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How Secure Are Your Security Transactions?

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It is entirely possible that every person in this room either now owns securities or expects to hold securities sometime in the future.

It is also possible that each of you will have not one, but many security transactions each year and each and every one of these transactions will have some effect on your taxable income for the year.

Most of these transactions are fairly simple. We buy the security, we hold it for a period of time, and we sell the security. We have either a gain or a loss and it is either short-term or long-term, depending on the period the security was held. However, time after time we have seen taxpayers who have gone ahead and completed a particular transaction with the result that they pay hundreds or even thousands of dollars of tax, which need not have been paid.

Fortunately, most of our clients will consult with us prior to the completion of a transaction, if any doubt exists in the client's mind. Therefore, in my remarks today, I would like to outline a few of the basic rules and thereby make you aware of some of the areas that could later prove troublesome.

No football coach in his right mind would send a football team on the field unless his team was well versed in the rules of the game. I am sure you will agree this common-sense approach applies equally well to your entrance into the field of security transactions.

I won't attempt to discuss some of the more sophisticated problems, each of which could be a study in itself. If you face such a problem, we have many competent attorneys and CPAs who can assist you in understanding the difficult language of the Internal Revenue Code, and in marshaling the necessary facts and figures that you must have before any intelligent tax planning can be accomplished.

CAPITAL GAINS AND LOSSES

DEALER VS. TRADER

Occasionally, some of our clients become concerned that they may be classed as a "dealer" rather than as a "trader" or an "investor." These questions are usually raised by taxpayers who have numerous

security transactions each year. Of course the distinction between a dealer and a trader is important, as the sale or exchange of securities by a dealer, in his capacity as a dealer, results in ordinary gain or ordinary loss. On the other hand, gains or losses to "traders" or "investors," are capital gains or losses. It is not the volume of security transactions that distinguishes the dealer from the trader. The primary difference is the source from which securities are acquired. Normally, a dealer will acquire a large block of securities from a particular source because he is aware that a market exists at a somewhat higher price for these securities. The difference between the price he pays and the price he receives is more in the nature of compensation for services rendered rather than a gain on an investment. A trader must acquire his securities from sources not significantly different from those available to the buyer and, further, the securities must not be held primarily for sale to customers in the ordinary course of his business. Of course, many companies and many individuals in business occasionally will invest in securities. Since these securities are not held primarily for sale to customers, such sales would still result in a capital gain or a capital loss. Of course most of us acquire securities for investment purposes, expecting either a reasonable rate of dividend return or a chance to sell at a gain, if the market price should rise. The number of transactions each year is usually rather small. In this case, we are classed as investors or traders. As traders or investors, securities held by us are capital assets and resultant gains or losses are capital gain or losses.

CASH BASIS VS. ACCRUAL BASIS

As we know, most individuals report their income on the cash basis. However some individuals do report their income on the accrual basis, and most companies will report their income on an accrual basis. Does this have any practical effect on your security transactions? Some corporations declare dividends payable late in the year. Dividend checks may be mailed on December 31 and received by the shareholders in the next year. In this particular case, a cash-basis taxpayer would not report the receipt of this dividend until the following year, but an accrual-basis taxpayer would have to pick it up in the year of declaration.

It is also possible for a cash-basis taxpayer to make a sale of securities at a gain late in the year and have this gain taxed to him in the following year. This can be accomplished if the sale is made

through a stock exchange late in December, with the actual delivery of the securities and the receipt of the cash scheduled to be made in January. Under these circumstances, the gain would be reported in the following year. An accrual-basis taxpayer, would of course have to report the gain in the year of sale.

YEAR-END LOSSES—SPECIAL RULE

Please note that this rule applies only to the year-end gains, and not to year-end losses. That is, the sale of the security through a stock exchange entered into near the close of the year, at a loss, will be deductible or reportable in the return for the year of sale. This is true, whether or not the cash is received in the following year.

LONG-TERM VS. SHORT-TERM INVESTMENTS

I am quite sure that all of us here are aware of the tax benefits available to taxpayers who realize long-term gains versus short-term gains. In general, the excess of net long-term gains over net short-term losses are includable in taxable income to the extent of 50 per cent thereof, and further are subject to an over-all limitation of 25 per cent. Because of this significant difference in the tax effect, of long-term gains versus short-term gains, it is extremely important that we know how to determine when we could have a long-term gain. The basic rule is quite simple. The security must be held by the taxpayer for more than six months. However, please note that this holding period must be more than six months and cannot be exactly six months. Should the security be held for exactly six months, the gain or loss on its sale is a short-term gain or loss. Now, how do we go about determining the holding period?

HOLDING PERIOD

The holding period begins the day after the taxpayer purchases the security and ends on the date he sells it. For example, a security was purchased on January 15th and was sold on July 15th of the same year. In this case, the holding period began January 16th, the day after purchase, and ended on July 15th, the date of sale. The security would be held for exactly six months, and the gain or loss on its sale is a short-term gain or loss.

Confusion often arises concerning sales or purchases made

through a security exchange, because the rules of the exchange normally require the delivery and payment be made on a date subsequent to the actual sale or purchase of the security. In this case, it is the date of purchase or sale, normally known as the trade date, that you must use in determining your holding period. It is not the settlement or delivery date of the cash or the securities. A few moments ago, I stated that a cash-basis taxpayer could sell a security at a gain late in December and report such gain in his return in the following year. Please note that the fact the gain may be reported in a subsequent year has no effect at all in determining whether or not the particular transaction resulted in either a long-term or a short-term gain.

If a security is purchased by a taxpayer, there is usually little difficulty in determining the date the holding period began. However, securities can be acquired in many ways other than by purchase. Here we find the determination of the holding period to be not so simple. For example, securities may be acquired by gift, by inheritance, by exchange, and in many other ways. In general, we can say that at any time it is necessary to look to a previous owner to determine the basis of the security, we may be required to use an adjusted holding period.

In many cases, it may be necessary to add to your own holding period the holding period of the prior owner. For example, if you receive securities as a gift, and later sell these securities at a gain, the holding period will include the period during which the securities were held by the donor. Thus, it may be possible for a taxpayer to sell securities received as a gift, shortly after the gift and still realize long-term gains. On the other hand, if the securities are later sold at a loss, the holding period will depend on whether or not the market value of the securities, at the date of the gift, was more or less than the cost basis in the hands of the donor. If the market value, at the date of the gift, is higher than the basis in the hands of the donor, then you must add his holding period. If the market value is less than the basis in the hands of the donor, the holding period would begin with the date of the gift. I am sure you will agree that relatively simple rules can become quite difficult in their practical application.

Of course many securities are acquired by bequest, devise, or inheritance, in which case the holding period will run from the date of the decedent's death. This is true whether or not an optional valuation date is used in determining the total value of the estate.

Here in San Diego, involuntary exchanges and voluntary tax-free exchanges of property are quite common. In each case, it is necessary

to determine the holding period, not from the date of the tax-free exchange, but from the date the prior property was acquired.

In recent years it has been a common practice of many corporations to issue non-taxable stock dividends. The holding period of these stocks does not begin on the date of receipt. The holding period of such stock is determined by reference to the holding period of the stock on which the dividend was paid. For example, if you had purchased one hundred shares of X Corporation stock in 1959, and an additional one hundred shares of X Corporation stock in October of 1960, and you received a stock dividend of ten shares in November of 1960, you would have to determine the holding period of five shares as beginning in 1959, and the other five shares as beginning in October of 1960. As you can see, the immediate sale of the ten shares received as a stock dividend would result in a long-term gain on five shares and a short-term gain on the other five shares.

On the other hand, occasionally, stock rights are issued and stock is purchased by the exercise of these rights. In this case, the holding period of the stock acquired dates from the day on which the rights were exercised. This is true whether or not the receipt of the rights resulted in a taxable gain to the taxpayer.

If securities are acquired pursuant to an option, the holding period begins on the date the shares were actually purchased under the option and does not include any period during which the option was held by the taxpayer.

As you can see, a seemingly simple task of determining the date your holding period began can become quite complex and difficult.

IDENTIFICATION OF SECURITIES

Quite often, taxpayers are not aware that the selection of a particular certificate for sale or gift could have important tax results. It is a common experience among taxpayers to acquire shares of stock in the same corporation at different dates and at widely varying prices. It is extremely important that your records indicate, preferably by certificate number, the exact stock purchased, the date, and the cost thereof. Upon a subsequent sale of stock, it is possible to select certain identified shares as the specific stock sold. If failure to keep proper records makes it impossible to identify the specific shares sold, or no specific shares are selected for sale, then the general rule applies. This rule is the first-in, first-out rule, and, therefore, the first stocks purchased will also be the first stocks sold. The importance of this rule

could be demonstrated in the following example. Taxpayer purchases one hundred shares of stock at ten dollars in 1940. In 1960 he purchases another one hundred shares of the same stock at 100 dollars per share. Three months later he sells one hundred shares of the same stock at $75.00. If the taxpayer fails to identify the fact that the shares he intends to sell, three months after purchase, are the shares he purchased in 1960, he will be required to report as a sale, not the shares purchased in 1960 but the shares purchased in 1940. He would, therefore, be reporting a long-term gain of $65.00 per share rather than a short-term loss of $25.00 per share, if the taxpayer had properly identified the securites sold. The same identification of securities is important should you decide to make a contribution to charities of securities that have appreciated in value. Ordinarily, it would be to your advantage to select a low-basis security and make your gift of that particular certificate. Also, in the case of a sale, it may not always be desirable to sell the stock with the highest basis. For example, if you have losses carried forward from prior years, and there is danger of the five-year carry-forward period running out, it may be highly important that you identify the particular stock in order to realize a substantial gain, which would offset the otherwise unused capital loss carry-forward.

Under certain circumstances, the commissioner has insisted that it was impossible to determine realistically the actual costs of specific shares of stock and therefore has insisted that average prices per share be used rather than a specific price per share.

It is also quite common to make a basket purchase of two or more kinds of stock in the same company at the same time. For example, a unit purchase may be made of a certain number of common shares, plus a certain number of preferred shares, or possibly bonds. In this case, it is necessary that the purchase price be fairly apportioned between the common stock and the preferred stock or bonds. Occasionally, a situation will arise where an apportionment of the unit cost is impracticable. In this case, the courts have held that the taxpayer is entitled to recover his original basis before gain or loss can be recognized.

WASH SALES

The term "wash sale" is an interesting one. Let's determine what it is, and the occasion under which it might arise. Sometimes a situa-

tion arises in which a taxpayer has a substantial paper loss in a stock he holds but feels the future of the stock is such that he does not wish to eliminate it from his portfolio. In this case, the taxpayer may decide to sell the stock to establish his loss and then later buy back the same stock in order to return it again to his portfolio. While this sounds good, at first glance, the law does not allow such a loss, if substantially identical securities were acquired either thirty days before the date of the sale, or thirty days after the date of the sale. The theory is that no actual loss was sustained in substance, but the whole transaction was merely a scheme to avoid taxes. Should you inadvertantly become involved in a "wash sale" transaction, you must also keep in mind that the holding period of the second stock purchase will be expanded to include the holding period of the original securities.

I would like to emphasize at this point, that the wash-sales rules apply only to the disallowance of losses, and not to the recognition and taxability of gains. It is because of this fact that, on occasion, it may be possible to make no real change in your portfolio, yet at the same time substantially increase the basis of the securities you own. This could happen if you had a rather substantial loss carry-forward or losses in other sales during the year, and you had large paper profits in other stocks that you wished to continue to hold. In this case, it would be possible to sell one day, recognize a large gain, to the extent, at least, of your otherwise unused capital loss carry-over, and repurchase the next day the same stocks at their current value. The result of this would be that the stocks purchased the second day would have the increased basis. Inasmuch as losses on wash sales are disallowed only if the securities reacquired are substantially identical to the securities sold it is important to be aware of the condition under which such securities would be held to be substantially identical. I believe this could be summarized by saying that the purchase of either the same stock, or of rights or warrants (which, in effect, control the stock sold), will normally be considered the acquisition of substantially identical securities. If you are in this position, I would suggest that you very carefully explore the nature of the securities to be repurchased, to be certain that your loss will not be disallowed.

RELATED TAXPAYERS

Following the same theory, that there must be a loss in substance rather than in form only, the law also denies losses from sales or exchanges between related taxpayers. The rules are spelled out spe-

cifically in the code concerning losses from sales or exchanges, directly or indirectly between certain specified persons. For example, losses between members of a family are not allowed. Losses between an individual and his more than 50%-controlled corporation are not allowed, neither losses on sales between a grantor and fiduciary of any trust; nor many others. As these rules are too detailed and too lengthy to discuss at this time, I can only suggest that if your plans include an attempt to transfer any shares from one taxable entity to another, and the recognition of the loss on such sale or exchange, that a careful reading of the code be made prior to the time you enter into such a transaction.

SHORT SALES

Now may be the proper time to go into a brief discussion of short sales. Short sales can be of considerable interest inasmuch as they have the effect of fixing the amount of your gain or loss, although the time for reporting the gain or loss is deferred until the actual closing of the short sale.

A taxpayer who wants to sell securities he owns in 1960, but who wants to report the gain or loss in his 1961 return, can attain this by making a short sale in 1960 and covering the transaction in 1961. For example, if you held shares that had substantially appreciated in value, you could sell short on one day and on the same day purchase an equal number of shares but make no delivery of these shares to the broker until the following year, at which time the sale would be closed and the gain reported.

It used to be possible to convert a short-term gain to a long-term gain by the use of the short-sale technique. This loophole has now been closed and if, at the time of the short sale, a taxpayer has held securities substantially identical to those sold short, and such securities have been held for less than six months, any gain on the subsequent closing of the short sale will be taxed as a short-term capital gain. This is also true if you sold short and later purchased substantially identical securities even though the actual covering of the short sale did not take place for more than six months after the date of the short sale. The reverse of this is also true, that any loss on the closing of a short sale will be a long-term capital loss, if on the date of the short sale substantially identical property had been held by the taxpayer for more than six months.

It should be noted here that the use of the short-sale technique for the recognition of losses will not permit you to avoid the application of the wash-sale rules, which prevent the recognition of losses under the circumstances previously discussed.

I am sure that some of you, on occasion, will deal in stocks on a "when issued" basis. If you do, you will find that the short-sales rules stated above will apply to stocks and securities dealt with on this "when issued" basis. For example, if a taxpayer owns no stock of the XYZ Corporation, and XYZ Corporation reorganizes, the taxpayer could contract to sell one hundred shares of the new stock, when issued, for a certain sum of money. No gain or loss will be realized until, and unless, the reorganization of XYZ Corporation is consummated. When that takes place, the taxpayer buys the new stock and settles his contract to sell. He then recognizes his gain or loss on the transaction. We should, however, distinguish this from the situation where a taxpayer contracts to buy or sell a certain number of shares of stock on a "when issued" basis and then sells his contract to a second party. The contract to buy or sell the new stock is a capital asset in the hands of the taxpayer and he will realize a capital gain or loss which would be either short-term or long-term, depending on the time between the date he acquired the contract and the date he sold the contract.

DEDUCTIONS FOR LOSSES

We have been talking all along of capital gains and losses, and I think it would be appropriate, at this time, to emphasize the fact that such losses may be deducted against ordinary income up to a maximum of $1,000 in each year. This maximum may be extended to $2,000 if the husband and wife should elect to file separate returns rather than a joint return. Further, losses may be carried forward for a period of five years, and the amount of $1,000 of loss could be deducted against ordinary income in each of these five years. Again, a husband and wife could elect to file separate returns and obtain the benefit of a $2,000 deduction.

Of course taxpayers would always like to have their losses fully deductible and have their gains taxed as long-term capital gains. In some instances taxpayers have attempted to do this with a single transaction. This possibility has arisen because of the fact that dividends paid on stocks sold short are a fully deductible loss. There-

fore, what the taxpayer would do would be to sell short in the case of a stock that had declared a rather substantial dividend, and at the same time, to arrange to purchase stock ex-dividend at a lower price to cover the short sale. The result of this would be that the sale of the stock covered by a stock purchased at the lower ex-dividend price, would result in a capital gain, while the dividends he paid on his short position, would be a fully deductible loss. We can understand that the Treasury Department is very unhappy about this situation, and has been quite successful in denying the favorable tax treatment to taxpayers when the transactions were entered into only for tax-saving purposes, and were not otherwise an ordinary and necessary business transaction.

BUSINESS PURPOSE

I think this might be the time to discuss briefly the current position of both the tax courts and the Commissioner. I have already said that transactions without real substance will not result in a tax benefit to a taxpayer. For many years I have been advising clients when they come to me for tax advice that it is important that they do not let the tax tail wag the business dog. I consistently have urged them first to make a good business decision; after that business decision has been made, I have assisted them in determining the best possible tax route. Transactions entered into purely for tax reasons quite often later prove undesirable from a business standpoint, even though allowed by the Commissioner. Now the Treasury has just issued its Revenue Ruling 60-331, which states, "A transaction which has no purpose other than the avoidance or reduction of taxes will be ignored for tax purposes." In other words, a transaction must have a business purpose or the Treasury's new position will knock it out as being merely for tax-saving purposes only. The Treasury would admit that a transaction may be valid and meet all the Code requirements but, if it has no legitimate business purpose other than to minimize taxes, the transaction may be ignored by the Treasury.

I have no idea whether or not the courts will uphold the Commissioner's ruling in this situation. I had always assumed that minimizing taxes was not only a good business practice, but was probably required as part of the duties of corporate officers. Certainly, there are many legitimate transactions that can be entered into purely for the purpose of minimizing the tax. For example, I have explained how

a matter of a few days in the holding period of a security could change its gain from a short-term to a long-term gain. Also, securities are often sold so that the loss may be applied against other ordinary income up to $1,000. There certainly must be scores more of perfectly legitimate transactions that are entered into for the principal purpose of minimizing a particular taxpayer's tax. I am sure we will all watch with interest the reaction of the various courts to the Commissioner's stated position in this matter.

TAX-EXEMPT SECURITIES

At this point, I would like briefly to mention tax-exempt securities. Certainly every investor should consider investing a portion of his money in tax-exempt securities if his tax rate is quite high. For example, to a taxpayer in the 50 per cent bracket, tax-free income is worth twice as much to him as fully taxable dividends. Or, to put it another way, the rate of dividend return would have to be almost twice the non-taxable interest return in order to end up with the same number of dollars after taxes.

Should you purchase tax-exempt securities at a premium, I would like to remind you it is necessary to amortize the premium over the life of the particular bond in order to determine the proper basis for gain or loss should you sell the security prior to maturity.

INVESTMENT EXPENSES

I would like to talk for a moment about the deduction of investment expenses. Investment expenses are deductible if they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for the production of income. Therefore, it may be possible for you to deduct fees for services of investment counsel and custodians, and expenses for clerical help, office rents, safe-deposit box rentals, and travel under certain circumstances. You may also deduct State transfer taxes, but you may not deduct commissions on purchases or sales or federal stamp taxes. Should you hold both taxable and tax-exempt securites, it may be necessary to allocate these expenses since expenses attributable to tax-exempt income are not deductible.

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Naturally, it has not been possible in this brief period to explore

the many problems of security investors in detail. I do hope what I have said has, in some way, alerted you to both the advantages and the problems that may arise in your day-to-day security transactions.