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G. GRAND

SEE page 5

PART 5

MISCELLANEOUS LOOPHOLES

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REVENUE TAXATION

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MISCELLANEOUS LOOPHOLES

HOBBY FARMS AND RACING STABLES

Many individuals operate farms for the production of crops, show, or racing horses, purebred livestock, etc., or operate racing stables primarily not for profit but for their personal gratification and pleasure. They do this in large measure at the expense of the revenues, since losses incurred from the operation of such enterprises are deducted against income from their normal business or professional activities and from investments. For example, one wealthy individual operates a large farm which has shown a loss every year for 26 years. In 1949, a deduction of $143,644 against the individual's other income was claimed with respect to this farm. Another individual for 17 years has successfully raised show horses and cattle and now maintains a racing stable. Losses from these operations have ranged from $25,000 to $83,000 per year, and, in the aggregate, amount to $767,197. In 17 cases, tax savings aggregating $3,390,000 have been obtained over a series of years through such operations.

.To the extent that expenses incurred in such operations are not, in fact, made for the purpose of producing a profit but for the personal comfort and gratification of the individual, they are not deductible, since section 23 (a) permits the deduction of only such expenses as are "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," and section 24 (a) specifically prohibits the deduction of "personal, living, or family expenses." Section 29.23 (a)–11 of Treasury Regulations provides that—

> If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions.

In practice, however, it has proved very difficult to establish the fact that the primary purpose of the enterprise is not profit but personal gratification. Moreover, in such cases, it is very difficult to segregate expenditures which are actually purely personal expenses from those which are more directly related to the "business" operations.

There is a long line of cases in which the conclusion has been reached that a taxpayer may deduct losses from a continually losing business. In some of these cases the facts were such as to indicate that the taxpayer could not reasonably have anticipated a profit and therefore, notwithstanding the taxpayer's testimony to the contrary, that the operations were primarily for personal pleasure.

For example, in *Marshall Field* v. *Commissioner* (26 B. T. A. 116; 67 Fed. (2d) 876), the taxpayer in 1920 purchased the Caumsett farm, and in 1923 began acquiring and developing a fine herd of cattle. The net result of operations for the period of operation in 1923 was a $43,282 net loss. Sales from the farm for the period 1924 to 1928, inclusive, varied from $31,844.86 in 1924 to $59,219.73

in 1928. The inventory on December 18, 1928, was $63,911.80. The net losses from operations for 1924 to 1928 were as follows:

1924	$70, 616. 97
1925	74, 344. 35
1926	85, 725. 97
1927	62, 670. 03
1928 (to Dec. 18, inclusive)	62, 435. 60

In 1921 petitioner became interested in racing and breeding thoroughbred horses in England and in 1923 petitioner started racing and breeding horses in the United States. He sustained a loss in 1923 of $72,234.

Petitioner realized profits from and sustained losses upon the racing and breeding of horses as follows:

Year	Stable	Profit	Loss	Net loss
1924	American	$6, 378. 51		
1924	English		$37, 956. 20	$31, 577. 69
1925	American		130, 013. 84	
1925	English		36, 946. 14	166, 959. 98
1926	American		134, 469. 62	
1926	English		36, 575. 90	171, 045. 52
1927	American		72, 817. 24	
1927	English		22, 031. 01	94, 848. 25
1928	American		50, 800. 31	
1928	English		51, 157. 56	101, 957. 87

In *Whitney* v. *Commissioner* (B. T. A. Memo Op. (1933) Dpt. No. 50004; rev'd. 73 Fed. (2d) 589), a similar result was reached where the taxpayer was permitted to deduct a loss from the operation of a racing stable, even though he had the following loss experience over the years:

	Expenses	Receipts		Expenses	Receipts
1918	$3, 850. 01	0	1926	$4, 385. 82	$279. 00
1919	3, 473. 66	0	1927	10, 776. 40	450. 00
1920	5, 029. 54	0	1928	15, 110. 71	312. 00
1921	4, 928. 05	0	1929	20, 462. 25	516. 73
1922	5, 420. 91	5. 00	1930	22, 448. 89	6, 514. 50
1923	7, 002. 86	1, 025. 00	1931	10, 674. 65	1, 744. 00
1924	10, 308. 38	1, 945. 00	1932	6, 798. 75	1, 052. 73
1925	17, 010. 54	431. 50			

It may be interesting to note that in the Washington Post for April 8, 1951, the following advertisement appeared:

ARIZONA

TAX REFUGE

ARIZONA CATTLE RANCH, $400,000

Huge Arizona cattle ranch now capable of earning 16 to 20 percent on investment—if you wish. Also capable of absorbing any amount of money into capital investment by converting thousands of acres range land into irrigated farm land.

Fully equipped for range operation. Sumptuous home near Tucson, $400,000.

Phone—Wire—Write

CANYON STATE LAND COMPANY

REALTORS

2749 E. Fort Lowell Road

Section 130, which has been a part of the code since 1944 was intended to restrict the tax avoidance resulting from such operations. However, in practice it has been almost totally ineffective. This section, in general, provides that if the deductions attributable to a trade or business carried on by an individual for five consecutive taxable years have in each of such years exceeded by more than $50,000 the gross income derived from such trade or business the net income of the individual for each of those years shall be recomputed with the disallowance in each year of such deductions as exceed the gross income by more than $50,000 and any net operating loss deduction resulting from such trade or business shall be disallowed.

There are several difficulties with the present provision: (1) The criterion that the loss in each year shall be more than $50,000 necessarily excludes all operations which are not of great magnitude, so that only a very wealthy taxpayer could be affected. (2) The requirement that for each of five successive years there must be a loss of more than $50,000 presents an obvious opportunity for avoidance, since the application of the section will be prevented if by the foregoing of expensive operations or the artificial bunching of income and expense items in any one of the five successive years a loss of less than $50,000 is created.

To make the provision more generally applicable, it has been suggested that the permitted loss be substantially reduced from $50,000 to, say, $4,000 per year. To prevent the nullification of the provision by having at appropriate times a smaller loss than is specified or a small income for that year, it has been further suggested that the excessive expenses be disallowed, if for a period of 5 years the average net loss is $4,000 per year; in other words, if the aggregate net loss for the 5-year period is more than $20,000.

Investigation of the proposal for averaging has disclosed the possibility that expenses attributable to a bona fide business operation would be disallowed. For example, a bona fide business might have income for each of the first 4 years and in the fifth year have an extraordinary loss which would result in an average or aggregate loss for the 5 years in excess of the specified maximum. Or a bona fide business might show the typical pattern of a new enterprise developing a new product or operating in a highly competitive field. Such an enterprise might have gradually decreasing losses in the first 3 years with small but increasing income in the fourth and fifth years, the over-all aggregate being, however, a net loss in excess of the specified amount. It would clearly be undesirable in either of the cases illustrated to disallow any part of the expenses for the loss years.

Thus, it appears that any attempt to differentiate bona fide business operations from operations conducted primarily for the personal gratification of the taxpayer by means of a specified pattern of losses would probably result in the disallowance of deductions in cases of actual business enterprise. However, it is impracticable to differentiate the one from the other by descriptive phraseology in the statute. Therefore, the following suggestion is made.

If the taxpayer has carried on an alleged business for 5 years with an aggregate net loss for that period of more than $20,000, if expenses attributable to such business exceeded the gross income therefrom in 3 or more of the 5 years, for each of such years and for the current year the deductions will be subject to disallowance to the extent that they exceed the gross income from the enterprise unless the taxpayer can establish by the clear preponderance of the evidence that the business was conducted primarily for profit and not for his personal gratification.

If this recommendation were adopted it is assumed that in many cases, even though there were losses in 3 out of 5 years and the aggregate loss exceeded $20,000, the deductions would not be disallowed, because it would be evident that the taxpayer was conducting a business run for profit. Personal gratification would not be the motive for conducting a laundry, a filling station, or a feed business, for example, and deductions would not be disallowed even if the enterprise were unsuccessful. In other cases a drought, a necessary period for development or other circumstances encountered by obviously bona fide businesses, would be sufficient to satisfy an examining agent that disallowance of deductions is unwarranted. Where a disallowance appeared justified the taxpayer nevertheless could by the submission of adequate evidence disprove the contention.

DEALERS IN SECURITIES

In recent years court decisions have held that a taxpayer may be a dealer as to some securities and at the same time hold a portion of the portfolio for investment.[1] Moreover, dealers may shift securities from the investment to the inventory account, or vice versa.[2] This presents the possibility of converting what would be ordinary gain into capital gain, and what would be a capital loss into an ordinary loss. In addition, there is the difficult, administrative task of determining in which portfolio the securities have in fact been held.

In one case a company was engaged in the purchase and sale of securities as broker, dealer, and underwriter. During the examination of the tax returns for the years 1941 through 1947, transactions on 22 different securities were arranged to minimize what would be considered their normal tax effect. For these 7 years, ending December 31, 1947, a total of $1,140,000 in taxes was paid on a total net income of $7,750,000, an effective rate of 14.7 percent. The taxpayer engaged in the practices of transferring securities from the investment account to the inventory account in situations where the ultimate sale would result in a loss, transfers from the inventory account to the investment account where the ultimate sale would result in a gain; and the accounting methods were so loose that it was impossible to determine what was actually done.

It is recognized that dealers in securities may actually acquire certain securities for investment purposes. However, it is exceedingly difficult to determine at the time of subsequent sale whether securities have actually been acquired for investment or for inventory purposes. Accordingly, it is recommended that dealers in securities be required to clearly earmark securities upon their purchase or acquisition as to whether they are held for investment or sale, and that any transfer from one account to the other be not recognized for tax purposes. To insure compliance with the foregoing rule, it is further recommended that, in the absence of such earmarking, if such securities are sold at a gain they be considered to have been held in inventory, and if at a

[1] E. Everett Van Tuyl, 12 T. C. 900.

[2] Carl Marks & Co., 12 T. C. 1196; Stifel, Nicolans & Co., 13 T. C. 755; and Stern Brothers & Co., 16 T. C. 40.

loss that they be considered to have been held as investments. It should be noted that the determination of whether securities are to be accorded inventory or investment treatment at the time of their acquisition is solely within the discretion of the taxpayer and, accordingly, he will be able to make the election which he believes will accord him the most beneficial tax treatment on their disposition.

CORPORATE SPLIT-UPS TO OBTAIN MULTIPLE EXEMPTIONS AND CREDITS

During the excess profits tax law of World War II, some corporations attempted to minimize their income and excess profits tax liability by incorporating as many branches of their business as possible in order to obtain for each separate branch the specific excess profits exemption of $10,000, and (where applicable) the lower income tax rates applicable to incomes of less than $25,000. Although the Treasury Department litigated two of these cases as a violation of section 129, the Tax Court held that the facts did not show that the principal purpose was tax avoidance and, therefore, concluded that section 129 did not apply.

In the first of these cases the King Grocery Co., during the period 1934–43, operated an interstate wholesale grocery business from separate stores in five different cities in Mississippi. In 1944 this company split up into five separate corporations, and one of the objects of this plan was stated to be to obtain Federal income and excess profits tax advantage. In the second case the Berland Shoe Stores operated, since 1928, 60 retail shoe stores, and in 1944 split up 22 of these stores into 22 separate corporations. Subsequently thereto 27 additional new corporations were organized, in the years 1945 to 1949. Tax considerations entered into the decision to make the above split-ups.

With the surtax exemption of $25,000, provided in the Revenue Act of 1950, and the introduction of the recent excess profits tax law providing for a minimum credit of $25,000, the incentive for splitting up corporations will be even greater than during World War II.

It is evident that the tax loss inherent in the multiple use of the minimum excess profits credit and the surtax exemption is not limited to new corporations which may be created in the future by splitting up existing corporations. Where an enterprise is already divided into several corporate entities, the tax loss is the same as in the case of the newly created subsidiaries. Moreover, the unwarranted use of multiple surtax credits and excess profits credits is as undesirable if two or more corporations are owned by the same stockholders as where one corporation owns the stock of another.

A direct method of dealing with this problem is to permit only one surtax exemption and only one minimum excess profits credit to a group of affiliated corporations. For this purpose such an affiliated group would include a group which under existing law may file a consolidated return. It would also include two or more corporations with 95 percent of the stock of each owned by the same person or persons. In the determination of whether an individual owns the stock of any corporation he should be deemed to own the stock held by his spouse or by a corporation owned or controlled by him; and if he directly, or thus indirectly, owns more than 50 percent of the stock he should be deemed also to own the stock held by his ancestors or lineal descendents.

REDUCTION OF TAX FROM THE SALE OF INVENTORY ITEMS THROUGH THE USE OF COLLAPSIBLE CORPORATIONS

Subsection 117 (m) was added to the Internal Revenue Code by the Revenue Act of 1950 to close the loophole resulting from the use of "collapsible corporations" to convert ordinary income into long-term capital gains. When that problem was presented to the Committee on Ways and Means, the principal use of collapsible corporations was by producers of motion pictures, builders of apartment houses, etc. Accordingly a collapsible corporation was defined as "a corporation formed or availed of principally for the manufacture, construction, or production of property * * *."

Recent reports of the Bureau of Internal Revenue have revealed that during the last war there were numerous instances of the use of collapsible corporations for the purpose of converting profits from sales of inventory and stock in trade into capital gains. The method used was to transfer the commodity to a corporation and then sell to the prospective buyer the stock of the corporation instead of the commodity itself. The cases in which this technique has been used most generally have been in connection with whisky.

A typical case illustrating the above problem is as follows: X corporation was incorporated in 1944 for $100,000 cash with its stock equally divided among members of the Y family. It was dormant until 1946, when one lot of 1,600 barrels and another of 21,000 barrels of whisky were purchased from the Y family which had been extensively engaged in the purchase and sale of bulk lots of whisky. Later in 1946, all the capital stock was sold to two distilling companies, the profit to the Y family being $7,200,000 which was taxed at capital gains rates. The corporation was immediately liquidated by the purchasers of the stock. Three similar transactions were entered into by this particular family, which used dormant or newly created corporations for the purpose. The total profit to the Y family in all of these transactions was $11,030,000. The tax savings which would be effected in this case by the conversion of this profit from ordinary income into long-term capital gains would be about $6,618,000.

It appears that the extraordinary profits realized by this family involved a violation in principle, if not at law, of the OPA price regulations. Presumably this violation was possible because the family sold not whisky as such but the stock of a corporation. The purchaser bought the stock merely to obtain the whisky since the corporation was immediately liquidated. Generally, the use of a collapsible corporation for the sale of merchandise or similar inventory items in the ordinary course of business would be relatively infrequent. However, in any period during which there are large price rises, or if, as in the present period, there are price controls which might be avoided by some artificial device, it would appear that the use of this technique to convert substantial ordinary gains into capital gains with greatly reduced taxes would become fairly frequent in cases involving purchase and sale of large lots.

It would appear, therefore, that an appropriate amendment should be made to section 117 (m) so as to include the use of collapsible corporations for acquisitions of the type described above in addition to their use for "the manufacture, construction, and production of property."

SALE OF PROPERTY TO CONTROLLED CORPORATIONS

Recent reports of the Bureau of Internal Revenue have revealed a growing practice of using controlled corporations for tax avoidance purposes by selling assets to such corporations in order to obtain tax benefits.

In the typical case a stockholder (or a small number of stockholders) controlling and owning a corporation, desires to convert ordinary income into long-term capital gain. The technique by which this is accomplished is through the sale of depreciable property owned by the stockholders to the corporation.

In one such case an individual and his wife owned all the stock of a corporation which was actively engaged in business. He had invented two designs, valuable in one phase of the automobile industry, and had obtained two patents at a cost of $601. More than 6 months after he acquired the design patents he sold them to the corporation for $525,000, the selling price to be paid to him over an 8-year period. Since design patents have a 14-year life the corporation may deduct one-fourteenth of $525,000, or $37,500, each year, in determining its taxable net income thus having no income with respect to the $525,000. The individual, however, will report his receipts each year (less a portion of the $601 cost) as long-term capital gains, and pay only the relatively low taxes on such gains.

In another case, a corporation in the automobile dealership business was owned and operated by husband and wife. In 1948 the land and building used in the business was sold by the sole stockholders to their corporation for $160,000. The gain upon the sale was about $77,000. As a result of this sale, the taxpayers received a capital gain, taxed at preferential capital gains rates, the corporation was able to take depreciation deductions on the stepped-up basis of the property, yet the individuals still retained full ownership of the property through their 100-percent control of the corporation. With respect to the corporation, it should be emphasized that in future years it would receive depreciation deductions based upon $140,000 depreciable cost basis ($20,000 being allocated to the land) instead of on $80,000, the cost basis of the building to the individuals.

Practices illustrated by the above case are reported to be frequent. It is recommended that this loophole of "selling" assets to closely held or controlled corporations, in order to secure a stepped-up basis for depreciation purposes for the corporation and in order to convert ordinary income into capital gain for the stockholder, be eliminated. It is further recommended that this be accomplished by providing that any depreciable assets sold by stockholders of a closely held corporation to the corporation be considered noncapital assets and thus that any gains from such sales be taxed as ordinary gains. It would appear desirable to define a closely held corporation as a corporation which is owned, directly or indirectly, by or for not more than 10 individuals; and that for the purposes of determining ownership the rules of section 503 be adopted, excluding brothers and sisters.

ESTATE AND GIFT TAX—UNITED STATES BONDS HELD BY A NONRESIDENT ALIEN NOT ENGAGED IN BUSINESS IN THE UNITED STATES

Prior to March 1, 1941, the estate tax regulations held that United States Government bonds owned by a nonresident alien not engaged in business in the United States were not to be included in his estate for estate tax purposes. This exemption applied without regard to where the bond certificates were situated, whether within or without the United States. This regulation was based upon the view that a provision of law exempting such bonds held by foreign investors from "all taxation" embraced estate taxes. On March 1, 1941, it having been concluded by the Treasury Department that the prior regulation was based upon misinterpretation of the statute, this regulation was reversed. This reversal was based upon a principle announced by the Supreme Court as early as 1900 and followed in several cases to the effect that provisions which exempt designated property from "all taxes" embrace direct taxes only and that estate and inheritance taxes, being excises, are not within the terms of such an exemption. However, since it was thought unfair to subject to estate tax, bonds which might have been acquired in reliance upon the prior regulation, the new rule that Federal securities should be included in the taxable estate of a nonresident alien was limited to such securities issued on or after March 1, 1941, the date of the new regulation.

On December 21, 1948, the Court of Appeals for the Second Circuit held in *Jandorf's Estate* v. *Comm'r* (171 F. (2d) 464) that the March 1, 1941 regulation was invalid under the statute. A similar case which had been pending in the Circuit Court of Appeals for the Third Circuit was also decided against the Government in November 1950 (*The Pennsylvania Company* v. *United States*).

It is recommended that the estate tax law be amended so as to overrule the result of these decisions. The exclusion of United States Government bonds from the taxable estates of nonresident aliens is inconsistent with the imposition of income tax upon interest received by nonresident aliens upon such bonds. The legislative revision should of course, be limited to estates of decedents dying after the date of enactment of the legislation and to securities issued after March 1, 1941. This revision will place United States Government bonds owned by nonresident aliens upon the same basis as other bonds, including those issued by domestic corporations; that is, they will be included for estate tax purposes if the certificates are physically situated within the United States. A similar amendment should be made to the gift tax statute.

Unless the Congress acts on this problem with reasonable promptness, it will become difficult to apply this legislation to the large volume of securities issued in the 1940's since foreigners who acquire those securities in the future will claim that their purchases were made in reliance on the recent decisions.

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