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SENATE

REPORT
No. 94-1392

TAX TREATMENT OF SECURITIES ACQUIRED FOR BUSINESS REASONS AND NOT AS AN INVESTMENT; WITHHOLDING OF INCOME TAX ON CERTAIN GAMBLING WINNINGS

OCTOBER 1 (legislative day, SEPTEMBER 30), 1976.—Ordered to be printed

Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 10902]

The Committee on Finance, to which was referred the bill (H.R. 10902) relating to the income tax treatment of securities which are acquired for business reasons and not as an investment, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY

The House-passed bill provides that a taxpayer cannot get ordinary loss treatment on disposition of a security unless he has filed a notice with the Internal Revenue Service that the security was not acquired as an investment. The notice must be filed before the 31st day after acquisition. If the notice is filed, then any gain on disposition is ordinary income, not capital gain. The committee agreed to the House-passed bill and added an amendment providing certain technical modifications.

In addition, the committee added an amendment which changes the provision dealing with withholding of income tax on gambling winnings contained in the Tax Reform Act of 1976. Under the Tax Reform Act, withholding on the winnings from "wagering pools" (which include horse races) applies to winnings of $1,000 of more regardless of the odds involved in the wager. The committee amendment changes this requirement in the case of paramutuel wagering on horse races, dog races, and jai alai to require withholding of tax where the winnings are $600 or more and the odds are at least 200 to 1 or more. In addition, the committee amendment eliminates the reporting requirement for any winnings to which withholding applies.

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II. General Statement

A. TAX TREATMENT OF SECURITIES ACQUIRED FOR BUSINESS REASONS AND NOT AS AN INVESTMENT

Present law

Under present law, the treatment of gain or loss on a sale or exchange of a stock or other security depends on whether the security is a capital asset in the hands of the taxpayer. Any stock or other security which is held for investment is treated as a capital asset and, if held for more than 6 months (or for the longer holding period provided by the Tax Reform Act of 1976), is accorded the more favorable long-term capital gain treatment (that is, only one-half of the gain is subject to tax). Capital losses, however, are limited for both individuals and corporations as to the amount that may be deducted in a year. If a stock or other security is held for business purposes, generally it is not treated as a capital asset and, therefore, any gain is ordinary income and any losses are ordinary losses (which are deductible in full in the current year). As a result, if a taxpayer has a gain on a sale of a stock or other security, he usually prefers to have capital gain treatment. However, if there is a loss from the sale, he usually prefers to have ordinary loss treatment.

Under present law (sec. 165(g)(1)) a loss resulting from a security becoming worthless during the taxable year is a capital loss if the security is a capital asset. The loss is ordinary if the security is not a capital asset in the taxpayer's hands. A special statutory rule also provides ordinary loss treatment for a security held by a parent corporation in a controlled subsidiary where the security becomes worthless during the taxable year (sec. 165(g)(3)).

Reasons for the provision

The question of whether a security (or any asset) is a capital asset is factual and depends on the facts and circumstances of the particular case, i.e., whether the taxpayer acquired and held the security as an investment or whether he acquired and held it for sale to customers in the ordinary course of business or held the stock for use in his business.

In some situations, individuals or corporations which have acquired stock and later sold that stock at a loss have successfully argued that although the stock may technically be within the statutory definition of "capital asset" (see sec. 1221), they acquired the stock for a purpose so closely related to their trade or business that loss from a later sale should be deductible as an ordinary loss (under sec. 165(a)) or as an ordinary and necessary business expense (under sec. 162(a)). If the stock has become worthless, taxpayers have also argued that the loss should be ordinary rather than capital (and that the general rule of sec. 165(g)(1) should not apply).

Purchases of stock to protect the taxpayer's source of income or his source of supply of another company's products have been held to be situations of this general kind where taxpayers have often been upheld in treating their loss as ordinary rather than capital. Few, if any, situations have arisen, however, where in similar circumstances a gain on later sale of the stock or securities has been held to be ordinary income.[1]

The committee has concluded that, under present law, a taxpayer can too readily obtain the best of both worlds when he sells or exchanges a stock or other security and knows whether he has a gain or a loss, by contending that he did not hold the stock as an investment (if he wants ordinary loss treatment) or that he did hold it as an investment (if he wants capital gain treatment).

Explanation of the provision

The House-passed bill adds a new provision (sec. 1240) which requires a taxpayer (including individuals and corporations), in order to obtain ordinary loss treatment on a sale or exchange of a security, to notify the Internal Revenue Service before the 31st day after initially acquiring the security that the acquisition was not made as an investment.

For purposes of this provision, "security" has the same meaning as it has in the rules of present law relating to worthless securities (sec. 165(g)). The term thus covers stock in a corporation; a right to subscribe for (or to receive) stock in a corporation; or a bond, debenture, note, certificate, or other evidence of indebtedness, issued by a corporation or by a government (or political subdivision thereof), with interest coupons or in registered form.

The bill requires the Treasury Department to issue regulations concerning how the notice must be given and what information it must contain. The giving of notice does not guarantee ordinary loss treatment for a taxpayer who later sells the stock at a loss; he still must establish that he did not acquire and hold the stock as a capital asset. The bill simply adds a threshold condition for ordinary loss treatment that, in any event, the taxpayer must have filed the required notice within the required period.

If a taxpayer files the necessary notice and realizes a gain when he sells the security, the bill provides that his gain is to be ordinary income and not capital gain. In such a situation, ordinary income treatment is automatic; the bill does not permit the taxpayer to show that on the particular facts he held the stock as a capital asset.

If a taxpayer does not file the notice, any loss which he realizes on a later sale or other taxable disposition of the security will in any event be a capital loss. Any gain will be capital gain unless, on the particular facts, the security was not acquired and held for investment purposes, or unless under specific provisions of the Code the gain is treated as ordinary income.

These rules operate together to prevent a taxpayer from subsequently coloring his description of his original purposes in acquiring a security depending on whether he suffers a loss or realizes a gain on sale of the security.

The bill also adds a notice requirement in order for a worthless security to be treated as producing an ordinary loss. Where a security becomes worthless during the year, the taxpayer may obtain an ordinary loss only if he establishes that the security was not a capital asset

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[1] For recent examples of the often uncertain criteria which the courts apply in determining how losses should be treated in this area, see *Union Pacific Railroad Co., Inc.*, v. *U.S.*, — F. 2d ——, 75–2 USTC ¶ 9800, at pp. 88,535–88,537, 36 AFTR 2d at pp. 6262–6263 (Ct. Cl. 1975); *W. W. Windle Co.*, 65 T.C. 695 (1976); *Elmer Carsello*, T.C. Memo. 1976–193.

in his hands and also that, before the 31st day after he initially acquired the security, he notified the Service that he held the security other than as an investment.

Exceptions.—This notice requirement is not to be imposed in the case of a worthless security in an affiliated corporation (under the provisions of present sec. 165(g)(3)), but is to be imposed in the case of a sale or exchange of a security in such a corporation.

The new section also is not to apply to a securities dealer. Present law (sec. 1236) creates uniform treatment for securities dealers by providing capital gain or loss treatment on a sale or exchange if, before the 31st day after he acquires a security, the dealer clearly identifies it in his records as held for investment and also if he does not later hold the security for sale to customers. A dealer who does not identify his securities in this manner receives ordinary income or loss when he sells the security.

The new rule also is not to apply to losses on stock in a small business investment company operating under the Small Business Investment Act of 1958, and to losses on certain other small business stock. In these situations, losses receive specific treatment as ordinary losses under present law (sec. 1242 and 1243, and 1244, respectively).

The new rule also is not to apply to losses on sales or exchanges of certain kinds of securities held by banks or other financial institutions if, and to the extent, such losses are governed by section 582(c) of present law.

Definition of acquisition; transfers of securities.—The committee amendment adds several rules to the bill which define the types of "acquisition" which permit a taxpayer who acquires a security to decide whether or not to file the notice. Other rules are added dealing with transfers of securities as to which a notice has been filed. Under the amendments, in general, every taxpayer who acquires stock by any means is entitled to make a new decision whether nor not to file the notice. This rule applies to a purchase of the security (i.e., a transaction in which the taxpayer takes a basis in the security equal to his cost), and an acquisition of a debt security in return for an advance or other loan to a corporation or other unrelated person. A taxpayer does not make an "acquisition" (entitling him to decide whether to file a notice) if he acquires the security from a related party. A related party is another individual or a corporation, trust, estate or partnership whose ownership of the security would be attributed to the taxpayer pursuant to the constructive ownership rules in section 318 of the Code.

This rule prevents, for example, an appreciated security for which a notice has been filed by an individual from being transferred to a 50 percent or more controlled corporation in a tax-free exchange under section 351 and thereby free the corporation from the tax effects of the notice filed by the transferor since, except for this rule, the corporation would be a different "taxpayer" and could elect for itself whether to file a notice with respect to the security it had "acquired." The bill deals with this type of case by providing, in effect, that when a shareholder files a notice and then transfers the security to such a controlled corporation, the corporation will not be considered, for purposes of this provision, to have "acquired" the security. Therefore, the corporation will not have its own opportunity to decide whether to file a notice, but must instead take over the security subject to the tax effects of the notice previously filed by the share holder. If and when the corporation later sells the security, any loss will be ordinary, provided the corporation can show other factors that its transferor and the transferee corporation acquired and held the security for business reasons. Any gain recognized will be ordinary income.

Similar results will occur under the amendment in the case of transfers between an estate or trust and any of its beneficiaries, and between a partnership and one or more of its partners.[2]

Where an owner of a security dies, the tax effect of a notice which he may have previously filed is removed on the transfer of the security from the decedent to his estate. The estate then has its own opportunity to decide whether to file a notice. If the estate files a notice, the tax effects of its having done so will pass to any heir, legatee or other beneficiary of the estate to whom the estate distributes the security. If the estate does not file a notice, a distributee of the security can decide for himself whether or not to file a notice with respect to his acquisition.

A gift of stock or other security as to which the donor filed a notice carries the tax effect of the notice to the security in the hands of the donee. (The donee will not be considered to have "acquired" the security so as to entitle him to make a separate decision whether to file a notice).

A shareholder who receives from a corporation (which he does not control) a taxable distribution consisting in whole or part of stock of a second corporation is considered, under the bill, to have acquired the latter stock and ordinarily can elect whether or not to file a notice with respect to his acquisition. For this purpose, it does not matter whether the distribution is made under section 301 of the code (relating to ordinary dividends) or in a taxable exchange in which the shareholder takes a basis in such stock equal to its current fair market value.[3]

If stock or other security with respect to which a notice has been filed is exchanged with another corporation in a tax-free reorganization (in which the other corporation acquires the stock or assets of the corporation with respect to whose security the taxpayer filed the notice), the amendment provides that the tax effect of the notice is retained as to the security received by the taxpayer in the exchange.[4]

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[2] If a partnership purchases or otherwise acquires a security, the committee intends that the decision whether to file the notice pursuant to this amendment shall be considered to be an "election" for purposes of section 703(b) of the code. (Section 703(b) provides that, with stated exceptions, an election affecting the computation of taxable income derived from a partnership must be made by the partnership rather than by each partner separately.) Therefore, if a partnership files a notice with respect to a security, a later disposition of that security by the partnership will be governed by the rules in this amendment. If a partnership distributes this security to one or more of its partners, each partner's later disposition of the security will continue to be affected by the notice filed by the partnership. However, if the partnership did not file the notice with respect to the security, each partner may separately decide whether or not to file the notice with respect to the security he receives from the partnership.

[3] Taxable exchanges treated ts "acquisitions" under this provision include distributions in partial or complete liquidation (sec. 331) and in redemption of stock (sec. 302).

[4] Other exchanges (in addition to tax-free reorganizations) covered by this rule include 1-month corporate liquidations (sec. 333); tax-free corporate spinoffs (sec. 355); divestiture distributions by a bank holding company (sec. 1101, et seq.); and exchanges of stock for stock of the same corporation (sec. 1036).

If a shareholder receives additional shares of stock in a corporation pursuant to a stock dividend or stock split, the shares received also constitute an "acquisition" for purposes of this provision.

In the case of an option to buy stock (including a convertible debenture, a warrant, or an employee stock option granted to an employee in connection with his performance of services), the "acquisition" (for purposes of this provision) will occur when the option is exercised and the option holder becomes the owner of the stock.

Effective date

This provision applies to taxable years ending after the date of enactment. However, the new rules are not to apply to any sale or exchange occurring (or any security becoming worthless) on or before the 30th day after the issuance of final regulations under the new Code provision.

The provision also contains a transition rule for securities acquired before the date on which the Treasury issues final regulations under the new rules added by the bill. In such cases, the taxpayer must give the required notice to the Service within 30 days after such regulations have been issued (rather than within 30 days after he initially acquired the security).

B. WITHHOLDING OF INCOME TAX ON CERTAIN GAMBLING WINNINGS

The Tax Reform Act of 1976 contained a provision applying withholding of income tax to gambling winnings. In the case of horse races and other parimutuel betting which were considered wagering pools, withholding was to apply to winnings of $1,000 or more regardless of the odds. On further consideration, the committee concluded that the absence of any test based on the odds of the wager (such as the 300 to 1 odds that is presently required in the reporting requirements for horse races) would create serious administrative problems and encourage bettors to split their bets to avoid withholding where it would apply to ordinary winnings. As a result, the committee added an amendment which reduces the amount to which withholding applies from $1,000 or more to $600 or more and adds a requirement that the winnings be at least at odds of 200 to 1 or more. The committee amendment applies this rule to parimutuel wagering on horse races, dog races and jai alai.

The committee amendment also eliminates the reporting requirement for any gambling winnings to which withholding applies. This is done by excluding from the reporting rules (under sec. 6041(a)) any payments to which the new withholding rules apply (under sec. 3402(q)). This means that no reporting will be required of winnings to which the $600 and 200 to 1 odds rules apply (parimutuels, as explained above). However, the present reporting requirement is to continue for winnings between $600 and $1,000 in the case of winnings other than parimutuel.

This provision is to take effect on the date of the enactment of the Tax Reform Act of 1976.

III. THE COSTS OF CARRYING OUT THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

REVENUE COST

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the costs incurred in carrying out H.R. 10902. The committee estimates that the provision dealing with the tax treatment of securities acquired for business reasons and not as an investment will not have a significant revenue effect during the first two years. However, in the later years this bill could generate annual revenue gains in the range of $20–$30 million. The Treasury Department agrees with this statement.

The provision dealing with the withholding of income tax on certain gambling winnings is not expected to have any revenue effect. It will not change the estimated revenue increase from the gambling withholding provision in H.R. 10612, the Tax Reform Act of 1976, because the reduction in revenue resulting from the addition of the 200 to 1 rule is offset by reducing the required amount of winnings from $1,000 to $600.

In accordance with section 403 of the Congressional Budget Act of 1974, the Director of the Congressional Budget Office has not made an estimate or comparison of the estimates of the cost of H.R. 10902, but has examined the committee's estimates and agrees with the methods and the dollar estimates resulting therefrom.

Vote of the committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill H.R. 10902 was ordered reported by a voice vote.

IV. Changes in Existing Law

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

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