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Chapter 9

Tax Avoidance through Capital Gains

As noted in Chapter 1, the markedly lower tax rates on capital gains have given many taxpayers a strong incentive both to choose investments likely to yield this type of reward and to contrive to have ordinary income take on its appearance. In an economic sense, as we saw in Chapter 4, a pure capital gain is best conceived as an unforeseen, unexpected increase in the value of a piece of property; ordinary income consists of more or less expected gains. We found this distinction difficult to apply in more than a general way because it becomes blurred when pressed far: 'expected' gains differ from 'unexpected' only in degree; most incomes are varying mixtures of expected and unexpected elements. The law nevertheless attempts to approximate this distinction by taxing as ordinary income the net receipts from a trade or profession, operating a business, or owning property, and by treating as capital gains those obtained from the sale of capital assets, i.e., assets not a part of the taxpayer's stock-in-trade. The former may be said to be expected because they tend to be recurring; the latter unexpected because they do not. But the law necessarily relies primarily upon the *form* of a transaction rather than its substance. It is not surprising, therefore, that in addition to the underlying difficulties of distinguishing sharply between economically overlapping types of income, difficulties arise from the application of the law itself. Particularly with the aid of the corporate form of business organization and property ownership, but through other means as well, many taxpayers have found it possible to convert into technical capital gains various amounts of more or less expected income actually representing personal services, profits, interest, or rents.

Congress and the Bureau of Internal Revenue have tried to meet the more obvious attempts to make ordinary income look like capital gains as a means of avoiding taxes by withholding preferential tax treatment from gains realized on capital assets owned less than a stipulated period, by successive technical refinements in the

law, and by closer administrative scrutiny of questionable and borderline transactions. Nevertheless, the precise position of the dividing line between capital gains and ordinary income has been difficult to determine in certain types of case, and in others the established division has clearly permitted tax avoidance.

In the broad sense in which the expression 'tax avoidance' is used in this book, no unethical, immoral, or illegal intent on the part of the taxpayer is implied. The distinction between tax evasion, which connotes an illegal attempt to evade taxes, and lawful tax avoidance is often difficult to draw but is suggested by an analogy the late Senator Pat Harrison, then Chairman of the Senate Finance Committee, used in a conversation with the author: a traveller who goes over a toll bridge without paying the toll is guilty of unlawful evasion; but he may lawfully avoid the toll by going over a free bridge nearby.

If the law offers two forms for conducting a given transaction and levies higher taxes in connection with one than with the other, the taxpayer cannot be blamed for adopting the form that lessens his taxes. If, further, the tax-favored form is open only to some classes of transaction, not to others, though no real difference exists in the character of the income from each, different groups of taxpayers are treated unequally, and the favored group might be said to avoid taxes. Finally, the tax treatment may be unequal not because some taxpayers deliberately choose legal forms that give their incomes the guise of capital gains, but because the law itself gives this designation to some types of income that do not differ fundamentally from those taxed at regular rates.

In the discussion that follows, we use 'tax avoidance' in a loose sense to cover all cases in which essentially ordinary income is taxed as capital gains.

1 UNCERTAIN BORDER BETWEEN INVESTORS AND DEALERS

All purchases and sales of investments entail some personal effort by the investor or his agent. In some instances a man's talents and exertions may repeatedly enable him to acquire properties at bargain prices or, by judicious timing or adroit selection of buyers, to sell them at unusually high prices. His personal services, rather than the capital funds with which he works, may be responsible for most of his gains. In other instances the larger part of the investor's income may come from rents, interest, or dividends, but a sizeable proportion may nevertheless be obtained more or less regularly by profiting

from informed judgment in timing the purchase and sale of investments. How much and what kinds of effort in buying and selling any type of property are enough to make a man a dealer in it rather than an investor? If classified as the former, his profits are taxed as ordinary income; otherwise, as capital gains. These questions are not answered specifically in the law. They raise difficulties for tax administrators and the indefiniteness of the answers creates opportunities for some taxpayers to convert the fruits of personal talent and exertions, even when regularly applied, into capital gains.

The chief considerations usually taken into account by the Bureau of Internal Revenue and the courts to distinguish the ordinary profits of a dealer from the capital gains of a trader or investor are the intention of the taxpayer (did he buy the property primarily for resale?), the proportion of his time devoted to the transactions, and, most important, the extent to which the purchases and sales actually require him to seek sellers and customers in the markets. The distinction does not turn on the type of good sold. A householder may realize a capital gain on an electric refrigerator or other consumer good, while a dealer in factory machinery is subject to ordinary income taxes on his profits from the sale of this class of capital goods. In the language of the Internal Revenue Code, Sec. 117 (a) (1): " 'Capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23(1). . . ."

If an individual were to engage extensively in the purchase and sale of a narrow class of goods, motor trucks, for example, he would doubtless be termed a dealer under the foregoing definition. If he made a few purchases and sales a year, wholly apart from his regular business, the circumstances and his intentions would have to be examined to determine the character of his gains. But if his transactions covered a broad variety of properties, and did not entail the maintenance of inventories or a regular place of business, he would be permitted, in most cases, to treat his profits as capital gains. Finally, a taxpayer may buy and sell listed securities on the stock exchange in any amount and with any frequency without being called

a dealer. He may acquire a big block of stock through the equivalent of a wholesale purchase, and dispose of it through several thousand separate sales of 100 shares each during a year, yet treat his profits as capital gains. Even professional traders and speculators who devote all their time to buying and selling securities for their own account are not regarded as dealers unless they hold securities "primarily for sale to cusomers" in the ordinary course of their trade or business. Hence, their profits are currently subject to the capital gain and loss tax provisions, rather than to those governing ordinary income.

British practice appears to differ from American in this respect, the British being readier to say that a series of similar transactions involving personal effort reflects a regular calling or business. A resident of Great Britain who can be shown to devote much or all of his time to stock market speculation, for example, is likely to be classified as a dealer and to have his profits taxed as ordinary income.[1] In the United States, even taxpayers whose entire incomes are from stock market speculation and investment are eligible for the preferential capital gains tax rates on their profits, provided they hold their securities longer than 6 months. Since the British exclude capital gains entirely from the income tax base, they have more reason to scrutinize hybrid and borderline transactions carefully.

Short term traders and speculators, however, do not benefit from the American treatment, since the effective tax rates on gains from capital assets held 6 months or less are the same as those on ordinary income. In fact, traders, because of the restricted deductibility of their net capital losses from other income, suffer a disadvantage when the net result of their short term operations is a capital loss.[2]

Dealings in real estate and in securities regarded differently

The situation of long term speculators and investors in real estate is different from that of those in corporate securities. A man who frequently buys and sells shares of stock in the leading steel companies is not usually thought of as engaging in the steel business,

[1] See R. M. Haig, Taxation of Capital Gains, *Wall Street Journal,* March 25 and 29, 1937.

[2] Until 1934, when Congress imposed a limit of $2,000 upon the deductibility of net capital losses, professional traders in securities were treated as dealers. Had they continued to be classified as dealers, their short term net losses on securities would have remained fully deductible. Congress avoided this result by excluding from the category of dealers, traders and others who do not hold securities "primarily for sale to customers."

because it is the steel companies, not their stockholders, who are viewed as engaged in that business. But a man who frequently buys and sells real estate is more readily regarded as a dealer. Both the Bureau of Internal Revenue and the courts have been inclined to regard even a moderate number of real estate transactions a year, if they involve the purchase and sale of similar properties such as houses or the disposition of a single large property in many small pieces, as sufficient to classify a man as a dealer even though he also practices law or medicine, or has some other occupation or business.

Anyone who subdivides his land for sale, regardless how long he previously owned it, is likely to have his profits taxed as ordinary income rather than as capital gains (Weil, TC memo op., Dec. 13, 973M). Even a man without previous transactions in real estate who acquires his land by inheritance but finds that he can dispose of it to good advantage only by selling it in several separate pieces through an agent is likely to be held to be engaged in trade as far as concerns the taxability of his profits from those sales (*Ehrman v. Com.*, 120 F (2d) 607, 314 U.S. 668). The presumption apparently is that frequent purchases and sales of real estate indicate resale at a profit as the primary purpose of the acquisitions, and that the transactions demand a sufficient search for customers on the part of the investor to constitute a business.

Even in real estate, however, a man may make a livelihood and a career from a series of similar transactions without being treated as a dealer for tax purposes. For example, if he made a practice of erecting a block of retail stores once every year or two, selling the block as a whole when the building was completed and the stores rented, the profit on each transaction would probably be taxed as a capital gain. But if he built 20 separate stores each year and sold them to 20 purchasers, it is likely, though far from certain, that his profits would be taxed as ordinary income, for then it would be easy to regard him as conducting a regular business. The former transactions appear to be discrete. They are not seen to constitute a more or less regular means of livelihood until looked at from the perspective of some years later. Similarly, many individuals enjoy the benefits of capital gains tax rates on their incomes from a more or less organized pursuit of profits through constructing or otherwise acquiring and selling a succession of apartment houses, theatres, hotels, etc.

2 PROMOTERS AND ORGANIZERS

The example just given of a man who makes a living and a career from a succession of separate construction projects is also representative of a wider class of situations in which the fruits of personal talent and effort take the form of capital gains. As noted in Chapter 4, some men make a life's work of promoting and organizing a succession of business enterprises, such as jewelry or furniture stores, or chains of them, and receive much of their compensation in the form of capital gains.

Promotion and organizing talents and services lend themselves peculiarly to compensation in the form of capital gains because their products can be embodied and sold in the form of the goodwill of a new or modified business enterprise. The assembling of a chain of 30 retail drug stores in a big city, for example, may create larger aggregate earnings on the invested capital by reason of quantity discounts on purchases and other advantages; and compensation for the promoter's services (and, in part, for his risks and capital investment) may readily take the form of a capital gain that represents the difference between the selling price of the chain based on a capitalization of its expanded earning power and the smaller aggregate of the purchase prices of the individual stores. Few other kinds of personal service can be sold in such a fashion. Professional men can sell their personal services only directly to an employer or to a number of individual clients, and the services are usually too personal to be readily transferable to others. Hence the relation between the professional man and his client is not usually saleable. Successful physicians, lawyers, accountants, and other professional men, and salaried corporate officials frequently complain that they do not share the recurring opportunities enjoyed by their friends among the independent business men to obtain compensation in the form of the preferentially taxed capital gains.[3] The promoter or organizer of a business firm differs by creating an organization that continues to function after his personal services have been withdrawn. To the degree that this organization yields an income in excess of the going rate of return on an amount equal to its original cost, it possesses a saleable goodwill.

Even among professional men capital gains are open to those who create continuing organizations; e.g., some physicians and others who have built up stable clienteles sell their practices. While these

[3] Some often get clues to profitable investments or actual participation in them in connection with their services to promoters, however.

capital gains are seldom large, there are noteworthy exceptions: organizing talent and a diminished emphasis upon the personal relationship in the reputation for superior services have enabled certain eminent physicians, engineers, accountants, advertising experts, and other professional men to build up continuing organizations possessing a valuable goodwill that persisted after their personal services had been withdrawn.

Although speculative talent may be employed in quest of capital gains without promotion effort, as in much stock market speculation, the two are often combined. The man who assembles a dozen parcels of land with an eye to the peculiar value of the assembled site for a particular use, then finds a buyer to exploit it, is an example. Somewhat similar is the case of a man who seeks a large capital gain by buying a promising piece of land, then contributing to the increase in its value by persuading others to build on contiguous sites.

In such ways the same personal qualities and exertions that enable one man to command a fully taxable salary of $100,000 a year from a large corporation may be used by another, with the aid of often trifling amounts of capital, to obtain rewards in the form of lower-taxed capital gains.

3 TRANSFORMING CURRENT INVESTMENT INCOME INTO CAPITAL GAINS THROUGH THE PERSONAL HOLDING COMPANY

The preceding discussion has been confined to individuals acting in their own names, and mainly to rewards for personal services. When the corporate form of conducting a business is used, the possibilities of transforming all kinds of ordinary income into capital gains are greatly facilitated and extended. The underlying reason is that the law conceives a corporation to be an entity distinct from its stockholders. A corporation's profits are therefore not regarded as the income of its stockholders unless and until distributed to them in dividends, and a stockholder may have buying and selling transactions with a corporation whose entire stock he owns.

An extreme use of this legal concept to convert dividends, interest, rents, and other income into capital gains took place in the 1920's and early 'thirties through the personal holding company: a corporation that is called a 'holding company' because its income is derived primarily from the ownership of securities rather than from the direct operation of a business, and 'personal' because it is owned by only one or a few persons. By forming such a company

and transferring to it a portion or all of his stocks, bonds, and other securities in exchange for its capital stock, the investor could substitute the corporation for himself as the legal recipient of his dividends, interest, and other income. Although his ownership gave him control over its income, the investor was subject to individual income tax only on the part of its earnings that he caused to be paid in dividends to himself. The holding company's income from its dividend receipts was exempt from the corporation income tax,[4] and the tax rate applicable to the taxable portion of its income, chiefly interest, was usually lower than the upper surtax rates on personal incomes. By having his holding company retain and reinvest a part of or all its income, the investor could add to his wealth without having to pay personal income taxes on the increase; and when he chose, he could liquidate the company and treat as a capital gain the increase in its value derived from the accumulations of ordinary income.

The personal holding company offered other tax advantages also. Even if the taxpayer planned ultimately to have his personal holding company pay out in dividends all the income it received, he could arrange to have the distributions made in years when his taxes on them would be smallest, e.g., in a year when his income from other sources was small or negative. He could avoid subjecting an unusually large profit from a contemplated transaction to the upper surtax rates by having his personal holding company realize the gain, pay the corporation income tax on it, and either reinvest it or pay it to him in installments. He could form more than one personal holding company and arrange tax-saving transactions between them or between one of them and himself. He could retain his underlying ownership of an asset that had fallen in value, yet obtain the tax advantage of realizing a loss, by selling the asset to one of his personal holding companies, or by having one of them, if it was the legal owner, sell it to another or to himself.[5] By handling the transaction as a loan rather than a dividend distribution, he could even pocket and consume the income received by his personal holding company,

[4] Beginning in 1936, 15 percent of dividends received by corporations was included in taxable income for the purpose of the normal corporation income tax, corporate surtax, and declared-value excess profits tax, and the whole amount was included for determining distributable income for the purpose of the surtax on undistributed profits under the Acts of 1936 and 1938.

[5] The asset would acquire a lower 'basis' in the hands of its new legal owner, however, thereby increasing the taxable capital gain or reducing the allowable capital loss from a subsequent sale.

yet not pay any personal income tax on it. One individual who reported a large net loss on his personal return for 1936 was found to own a personal holding company, organized in Canada, that had an income in 1936 of over $1,500,000 from dividends of United States corporations; and a considerable part of his reported loss arose from a deduction he claimed for interest on a loan made to him by his personal holding company.[6] Some personal holding companies were able to offset taxable income from dividends and interest on securities or from capital gains by the losses they reported from renting yachts, summer houses, etc., to the sole or principal owner of their common stock.

So conspicuous were these and other tax advantages of the personal holding company that lawyers came to advise nearly everyone with substantial holdings of property to resort to its use. Until 1934 the only means available to the Treasury Department of preventing tax avoidance through this device was a provision (now Section 102 of the Internal Revenue Code) authorizing the Commissioner of Internal Revenue to impose a penalty tax on corporations formed or used for the purpose of avoiding the imposition of income taxes on their shareholders. This provision proved to be exceedingly difficult to apply because proof that retention of earnings was motivated by improper purposes was almost impossible to establish in the face of statements by the corporation's officers of the actual or intended uses for the funds. To eliminate the necessity of such proof when personal holding companies were employed, Congress, in the Revenue Act of 1934, levied graduated surtaxes of 30 and 40 percent on the undistributed earnings (after various allowable retentions) of *all* personal holding companies as defined in the Act. The range of these surtaxes was made 20-60 percent in the Revenue Act of 1935, and 8-48 percent in that of 1936. But this treatment was apparently inadequate. The Secretary of the Treasury reported in a letter to the President, dated May 29, 1937, that the single stockholder of one large domestic personal holding company "saved himself $322,000 by causing his company to distribute none of its income to him"; and that in another case, "a man and his wife saved $791,000 through the use of personal holding companies in 1936".

Compounding the difficulties of the tax administrators were the attempts of persons to avoid the surtax on personal holding companies by incorporating them in the Bahamas, Panama, Newfound-

[6] Hearings, Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. (1937), Part 1, p. 3.

land, and other places. The Secretary of the Treasury reported that 64 such companies were organized by Americans in the Bahamas alone in 1935. In some instances the formation of foreign personal holding companies was motivated by the desire to avoid the capital gains tax on profits about to be realized. A case of this sort was described by the Secretary as follows: "Perhaps the most flagrant case of this character is that of a retired American Army officer with a large income from valuable American securities which he desires to sell at a very large profit. To escape our income and inheritance tax laws, he used the device of becoming a naturalized Canadian citizen, and 6 days later organized four Bahamas corporations to hold his securities. He and his lawyers apparently think that he can now sell his securities free from any taxes on his profits, since there are no income taxes in the Bahamas, and that he has adroitly escaped American taxes."

The foreign personal holding companies offered special difficulties because they were frequently organized through foreign lawyers, with dummy incorporators and directors. The names of the real parties in interest were not evident, and the laws of the countries where the companies were established did not require that they be disclosed.

Following a special Presidential message on tax avoidance and evasion, and hearings before a joint Congressional committee, Congress greatly reduced the tax avoidance possibilities of personal holding companies in the Revenue Act of 1937, and further changes in this direction have since been made. A personal holding company is now defined in the statute as one that received at least 80 percent of its gross income for the taxable year from royalties, dividends, interest, annuities, compensation for personal services, and, if they constituted less than half of the gross income, rents; provided half or more in value of the company's common stock was owned directly or indirectly at any time during the second half of the year by not more than five individuals. An individual, for this purpose, is considered to own the stock owned directly or indirectly by or for his family or partner, and the family of an individual includes his brothers and sisters, spouse, ancestors, and lineal descendants. Only 70 instead of 80 percent of the gross income for the taxable year need be derived from the sources cited if, with certain exceptions, the company had been classified as a personal holding company for any preceding taxable year beginning after December 31, 1936. Besides being subject to the same rates of income tax as other cor-

porations, statutory personal holding companies are subject to a surtax of 75 percent on the first $2,000 of their undistributed net income, after certain allowances, and to a surtax of 85 percent on the amount in excess of $2,000. The result has been that substantially all the net income of such companies, after the amounts permitted by statute to be retained, is now distributed to their stockholders and subjected to the individual income tax.[7] American shareholders of foreign personal holding companies, as defined in the statute, are required to report as a part of their personal incomes their shares of the latter's undistributed net incomes, after specified deductions.

While the foregoing provisions have been extremely effective against companies that come under the strict definition of the statute, they do not cover all companies that use the corporate form to enable their stockholders to convert ordinary income into capital gains or numerous other cases in which this result is achieved without being deliberately sought.

4 TRANSFORMING CORPORATE PROFITS INTO CAPITAL GAINS BY REINVESTING THEM

Probably the most important way in which current income — interest, rents, profits, and wages — is converted into capital gains is through the direct reinvestment of profits by ordinary business corporations. Between 1923 and 1929 more than 45 percent of the compiled net profits, after income and excess profits taxes, of all corporations reporting net incomes was retained by the corporations, and was therefore not subject to the individual income taxes applicable to their stockholders. When the figures for corporations reporting net deficits, for which their stockholders did not receive any allowance, are combined with the former, approximately 27 percent of the aggregate compiled net profits of *all* corporations, after income and excess profits taxes, was withheld (*Statistics of Income,* 1923-29). In the early 'thirties operating losses and large writedowns of plants, equipment, and intangible assets wiped out the surplus accumulations of many, though not all corporations. An aggregate net deficit of $11.5 billion was reported to the Bureau of Internal Revenue by corporations as a whole for the 3 years 1931-33. Individual differences, however, were marked. While most corpora-

[7] A personal holding company may retain all its net long term capital gains without becoming subject to surtaxes on them. Such retention does not result in avoidance of individual income taxes by the shareholders because the gains would be taxed at only 25 percent if realized by them directly.

tions were incurring net deficits totaling $20.3 billion, others earned net income totaling $8.8 billion.

The reinvested earnings of the 'twenties were also drawn upon to pay dividends in excess of current earnings during the early 'thirties. Here too, however, it is desirable to distinguish between the aggregate for all corporations and its components. According to *Statistics of Income,* 65 percent of the cash dividends disbursed in 1931-33 came from corporations that remained profitable, and their dividend distributions in the aggregate were less than their compiled net profits after income tax.

Individual case studies reveal more sharply than group statistics the importance of reinvested earnings in the growth of many enterprises. In a study of 72 major manufacturing and mercantile corporations for 1922-33, O. J. Curry found that 27 had increased their assets from reinvested earnings more than 50 percent.[8]

Among larger corporations the desire of the common stockholders for liberal dividends and that of the management to retain earnings is often compromised by the payment of a portion of the dividends in the form of additional common stock. Such stock dividends, though they capitalize current or previous retained earnings, are not taxable as income in the hands of the recipients. Yet the latter may realize cash from them by selling them. If the sale is at a price higher than the stockholder's cost per share, as adjusted for the larger number of shares, the excess is taxed as a capital gain. The shareholder enjoys the further advantage of being able to choose when to sell his stock dividend. By selling a portion of his holdings, the stockholder may achieve substantially the same result without a stock dividend. In both cases, however, the sale of stock reduces his proportionate interest in the corporation.

Doubtless most withholding of corporate earnings is motivated by legitimate business considerations. It takes place because it offers corporate managements a flexible and convenient means of securing new capital funds for additional inventories, plant capacity, and similar assets, or for liquid reserves against adverse contingencies. Nevertheless, on the earnings withheld, the stockholders avoid current personal income taxes. If the retained earnings are profitably employed, the market value of the common stock can be expected to rise in reflection of the resulting growth in the corporation's resources and earning power, though not in any fixed relation to the

[8] *Utilization of Corporate Profits in Prosperity and Depression* (Michigan Business Studies, IX, No. 4, University of Michigan, 1941), p. 40.

earnings reinvested. In such instances the stockholders can look forward to receiving a varying and uncertain proportion of the withheld earnings in the form of a rise in the earning power and market value of their holdings, or in the form of a capital gain, taxable at the preferentially low rate, if they sell their stock. As we noted also, even the capital gains tax will be avoided if the stockholders leave their unrealized gains to their heirs.

An extreme example is provided by the Ford Motor Company. Between the middle of 1903 and the end of 1926 the market value of the Ford Motor Company rose from about $100,000, the original investment including intangibles, to about $1 billion, the price offered by Hornblower and Weeks, an investment banking firm.[9] The vast expansion in the company's earning power was doubtless the immediate cause of the increase in its market value, but was itself due, in considerable measure, to the capital resources added through reinvestment of corporate profits. No other additional investment was made by the stockholders. The earnings directly reinvested by the company in its business during this period amounted to $714,802,288. The remainder of the increase in value was attributable to the creation of goodwill.

John W. Anderson and Horace H. Rackham, who had each invested $5,000 in the Ford enterprise in 1903, sold out to Henry Ford in 1919 for $12,500,000 each. The book value of the stock held by each had increased approximately $10,000,000 through the direct reinvestment of corporate earnings during their ownership; in addition, each had received cash dividends of $4,935,750.[10] It might be said, therefore, that $10,000,000 of ordinary income was converted, through corporate reinvestment of earnings, into a capital gain for each. As the law did not distinguish between capital gains and ordinary income in 1919, Anderson and Rackham did not enjoy preferential rates on their share of the corporate profits reinvested on their behalf. On the contrary, the concentration of so much realized income in a single year, as well as the rise in the whole level and progression of the income tax scale, caused them to pay larger taxes than they would have paid if they had received the same aggregate amount in installments during the entire period.

On the other hand, Henry Ford's son, Edsel, who had acquired 42 percent of the company's stock by 1920, presumedly through

[9] Lawrence H. Seltzer, *A Financial History of the American Automobile Industry* (Houghton Mifflin, 1928), p. 133.
[10] *Ibid.*, pp. 112, 128.

gifts from his father, and Henry Ford himself completely avoided both capital gains and ordinary personal income taxes on their shares of the company's reinvested profits because they did not sell any of the stock. In the hands of their heirs, the 'basis' of the stock for measuring gains and losses became the value on the day of death, not the original cost to the Fords.

Some evidence in support of the *a priori* presumption that reinvested earnings tend to raise the market value of a corporation's shares is to be found in *Common-Stock Indexes, 1871-1937*. Alfred Cowles and his associates portray the average experience of those investing in common stocks 1871-1937 by noting what would have happened to an investor's funds, ignoring brokerage charges and taxes, "if he had bought at the beginning of 1871 all stocks quoted on the New York Stock Exchange, allocating his purchases among the individual issues in proportion to their total monetary value, and each month up to 1937 had by the same criterion redistributed his holdings among all quoted stocks" (p. 2). For the 67 years as a whole, the average earnings annually retained by the listed corporations was 2.5 percent of the market value of their common stocks, and the stocks advanced in price at the rate of 1.8 percent a year (pp. 42-3). In short, on the average, for every $2.50 of earnings retained by a corporation the market value of its stock rose $1.80.

The absence of any close and consistent relation between the amount of earnings a corporation retains and the market value of its common stock is often conspicuous in the short run, and is not uncommon for longer periods also. The prospective earning power of different enterprises is affected in highly unequal degree by equal additions to their invested capital from profits. A rapidly expanding and unusually profitable company may be expected to raise its earning power more than a slowly growing or declining one by the use of a given amount of additional funds; hence the former's stock may well rise more than the amount of earnings retained, and the latter's, perhaps less. Sometimes, moreover, the reinvestment of a large proportion of its current earnings merely permits a concern to maintain its previous earning power. In other instances it may serve merely to retard a decline in earning power. In such situations the reinvestment of profits may operate mainly to prevent or moderate a decline in the price of the stock. When the common stock equity is relatively small, as in many railroad companies, the reinvestment of $4 or $5 a share in a particular year may affect the price of the common stock

little if investors expect that the retained earnings will not appreciably improve the prospects of dividends for the common stock in the foreseeable future, but will be used only for increasing the margin of protection of the senior securities. If a corporate management decides to retain earnings to protect or expand the enterprise at a time when many of the stockholders would prefer to spend or invest the funds in other ways, the market may well add less to the value of the stock than the amount of earnings retained. These, among other, reasons help explain why the market prices of the common stocks of many well-known railroad, steel, oil, rubber, and other companies, through much of the decade of the 'forties, advanced less than the current additions to their book values from reinvested profits.

The deliberate retention of corporate earnings as a device for avoiding personal income taxes is doubtless much less prevalent than is sometimes charged, particularly among the larger corporations listed on national stock exchanges. When stock ownership in a corporation is widely diffused, as it is in most large corporations, the management is usually subject to strong and steady pressure by the numerous small stockholders to make the dividend payments as large as possible. And, in such cases, liberal dividend payments are often favored by the management as a means of enhancing the attractiveness of the stock to investors in the event of future stock financing. Some retention of earnings, sometimes substantial, may be essential to supplement the allowable deductions under the income tax for depreciation and obsolescence, as we have noted. Further, the mere maintenance of a firm's earning power may recurringly call for new investment in excess of the conventional depreciation charges against current operations because of changes in customer preferences with respect to products, in distribution practices, manufacturing techniques, and other factors. Beyond these requirements, the funds needed for a gradual expansion of the business can usually be secured more conveniently and economically through the direct reinvestment of earnings than through frequent offerings of relatively small amounts of new capital securities. Among smaller or closely held corporations the reinvestment of corporate earnings often affords the only practicable means of getting the capital funds needed for expansion.

Nevertheless, many persons have long been concerned that even the most justifiable retention and reinvestment of profits by corporations, beyond the amounts that are really supplementary deprecia-

tion allowances, impairs the effectiveness of the graduated rate schedule of the personal income tax by tending to substitute lower-taxed capital gains for dividend income for stockholders who sell, and by relieving those who do not sell from any personal income tax on their shares of reinvested corporate profits. As early as 1916, Thomas S. Adams of Yale University, who served as a consultant for the Treasury and the Congressional committees during the formative period of the federal income tax, in discussing the proposed Revenue Act of 1917, declared: "This question of taxing undistributed earnings carries us to the very heart of the difficult subject of business taxation. . . .

Should not the sole trader and partnership enjoy the same privilege as the corporation? Unfortunately, we cannot answer this question lightly in the affirmative. To say to every business man that the income tax is to apply only to amounts withdrawn from his business would seriously impair the productivity of the income tax. Moreover, if the corporation, partnership, and the active business men are to be taxed only on the sums withdrawn for consumption, we should be logically compelled to exempt all salaries and other personal income which is reinvested or saved. And we could not stop here. Much of our consumption is productive. We could not consistently exempt profits reinvested in the saloon business and tax the average citizen upon the savings which he invests in the education of his children.

. . . In short, the undivided profits of a corporation should be taxed at the rates which would apply if such profits were distributed to the shareholders. . . ."[11]

Professor Adams later changed his views concerning the correct method of achieving equality of treatment for reinvested corporate earnings and other saved income. In an address before the National Tax Association in 1923 he argued that the high level of income tax rates made it extremely desirable to exempt all saved income, personal and corporate, from the income tax.[12]

In one respect the capital gains attributable to the retention of corporate profits may be regarded as deserving a lower rate of tax than other capital gains or than most forms of ordinary personal income. Heavy income taxes have been paid by the corporation on

[11] *American Economic Review,* Vol. 8, No. 1, Supplement, March 1918, Dec. 1917, pp. 25-6.

[12] Evolution versus Revolution in Federal Tax Reform, *Proceedings, Sixteenth Annual Conference,* p. 306.

the reinvested earnings. For many stockholders the corporate rate alone is substantially higher than the rates they would pay if their share of a corporation's undistributed as well as distributed earnings were taxed as parts of their personal income. For some others, the sum of the corporate and the special capital gains taxes is larger than they would pay as individuals if their share of the corporation's total profits were included in their personal income. In short, if we regard the corporation income tax as a personal tax levied on the stockholders, rather than as an impersonal tax levied on the privilege of using the corporate form, capital gains attributable to the reinvestment of corporate profits have already been taxed through the corporate income tax.

However, as long as the corporation income tax is levied equally upon distributed and undistributed profits, the shareholder in a corporation that retains its earnings will enjoy a tax advantage over the shareholder in one that distributes its earnings, provided the former is able to obtain the equivalent of the reinvested earnings in the form of capital gains taxable at a preferential rate. Another difficulty is that not all capital gains from common stocks are attributable to reinvested corporate profits.

5 THE UNDISTRIBUTED PROFITS TAX

Congress has attempted to meet this problem at different times in one or more of three ways: (a) By ignoring the separate existence of the corporation and treating its earnings as those of the stockholders. This was done under the Civil War income tax acts, and is done at present, as noted several pages back, in the case of American shareholders of foreign personal holding companies. (b) By imposing corporation taxes designed to yield substitute revenues for the personal income taxes avoided through withholding corporate profits. The traditional corporation income tax, which involves a double tax on distributed corporate income, is regarded by some in this light. But the corporation income tax does not allow for differences in the dividend policies of corporations or in the amounts of personal income stockholders receive from other sources. (c) By imposing such severe taxes on undistributed earnings as to force their distribution — the present policy with respect to personal holding companies.

When the Senate Finance Committee first reported the bill that became the Revenue Act of 1917, it included a provision for a 15 percent tax, in addition to the regular corporate income tax, on

undivided earnings exceeding 20 percent of the total net income. In the Act as finally passed, the 20 percent exemption was eliminated and the rate of additional tax was cut to 10 percent, applicable to the portion of the total net income, after federal income taxes, remaining undistributed 6 months after the end of the calendar or fiscal year, but the tax was rendered ineffective by a broad new exemption: "The tax imposed by this subdivision shall not apply to that portion of such undistributed net income which is actually invested and employed in the business, or is retained for employment in the reasonable requirements of the business, or is invested in obligations of the United States issued after September 1, 1917." The broad character of the permission to retain earnings without tax liability if such earnings are employed "in the reasonable requirements of the business" made it extremely difficult to prove tax liability; and the entire provision was repealed by the Revenue Act of 1918.

Further action in this direction was proposed in 1924, when the Senate approved the Jones amendment to the revenue bill then under consideration, providing for a schedule of tax rates on undistributed corporate earnings in addition to the ordinary corporation income taxes, but the House failed to pass the amendment. In 1927 a committee of the National Tax Association, reporting on 'Simplification of the Income Tax', declared: "One method might be to place a reasonable tax on the corporation on that portion of the income which it does not actually distribute. It is impossible to make this amount even roughly approximate the revenue which would be collected, if complete distribution were made, as the conditions vary in each and every corporation. It should therefore rather be considered as a premium tax paid by the corporation for its stockholders, in exchange for retaining the earnings in the business and thereby postponing the normal and surtax until a future day. For that purpose a tax of 10 percent on that amount of its net income which exceeds the dividends paid out in any year would be a reasonable tax.

Argument has been made that this form of tax is uneconomic, because it creates an incentive to pay out dividends instead of plowing the profits back into the business. One answer might be the question, 'Why should the Government permit corporations to accumulate partly tax-paid surplus to plow back into the business, where it insists on the full tax on surpluses of partnerships and individuals, even though they are plowed back into the business? The

argument of an individual that he should receive an exemption from tax on that part of his year's earnings which goes back into his business would receive short shrift.'

In his message to Congress on March 3, 1936 President Roosevelt proposed a radical solution of the problem: the complete repeal of the corporation income, capital stock, and declared-value excess profits taxes and the substitution of graduated taxes on *undistributed* corporate profits only. The rates were to be high enough to encourage the current distribution of most corporate earnings, thereby subjecting them, when received by the shareholders, to the individual income tax rate schedule, and to compensate the Treasury for revenues lost through nondistribution. After extended committee hearings, Congress adopted the President's recommendations in part in the Revenue Act of 1936 by imposing graduated taxes on undistributed corporate earnings, but refused to remove the ordinary corporation income, capital stock, and declared-value excess profits taxes. The tax rates imposed on undistributed corporate earnings were 7 percent on the first 10 percent, and 12 percent on the next 10 percent, 17 and 22 percent respectively on each of the next two 20 percent segments of income retained, and 27 percent on the remainder. Banks, insurance and mutual investment companies, and corporations in receivership were exempted, and special relief provisions were included for corporations under contract to restrict payment of dividends or to use a stipulated portion of earnings to discharge debts, and for corporations with net incomes of less than $50,000.

The new law stimulated the distribution of dividends in 1936 and 1937, years of relatively good business and large profits. But with the recession that became evident in the second half of 1937, corporate officials increasingly demanded the repeal of the undistributed profits tax.

Certain features of the law were harsh. No allowance was made for the fact that the net income reported for any single year is essentially an estimate for which a margin of error, in the form of some retention of earnings tax-free, might well be allowed. Inadequate relief was provided for corporations that, because of deficits in their capital structures, could not pay dividends without violating state laws. The tax was hard on corporations that had incurred debts on the assumption that these could be retired out of earnings without penalty taxation. No retention of ordinary income tax-free was permitted to offset disallowed net capital losses (capital losses were

5.9+a

5.9+a

4 exemptions, would add less than $15,000 to his income after income taxes if his employer doubled his salary to induce him to stay. But if he secured an automobile dealership, incorporated the enterprise, and gave it his full energies and talents while paying himself only a small salary, he would avoid a current individual income tax on most of the earnings attributable to his services, leaving these, after corporation income taxes, to be reinvested by his company as a part of its undistributed profits. In this way he would be converting personal compensation into potential capital gains. He could avoid current individual income taxes on the interest and profits earned by the capital he invested in the business also, leaving these current earnings to be reinvested by the corporation. He might enjoy other tax advantages by charging off as corporate expenses various outlays made on his behalf for more or less personal consumption, such as the cost of an automobile, perhaps with chauffeur, and a portion of the cost of travel and entertainment. If, after a time, he decided to sell out, the increase in the value of his holdings would be subject only to the capital gains tax, and he and his heirs would escape this tax too if his holdings were passed on to his heirs as a part of his estate.

The extent to which a closely held corporation can be used effectively to save taxes for its owners varies with the relative levels of corporation and personal income taxes, with the surtax brackets of the shareholders, with the applicability of Section 102 to the retained earnings and the extent to which it is enforced. Under the high income and excess profits taxes imposed on corporations during World War II, many business men with moderate incomes found it more economical from a tax standpoint to transform their corporations into partnerships. For many with large incomes, on the other hand, personal income tax rates have been so high in recent years that the conversion of the fruits of personal efforts and capital into unrealized capital gains through closely held corporations in the manner just described has offered a tax saving, especially in years when an excess profits tax was not in effect.

Viewed as penalties designed to discourage deliberate tax evasion, the surtax rates imposed for "improper accumulation of corporate surplus" may be too low to be fully effective. In his *Business Tax Guide for 1947,* J. K. Lasser advised his readers (p. 29): "Penalty tax rates on corporations are often considered relatively low. Sometimes, it may pay you to risk the tax. The rate is only 27½ percent on the first $100,000 of undistributed earnings. Stockholders who

have incomes over $6,000 pay income taxes of over 27½ percent. Hence, they may lose nothing if they do not distribute all the earnings. *Caution:* If you distribute these dividends in the future the stockholders will have to pay the tax. But if these earnings are to be retained for long periods by the corporation, you should consider the whole problem with an eye as to how you may be benefited. Often a partial distribution is indicated."

It is probable, however, that the penalty rates themselves would be high enough to discourage most attempts to avoid taxes through retaining corporate earnings if they were reasonably certain to be imposed. The real difficulty is that the wide range of acknowledged legitimate reasons for retaining earnings not only protects corporations clearly motivated by business needs or contractual agreements, but makes the application of the tax to others highly uncertain, and hence invites attempts at avoidance.

7 DISTRIBUTING CORPORATE EARNINGS BY REDEEMING SECURITIES

If the organizers of a closely held corporation arrange to take the company's notes or bonds *pro rata* in exchange for a part of their capital contributions, they may subsequently receive distributions of its earnings in the form of a return of their capital through partial or complete redemption of the obligations. If the amount of earnings and of dividends distributed were the same, the latter would be taxable as ordinary income in the hands of the recipients; when received in redemption of bonds, the distributions are not taxable income.

The same principle was formerly applied also to preferred and common stocks. Instead of distributing taxable dividends, some corporations used equivalent amounts of earnings to make *pro rata* redemptions of their preferred stocks or *pro rata* purchases of common stock from their own stockholders. By an amendment to the Internal Revenue Code, Section 115 (g), Congress attempted to stop this form of tax avoidance, providing that when a corporation redeems its stock in such a manner as to make the redemption essentially equivalent to a taxable dividend, the distribution shall be treated as a dividend to the extent that it represents a distribution of earnings or profits.

Some corporations got around this provision by having a subsidiary buy a portion of their outstanding capital stock from their stockholders.[15] If the price paid was no more than the stockholder's

[15] A practice that was held outside the scope of Section 115 (g) in *Commissioner v. Wanamaker* (178 Fed. (2d) 10).

cost, he did not report any taxable income from the transaction; if it was more, he reported a capital gain equal to the difference. Meanwhile, if the redemptions were *pro rata,* he retained as large a proportional interest in the enterprise as before. The net effect was a tax free distribution of earnings or the partial conversion of what would ordinarily be dividend income into capital gains.

In the Revenue Act of 1950 Congress amended Section 115 (g) to make it cover the indirect redemption of shares in a parent company through purchases by its subsidiary, but the Senate refused to accept a further extension proposed by the House to have the Section cover cases in which both the issuing corporation and the acquiring corporation, though not related as parent and subsidiary, are controlled directly or indirectly by the same interests.

8 COLLAPSIBLE CORPORATIONS

A device that not only transforms corporate profits and personal compensation into capital gains but also avoids the corporation income tax and all danger of penalty for "improper accumulation of surplus" is the collapsible or so-called Hollywood corporation. Section 115(c) of the Internal Revenue Code provides that if a corporation is liquidated completely through the distribution of its cash and its assets in kind, the latter are to be valued at the fair market value as of the date of liquidation, and the total amounts received by the stockholders are to be treated as full payment in exchange for the stock of the corporation. In consequence, for a person who has held his shares more than 6 months, any gain resulting from the liquidation qualifies as a long term capital gain under the provisions of Section 117(a) (4). Hence, whatever the source of the increase in value of the corporation's assets during its lifetime, the entire increase is transformed into a capital gain in the hands of the shareholders. And by liquidating the corporation soon after it has developed its assets to a point where they are about to yield large revenues, the owners will avoid the corporation income tax on the latter.

The commonest form of this tax-saving device is one that has been used extensively in the motion picture industry by independent producers, actors, story writers, directors, and others. While the procedure varies in detail, its general character is as follows: The principal interested parties in a contemplated film create a corporation with nominal capital, usually about $2,000. They subscribe to the stock in proportions previously agreed upon for the division of

the profits. The picture may take from 6 months to a year to produce, and its cost may exceed a million dollars. The independent producer will frequently provide for about 40 percent of the total cost by entering into an agreement with one of the larger producing and distributing companies for both production and distribution. About half of the cost will be borrowed from a bank, and the remaining 10 percent provided by the independent producer in the form of his services.

As soon as the picture has been completed, and usually before its release, the producing company is dissolved and liquidated. At that time its principal asset is the completed picture, which may yield an income for some years. Each stockholder receives an undivided interest in the film, after allowance for prior claims, equal to the percentage of outstanding stock he had owned. Stockholders will value the film on their books at an amount equal to its total estimated earnings, minus indebtedness and prior charges against profits, including the estimated future distribution costs. They will report for income tax purposes as a long term capital gain the entire difference between this value and the nominal original cost of the stock, paying a 25 percent tax as a maximum on the difference. No further taxes, as a rule, will be paid by the former stockholders on their receipts from the production because these serve merely to amortize the value they had placed on the assets received in liquidation. If revenues from the distribution of the picture are found to have been overestimated, the stockholders will report the difference as an ordinary loss; if underestimated, as ordinary income. The Bureau of Internal Revenue has attacked the validity of these arrangements in some cases on the ground that they are merely subterfuges for avoiding ordinary income tax rates on salaries and profits, but no attack has been sustained on the broad principle that stockholders may transform their potential corporate and individual income into capital gains by dissolving a corporation at an opportune time.

A similar device is common in the building and construction industry. A special corporation is organized for each construction project and is liquidated upon completion of the project but before the buildings are sold. In the hands of the corporation or in those of individuals operating in their own names, the assets of the corporation would constitute "property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for

sale to customers in the ordinary course of his trade or business". As such they would not qualify as capital assets under Section 117 of the Internal Revenue Code. The difference between the amount received for the units comprising the construction project and the cost of construction, minus expenses, would be taxable as ordinary income if the corporation itself sold the units, and dividends distributed from these earnings would be taxable as ordinary income in the hands of the stockholders. Dissolving the corporation as soon as construction is completed or 6 months after the stock was issued, whichever date is later, eliminates these taxes. The stockholders report as a long term capital gain the difference between the market value of the assets they receive and the cost basis of their stock. As they sell the assets, they treat the proceeds as amortization of the gain and cost they had previously reported, except that differences between the estimated value and the actual receipts are reported as ordinary gains or losses.

Taxes may similarly be saved by liquidating an old corporation and distributing its assets in kind. For example, the owners of a closely held corporation possessing inventories that can be sold at an abnormally large profit liquidate it. The stockholders will then be subject only to a capital gains tax on the difference between the current market value of the assets they receive and the cost of their stockholdings; and they may continue the business as a partnership. Or, if a closely held corporation owns valuable patents or leaseholds it had acquired at a relatively low cost, and for which, therefore, its allowance for depreciation or amortization is small as compared with the income, a substantial tax saving can be accomplished by liquidating it. The stockholders would acquire the patents or leaseholds at their current high market value, pay the 25 percent capital gains tax, and transfer the assets at current value to a partnership organized for the purpose of carrying on the business. In this way, the partnership will acquire the patents or leaseholds at a value permitting a larger allowance for depreciation or amortization. The bigger deduction may result in a net over-all tax saving for the owners.

In the Revenue Act of 1950 Congress made a partial attack upon the problem of tax avoidance through collapsible corporations by enacting Section 117 (m): the gain realized from the sale or exchange (whether in liquidation or otherwise) of stock in a collapsible corporation is to be treated as ordinary income for stockholders who, with their close relatives, own 10 percent or more of the corpora-

tion's stock, if the gain realized during the year is more than 70 percent attributable to property produced by the corporation, and the gain is realized within 3 years following the completion of the manufacture, construction, or production of the property. A collapsible corporation is defined as one formed or availed of principally with a view to (a) the sale or exchange of stock by its shareholders or a distribution to its shareholders before the realization of a substantial part of the net income to be derived from the property produced or stock held, and (b) the realization by the shareholders of gain attributable to such property.

Other opportunities for tax avoidance through corporate liquidations could be reduced if the statute were modified to provide that the basis of property received by the shareholder in exchange for his stock upon the complete liquidation of a corporation that distributes its assets in kind shall be the same as the shareholder's basis for the stock. The effect of such a rule would be to tax the shareholder, when he sells the property, upon any appreciation in its value. If the assets he receives are capital assets in his hands, the gain would be treated as a capital gain; otherwise, as ordinary income. Another possibility is to amend the law to specify that a corporation that completely liquidates and distributes its assets in kind realizes taxable income or deductible loss in the amount of the difference between its cost or other basis and the fair market value of its assets at the time of the distribution. A more extreme possibility is to treat the excess of the value of the assets received by the stockholder over his cost as an ordinary dividend.

9 PARTNERSHIP LIQUIDATIONS

Selling an interest in a partnership too may offer an opportunity to avoid taxes. If the underlying assets contain substantial unrealized ordinary income, perhaps in the form of appreciated inventories, the withdrawing partner can treat his profit as a capital gain if he sells his interest as a whole. On the other hand, if the partnership's assets are worth less than they cost, liquidation of the assets by the partnership will establish a loss that is fully deductible from the net incomes of the partners from other sources.

10 STOCK PURCHASE OPTIONS AS PERSONAL COMPENSATION

Many corporations, including some very large ones with widely distributed ownership, have succeeded in compensating their executives partly through capital gains arising from stock purchase options granted them. The options are commonly contracts permitting the

recipient to purchase from the corporation, or from certain designated stockholders, stated amounts of the common stock during a stipulated period of years at a price below, equal to, or slightly above the market price at the time the option is granted. In this way the recipients are enabled to benefit from increases in the market value of shares without prior capital investment, and without subjecting the gain, it has usually been hoped, to ordinary income tax rates, but rather to the capital gains tax rates.

D. F. Zanuck, President of the Twentieth Century-Fox Film Corporation, received an option in 1940 good for 12 years to buy up to 100,000 shares of common stock from the corporation at $13 a share.[16] The closing price of this stock on the New York Stock Exchange at the end of June 1946 was just over $55 a share. The aggregate market value on that date of the 100,000 shares optioned to Mr. Zanuck was more than $4,200,000 greater than the amount Mr. Zanuck was required to pay for this stock, whenever he chose to take it up, under his option. Similarly, in May 1944 Harry F. Sinclair, President of the Sinclair Oil Corporation, received a 3-year option from the corporation to buy 150,000 shares of its stock at $13.25 a share, about 50 cents above the market price. *Time* commented as follows (May 29, 1944, p. 79): "Wall Streeters viewed Sinco's latest fast financial footwork as a slick scheme to get a big raise in salary, while avoiding the enormous top-bracket taxes. By the stock deal he can increase his long term capital gains, which are taxable at only 25 percent. . . .

Many a solemn proponent of the free enterprise system, knowing how difficult it is to build up an adequate capital position for executives, in order to make good corporate management worthwhile, pondered and argued with the question: How can U. S. business pay its top men the salaries they are really worth? But while slow-moving conservatives pondered, fast-moving Harry Sinclair might well smile."

The decision of the Supreme Court in *Commissioner v. Smith*, decided February 26, 1945 (324 U. S. 177), greatly circumscribed the possibilities of using stock options to transmute personal compensation into capital gains. The Court held that when a stock option is granted as compensation for services, its mere exercise when the market price is higher than the option price gives rise to ordinary taxable income equal to the difference, even if the market price was only equal to or even below the option price when the option was

[16] Standard and Poor's Corporation, *The Outlook*, Feb. 19, 1945, p. 920.

granted. The income is recognized upon the exercise of the option even though the recipient does not actually realize a profit by selling the stock. The Court declared that in some circumstances the option itself, unexercised, might be found to constitute compensation for services rendered.

The Smith decision dealt with a stock option clearly granted as compensation for services. In several cases the lower courts had previously ruled that various stock options given employees were *not* intended to constitute additional compensation.[17] The gains realized in connection with them qualified as long term capital gains if the stock had been owned the required period. In these decisions the courts drew a distinction between stock options granted as compensation for services and those granted to employees "in order to benefit the company by making the employees more interested in the welfare of the company . . ." (*Charles E. Adams v. Commissioner*). The Treasury Department interpreted the Smith decision as overruling this distinction, and on April 12, 1946 the Bureau of Internal Revenue issued an amended regulation (T. D. 5507), providing that all capital stock obtained by employees through stock options granted after February 25, 1945 be regarded as compensation for services in the year the stock is received in the amount the fair market value exceeds the option price.

Congress apparently decided that this policy was too stringent, for in the Revenue Act of 1950, Section 218, the Internal Revenue Code was amended to provide for nonrecognition of income from the grant or exercise of certain kinds of employee stock options, called "restricted stock options," and for capital gains tax treatment of profits resulting from the sale of stock acquired under them; and the new rules were made retroactive to options granted, modified, extended, or renewed after February 25, 1945 and exercised after December 31, 1949.

Roughly, a restricted stock option is defined as an option granted by an employer corporation or its subsidiary or parent corporation to an employee in connection with his employment to buy stock in any of such corporations, provided the option price is at least 85 percent of the fair market value of the stock when the option is granted, the option is not transferable except at death, and the employee receiving the option does not at that time own more than 10 percent of the combined voting power of all classes of stock of the

[17] *Delbert B. Geeseman,* 38 B. T. A. 258, *Herbert H. Springford,* 41 B. T. A. 1,001, *Gordon M. Evans,* 38 B. T. A. 1,406.

corporation, including the holdings of close relatives and his proportionate share of stock owned by a partnership, estate, trust, or corporation in which he has an interest.

If the option price is 95 percent or more of the fair market value of the stock when the option is granted, the entire profit realized on the sale of the stock is taxed as a capital gain, provided certain other requirements are met. If the option price is less than 95 percent but 85 percent or more of the fair market value of the stock when the option is granted, the difference between the option price and the fair market value when the option is granted or when the stock is disposed of, whichever is lower, is taxed as ordinary income when the stock is disposed of, and the balance is taxed as a capital gain. To qualify for such treatment, the stock must not be sold within 2 years of the grant of the option or within 6 months of the purchase of stock under the option, and the holder of the option must exercise it while an employee, or within 3 months after he ceases to be an employee, of the granting corporation or its parent or subsidiary.

Other devices have been used to afford the possibility of capital gains as a means to attract, stimulate, and reward personal talent and effort. Stock has been sold to valued employees in exchange for their promissory notes, the notes containing a clause limiting the recourse of the creditor to the seizure of the stock itself in the event of nonpayment. Like the stock option, this device puts the employee in a position to benefit from an enhancement in the value of the stock without prior capital investment and without risk. Another expedient was employed by Paramount Pictures, Inc., which privately sold $2,000,000 of 2¾ percent convertible debenture notes to its president, Barney Balaban, in December 1944. The notes were convertible at the rate of $500,000 a year into common stock of the corporation at $25 a share. The board of directors, in a letter to the stockholders dated June 9, 1944, clearly stated that the purpose of the arrangement was to give Mr. Balaban an adequate incentive to remain with the enterprise: "Your directors have been trying for the past few years to find a way to give Mr. Balaban a strong incentive to remain as President of the Company for many years to come. They offered Mr. Balaban options on common stock of the Company, but Mr. Balaban was personally opposed to straight options; he felt that he should give something to the Company therefor, above and beyond serving it.

After long and serious study, your directors finally proposed to Mr. Balaban that he purchase a $2,000,000 convertible note of your

Company on the terms set forth in the Proxy Statement. In this way, Mr. Balaban would be tied to the Company with a $2,000,000 investment on which he would make no profit unless your Company's stock rose above the conversion price and unless he remained with the Company long enough to exercise the options.

While your Company does not need to borrow $2,000,000 from Mr. Balaban this sale of the note is considered more advantageous to the Company than the granting of straight options, for it immediately provides the Company with $2,000,000 in cash out of which it may purchase Paramount stock in the open market. *To the extent of such purchases dilution of your Company's stock will be prevented.*"

The market price of the stock rose above $80 a share in the spring of 1946, before the shares were split up 2 for 1. The convertible privilege of Mr. Balaban's debentures contained a clause adjusting the conversion price to offset the effects of such increases in the number of shares.

In view of the Smith decision and subsequent rulings of the Bureau of Internal Revenue, this and similar devices may be challenged in the courts. But other means of converting personal compensation into capital gains have received express statutory authority in connection with profit-sharing, stock-bonus, and pension plans, discussed in the next section.

11 DEFERRED COMPENSATION, PENSION, STOCK-BONUS, AND PROFIT-SHARING PLANS

Liberal retirement allowances to attract, retain, and compensate leading salaried officials of business corporations have expanded rapidly in recent years. An employer's current contributions to an employee's future retirement or separation benefits are not currently taxable as part of the latter's income, even if nonforfeitable, when made under a formal pension, profit-sharing, or stock bonus plan conforming to statutory requirements. The employee becomes taxable on his deferred compensation and the accumulated income on it only when and as they are received. Hence such arrangements usually reduce the individual income taxes of the recipients by deferring a portion of their effective compensation from the years it is earned and in which it would be taxed at higher bracket rates to years in which their other income and effective tax rates will presumably be less. Moreover, if the benefits are paid in a lump sum after separation from service, they are taxed as a long term capital gain.

On the other hand, the employer may deduct currently from his

taxable income the full actuarial cost or other definite and reasonable appropriations for valid pension, profit-sharing, and stock bonus plans established for the exclusive benefit of employees and their beneficiaries. The trusts created under such plans are also tax exempt. This favorable tax treatment became more pronounced under the high corporate and personal income tax rates of the war and postwar periods. Consequently, the movement toward a wider adoption of corporate pension plans, which owed much to an increasing sense of responsibility on the part of corporations for their employees generally, as well as to motives cited above, was greatly stimulated.[18]

To prevent the tax advantages of these plans from being exploited primarily for the benefit of a few managerial employees or the stockholders, and to prevent corporations from using the plans to reduce corporate taxes unduly in years of large earnings through extraordinary deductions for this purpose, Congress enacted various restrictions, which it greatly altered and elaborated in the Revenue Act of 1942 (Internal Revenue Code, Secs. 23 and 165), and the Bureau of Internal Revenue has since issued an increasing number of regulations (*R* 111). In general, plans that qualify under the Act for current deductibility of the employer's contribution, tax-exemption of the trust set up for employee benefits, and deferment of the employee's tax liability on the employer's contribution on his behalf must be formal and definite, made known to employees, cover a large proportion of employees, be nondiscriminatory and nondiscretionary, and render impossible the diversion of the funds for any purpose except the exclusive benefit of the employees and their beneficiaries.

An employer's contributions to employees under a plan that does not conform to the requirements of Section 165 must be included in his gross income for the year in which the contributions are made if the employees' beneficial interest in them is nonforfeitable.

Presumably to avoid the restrictions governing the preferential tax status of qualified plans, several large corporations have recently entered into individual employment contracts with their chief officials calling for stated retirement allowances, stock bonuses, or profit-sharing rights. If the employee's benefits under these contracts are specifically subject to significant contingencies, such as the completion of a minimum term of future employment, or if they

[18] The Bureau of Internal Revenue found in a survey that of more than 9,000 pension, deferred profit-sharing, and stock bonus plans adopted by American business enterprises by August 31, 1946, covering more than 3.5 million employees, only 659 had been established before 1940.

become void if he enters the employ of a competitor, the corporation's contributions to his pension reserves or other deferred benefits presumably cannot be taxed as his current income. He acquires a nonforfeitable right to the contractual benefits only after conforming to the prescribed conditions.

Substantial retirement allowances have been adopted for leading corporate officials in many supplementary pension plans or individual employment contracts since 1944, and in many instances no contribution is required from the employee. The main provisions of some of these are to be found in data supplied to the SEC. Under a supplemental noncontributory retirement plan adopted in 1947 by a large can manufacturing enterprise, the three highest paid executives are entitled upon retirement to noncontributory annuities of $69,467, $48,344, and $36,139 respectively, in addition to pensions arising from the company's general pension plan to which employees contribute a part of the cost. The values of these annuities at age 65 are approximately $750,000, $500,000, and $300,000 respectively. A well-known producer of proprietary medicines and packaged foods has an employment contract with its leading official by which it agrees to pay him upon the termination of his employment, or to his heirs, $15,000 a year for as many years as the official shall have been employed after May 1, 1935. If he should continue with the company in his present capacity until he is 65 he will have accumulated the right to annual payments of $15,000 for 26 years, in addition to his rights under the company's general retirement plan. The noncontributory pension plan of an important steel producer provides annual retirement benefits ranging from $32,892 to $74,453 for 9 of the leading officials. Another steel company has entered into an employment contract with its chief executive officer calling for a life annuity, after 6 years of employment, when the official will be 61 years old, of $25,000, with payment for 8 years certain. The value of such an annuity will then be approximately $425,000. A major rubber producer has an employment contract with its president stipulating that it will pay deferred contingent compensation in annual instalments for 14 years unless he engages in a competing business within 3 years after he leaves it. A New York department store has similar contracts with 9 of its executives calling for deferred contingent compensation for 15 years after they leave it.

In the case of qualified pension, profit-sharing, and stock bonus plans ordinary income is converted into formal capital gains when the benefits are paid in a lump sum after separation from service

[Sec. 165, (b)]. Some plans specify the right to a lump sum settlement. Even when they do not, a corporation that carries its own pension reserves may be quite willing to commute the right into a capital sum at the annuitant's request. Some annuitants might well desire to sell their rights, particularly if they terminate at death, in order to add to their estates, or to obtain the advantage of the lower capital gains tax rate and invest the remaining proceeds in tax-exempt securities. Similarly, when an accumulation of stock bonuses is paid to a retiring employee, it is taxed as a capital gain though it represents compensation for personal services. Whether lump sum settlements of retirement allowances under nonqualified plans and individual employment contracts will also be accorded capital gains tax treatment under current law has yet to be determined.

In effect, the deferred compensation arrangements that qualify under the statute, and perhaps some that do not, permit an employee to accumulate savings and build up an estate free from the individual income tax during the period of accumulation. If, upon separation from service, he takes all his benefits in a lump sum, no tax is levied on the part that represents his own direct contributions, and only the preferential capital gains tax rate is applied on the remainder. If he takes his accumulations in the form of annual payments, no tax is levied on their capitalized value, even though the payments are scheduled to continue long after his death and are equal in value to a large capital sum, though ordinary income tax rates will apply to the part of the annual benefits that exceeds the allocated amount of his own direct contribution.

While qualified pension, profit-sharing, and stock bonus plans entail preferential tax treatment for some kinds of personal compensation, Congress has decided that it is good public policy to encourage retirement allowances and profit-sharing in this way.[19] Besides supplementing the Federal Social Security System for ordinary employees, they enable corporations and their executives to offset in some measure the effects of heavy personal income taxes in preventing highly-paid officials from accumulating an estate sufficient to provide income in retirement comparable with their incomes during their working lives; salaried positions are thereby made more attractive. The principle of retirement allowances as such is less commonly criticized than the absence of similar preferential tax treatment for the savings of professional men, partners, and other individuals who

[19] Report of Ways and Means Sub-Committee, 75th Cong., 3d Sess., Jan. 14, 1938, p. 48.

must accumulate resources for their old age outside of qualified pension systems.[20]

12 OTHER RIGHTS TO FUTURE INCOME

The whole question of when rights to future income should be deemed to constitute capital assets for tax purposes raises difficult practical problems. In some instances taxpayers can convert into capital gains their rights to future ordinary income from patents, copyrights, oil and gas leaseholds, annuity and insurance contracts, and life interests in trust estates. In other instances the net gains from sales of rights to future income have been held to constitute ordinary income.

From an economic standpoint it is impossible to draw a clear line between a capital asset and rights to future income precisely because the value of a capital asset is derived from and consists of the value of the future incomes that are expected from it. On the other hand, when the future incomes are fairly definite in amount, the sale may represent, in effect, only an advance collection of ordinary income. If the net proceeds are spent on consumption, the seller derives a tax advantage if they are taxed as capital gains. If they are reinvested, however, this advantage may be reduced or more than offset by the additional taxes at ordinary rates on the income derived from the reinvested funds.

When rights to receive rents or dividends are sold, the proceeds are usually taxed as ordinary income. When the future payments consist in large part of a return of capital, as in the case of insurance and annuity contracts, the net proceeds are usually taxed as capital gains. When the rights are somewhat indefinite and are deemed not to constitute 'property held primarily for sale to customers in the ordinary course of trade or business', they are frequently regarded as capital assets whose sale gives rise to capital gain or loss. Before 1950 a nonprofessional author such as General Eisenhower could obtain capital gains tax treatment for the net proceeds from his book by selling exclusive rights to it. He did not need to receive the purchase price in a lump sum. The sales contract could provide that the price be paid in installments calculated in the same manner as royalties. The taxpayer then had the additional advantage of being able to

[20] See John R. Nicholson, Pensions for Partners: Tax Laws Are Unfair to Lawyers and Firms, *American Bar Association Journal,* April 1947; Harry J. Rudick, More About Pensions for Partners, *ibid.,* Oct. 1947; Harry Silverstein, A New Tax Proposal, *American Mercury,* March 1947.

report the gains over a series of years. The price itself did not need to be a fixed number of dollars. A publisher could contract to pay the author a nominal sum at the time of the sale of the exclusive publishing rights, plus a stated percentage of the receipts from the sales of the book. The same principle may still be applied in connection with the sale of exclusive rights under a patent. Professional authors and inventors, however, were and are still regarded as earning ordinary income through such sales because the property is said to be held by the taxpayer for sale in the ordinary course of his trade or business. By section 210 of the Revenue Act of 1950, amateur authors and artists but not amateur inventors were put in the same tax position as professionals: their gains from sales of the products of their personal efforts were made taxable as ordinary income.

In some circumstances the courts have decided that the net proceeds from the sale of other rights to future income must be taxed as ordinary income. A lump sum payment to a retiring partner who was entitled to a share of future fees (90F. (2d) 590) and the sum paid for a promise not to compete (82F. (2d) 268) have been held to be ordinary income. Royalties under an oil and gas lease are ordinary income, but the unlimited conveyance for cash of a lessor's reserved royalties under an oil and gas lease may be treated as a sale of a capital asset (G. C. M. 12118). A woman who sold her life interest in a trust estate was held to have incurred a deductible capital loss when the sales price was less than the value of her interest on the date of the decedent's death (157F. (2d) 235).

Widely reported in the press during the summer and fall of 1948 were the attempts of the owners of the Amos 'n Andy and Jack Benny radio shows to transform into capital gains the ordinary income they were receiving from them. The owners of the Amos 'n Andy program were reported to have sold their rights to the show to the Columbia Broadcasting System for a capital sum. The owners of the Jack Benny show did likewise, but the Bureau of Internal Revenue apparently decided to distinguish the latter case from the former on the ground that new actors could be substituted in the former program without material damage, giving it the character of a capital asset, whereas the personal services and reputation of Mr. Benny and his staff were decisive elements in the value of the latter program. These transactions aroused so many inquiries that the Commissioner of Internal Revenue was moved to issue a statement (S 952, Jan. 3, 1949): "The tax effect of any business transaction is determined by its realities.

Accordingly, proposals of radio artists and others to obtain compensation for personal services under the guise of sales of property cannot be regarded as coming within the capital gains provisions of the Internal Revenue Code. Such compensation is taxable at ordinary income tax rates."

13 CONVERTING INTEREST INTO CAPITAL GAINS

Purchasing obligations at a discount

Interest income is frequently transformed into a capital gain for tax purposes, although to a much lesser extent than appears to be technically possible under the law. The simplest case is the purchase of corporation bonds at a discount. Bonds that bear a lower contractual rate of interest than the effective yield the market demands naturally sell at a discount. The discount, supplementing the contractual interest payments, must be sufficient to raise the effective rate of return on the amount actually invested to the going market rate. But when the full principal amount is paid off at maturity or at an earlier call date, the investor is permitted to treat the difference between his cost and the amount received upon redemption as a capital gain.[21] From an economic standpoint, however, this so-called capital gain is a part of the true interest income. It does not arise because of a change in interest rates or credit standing, but merely because a part of the interest return is not expressly so designated and is not received until the obligation matures.

Utilizing this legal situation, a lender can obtain a direct tax advantage at no cost to the borrower by arranging to have the loan take the form of the purchase of the borrower's low interest obligations at a substantial discount. Thus, a lender who purchased a 10-year 2 percent note at a discount of 19.95 percent would really be getting an effective interest yield of 4.5 percent annually. For income tax purposes, however, nearly half of his true interest return would take the form of a capital gain upon maturity (the current interest payments would amount to approximately 2.5 percent on his actual investment). Similarly, a 20-year mortgage obligation bearing a nominal rate of interest of 2 percent would yield 4.5 percent if purchased at 67.77 cents on the dollar, but ordinary income taxes

[21] On the other hand, he is permitted to amortize a bond premium. On fully tax-exempt bonds, Section 125 requires purchasers to amortize premiums during the life of the bond; on partly tax-exempt bonds, only corporations are required to do so; and on fully taxable bonds, both individuals and corporate purchasers may choose whether or not to amortize.

would be assessed only on the current interest receipts, while the capital gains rate would be applied to the $32.23 of postponed interest payments received at maturity on each $100 of nominal principal. The tax advantage of the lender is not accompanied by a corresponding disadvantage to the borrower because the discount, amortized over the life of the obligation, is no less deductible for tax purposes than direct interest expense. And the borrower too may gain if competition permits him to force the lender to share his tax advantage in the form of a lower effective interest charge.

Raising the selling price in lieu of interest

J. K. Lasser, in his widely used guide to taxpayers, advises: "If you sell a long term asset at a profit and payment is to be made in instalments over a period of years, it may be to your advantage if the sales contract did not provide for interest on the subsequent payments, and in lieu thereof, the sales price was increased."[22] In *Commissioner v. Caulkins* the Sixth Circuit Court of Appeals went so far as to hold that a man who made 10 annual payments of $1,512 each for the purchase of an "accumulative investment certificate," entitling him to $20,000 at the end of the 10 years, was subject to capital gains rather than ordinary income taxes on the amount of the increment he received above cost, though the increment was identical in amount with interest at 5 percent compounded annually.[23]

Switching out of securities with high book yields

When market rates of interest fall, owners of government and other bonds who amortize premiums and discounts in reporting their interest can reduce their taxable interest by selling the bonds and immediately reinvesting most of the proceeds in the same or similar bonds at the higher market prices. Their profits will be bonafide long term capital gains and will be so taxed if the bonds have been held the required interval (more than 6 months at present). The newly purchased bonds will yield substantially the same gross income in dollars as the bonds sold (ignoring commissions), but more of this income will be charged off as a return of capital because of the higher prices paid, and hence will not be taxed. In consequence, a part of the former taxable interest income will have been converted into capital gains. This example differs from the preceding in that the capital gains are genuine, though it can be contended in some cases that they represent mainly the rewards of professional skill.

[22] *Your Income Tax* (1945 ed.), p. 122.
[23] July 24, 1944, 114 Fed. (2d) 482.

Banks and similar institutions have been moved by tax considerations to realize such capital gains on a large scale in recent years, though the possibility of their doing so was created by the marked and nearly continuous decline in interest rates. In *Taxes — The Tax Magazine,* March 1946, S. S. Lawrence, advised bankers: "Sell taxable government bonds held over six months which show a profit after amortization. Buy back the same issues immediately. Any dealer will put through this trade at a cost of not more than 1/32. A tax of twenty-five per cent is paid and the bonds are back on your books at the new higher cost. The ordinary income is thereafter reduced because the yield is lower.

For instance, if a bond bought a year ago at a yield of 1.50 percent is sold and repurchased at a yield of 1.30 percent, the taxable ordinary income hereafter is only $13.00 annually instead of $15.00. If the bond has five more years to go, the ordinary income will be $10.00 less than if it had not been rolled over. This $10.00 is not lost because it has been taken out at the time the bond was sold and repurchased, but is the profit on the sale and subject to a twenty-five percent tax rate rather than the higher rate applicable to current income.

No gross income is lost except the broker's commission of 31¼¢ or less per bond. The saving is the differential between the ordinary rate and the long term capital gain rate, less 31¼¢. On the basis of thirty-five percent average tax on ordinary income for the next few years and twenty-five percent on long term gains, the saving effected in this case would be $1.00 less 31¼¢ or 68¾¢ per bond. On $100,-000 par value of bonds, the saving or, as we could describe it, the extra tax-free income, would be $68.75; on ten million dollars, $6,875.00.

. . . The writer takes a keen pleasure in converting income taxable at thirty-eight percent (fifty-three percent for Class II banks) into the same amount of income taxable at twenty-five percent. . . ."

14 RENTS

The chief method of converting current rental payments into capital gains appears to be that of making excessive deductions for depreciation from the gross income of apartment houses, office buildings, hotels, and similar structures. The Bureau of Internal Revenue allows the owners of such buildings to depreciate them at the rate of 2-3 percent a year. This often causes the owner's cost basis to decline more rapidly than the economic life or market value of the property.

When the owner sells, the difference between his reduced cost basis and the sales price is taxed as a capital gain. The part of the gross rental income that had been unnecessarily treated as an allowance for depreciation is in this way converted into a capital gain. This frequent possibility, together with the convenience of being able to reduce their annual taxable incomes by a non-cash expense (depreciation), has made the ownership of income-producing improved real estate attractive to many wealthy investors. The purchaser of a building is not required to adopt the depreciated basis of the seller as the basis for his depreciation allowances. A building that has been depreciated from $200,000 to $50,000 in the hands of one owner may acquire a basis of $150,000 in the hands of the purchaser.

In the oil and gas industry, the cash sales of rights to future leasal incomes of oil are converting ordinary income into profits taxable at capital gains rates. A corporation owning a leasehold in oil and gas lands on which producing wells have just been completed estimates the gross income for the next 12 months after deduction of gross production and severance taxes and without regard to development and operating expenses. The corporation then sells to a bank, at a discount representing interest, an in-oil payment right (a right to receipts of oil) for the expected gross income. On the ground that the in-oil payment right constitutes real property held more than 6 months and used in its trade or business, the corporation reports the gain on the sale as one taxable at a maximum rate of 25 percent under Section 117(j). If it had sold the oil or gas as it was produced, its receipts, minus expenses and other allowable deductions, would have been taxable as ordinary income.

15 CONVERTING CAPITAL LOSSES INTO ORDINARY LOSSES

Since 1942 the Internal Revenue Code has provided that depreciable property and real property used in trade or business are not capital assets, but gains on them shall nevertheless be treated as long term capital gains if the assets have been held more than 6 months, while losses on them shall be treated as ordinary losses.[24] These provisions have been used, especially in years of exceptionally high corporate taxes, to shift to the government large real estate losses not incidental to ordinary business operations or not due to wartime or other involuntary conversions. A department store, for example, whose land

[24] Sections 117(a)(1) and (j). The net loss or gain reported must cover the net results of transactions in these assets and of involuntary conversions of such property as well as transactions in long term capital assets.

and buildings had depreciated $5,000,000 over many years, may deduct the entire amount from the income of the year the loss is technically realized. If that year happens to be a year like 1944, when corporation income and excess profits taxes were high and corporate incomes large, the corporation might easily save in taxes nearly the entire amount of its reported loss. At the same time, by leasing back the property from the purchaser as a part of the selling arrangement, it may retain the use of the property. Numerous transactions of this type have been reported to the Bureau of Internal Revenue in recent years.

16 DEVICES TO POSTPONE OR AVOID TECHNICAL REALIZATION OF CAPITAL GAINS

Since a capital gain is not taxable as such until it is realized in a technical legal sense by sale or taxable exchange, investors and their lawyers have sought various devices to avoid technical realization while nevertheless achieving its approximate equivalent. The whole complex body of law relating to corporate reorganizations and to other tax-free versus taxable exchanges of property has largely grown out of the desire of Congress to permit the postponement of tax liability income in various cases where the continuity of ownership is essentially uninterrupted, and out of legislative action and court decisions restricting the types of transaction in which this is possible.

Tax-free exchanges of property are of two kinds: those in which the courts have held the investor obtains no separable profit or other income; and those Congress has expressly declared to be tax-free. In theory a tax-free exchange of either kind merely postpones recognition of the gain for tax purposes. The basis of the cost on which the investor will calculate his gain upon ultimate sale is not changed. As noted in Chapter 2, Congress was moved to provide for the nonrecognition of a taxable gain or loss in connection with certain types of exchange by the desire to avoid obstructing various common transactions in capital assets, notably between corporations and between corporations and their stockholders.

When mere postponement of tax liability is the sole result, no significant tax avoidance takes place. A taxpayer with such an unrealized capital gain may of course choose to realize it in a year when he suffers an offsetting capital loss, and in this way escape the tax on it entirely. As long as the offsetting is real, however, it only extends the opportunities already offered in the tax system for averaging capital gains and losses over a period longer than a year, an

extension that has much to commend it from an equitable standpoint. But in many other cases the real effect of tax-free exchanges is to eliminate the taxation of capital gains altogether. The investor is enabled without tax payment to convert his gains into property more suitable for leaving to his heirs. With his death the contingent tax liability on his capital gains is eliminated. His heirs do not inherit the cost basis of his holdings, but place them on their books at their values on the date of his death. If unrealized capital gains embodied in property transferred at death were taxable as such, the ultimate tax avoidance now possible by postponing technical realization of capital gains would be largely eliminated.

A common example of tax avoidance of this kind is a corporate reorganization whereby the owners of a smaller or more localized or otherwise more specialized enterprise sell it at a profit to a large, more diversified corporation in exchange for some of the latter's common stock. By so doing, they achieve the same result as if they had sold their holdings for cash and invested the money in the stock of the larger corporation, except that a capital gains tax would be payable in the latter case and is not payable in the former. The stock they acquire may be highly marketable, may constitute excellent security for loans, and may enable them to transmit wealth to their heirs in a form they deem more desirable than their preceding holdings or even cash itself. Perhaps the most extreme example would be the exchange of ownership in a mercantile or industrial enterprise at a profit for shares of stock in an investment trust company. The proceeds would perhaps be in precisely the form in which the sellers would have invested the fruits of a cash sale, yet no taxable gain or loss would presumably be recognized unless and until they sold the stock received.

As implied in the preceding paragraph, a man with a very large unrealized capital gain may sometimes enjoy its substance without incurring a tax liability on it by borrowing a large fraction of its value, using the proceeds of his loan for consumption or new investment, and retaining title to the property embodying his gain until his death. Suppose, for example, he owns a piece of city real estate that cost him $60,000 and is now yielding a net rental income of $40,000 a year from a long term lease and is worth $500,000. If he sells, he will be subject to a tax of $110,000. If he borrows $400,000 on the property, perhaps with his liability limited to the loss of the property, he will obtain in cash more than would be left to him after taxes from an outright sale; and he will still own a 20 percent residual

equity in it which he can pass on to his heirs free from the capital gains tax.

We do not know how much revenue is lost to the government through the various methods whereby ordinary income is made to assume the form of capital gains. Such methods have doubtless been used far less extensively than their tax-saving possibilities would lead one to expect. Ignorance of these possibilities has probably been an important factor restricting their adoption. But as knowledge of them becomes more widespread, especially through professional tax advisers and published discussions of clarifying court decisions, they are likely to become increasingly exploited.