C
O
P
Y

TREASURY DEPARTMENT
WASHINGTON 25

March 5, 1945

IT:NDC

MEMORANDUM FOR

Mr. Blough

Reference is made to your inquiry as to the administrative problems likely to be encountered under a capital gains penalty tax of the type which you discussed with me.

It is understood that this type of tax has for its objective the discouragement of speculative trading without hindrance of investment in new ventures. The form of tax proposed is a 90 percent (less 10 points for each additional year assets are held) tax on gains realized from the sale of capital assets acquired after January 1, 1945, with the exception of those purchased since January 1, 1945, which represent investments in new ventures. Thus, gains on farms and urban properties and securities sold after January 1, 1945, which were acquired before January 1, 1945, would not be subject to the tax. Those acquired after January 1, 1945, would be subject to the tax unless it could be demonstrated that they represented investment in new ventures.

This proposal presents a number of major problems among which are:

I. Definition of tax base--

(a) Distinction between old and new ventures.
(b) Treatment of loss off-sets.
(c) Treatment of dealers.
(d) Treatment of organization under section 101.
(e) Treatment of estates in liquidation.
(f) Treatment of depreciable assets used in trade or business.

II. Classification of assets--

(a) Identification of assets purchased before and after January 1, 1945, and separated as to new and old ventures (and by time held after the first year of the penalty tax).

(b) Identification of assets by time held (as at present) irrespective of the January 1, 1945, date and irrespective of whether the venture was old or new.

III. Expansion and complication of tax blank--

(a) Additional schedules must be provided for identification of assets purchased after January 1, 1945, representing old ventures.

(b) Additional tax computation schedule must be provided for computation of the penalty tax and the allowance of appropriate off-setting credits.

(c) Extension of tax blanks to persons who will be required to pay a penalty tax but who are not now required to file a return.

(d) Multiple adjustment schedules for use in computing carry-backs of net operating losses, excess profits credits and accelerated amortization which would revise, eliminate, or institute the penalty tax retroactively by reason of the inter-dependent nature of these items.

IV. Enforcement of the tax--

(a) Taxpayers' records are not likely to accurately reflect distinction as between old and new ventures making voluntary compliance very spotty.

(b) Confiscatory rate and discriminatory treatment of old versus new ventures and date of acquisition creates a powerful incentive for tax avoidance and evasion.

<u>Discussion of each of the foregoing problems</u>

I. <u>Definition of tax base</u> -- The statute must be so drawn as to permit definite administrative rules for determining gains subject to the penalty tax. In order to draft the necessary regulations and instructions for forms, the statute must be rather specific. Among the questions which the statute must provide as answer are the following:

(a) Are securities of all corporation organized after January 1, 1945, new ventures?

(b) Are all new securities issued after January 1, 1945, by old corporations new ventures? And, if not, how is a purchaser to distinguish between issues, the proceeds of which are used solely for a new venture, partly for a new venture or for refinancing an old venture?

(c) If securities issued by an old corporation are partly for a new venture, how is the corporation to allocate a single share of stock or a single bond between the old and the new?

(d) Does the issuance of stock or bonds for the acquisition by a corporation for new and improved labor-saving machinery to manufacture the same product in additional volume constitute a new venture?

(e) Does the liquidation of a corporation and immediate re-incorporation to engage in the same type of business constitute a new venture? If not, how much change in the character of the business is necessary in order that the security issued be exempt from the penalty as a new venture?

(f) Does the purchase of a farm formerly used in the production of cotton for use in the production of soy beans constitute a new venture? If not, does the purchase of idle lands for use as a dairy farm constitute a new venture?

(g) Does the fact that a purchaser of a farm, operate it himself, or lease it for operation by another, have any bearing on the definition of new venture?

(h) If a returning serviceman purchases a filling station that is in operation and after a few months disposes of it at a gain, is the gain the result of a new venture? Does the fact that he has changed the character of the business by expanding its services have any effect on the definition of new ventures? And, if so, how will the law define the extent and type of expansion?

A number of further technical points which must be taken into consideration from the standpoint of administrative feasibility of the classification of old and new ventures are set forth in the appendix of this memorandum.

A basic problem of definition is how to define net gains after loss off-sets. While it would be consistent with the prohibitory purposes of the tax not to recognize losses, such treatment might be unduly severe and, therefore, will probably be allowed to some extent. If the penalty tax were applied only to net gains after loss off-sets problems would arise in connection with the method of allowing losses. Alternative methods would be to: (a) allow all losses on assets acquired within the effective period to be off-set indiscriminately against gains; (b) allow losses to be off-set only against gains on assets held for the same period; (c) allow losses to be allowed against gains with the same or longer holding period; and (d) provide that losses be off-set first against the longest term gains.

Any one of these alternatives add to the taxpayers' task of record-keeping and classification. The further question may be raised as to the desirability from an equity standpoint of off-setting losses in excess of gains from new ventures against gains from old ventures. This would, of course, serve further to confuse the accounting record as it is an exception to the general classification rule.

Losses in excess of gains also raise the question as to loss carry-overs. Will such losses, if carried forward, be applicable in the following year only to gain subject to the penalty tax and will they be allowable, if allowable at all, only against gains on assets held for the same periods?

An important problem in defining gains subject to the penalty tax is how to treat dealers and traders. It is assumed that the present definition of capital assets will continue, in which case dealers will be exempt from the tax.

In a rising market, dealers exempt from the penalty tax would occupy a strategic position to reap gains subject only to ordinary income tax rates and pass on inflated values to other investors. The dealer loophole would be especially dangerous if it were easy, as it appears it would be, for individuals, partnerships, syndicates, pools, and corporations to meet the requirements for dealer status.

Organizations now exempt under section 101 from income tax own substantial amounts of capital assets. Unless the statute specifically made these organizations taxable, it is assumed that they would retain their nontaxable character and gains from trading would be exempt. If they retained their nontaxable character, increased pressures for organizations of this type would have to be met in order to avoid use of such organizations as a means of evading the tax. If the organizations are exempt it would also encourage the use of contributions in the form of capital assets which if sold by the donor would be subject to the penalty tax.

In respect to estates in liquidation, there is a policy question as to whether gains from necessary sales should be subject to the tax. It would appear that all sales made necessary in closing estates and other necessary sales made by estates might be exempt. If such exemptions are provided there will be an administrative problem in ascertaining the sales made as a consequence of necessity as distinct from those not so made.

If the present definition of capital assets is used as a basis for determining the type of assets subject to the penalty tax, an inconsistency arises in the case of the gain from the assets or exchange of property used in trade or business of the kind subject to depreciation. On one hand, assets held less than 6 months are not considered as capital assets and any gain from the sale of such assets is taxed as ordinary income. On the other hand, gains from the sale of depreciable assets used in the trade or business and held more than 6 months are considered capital gains and would, therefore, be subject to the penalty tax.

II. Classification of Capital Assets--

The record-keeping on the part of the taxpayer in respect to identification of assets may be visualized from the following chart showing the breakdown required for proper accounting purposes.

A. Assets acquired on or after January 1, 1945.

(1) New venture--

(a) Held not more than 6 months
(b) Held for more than 6 months

(2) Old ventures--

(a) Held for not more than 6 months
(b) Held for 6 to 12 months
(c) Held for 1 to 2 years
(d) Held for 2 to 3 years
(e) Etc., depending upon the length of time the tax is in effect

B. Assets acquired prior to January 1, 1945.

(1) Held for not more than 6 months
(2) Held for more than 6 months

Every share of stock, every bond, or other evidence of indebtedness, as well as every physical asset falling under the definition of capital assets, sold by the taxpayer must be classified according to the above chart. The classification by time held is generally readily ascertainable since the date acquired and date sold is determinable. The classification as to new or old venture is not readily ascertainable by the buyer either from the one from whom the asset was immediately purchased or from the debtor. Moreover, a single share of stock or a single bond may be classifiable in two separate categories as it may represent a venture partly new and partly old.

An additional complication arises in case a corporation obtains new capital for a contemplated new venture which venture actually does not materialize but which capital is used in connection with an old venture. The purchasers of the stock in this case could scarcely be expected to properly classify their assets.

III. Expansion and complication of tax blank--

Following out the breakdown described in the chart in II above, the additional space required would necessitate adding a minimum of two full pages to the individual tax return. In other words, the present capital gain schedule requires one page, the proposal would require three. This does not include the space required for additional instructions which instructions would be most voluminous and extremely difficult for the average taxpayer to apply.

Since there are three possible tax results, schedules must be provided to guide the taxpayer in the arrangement of the various factors affecting the tax in such a way as to produce the tax required to be paid.

Complicated choice problems would arise in determining whether a joint or separate return would produce the smaller tax in cases where husband and wife both have capital asset transactions.

Under present law a person with a capital gain of $50 of the type subject to the penalty tax and no other income, is not required to file a tax return. Under the proposal, such a person would be required to file a return for purposes of the penalty tax and liable in the first year for the payment of $45 in tax. This rule would undoubtedly add materially to the number of tax returns due to be filed.

In addition to the individual income tax returns, substantial additions must be made to the return blanks of fiduciaries and partnerships in order to show the distributive interest of each beneficiary or partner in respect to the gains or losses attributable to new as distinct from old ventures. Gains derived through partnerships and fiduciaries serve to further complicate the schedules on the individual returns.

Appropriate changes must also be made on the alien series of returns. In respect to certain nonresident aliens, there is no tax at present on capital gains. A continuation of this exemption coupled with the high penalty may result in the development of some tax avoidance schemes whereby trading may be carried on in the name of nonresident aliens for the actual benefit of citizens.

In the time allotted it has not been possible to formulate, even in outline, a schedule which would aid the taxpayer in making the multiple adjustments in connection with carry-backs of net operating losses, excess profits credits and accelerated amortization. The adjustments appear at first hand to be so complex that it is doubtful if any reasonably standard schedule can be developed.

IV. Enforcement of the tax—

Manifestly, the penalty tax cannot be determined in the absence of adequate records. The taxpayers, themselves, will not be in a position to maintain adequate records unless the corporations and others embarking upon new ventures advise the taxpayers in respect to the proportion of their gains which are taxable and those nontaxable. In the case of bearer bonds and stocks bought through record owners, the debtors will not know the names of their bondholders and shareholders. Thus, the taxpayers will have to take the initiative in making inquiry of the debtors. Unless the taxpayer does voluntarily take the initiative it is unlikely that his return will be properly prepared and the Bureau will have to contact each taxpayer and through such taxpayer contact each debtor in order to definitely establish the true tax liability.

On the whole subject of capital gains, even under present law, the Government is in a rather weak position from an information return standpoint. There is no practical information-at-the-source system available which will furnish leads to taxpayers who fail to report their gains. With a high penalty tax on such gains, it is likely to further discourage voluntary reporting on the part of persons disposed to avoid taxes. For a number of years, information returns were required of brokers in the case of each of their customers for whom sales aggregated $25,000 or more. This was abandoned in 1942 as a result of the burden imposed upon brokers and others and the relatively small value of the forms due to the high minimum amount. Under the penalty tax it would be essential that some system of this type be re-instituted with a much smaller minimum. This is certain to add tremendous burdens to all financial offices. However, this would not cover the private transactions which are far more difficult to trace and around which there would be an enormous amount of tax evasion which would bring both the tax and the Department into disrepute.

(Signed) Norman D. Cann
Deputy Commissioner
Income Tax Unit
Bureau of Internal Revenue

The M Corporation, engaged in mining copper in Colorado, is approaching the end of its ore. Its engineers locate a body of ore adjacent to the depleted mine and the corporation's stockholders decide to build up the capital of the corporation to enable it to acquire the new ore.

Proposition #1:

The stockholders voluntarily contribute $50.00 per share on their old stock.

Proposition #2:

A valid assessment of $50.00 per share is levied.

Proposition #3:

Additional stock is sold to stockholders prorata at $50.00 per share.

Proposition #4:

Additional stock is sold by the corporation to public at $50.00 per share.

Assume in each case (a) all the funds are used to acquire the new ore; (b) half the funds are used for new ore and other half retained for working capital; (c) half the fund for ore - other half for old debts.

What is extent of new venture during the first year when old mine is being worked out and new mine is dormant?

Would it be necessary to wait until new mine is started before this would classify as a new venture?

Answers to the above questions would necessarily have to be spelled out in any legislation, in order to properly recognize bona fide new ventures.

A syndicate purchases for cash all of the stock of a corporation whose only asset is a factory building. The corporation had previously been engaged in munitions manufacturing. The factory is retooled and starts to manufacture radios.

Query: How can this stock be identified after the syndicate starts to sell the stock to the public?

Assume a munitions manufacturer shifts from guns to soup in 1945 - is this a new venture or old venture?

Assume a new corporation is formed and acquires for its own securities, in either a taxable or nontaxable exchange, stock or securities of "old venture" corporations. Is this corporation to be considered a new venture or old venture? The formation of the new corporation may be for a business purpose or for avoiding the "penalty tax". In this connection attention is directed to section 129 of the Code which was intended to plug the loophole of advantages growing out of acquisition of corporations with high excess profits tax credits by determining whether the acquisition had as one of its principal purposes the avoidance of Federal taxes. Would it be necessary to have a similar provision in the proposed legislation to distinguish business purpose from tax purpose, not only in the formation of a new corporation to hold "old venture" securities, but all other types. Section 112(i) containing a similar provision has been in effect since 1932 Act. All rulings under 112(i) must be made by the Commissioner in advance of the transaction. From 1932 to date, 247 applications were filed, of which 208 received favorable rulings, 26 unfavorable and 13 were withdrawn.

STOCK RIGHTS

In the event rights to new securities are issued to stockholders by an old venture corporation, for a bona fide new venture, it is necessary, as in the case of any stock rights, to allocate a portion of the old cost of stock to the rights so issued. Therefore, upon exercise of the rights, the stock purchased has two elements of cost, the subscription price plus an allocated portion of the old cost. These separate elements would necessarily have to be recorded and traced into successive stock rights.

The difficulties of recording and reporting such elements where the new securities are sold, is aptly illustrated in the memorandum of March 24, 1941 signed by J. P. Wenchel:

> "Reference is made to your memorandum of February 17, 1941, in which you request that reconsideration be given to G.C.M. 22532, published in Internal Revenue Bulletin (1941) No. 5, p. 7, dated February 3, 1941.
>
> Upon further consideration of the issue presented, G.C.M. 22532, supra, is withdrawn and the following memorandum is substituted therefor as of the above date:
>
> > An opinion is requested whether in view of certain court decisions referred to herein G.C.M. 10063 (C.B. X-2, 159 (1931), G.C.M. 12942 (C.B. XLLL-1, 73 (1934), and I.T. 2609 (C.B. X-2, 339 (1931)) should be revoked, and G.C.M. 11645 (C.B. XII-1, 117 (1933)) and I.T. 1786 (C.B. II-2, 45 (1923)) should be reinstated.
> >
> > The question involved is whether stock sold, which had been acquired by the exercise of stock rights, was a capital asset within the meaning of the statute; or, to state it otherwise, where stock is acquired through the exercise of stock rights, is the date of acquisition the date on which the original stock (in respect of which the rights were issued) was acquired or the date on which the rights were exercised?

STOCK RIGHTS (Cont'd)

In G.C.M. 12942, supra, it was held that where stock is acquired through the exercise of rights, the holding period begins from the date of acquisition of such stock and not from the date of acquisition of the stock with respect to which the rights were issued. That ruling revoked, in so far as inconsistent, G.C.M. 11645, supra, and reinstated G.C.M. 10063, supra, which was in accord with G.C.M. 12942, supra. In G.C.M. 11645, supra, it was stated in effect that stock acquired through the exercise of rights and held for less than two years, where the stock in respect of which the rights were issued had been held for more than two years, was in part a capital asset (the portion attributable to the right) and in part a noncapital asset (the portion attributable to the subscription price). Under the ruling made in G.C.M. 12942, supra, which was based upon decisions of the Board of Tax Appeals in Rodman E. Griscom v. Commissioner (22 B.T.A., 979) and Ellen Ayer Wood v. Commissioner (29 B.T.A., 1050), nonacquiescence, C.B. XIII-2, 38 (1934)), no part of such stock was considered to be a capital asset.

The decision of the Board in the Griscom case, supra, earlier had resulted in the revocation of I.T. 1786, supra, which ruling had indicated that stock acquired through the exercise of rights, where the stock in respect of which the rights were issued was held for more than two years, constituted a capital asset. I.T. 1786 was revoked by I.T. 2609, supra, in conformity with G.C.M. 10063 and G.C.M. 12942, supra.

This question has now been considered by the courts (Wood v. Commissioner, 75 Fed. (2d) 364; Macy v. Helvering, 82 Fed. (2d), 183; Insull v. Commissioner, 87 Fed. (2d) 648), and the conclusions reached have been in substantial accord with G.C.M. 11645, supra.

The Board of Tax Appeals later recognized and followed the general rule established by the courts in the Wood case, the Macy case, and the Insull case, and stated that its prior decisions, in so far as in conflict, would not be followed in the future. (Walter Fitch, Jr., v. Commissioner, 35 B.T.A., 537.)

STOCK RIGHTS (Cont'd)

In view of the fact that the ruling made in G.C.M. 11645, supra, is in harmony with the principles laid down by the courts in the above cited court cases, that G.C.M. is reinstated, and G.C.M. 10063, supra, and G.C.M. 12942, supra, are revoked in so far as inconsistent therewith.

It is recommended that I.T. 2609, supra, be revoked but that I.T. 1786, supra, not be reinstated."

This matter of allocation finally became so complicated it was eliminated by legislation.

APPENDIX

PARTNERSHIPS

A series of problems can arise in the typical American method of conducting business, to wit, partnerships. The use of family partnerships for the purpose of minimizing, avoiding or evading taxes is well known, and this problem may be interlaced with some of the examples which are given below:

The purpose of admitting a new partner to a partnership is to:

(1) Raise more capital

(2) Reduce fixed charges, as on plant and machinery, or mortgages on land, etc.

(3) Eliminate an unprofitable part of the business

(4) Pay off pressing obligations

(5) Take care of an accumulation of unpaid obligations

(6) Exploitation by old partners, as where valuable assets are sold just prior to the admission of the new partners. Before the new partner has been admitted, has there been a definite valuation as far as possible:

   (1) Fixed tangible assets
   (2) Current assets
   (3) Intangible assets

These evaluations are necessary before it may be determined that the investment is additional capital.

In the several propositions outlined hereinafter, could it be held that the members of the partnership have entered into new enterprises?

Proposition: A and B are equal partners in a business having a net worth of $30,000. More capital is needed to pay off some of the notes payable of the firm. C is invited to become a partner. He makes an investment of $10,000 and acquires a one-fourth interest in the business.

Question: Does this represent the entry into a new enterprise for C? How are A and B affected by the transaction?

Proposition: A and B are equal partners in a business having a net worth of $30,000. More capital is needed to acquire additional machinery, but of the same character now being used by the partnership. C is invited to become a partner. He makes an investment of $10,000 and acquires a one-fourth interest in the business. The new machinery is purchased.

Question: Does this constitute the entry into a new venture for C? Are A and B affected by this transaction?

Proposition: A, B and C are partners in a trading partnership. They decide to expand the business and engage in a nontrading business, but in a business proximately related to the trading partnership. The capital for the new business is contributed by A, B and C.

Question: Can this be held to be a new enterprise for the three partners, A, B and C?

Proposition: A and B are partners in a trading partnership, They decide to expand the business and engage in a trading business, but wholly unrelated to the old business. They need more capital for the new venture. C is invited to become a partner. He makes an investment of $10,000 and acquires a one-fourth interest in the business.

Question: Does this represent a new venture for the new partner C? How are partners A and B affected?

Proposition: A and B, equal partners in an established business, consolidate with C and D, equal owners of an allied business. A and B are each to have a one-third and C and D each a one-sixth interest in the new firm. No change is made in the nature of the kind of business carried on by the allied businesses.

Question: Are A, B, C and D entering into a new venture?

Proposition: A, B and C as partners form a trading partnership, C dies, and by operation of law the partnership is terminated. A new partnership is formed and the Estate of C becomes a member of the new firm. The new firm continues in the same line of business and the partnership interests remain in the same proportion.

Question: Does this represent a new venture for the estate of C? How are A and B affected by the change?

Proposition: A, B and C are partners in a non-trading partnership, each owning a one-third interest in the partnership. Due to the insanity of C, the partnership is dissolved by decree of the court. A new partnership is immediately formed by A and B to continue in the same line of business, they are to be equal partners in the new partnership.

Question: Does this constitute a new enterprise for A and B?