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AMENDING SECTION 1233 OF THE INTERNAL REVENUE CODE OF 1954

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

REPORT

[To accompany H. R. 6263]

The Committee on Finance, to whom was referred the bill (H. R. 6263) to amend section 1233 of the Internal Revenue Code of 1954, having considered the same, report favorably thereon with amendments and recommend that the bill do pass.

FIRST SECTION

The first section of the bill amends section 1233 of the Internal Revenue Code of 1954 relating to gains and losses from short sales. It provides a special rule for the application of the new holding-period rule in section 1233 (b) (2) for certain "substantially identical property" in cases where the taxpayer has made what have been held to be short sales in connection with arbitrage operations in securities. This section will apply only to taxable years ending after the date of enactment of this bill and only to sales after that date.

PROBLEMS DEALT WITH BY FIRST SECTION

In the Revenue Act of 1950 Congress enacted a special provision relating to short sales to prevent the artificial conversion of short-term gains (taxed as ordinary income) into long-term gains (subject to a maximum rate of 25 percent) and long-term losses into short-term losses. Prior to the enactment of this provision, it was possible for an investor in stocks to realize a capital gain in less than 6 months and to obtain long-term capital gain tax treatment on it by making a short sale, assuring his gain on his original investment, and then defer closing out the short sale until the original stock had been held more than 6 months. Also, prior to the 1950 act substantially identical property could be acquired after a short sale and used to close the sale with little or no realized gain resulting. Meanwhile, substantially

similar property, with a potential gain, acquired before the short sale could be retained with no tax effect even though the taxpayer was not at risk in the market from the time of the short sale until the time of acquiring the stock used to close the sale.

To prevent this type of abuse the Revenue Act of 1950 provided two rules intended to cover the situation where on the date of a short sale the taxpayer had held substantially identical property for not more than 6 months or where such property was acquired after the short sale but before it was closed. First, any gain from the closing of this short sale was considered as a short-term gain (sec. 1233 (b) (1) of the 1954 code). Second, the holding period of substantially identical property (with certain exceptions) was considered as starting on the date of the closing of the short sale (sec. 1233 (b) (2) of the 1954 code). Where the substantially identical property held exceeded the amount sold short, the special rule relating to the holding period of the substantially identical property applied in the order of the dates of acquisition.

This section is intended to restrict the application of the rule relating to the holding period of the substantially identical property where the sale is made in arbitrage operations in securities. Revenue Ruling 154 (1953–2 C. B. 173) of the Internal Revenue Service both gives an example of these arbitrage operations and indicates the Service considers them to be short sales. The ruling is as follows:

> Certain bonds traded in on the New York Stock Exchange are convertible, at the option of the holder, into common stock of the issuing corporation. The market price of the bonds tends to fluctuate in direct relation to the market price of the stock. At times, however, there is a slight difference in the relative market prices of the bonds and stock. When the price of the bonds is down, in relation to the price of the stock, members of the exchange buy the bonds at the market price and as nearly simultaneously as possible sell the stock into which the bonds are convertible. The bonds purchased are then converted and the stock so received is used to close the sale. These transactions are known as arbitrage operations. Held, sales of stock in the manner described constitute short sales within the purview of section 117 (1) of the Internal Revenue Code.

By holding these sales to be short sales the second rule described above is made applicable. Thus, under present law, if the taxpayer acquires securities for investment purposes and during the holding of such securities makes short sales of other but substantially identical securities in arbitrage operations, the application of section 1233 (b) (2), as interpreted in the ruling, results in the securities held for investment purposes losing their original holding period. These securities lose their holding period rather than the securities acquired at the time of the short sale, because they were the first acquired, even though held for investment purposes. The result is that the taxpayer may for an indefinite period of time be prevented from establishing a holding period of more than 6 months for the securities held for investment purposes.

Bona fide arbitrage operations in securities do not present opportunities for abuse. The taxpayer who engages in such operations does not thereby convert a short-term gain into a long-term gain. Rather the arbitrager is performing a valuable function by facilitating the self-regulation of the stock market.

EXPLANATION OF FIRST SECTION

The first section of the bill as reported provides that the rules of subsection (b) (2) of section 1233 are not to apply to property not acquired for arbitrage operations if the taxpayer engages in an arbitrage operation under the conditions set forth in the bill.

This bill adds a new subsection (f) to section 1233. The first part of this subsection provides that when a short sale entered into as part of an arbitrage operation is closed and the rules of subsection (b) (2) become applicable, these rules are to apply first to the substantially identical assets acquired for arbitrage operations held on the day the short sale is made. The rules of subsection (b) (2) are to apply to other substantially identical assets only to the extent that the quantity sold short exceeds the substantially identical assets held for arbitrage operations. In determining the quantity of substantially identical assets held for arbitrage operations on the day the sale is made, all assets acquired on the day of the sale are to be taken into account.

The operation of subsection (f) (1) is illustrated by the following example:

Assume that A buys 100 X bonds on January 2 for purposes other than arbitrage operations and that X bonds are convertible into X stock on the basis of 1 bond for 1 share at the demand of the bondholders. Assume also that on April 2 A sells 100 shares of X stock in a transaction identified and intended to be part of an arbitrage operation and that on the same day he buys 100 bonds of X in a transaction also identified as, and intended to be part of, an arbitrage operation. A holds no other bonds or stock of X corporation. If the sale on April 2 is a short sale, the 100 X bonds purchased on April 2 for arbitrage operations will have no holding period until the short sale is closed. If the bonds purchased on April 2 are converted into stock and such stock is delivered to close the sale of April 2, the holding period of the bonds purchased January 2 is not to be affected.

Under paragraph (2) of subsection (f) the rules of subsection (b) (2) become applicable at any time assets acquired for arbitrage operations are disposed of in such a manner as to create a net short position in assets acquired for arbitrage operations. To the extent of such net short position the open short sale in the arbitrage operations will be deemed to be short sales made on the date that such net short position is created. For example, in the example above, if on June 1 A sells the 100 X bonds acquired on April 2 (or converts such bonds into stock and sells the stock) without closing the short sale made on April 2, thereby creating a net short position in the arbitrage operations at the close of business on June 1, the short sale made on April 2 would be deemed to be a short sale made on June 1 and such short sale would make the rules of subsection (b) (2) applicable to the 100 X bonds purchased on January 2.

Paragraph (3) of subsection (f) provides that solely for the purpose of applying paragraphs (1) and (2) of subsection (f) and not for the purpose of determining what property is held by the taxpayer or what constitutes a short sale under any other provision of this subtitle, the taxpayer is to be deemed to hold assets for arbitrage operations as of the close of any business day (even though he may not physically hold such assets), if he has the right to receive or acquire such property by virtue of any other asset acquired for arbitrage operations, or by virtue of any contract he has entered into in an

arbitrage operation. To illustrate: Taxpayer holds 100 convertible bonds of X. He thereafter contracts to purchase for arbitrage operations 100 convertible bonds of X and on the same day as the purchase makes a short sale for arbitrage operations of the quantity of shares of X that will be received on conversion of 100 bonds of X. At the close of the day the short sale is made the taxpayer has not received the bonds contracted to be purchased. By reason of paragraph (3) the taxpayer will be deemed to hold the bonds contracted to be purchased and there will be no net short position in assets acquired for arbitrage operations. If it were not for paragraph (3), it could be held that taxpayer did not "hold" any substantially identical asset for arbitrage operations at the close of business on the day of the short sale, with the result that the rule of subsection (b) (2) would be applied to the bonds held for investment.

"Arbitrage operations" are defined in subsection (f) (4) as—

transactions involving the purchase and sale of assets for the purpose of profiting from a current difference between the price of the asset purchased and the price of the assets sold, and in which the asset purchased, if not identical to the asset sold, is such that by virtue thereof the taxpayer is, or will be, entitled to acquire assets identical to the assets sold.

Any transaction, to be considered as an arbitrage operation, must be clearly identified by the taxpayer in his records as an arbitrage operation as soon as he is able to do so. This identification must ordinarily be made on the day of the transaction.

Arbitrage operations may involve the right to acquire stocks and securities, as well as bonds, preferred stock, and common stock. Thus, arbitrage operations coming under this subsection may include the purchase of convertible preferred stock and the sale of common stock, the purchase of stock rights and the sale of stock to be acquired through the exercise of rights and other situations, as well as the example given in Revenue Ruling 154.

Property acquired in a transaction properly identified as an arbitrage operation is the only property considered to be "acquired for arbitrage operations" under this section, and all property so acquired is deemed to be an asset acquired for arbitrage operations although the taxpayer may decide after the acquisition of the property to dispose of the property in some manner other than by the completion of the arbitrage operation. For example, if A bought bonds of X corporation and identified the bonds as acquired for arbitrage operations and A intended at the time of the acquisition of the bonds to immediately sell stock of X corporation into which the bonds were convertible, the bonds so acquired would continue to be characterized as assets acquired for arbitrage operations although, due to a change in the value of the stock or bonds, the taxpayer decided to sell the bonds outright rather than make a short sale of stock, convert the bonds into stock, and deliver the stock received on the conversion to close the sale.

No inference is to be drawn from the enactment of this provision with respect to Revenue Ruling 154. If, in fact, an arbitrage sale is not a short sale, section 1233 of the Internal Revenue Code of 1954 would not apply, since it is the classifying of these arbitrage sales as short sale which makes the holding period rules of section 1233 applicable.

Your committee amended H. R. 6263 as passed by the House by striking out in line 7 on page 1 the words "the closing of". The problem dealt with in the House bill arises when an arbitrager makes

a short sale in an arbitrage operation and it exists whether or not the taxpayer closes the short sale before he disposes of his other securities. The amendment therefore brings the new subsection into operation when the taxpayer makes a short sale in an arbitrage operation rather than at the time he closes the short sale.

SECTION 2

Section 2 makes the provisions of the first section of this bill applicable only to taxable years ending after the date of enactment of this act and only in the case of a short sale of property made by the taxpayer after such date.

SECTION 3

Section 542 (a) (2) of the Internal Revenue Code of 1954 (defining the term "personal holding company") provides for treating charitable foundations or trusts as "individuals" in determining the stock ownership test for personal holding companies. This provision was new in the 1954 code and is so broad in its wording as to include investment companies which have been wholly owned by charitable foundations for many years and would thereby for the first time require treatment of such investment companies as personal holding companies.

Certain long-established charitable trusts have, solely for business reasons, owned and controlled certain of their investments through the means of a separately formed investment company. Such company is, of course, subject to payment of the customary Federal income taxes and is used as a matter of convenience in the business-like handling and development of enterprises requiring additional capital from time to time in their expanding activities. If such organizations are to come under the rule for personal holding companies then they would become subject to the penalty tax applicable thereto. This would make it impracticable to conduct their activities on a normal business basis involving carefully planned reinvestment to provide required capital to meet the needs of growth situations such as public utilities with resulting expansion of income. The alternative would require dissolution of such investment companies which would deprive the Federal Government of the income tax now being paid by such companies.

Section 3 of the bill, which has been added by your committee, amends this provision of the 1954 code in a limited manner so that certain long-established charitable foundations may retain the tax status under which they have operated for many years.

DETAILED EXPLANATION

Section 3 amends section 542 (a) (2) of the Internal Revenue Code of 1954 which deals with certain charitable foundations. Three conditions must be met. The foundation must be organized or created before July 1, 1950. Second, at all times on or after July 1, 1950, through the close of the taxable year such foundation must own all of the common stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Thirdly, such foundation must not be denied exemption under section 504 or such trust must not be denied the unlimited charitable deduction under section 681 (c) and, for this purpose, the income of the investment

company is treated as though distributed to the foundation or trust to the extent of their proportionate interest in income available for distribution as dividends. Also, for purposes of this last condition it is provided that the restrictions in sections 504 (a) (1) and 681 (c) (1) of the 1954 code against unreasonable accumulations will not apply to income attributable to property of a decedent dying before January 1, 1951, which was transferred, either to an inter vivos trust during his lifetime or was transferred under his will to such trust.

SECTION 4

Section 4 provides that the amendments made by section 3 of this bill will apply only with respect to taxable years beginning after December 31, 1954.

CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italics, existing law in which no change is proposed is shown in roman):

SECTION 542 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 542. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) GENERAL RULE.—For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) GROSS INCOME REQUIREMENT.—At least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543; and

(2) STOCK OWNERSHIP REQUIREMENT.—At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. For purposes of this paragraph, an organization described in section 503 (b) or a portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642 (c) or a corresponding provision of a prior income tax law shall be considered an individual. *The preceding sentence shall not apply in the case of an organization or trust organized or created before July 1, 1950, if at all times on or after July 1, 1950, and before the close of the taxable year such organization or trust has owned all of the common stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation but only if such organization or trust is not denied exemption under section 504 or an unlimited charitable deduction is not denied under section 681 (c) and, for this purpose,—*

(A) all income of the corporation which is available for distribution as dividends to its shareholders at the close of any taxable year shall be deemed to have been distributed at the close of such year (whether or not any portion of such income was in fact distributed); and

(B) section 504 (a) (1) and section 681 (c) (1) shall also not apply to income attributable to property of a decedent dying before January 1, 1951, which was transferred during his lifetime to an irrevocable trust, or property that was transferred under his will to such intervivos trust.

SECTION 1233 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 1233. GAINS AND LOSSES FROM SHORT SALES.

(a) CAPITAL ASSETS.—For purposes of this subtitle, gain or loss from the short sale of property, other than a hedging transaction in commodity futures, shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property, including a commodity future, used to close the short sale constitutes a capital asset in the hands of the taxpayer.

(b) SHORT-TERM GAINS AND HOLDING PERIODS.—If gain or loss from a short sale is considered as gain or loss from the sale or exchange of a capital asset under subsection (a) and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 6 months (determined without regard to the effect, under paragraph (2) of this subsection, of such short sale on the holding period), or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof—

(1) any gain on the closing of such short sale shall be considered as a gain on the sale or exchange of a capital asset held for not more than 6 months (notwithstanding the period of time any property used to close such short sale has been held); and

(2) the holding period of such substantially identical property shall be considered to begin (notwithstanding section 1223, relating to the holding period of property) on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever date occurs first. This paragraph shall apply to such substantially identical property in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short.

For purposes of this subsection, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale.

(c) CERTAIN OPTIONS TO SELL.—Subsection (b) shall not include an option to sell property at a fixed price acquired on the same day on which the property identified as intended to be used in exercising such option is acquired and which, if exercised, is exercised through the sale of the property so identified. If the option is not exercised, the cost of the option shall be added to the basis of the property with which the option is identified. This subsection shall apply only to options acquired after the date of enactment of this title.

(d) LONG-TERM LOSSES.—If on the date of such short sale substantially identical property has been held by the taxpayer for more than 6 months, any loss on the closing of such short sale shall be considered as a loss on the sale or exchange of a capital asset held for more than 6 months (notwithstanding the period of time any property used to close such short sale has been held, and notwithstanding section 1234).

(e) RULES FOR APPLICATION OF SECTION—

(1) Subsection (b) (1) or (d) shall not apply to the gain or loss, respectively, on any quantity of property used to close such short sale which is in excess of the quantity of the substantially identical property referred to in the applicable subsection.

(2) For purposes of subsections (b) and (d)—

(A) the term "property" includes only stocks and securities (including stocks and securities dealt with on a "when issued" basis), and commodity futures, which are capital assets in the hands of the taxpayer;

(B) in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in 1 calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month; and

(C) in the case of a short sale of property by an individual, the term "taxpayer", in the application of his subsection and subsections (b) and (d), shall be read as "taxpayer or his spouse"; but an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

(3) Where the taxpayer enters into 2 commodity futures transactions on the same day, 1 requiring delivery by him in 1 market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, subsections (b) and (d) shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other.

(f) ARBITRAGE OPERATIONS IN SECURITIES.—In the case of a short sale which had been entered into as an arbitrage operation, to which sale the rule of subsection (b) (2) would apply except as otherwise provided in this subsection—

(1) subsection (b) (2) shall apply first to substantially identical assets acquired for arbitrage operations held at the close of business on the day such sale is made, and only to the extent that the quantity sold short exceeds the substantially identical

assets acquired for arbitrage operations held at the close of business on the day such sale is made, shall be holding period of any other such identical assets held by the taxpayer be affected;

(2) in the event that assets acquired for arbitrage operations are disposed of in such manner as to create a net short position in assets acquired for arbitrage operations, such net short position shall be deemed to constitute a short sale made on that day;

(3) for the purpose of paragraphs (1) and (2) of this subsection the taxpayer will be deemed as of the close of any business day to hold property which he is or will be entitled to receive or acquire by virtue of any other asset acquired for arbitrage operations or by virtue of any contract he has entered into in an arbitrage operation; and

(4) for the purpose of this subsection arbitrage operations are transactions involving the purchase and sale of assets for the purpose of profiting from a current difference between the price of the asset purchased and the price of the asset sold, and in which the asset purchased, if not identical to the asset sold, is such that by virtue thereof the taxpayer is, or will be, entitled to acquire assets identical to the assets sold. Such operations must be clearly identified by the taxpayer in his records as arbitrage operations on the day of the transaction or as soon thereafter as may be practicable. Assets acquired for arbitrage operations will include stocks and securities and the right to acquire stocks and securities.

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