example. This rule is of particular importance in regard to State and municipal bonds since interest thereon is tax exempt, but gain realized is taxable.

In another case, for illustration, the surrender of a combined annuity and insurance policy to the company was held not to constitute a sale or exchange and the amount received in excess of cost was held not to be capital gain.[11]

Loss due to the abandonment or worthlessness of property is rather obviously not the result of a sale or exchange and is generally held not to be a capital loss. However, the Code contains exceptions to this rule, evidently intended to limit the corresponding deduction. It is provided in Section 23 (g) that if any stock in a corporation, or rights to subscribe thereto, become worthless during the taxable year and they are capital assets, the loss shall be considered as arising from a sale or exchange on the last day of such year (with an exception relating to certain affiliated companies).

Again in Section 23 (k) of the Code dealing with bad debts, the same rule is applied to evidences of debt of a corporation or government or political subdivision with coupons attached or in registered form (with an exception relating to certain affiliated companies). In the case of a taxpayer other than a corporation a non-business debt, not including the formal securities just mentioned, becoming worthless results in a short-term capital loss. The Section further provides that except in the case of a bank no deduction shall be allowed for a debt due from a political party or committee becoming worthless.

The question as to a non-business bad debt frequently comes up in this manner. A man advances money to several companies in which he is interested and he may participate in the management. When one of the companies fails and his loan becomes a bad debt he claims he is in the business of financing corporations. If he succeeds it is a business bad-debt deductible in full. If he loses, it is a short-term capital loss subject to the limitations thereon. The difference

11. G. A. Hellman, 33 B.T.A. 901 (1936).

is essentially a question of fact as to whether he is sufficiently engaged in the business claimed, rather than a question of law.

Probably the most frequent controversy has been in reference to the definition of what are "capital assets." This is presumably because the term is made inclusive rather than exclusive. The definition starts with the phrase: "The term capital assets means property held by the taxpayer (whether or not connected with his trade or business)," and then states that it does not include a few certain types of property.[12]

Hence, the term should include every conceivable type of property not specifically mentioned for exclusion. A few examples would be: antique furniture sold at a profit, not by a dealer, held to result in capital gain; personal jewelry, a valuable gem, a personal residence; gains on these have been held capital gains. We emphasize the unusual, as often there has been a failure to realize their inclusion as capital assets.

We should also like to add here a personal opinion that a loss on any such sales should equally be a capital loss and a deduction irrespective of the nature of the capital asset. The requirement of the 1921 Act that a capital loss be a deductible loss was dropped in the later acts. Meanwhile some cases have continued to follow that rule without reference to the statute. However, in its present form the Code makes no distinction among capital assets in the computation of loss. It does specifically authorize offsetting capital losses against gains, and grants, in Section 117 (d)(2), a limited deduction, for a taxpayer other than a corporation, up to $1,000 per year. Again in Section 23 (g)(1) it is stated that: "Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in Section 117." We submit that the offset and deduction is specifically granted in reference to a loss on any capital asset no matter how personal and non-business in nature it may be. This may be an oversight, but Congress has the power to grant deductions, and apparently has done so here.

The first exclusion from capital assets[13] refers to stock in trade, or property of a kind properly includable in inventory, or property held primarily for sale to customers in the ordinary course of trade or business. Gain on this class of property is evidently considered to be ordinary, recurrent business income which should be taxed at regular rates. This exclusion has been in the statute since 1924, and as would be expected there are numerous decisions on the point.

12. § 117 (a) (1).
13. § 117 (a) (1) (A).

Even the issue as to inventories is not altogether simple. It has been held in another connection, for example, that factory supplies and small tools which do not become a part of the merchandise sold are not properly to be included in inventory, although many corporations do so.[14] Such items would therefore appear to be capital assets and if sold the gain or loss should be capital gain or loss. On the other hand, it has been held that whiskey produced in excess of current sales requirements and carried in a separate account for "old whiskey" constituted stock in trade of a distillery.[15]

This classification may be further illustrated by some more recent cases. Partners in a whiskey brokerage business sold their interests to a new corporation, but continued the partnership business for some six months after the sale to negotiate release of two burdensome contracts which the corporation did not want. This was held not a sale of partnership interests, which would have been a capital asset and would have resulted in capital gain, but was held to be actually the sale of the merchandise and other individual assets.[16]

In contrast, a transfer of a partner's interest in a firm to the remaining partners has been held to be a *bona fide* transaction resulting in a sale of a capital asset. The payments did not represent the taxpayer's share of the firm's earnings for past services as contended for by the Commissioner.[17]

In a further case involving a sale of a 7/16ths interest in a partnership, dealing in merchandise and which had made some installment sales, the gain was held to represent the realization of profit on installment obligations, under Section 44 (d) of the Code, and hence was ordinary income.[18] The decision may be mistaken in that the taxpayer apparently was not disposing of or transmitting installment obligations which remained with the firm all the time, but was selling a fractional interest in the partnership entity, which has been held in other decisions to constitute a capital asset, irrespective of the nature of the underlying assets which have usually included some accounts receivable and inventories, items not in themselves capital assets. However, the case serves to illustrate the fact that the Internal Revenue Code contains many provisions that often appear to conflict or overlap on a particular point, and the answer on a question of capital gain or loss may not always depend alone upon Section 117.

14. Burroughs Adding Machine Co., 9 B.T.A. 938 (1927).
15. Renziehausen v. Lucas, 280 U. S. 378 (1930).
16. Kaiser v. Glenn, 5 CCH 1953 Fed. Tax Rep. ¶ 9532 (W.D. Ky. 1953).
17. Snow v. United States, 5 CCH 1953 Fed. Tax Rep. ¶ 9530 (D. Idaho 1953).
18. Bright v. United States, 5 CCH 1953 Fed. Tax Rep. ¶ 9519 (E. D. Pa. 1953).

In another case, a partner in a firm dealing in treated wood products entered into a separate venture on his own account buying, lumping, and selling surplus war piling. He made only one sale in 1946 and four in 1947, on which payments were received in 1947 and 1948. One of the sales consisted of piling, which the firm had acquired as stock in trade and sold, but proved to be defective and was taken over by the taxpayer individually. The Tax Court upheld the Commissioner's contention that the taxpayer was in the business of buying and selling second-hand materials and hence these were includable in inventory. Consequently the profits were ordinary income, reportable on the accrual basis, and not capital gains reportable on a cash basis. The court said that in selling the defective material the taxpayer did merely what the partnership would have done.[19] In other words, it was stock in trade to the firm and so stock in trade to him.[20]

In many cases under this exclusion the essential issue is one of intent: under what circumstances is property held primarily for sale to customers in the ordinary course of a trade or business. Since most personal property dealt in is usually includable in inventory, cases under this part more often relate to dealings in real estate.

The leading decision on this point is probably *Loughborough Development Corporation.*[21] In that case a corporation which may have been a regular dealer in real estate was found to have purchased a property for investment or as a long-term speculation, and even though it was exchanged with a customer for another property and cash, the Board concluded that the property was not held primarily for sale. That case did not involve capital gain, but was interpreting a similar term of the exchange provisions.

This case illustrates a general principle of revenue practice. The same term may appear in several unrelated sections of the statute. If you can't find a decision relating to a particular section under consideration, look for the same term in another section of the Code and examine the decisions with reference to that provision.

The closeness of the issue may be illustrated by two recent cases arising here in South Carolina, both involving lawyers. In one[22] a lawyer who subdivided a tract into lots but sold these only in blocks to builders, and did not advertise or push the sales which were most-

19. Citing Boomhower v. United States, 74 F. Supp. 997 (N.D. Iowa 1947).
20. Amor W. Sharp, CCH Tax Ct. Rep. 19,865 (M) (1953).
21. 29 B.T.A. 95 (1933).
22. McKay v. Bowers, 5 CCH 1953 Fed. Tax Rep. ¶ 9535 (E.D. S. C. 1953).

ly solicited by the builders, and did not hold himself out as a real estate dealer, was found by the jury to have realized capital gain.

In the other case[23] a lawyer with two others purchased acreage in 1946, taking title in one as trustee. The tract was subdivided in that year and 18 lots sold, with 8 more sold in 1947. The taxpayer took no part in the sales except as attorney. The court held that the profit was not capital gain. These cases, however, may merely illustrate the desirability of going before a jury on a question of intent.

In another case a different type of question was presented. A taxpayer bought land and erected an apartment building and then sold both, but the completed building was not held six months before sale. The Tax Court held that only the profit on the land was long-term capital gain. On appeal the Third Circuit held that the profit on the parts of the building erected over six months before the sale, represented long-term capital gain.[24]

The second exclusion from capital assets[25] refers to property used in the trade or business of a character subject to depreciation,[26] or real property used in the trade or business. This is, however, in effect only a partial exclusion in that the same property is picked up again under Section 117 (j), together with other property therein listed. The general effect of the latter provision is that for such property held over six months, if there is a net profit on sale, exchange, or involuntary conversion, including involuntary conversion of capital assets generally, it is treated as capital gain, but if there is a net loss on such dispositions it is a business loss deductible in full.

This is one of the few places in the revenue statutes where the taxpayer gets the benefit both ways. If there is a gain he gets the benefit of the reduced tax rate on long-term capital gains; if a loss, he gets the deduction in full, not limited as in the case of long-term capital losses generally.

The other types of property included in the term "property used in the trade or business" that also benefit under Section 117 (j) are: timber and coal to which Section 117 (k) is applicable, unharvested crops sold with the land as covered in Section 117 (j)(3), and livestock regardless of age held over twelve months for draft, breeding, or dairy purposes, but not including poultry.

Then there are also specific exclusions from the benefit of Section

23. Thornton v. United States, 5 CCH 1953 Fed. Tax Rep. ¶ 9536 (W.D. S. C. 1953).
24. Paul v. Commissioner, 5 CCH 1953 Fed. Tax Rep. ¶ 9527 (3d Cir. 1953).
25. § 117 (a) (1) (B).
26. § 23 (1).

117(j): of inventories, property held primarily for sale to customers (evidently aimed primarily at real estate in that category) and the group covered in the third exclusion from capital assets,[27] a copyright, a literary, musical or artistic composition or similar property. The latter type of property is excluded only if held by a taxpayer whose personal efforts created such property, or a successor holder who would have the same basis in whole or in part for the property as the creator. Examples of the latter might be a wife of an author who had received the gift of a book created by her husband, or a corporation controlled by an author to which he transfers a copyright. It should be noted that patents and inventions are not excluded, so that holders thereof get the benefit of capital gain as well as Section 107 (b). Apparently authors and composers are left to obtain such benefit as they may from Section 107 (b) or other more general provisions of the Code.

The fourth exclusion from capital assets[28] refers to obligations issued at a discount and payable without interest at a fixed maturity date not exceeding one year from date issued after February 28, 1941, by the United States, its possessions, or any state or territory or political subdivisions or the District of Columbia. This is a narrower class of obligations than the one previously referred to on which the realized discount has been held to represent interest and not gain.

There are other exclusions from the term capital assets which do not appear in the original definition in Section 117 (a)(1). Gain from the sale or exchange of property which has been subject to amortization as a defense facility under Section 124 A to the extent of the over-reduction of basis by such amortization is to be treated, by Section 117 (g)(3), as gain from property which is not a capital asset nor property described in Section 117 (j). Such an adjustment could in many cases represent a large amount taxable at regular rates.

The allowance in full of a net loss to banks on the sales and exchanges of obligations with coupons attached or in registered form, previously referred to, is accomplished by denominating such obligation not capital assets.[29]

Also where there is a gain on the sale or exchange of stock of a collapsible corporation held over six months, the stock is to be considered not a capital asset. That makes the gain taxable in full.[30]

Similarly, where there is a gain on a sale or exchange of depreci-

27. § 117 (a) (1) (C).
28. § 117 (a) (1) (D).
29. § 117 (i).
30. § 117 (m).

able property between a husband and wife, or between an individual and a corporation controlled by his family in the degree specified,[31] any gain recognized is to be considered as from property which is neither a capital asset nor that described in Section 117 (j). This is evidently intended to prevent such a transfer of property with a capital gain tax where the recipient would have an increased basis for depreciation deductible at regular tax rates.

Then there are some miscellaneous provisions relating to capital gains and losses. There are two subsections[32] dealing with short sales of property. The purpose of these appears to be to prevent any tax avoidance by the time or manner in which the short sale is covered.

A special provision relating to dealers in securities[33] was added in the 1951 Revenue Act applying to trades made after November 19, 1951. For a dealer, a security is usually considered to be stock in trade. In a decision a short time ago, however, it was held that a dealer could set aside a security designated for investment and not for sale to customers, and the gain on a later sale after a six months holding would be long-term capital gain. The new provision requires a dealer to clearly identify on his records a security held for investment, within 30 days after its acquisition,[34] in order to have capital gain when the security is disposed of. Also if there is a loss it remains as a capital loss even if the dealer should attempt at any time to redesignate the security as not held for investment.

Then there is a further provision also added by the 1951 Act, effective for taxable years beginning after December 31, 1950, dealing with the settlement of a profit-sharing arrangement when an employee has terminated his employment.[35] If the quite restrictive terms are met, the amount if received in one year and after termination of the employment, is considered to be long-term capital gain.

One decision under this provision has already arisen. In that case the employee had "retired" before receiving the payment, but had continued for a period to receive a salary, and it was held that he

31. § 117 (o).
32. § 117 (g) (1).
33. § 117 (o).
34. Or before November 19, 1951, as to acquisitions made more than 30 days before that date.
35. If the employment had extended more than 20 years and had included for not less than 12 years the right to receive after termination of employment, for a period of at least five years (or ending at death) a percentage of future profits or receipts of the employer, and if the entire amount is received in one year and after termination of employment, the amount is considered to be long term capital gain. This looks like what we call "special legislation" to cover a particular case, but shows what can be done even in revenue legislation.

had not terminated his employment as required by this subsection and hence was not entitled to consider the payment as long term capital gain. This serves to illustrate the principle that an exception from taxation is most likely to be strictly construed.

We turn now to a consideration of how the "holding period" of a capital asset is to be determined. It appears to follow directly from the wording of Section 117 (a) that a taxpayer is entitled to count the period of time he has himself held a capital asset. Under a predecessor provision,[36] it has been held, for example, that a taxpayer, who acquired property by bequest or under intestacy laws, held from the date of death of the decedent and not from the time of subsequent distribution to him of the property. From this it would seem to follow that the holding period runs, not from the time legal title passes to the taxpayer, but from the time he acquires, or becomes entitled to, the property. Where an option held for several years was exercised and the property was purchased, it was held, however, that the period of holding of the new property ran from its purchase and not from the time the option was acquired. The generally accepted rule for counting time has been applied to capital assets in a decision holding that property, acquired on October 10, 1925, and sold on October 10, 1927, was held "exactly two years" and not "for more than two years".

The statute also provides for the tacking of periods of ownership of a capital asset in certain cases.[37] The fundamental principle of this provision appears to be that, where the basis of the capital asset disposed of is in whole or in part a "substituted basis," the holding period will include also the time the preceding property was held by the taxpayer, or the time the same property was held by the preceding owner. A similar tacking of holding periods of a capital asset was permitted by the Supreme Court under the 1921 Act (which contained no such provision as that of the current statute) when the basis of the property in the hands of a preceding owner was imposed upon the taxpayer. Conversely, where an entirely new basis arises upon acquisition by the taxpayer, the tacking of a prior period has been denied.

There are two specific provisions dealing with rights to acquire stock.[38] In general if the rights are sold they take the holding period of the stock on which they were distributed. If the rights are exer-

36. Revenue Act of 1928, § 101 (c) (8).
37. § 117 (h).
38. § 117 (h) (5), (6).

cised and the stock is purchased, the holding period of the new stock runs from the date of such exercise.

In summary, it appears that all of the fundamental considerations concerning non-recognized transactions and the determination of basis thereafter are involved in the tacking of holding periods of capital assets.

In conclusion we would call attention to two additional opportunities an investor may have to realize capital gain. In the case of bonds purchased with a substantial amount of back interest in default, it has been held that such interest when received is a return of capital and not income.[39] Then before the interest catches up beyond the date the bonds were bought, the bonds can be sold and the profit, the excess of the selling price over the cost reduced by the defaulted interest received, is capital gain. Hence for such bonds held over six months before sale, this has the effect of converting the defaulted interest received into long-term capital gain.

Another such investment opportunity of even greater importance relates to a special class of taxpayers known as Regulated Investment companies, defined in Section 361 of the Code. These are the so-called "investment trusts" such as Lehman Corporation or the National Shares Corporation listed on the New York Stock Exchange and many others dealt in both on the big board and over-the-counter.

Such a company must not be a personal holding company and must be at all times during the taxable year registered with the Securities and Exchange Commission under the Investment Company Act of 1940. There are a number of limitations upon the types and amounts of investments that may be held, and at least 90% of the gross income must be derived from dividends, interest, and gains from sales or other dispositions of stock or securities. This, for example, cuts out real estate investment companies deriving large amounts of income from rents or capital gains on real estate.

Probably the outstanding feature of a regulated investment company is this. If it pays out at least 90% of its net income (other than capital gains) as taxable dividends, it may designate and declare as a capital gain dividend all or part of the excess of long-term capital gain over short-term capital loss. The amount so declared is not taxed to the company and is treated as a long-term capital gain in the hands of the shareholder recipient.

The stock of these companies appears to sell on about the same basis as industrial companies whose dividends are taxable in full.

39. Erskine Hewitt, 30 B.T.A. 962 (1934), Acquiesced.

For example, last year National Shares paid $1.14 per share in regular dividends and $1.59 per share as capital gain, a total of $2.73, and sold at a high of $34.50 per share. Thus out of an investment return of about 8%, the shareholder could report over 56% of the dividends received as long-term capital gain. That is a tax saving opportunity that apparently is being overlooked by many large as well as small investors.