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{ REPORT
No. 1113.

EXCHANGE OF PROPERTY.

FEBRUARY 5 (calendar day, FEBRUARY 8), 1923.—Ordered to be printed.

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

REPORT.

[To accompany H. R. 13774.]

The Committee on Finance, to whom was referred the bill (H. R. 13774) to amend the revenue act of 1921 in respect to exchanges of property, having considered the same report favorably thereon with the recommendation that the the bill do pass without amendment. House Report No. 1432 on this bill is adopted and is as follows:

[House of Representatives, Report No. 1432, Sixty-seventh Congress, fourth session.]

The Committee on Ways and Means, to whom was referred the bill (H. R. 13774) to amend the revenue act of 1921 in respect to exchanges of property, having had the same under consideration, reports it back to the House without amendment and recommends that the bill do pass.

Concerning the proposed bill the following letter has been received from the Treasury Department:

TREASURY DEPARTMENT,
Washington, January 13, 1923.

HON. WILLIAM R. GREEN,
*Acting Chairman Committee on Ways and Means,
House of Representatives.*

MY DEAR MR. GREEN: I have your letter of January 12, 1923, requesting any comment that I may care to offer with respect to a bill (H. R. 13774) To amend the revenue act of 1921 in respect to exchanges of property.

The proposed bill amends the existing revenue law and eliminates the provision which allows the exchange free from tax of stock for other stock and bonds for other bonds, except where any such exchange of securities is made in connection with the reorganization, consolidation, or merger of one or more corporations. It further amends the existing law to provide that where a person receives money in connection with an exchange, which would otherwise be tax free, the amount of the money so received shall be taxable to the extent that it represents an actual gain. In connection with this matter it is stated in the Annual Report of the Secretary of the Treasury for the fiscal year ended June 30, 1922, that:

"The revenue act of 1921 provides, in section 202, for the exchange of property held for investment for other property of a like kind without the realization of taxable income. Under this section a taxpayer who purchases a bond of \$1,000 which appre-

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ciates in value may exchange that bond for another bond of the value of \$1,000, together with \$100 in cash (the \$100 in cash representing the increase in the value of the bond while held by the taxpayer), without the realization of taxable income. This provision of the act is being widely abused. Many brokers, investment houses, and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain. Under this section, therefore, taxpayers owning securities which have appreciated in value are exchanging them for other securities and at the same time receiving a cash consideration without the realization of taxable income, but if the securities have fallen in value since acquisition will sell them and in computing net income deduct the amount of the loss on the sale. This result is manifestly unfair and destructive of the revenues. The Treasury accordingly urges that the law be amended so as to limit the cases in which securities may be exchanged for other securities without the realization of taxable income to those cases where the exchange is in connection with the reorganization, consolidation, or merger of one or more corporations."

In accordance with this recommendation made in the annual report, I approve the proposed bill as to both form and substance and earnestly urge that this bill, amending the revenue act of 1921, be promptly adopted.

Yours very truly,

A. W. MELLON,
Secretary.

In order that the changes made by the bill from the present law may clearly appear, the original text of paragraph (1) of subdivision (c) of section 202 of the revenue act of 1921 is set out below, the proposed changes being indicated in stricken-through type and italics, the part struck through being omitted from the bill, and the part in italics being new matter not included in the present law.

(1) When any such property held for investment, or for productive use in trade or business (not including stock in trade or other property held primarily for sale) is exchanged for property of a like kind or use;

The most important feature of the bill is the change made in the text of paragraph (1) of subdivision (c) of section 202 of the act of 1921. The necessity for such change is explained in the letter of the Secretary of the Treasury set forth above. The evasion of the law in the manner pointed out in the Secretary's letter is a growing evil and if not checked will materially affect the amount of revenue which the Government receives. It will be observed that this paragraph as contained in the present law applied to exchanges of securities, both stocks and bonds. Striking out the words "investment or for" in the first line of this paragraph and the words "kind or" in the last line of the paragraph excludes exchanges of securities from the application of this paragraph. In case the exchange of stock is made in the process or course of a reorganization of one or more corporations a provision governing such transactions is embodied in paragraph (2) of subdivision (c) of the same section (202). The bill therefore complies with the recommendations of the Treasury "that the law be amended so as to limit the cases of securities which may be exchanged for other securities without realization of taxable income to those cases where the exchange is in connection with reorganization, consolidation, or merger of one or more corporations."

The bill also amends subdivision (e) of section 202 to comply with the Treasury recommendations.

The original text of subdivision (e) of section 202 of the revenue act of 1921 here follows, the proposed changes being indicated in stricken-through type and italics:

"(e) Where property is exchanged for other property which has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis shall be taxable to the extent of the excess; but when property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivision (c) as received in exchange, together with money or other property of a readily realizable market value other than that specified in such paragraphs, ~~the money or the fair market value of such other property received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess.~~ *the amount of the gain resulting from such exchange shall be computed in accordance with subdivisions (a) and (b) of this section, but in no such case shall the taxable gain exceed the amount of the money and the fair market value of such other property received in exchange.*"

It should be observed that the changes made by section 2 of the bill apply only to that portion of subdivision (e) following the semicolon in line 9 of page 2; that is, the new provisions apply to cases where "property is exchanged for property specified

in paragraphs (1), (2), and (3) of subdivision (c) as received in exchange together with money or other property of a readily realizable market value other than that specified in such paragraphs. Paragraph (1) of subdivision (c) is the provision amended in the first section of the bill. Paragraph (2) refers to exchanges of stock or securities in connection with the reorganization of one or more corporations. Paragraph (3) refers to cases where persons transfer property to a corporation and immediately after the transfer are in control of the corporation, the amounts of stock being in substantially the same proportion as their interest in the property before the transfer.

Under the law as it now stands, when, in the course of such an exchange as is described in paragraph (2), what is commonly called "boot" is received, whether in money or in property of value, the only amount which could be taxed would be the excess of the value of the "boot" over the original cost of the property exchanged. This result was brought about by the language which is proposed to be stricken from the law by the bill. For example, if the holder of stock in corporation A which cost him \$100 exchanges it for stock in corporation B and receives in addition "boot" amounting to \$95, no tax is imposed under the present law. If, however, the amount of the "boot" in such cases is \$105, the tax would only be on \$5, namely, the amount by which the "boot" exceeded the cost of the old stock.

The bill provides that the amount of gain resulting from such exchange shall be computed in accordance with the ordinary method, which is that the gain is computed by subtracting from the total value of all the property received in exchange the cost of the property given in exchange, but with a provision that the taxable gain shall not exceed the amount of the "boot" received in exchange. Thus, if a taxpayer exchanges stock which cost him \$100 for stock in a new corporation, together with \$100 in "boot," the stock of the new corporation received in exchange would be valued, and if it is found that it is worth \$100 the total amount received by the taxpayer has been \$200, which is \$100 in excess of the cost of the old, and he would therefore, under the proposed law, pay a tax on a gain of \$100. If, however, the amount of the "boot" received is only \$95 and the stock in the new corporation is worth \$105, he has made the same gain of \$100, but he would be taxed only on \$95, namely, the amount of the "boot" received in exchange. The reason for this is that the profit, so far as it is contained in the new stock received, has not yet been realized, and therefore should not be taxed until the new stock is sold or in some way disposed of so that the profit will be actually realized.

It should be observed that any amount of the "boot" which is not taxed as gain under the subdivision as amended by the bill would be applied against and reduce the basis for ascertaining the gain or loss in case of a future sale of the stock received in exchange. The law in subdivision (d) of section 202 already provides that where in case of exchange no gain or loss is recognized, the property received in exchange shall take the place of the old. For example, if the taxpayer exchanges stock which cost him \$75 for stock in a new corporation which is worth \$40, and \$60 in cash, he has received \$100, in all thus realizing a profit of \$25 which would be taxed to him under the proposed bill. But he has also received in cash \$35 which has not been taxed and which would therefore be applied against and reduce the cost of the old stock (\$75), with the result that the stock in the new corporation would be carried on the books of the taxpayer at \$40, so that if he subsequently sold it his gain or loss would be computed on the basis of \$40 instead of on the basis of \$75, which the old stock originally cost him.

