Capital Gains and Losses - As Affected by the Tax Reform Act of 1969

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I. TAX REFORM ACT OF 1969—SOME GENERAL COMMENTS

While the Tax Reform Act of 1969 had a major impact on many areas, it had a relatively minor impact on the capital gains area. To be sure, there were a number of changes made with respect to taxation of capital gains and losses—important especially to the tax practitioner—but the changes were made largely within the framework of the existing policies and Code structure.¹ In the capital gains area, the 91st Congress is noted most for what it didn’t do.

Six Months’ Holding Period Retained

One might have thought—merely on logical grounds—that the six-months’ holding period was in trouble. How can one justify the rule that capital assets which are held for more than six months are entitled to long-term capital gain or loss treatment, whereas those held for six months or less are entitled to short-term capital gain or loss treatment?

One justification for according long-term capital gains preferential tax treatment is because gain on the sale of an asset may represent appreciation in value accruing over a relatively long period of time, which would otherwise be taxed in the year of sale at progressive ordinary income tax rates. This justification for the capital gains preference (of somewhat doubtful validity in any case, in view of the availability of income averaging)² clearly cannot support a holding period of less than one year. The six months’ holding period also does not appear to be a satisfactory device for separating investment gains from speculative gains. As demonstrated by the tables in the House Ways & Means Committee Report on the Tax Reform Bill,³ the avail-


²General income averaging provisions (I.R.C. §§ 1301-1305) were added by the Revenue Act of 1964, and were expanded by the Tax Reform Act of 1969. However, instead of substituting income averaging for capital gains treatment, in 1969 Congress made averaging available to long-term capital gains. It also provided that if an individual elects to use the income averaging provisions he cannot use the alternative capital gains tax rate. I.R.C. §1304(b) (5).

able evidence strongly suggests that assets held for periods of between six months and one year also tend to be speculative. For these reasons, the House Ways & Means Committee proposed in 1969 that in order to qualify for long-term capital gain or loss treatment, assets should be held for more than twelve months, instead of more than six months. The Senate Finance Committee disagreed, arguing that the six-months' holding period should be retained, and assigning as the reason its concern, shared by the Treasury Department "as to the impact this might have on the willingness of investors to take risks and thus, on capital investments and on revenues." In conference, the Senate prevailed, and thus six months is still the dividing line between long- and short-term capital gains and losses.

**Effect of Capital Gains on New Minimum and Maximum Taxes**

Before getting into the detailed changes made by the 1969 legislation respecting capital gains, it would be well to review briefly the effect capital gains can have under two other Code provisions added by the 1969 legislation. The first of these provisions is designed as a partial curb on tax avoidance. This is the minimum tax for tax preferences (I.R.C. §§ 56-58), more commonly known as the minimum tax. The other new provision is designed to alleviate the distortions and pressures to find loopholes created by the top tax rates on earned income, and is known as the 50% maximum tax rate on earned income (I.R.C. § 1348).

In the case of both provisions, one-half of the excess of long-term capital gains over short-term capital losses (the one-half that isn't taxable at ordinary income rates) is treated as an item of tax preference. The intent of such treatment in both cases is to increase the tax otherwise payable, or to reduce the tax benefit otherwise provided. However, in both cases, the actual effect which capital gains will have on the minimum or the maximum tax may be comparatively little or even none.

In the case of the 10% minimum tax, this is because the 10% tax is levied only on items of tax preference in excess of the sum of $30,000, plus the taxpayer's Federal income taxes for the year, computed without regard to the minimum tax. In most cases, if the taxpayer has a significant amount of ordinary income, the minimum tax will have no effect on capital gains. At most, the effect can be only 1.5% or so.\(^4\)


The 1.5% does not take into account the 25% alternative tax rate on the first $50,000 of capital gains, but rather assumes that the maximum tax rate of 70% will be applied to one-half of that net long-term capital gain, providing an effective tax rate of 35%. Subtracting the 35% effective rate from the capital gain tax preference item (the 50% of the gain not taxed) leaves 15% of the gain which would be subject to tax at the 10% rate, producing an effective tax rate (measured in the terms of the total net long-term capital gain) of 1.5%.

\(^5\) The 1.5% does not take into account the 25% alternative tax rate on the first $50,000 of capital gains, but rather assumes that the maximum tax rate of 70% will be applied to one-half of that net long-term capital gain, providing an effective tax rate of 35%. Subtracting the 35% effective rate from the capital gain tax preference item (the 50% of the gain not taxed) leaves 15% of the gain which would be subject to tax at the 10% rate, producing an effective tax rate (measured in the terms of the total net long-term capital gain) of 1.5%.
The effect of capital gains on the maximum tax on earned income can in theory be somewhat greater since if the items of tax preference income (e.g., one-half of the long-term capital gains) exceed $30,000, then the tax preference items reduce, dollar-for-dollar, the earned income eligible for the 50% maximum tax. However, the tax practitioner who gets out his pencil and starts making computations in an actual case is likely to find: (a) that the benefits of the maximum tax on earned income will frequently not be as much as he may have thought in the first place; and (b) that since the benefit of the maximum tax isn’t so great, the detriment from reducing the earned income eligible for the maximum rate by one-half of the taxpayer’s capital gains also isn’t as significant as he might have thought at first.6

Thus, in the case of both the minimum and the maximum taxes, the detrimental treatment which Congress has accorded to capital gains is less significant than one might at first think.

II. ALTERNATIVE TAX ON CAPITAL GAINS

Modification of Alternative Tax on Individuals

The House Ways and Means Committee proposed to eliminate entirely the so-called alternative tax for individuals. The alternative tax is really just a ceiling on the tax rate applicable to capital gains. All individuals who have an excess of net long-term capital gains over net short-term capital losses are entitled to deduct from their gross income 50% of the excess. Thus, only one-half of an individual’s net long-term capital gains are included in taxable income and then taxed at regular tax rates. To put this another way, long-term capital gains usually are subject to tax at a rate which is one-half of the individual’s marginal tax rate.

Where an individual’s marginal tax rate is over 50%, so that his long-term capital gains would be subject to a tax rate of over 25%, the alternative tax rate comes into play and limits the maximum capital gains rate to 25%. For married persons filing a joint return, the 50% marginal rate is exceeded if taxable income is more than $52,000. Thus, for taxable income in excess of that amount—whether $53,000 or $1,000,000—the 25% alternative capital gains rate would be less. As

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6 Two reasons why the 50% maximum tax rate may have a more limited effect (in terms of rate reduction) than might appear on first impression are (1) because of the fact that the full impact of the rate difference (50% versus 70%) only comes into play when taxable income exceeds the top bracket rate ($200,000 for married taxpayers); and (2) because if the taxpayer has any nonearned income and itemized deductions, the itemized deductions which are allocated to earned taxable income only reduce income taxed at a 50% rate, rather than income taxed at the higher rate which applies to nonearned taxable income. For a comprehensive discussion of § 1348, see Watts, “The Maximum Tax on Earned Income: Section 1348,” 26 Tax L. Rev. 1 (1970).
the taxpayer's marginal rate increases it is obvious that the benefit from the 25% rate increases.\textsuperscript{7}

The House thought that the alternative tax rate was at variance with the intent of the progressive rate structure and that it operated to create an exceedingly large difference between the tax rate paid on capital gains and that paid on ordinary income by taxpayers in higher tax brackets. It pointed out that the alternative tax rate was used by only 1.4% of the total number of taxpayers reporting capital gains for 1966.\textsuperscript{8} Thus, the House proposed to repeal the alternative tax rate.

The Treasury opposed the elimination of the alternative tax before the Senate Finance Committee. The latter Committee adopted what was essentially the Treasury's recommendation, so that what the Committee termed "relatively small amounts of capital gains" would be entitled to the alternative tax, provided the taxpayer had only a "nominal" amount of tax preference income.\textsuperscript{9} The "relatively small amounts of capital gains" turned out, on examination, to constitute $140,000 of long-term gains annually, and the "nominal" amount of tax preference income which taxpayers could have was $10,000 per year. The conferees took a somewhat more modest approach, retaining the alternative tax for a maximum $50,000 long-term capital gains annually (and dropping the tax preference restriction). Thus, we now have a three-tiered capital gains rate structure:

1. One-half of the excess of the net long-term capital gain over the net short-term capital loss is deductible from gross income in the case of all individuals. Thus, if the taxpayer's marginal tax rate is less than 50%, the alternative tax computation never comes into play.

2. If the taxpayer's marginal rate is in excess of 50%, then the 25% alternative tax rate will apply to the first $50,000 of long-term capital gains.\textsuperscript{10}

3. For capital gains in excess of $50,000 the alternative tax, commencing with 1972, will be completely eliminated. Thus, capital gains in excess of $50,000 will be taxed at a maximum rate of 35% (one-half of the maximum 70% ordinary income rate).

The statutory device for preserving the 25% alternative tax rate for up to $50,000 of long-term capital gain is section 1201(d), which characterizes this class of capital gain as "subsection (d) gain." This

\textsuperscript{7} For example, a taxpayer with a 70% marginal tax rate (the top bracket) in effect includes only 36% of his net long-term capital gains in his income—or, in other words, he is permitted in effect to deduct from income 64% of his capital gains.

\textsuperscript{8} H.R. Rep. 145.

\textsuperscript{9} S. Rep. 192.

\textsuperscript{10} $25,000 in the case of a married individual filing a separate return. For convenience reference will be made hereafter solely to the $50,000 limitation.
definition is used also as a transitional device, whereby certain capital gains will continue to be eligible for the 25% rate—these include gains from sales made pursuant to certain binding contracts,11 entered into on or before October 9, 1969, provided that they are received before January 1, 1975. The “subsection (d) gain” definition also includes gains on certain corporate distributions made before October 10, 1970, pursuant to a plan of complete liquidation adopted on or before October 9, 1969. While all of these excluded transitional gains count against the $50,000 ceiling, they are not themselves limited by it.

Where capital gains exceed the $50,000 ceiling (i.e., do not qualify as “subsection (d) gain”), the elimination of the alternative tax is “phased in”. For 1970 the maximum rate of tax on gain in excess of $50,000 is 29\(\frac{1}{2}\)% (this works out to be 30.2375% including the surcharge); and for 1971 the maximum rate is 32\(\frac{1}{2}\)%.

For 1972, the maximum rate is 35%, established by virtue of the fact that the top ordinary income tax rate is 70%, and will be fully applicable to one-half of the capital gain included in income.

It is obvious that the foregoing system is appallingly complex; that it has little application to the majority of taxpayers who file returns reporting capital gains; and that when the new rules do apply they are of relatively little value even for the high bracket taxpayer. This can be demonstrated several ways: First, only a small portion of the individuals reporting capital gains—about 2% in 196912—presently use the alternative rates. Secondly, when the new law becomes fully effective in 1972, the maximum tax savings through the alternative tax computation cannot exceed $5,000—and this assumes a marginal tax rate of 70% (which in turn is premised on ordinary taxable income in the case of a married taxpayer of $200,000). The $5,000 figure is the difference between the 35% tax rate which would otherwise apply to the first $50,000 of capital gain (i.e., one-half of the 70% rate) and the 25% rate applicable to the first $50,000 of gain.13

Thus, the new alternative tax rules are of limited importance even to the upper bracket taxpayer having capital gains income, and are of virtually no significance to the majority of taxpayers reporting capital gains income.

There will be, of course, cases in which the new rules will produce some tax savings, and in these instances taxpayers will undoubtedly wish to time their capital gains, to the extent possible, so as to produce

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11 Excluding gains from dispositions of patents, timber, coal and iron ore pursuant to transactions described in §§ 631 or 1235.
12 S. Rep. 191. This group accounted for approximately 28% of all capital gains reported by individual taxpayers. Ibid.
13 Additional computations will also demonstrate that if the taxpayer's only income is long-term capital gain the new alternative tax provisions will never produce a lower tax than the tax determined by including only one-half of the capital gain in ordinary income.
maximum savings under the $50,000 ceiling. This may mean spreading sales out over a period of more than one year, making sales on the installment method or employing other tax accounting techniques to spread gains over more than one year.

**Modification of Alternative Tax on Corporations**

Corporations are not entitled to deduct one-half of the excess of not long-term capital gains over net short-term capital losses. In the past, they were, generally speaking, subject to a straight 25% alternative tax rate on long-term capital gains. The 1969 legislation increased the corporate alternate tax rate to 28% for 1970 and 30% for 1971 and subsequent years. The "subsection (d) gain" definition is also used to permit the transitional capital gains previously described to continue to qualify for the 25% rate. However, the "subsection (d) gain" definition does not include, in the case of corporations, the $50,000 exclusion available to individuals.

**III. CAPITAL LOSSES**

**Individual**

A particularly timely subject just now, unfortunately, is that of capital losses. Here the Tax Reform Act brings bad news to a good many small investors.

To explain the changes we need to lay some groundwork. Both long- and short-term capital gains and losses go through a double "netting" process. Gains and losses from sales and exchanges of assets held less than six months are offset against each other and a net short-term gain or loss determined. Similarly, gains and losses from sales and exchanges of assets held more than six months are offset and a net long-term gain or loss determined. Then the net short-term gain or loss is offset against the net long-term loss or gain.

Under prior law a net loss, whether long-term or short-term, could be deducted up to $1,000 per year from ordinary income, and if the loss exceeded $1,000 the excess could be carried forward indefinitely and treated as a capital loss in the succeeding taxable years until the loss was fully absorbed. Furthermore, by filing separate returns, a husband and wife who each had capital losses (as would generally be the case in community property states) could, by filing separate returns, each claim the $1,000 capital loss deduction against ordinary income.

The Tax Reform Act changed the long-term capital loss rule to make it symmetrical with the long-term capital gain rule—i.e., since only 50% of net long-term capital gains are subject to tax, it was provided that only 50% of net long-term capital losses in excess of
net short-term capital gains may be deducted from ordinary income.\textsuperscript{14} The $1,000 limitation on the amount of capital losses which may be deducted from ordinary income was retained. Thus $2,000 of long-term capital losses is now needed to produce the maximum permitted offset of $1,000 of ordinary income. The one-half of the excess long-term capital loss which cannot be deducted, furthermore, cannot be carried forward as a capital loss carryover.\textsuperscript{15}

A transitional rule (§ 1212(b) (3)) is provided to take care of cases where there are net capital losses arising in 1969 or earlier years which are carried forward to 1970 or later. These losses will continue to be governed by the old law, and thus will be deductible against ordinary income, dollar-for-dollar up to $1,000 (even in years subsequent to 1969).

Note that no change is made insofar as net short-term capital losses are concerned—they continue to be deductible in full against ordinary income, subject to the $1,000 limit.

Another change made by the Tax Reform Act affecting capital losses of individuals was to provide that where married persons file separate returns the capital loss deduction is limited to $500 for each spouse, in place of the $1,000 allowed under prior law. Thus, the ability to obtain an additional $1,000 ordinary income offset for capital losses by having married taxpayers file separate returns—something that was relatively easy to do in the case of spouses living in community property states—was eliminated.

\textit{Corporations—Three-Year Capital Loss Carryback Added}

Net operating losses, generally speaking, can be carried back for three years and forward for five years, in the case of both corporations and individuals. In the case of capital losses, the rules are quite different. Individuals have an unlimited loss carryforward, and corporations a five-year carryforward. Prior to the Tax Reform Act, there was no carryback for capital losses in the case of either individuals or corporations. There still is no carryback for capital losses of individuals, but the Tax Reform Act provided a three-year capital loss carryback for corporations.\textsuperscript{16} The new rule does not apply to foreign expropriation capital losses (they have a special ten-year carryforward), nor is it available for a net capital loss arising in a year for which a corporation is treated as a subchapter S corporation. Furthermore, a

\textsuperscript{14} I.R.C. § 1211(b).

\textsuperscript{15} I.R.C. § 1212(b) (2) (B), which provides that the one-half of the excess long-term capital loss allowed as a deduction in the first taxable year, plus the disallowed one-half of the excess loss, is to be treated for purposes of the capital loss carryover in subsequent years as a short-term capital gain in the first taxable year.

\textsuperscript{16} I.R.C. § 1212(a).
net capital loss of a corporation cannot be carried back to a taxable year for which a corporation is treated as a subchapter S corporation.

Extension of the three-year loss carryback privilege to corporate capital losses was one of the liberalizing provisions of the Tax Reform Act of 1969, intended to provide relief for corporations having capital losses. Carryforward of a loss only holds out the prospect of a lesser tax sometime in the future. On the other hand, permitting capital losses to be carried back can frequently offer prompt relief, as the headache remedy ads claim. Promptness of the relief here—the tax fizz—was provided by making the so-called "quickie" refund procedure which can be used for net operating loss carrybacks also available to capital loss carrybacks.

Corporations, thus, are now allowed a three-year loss carryback for the excess of capital losses over capital gains in any year beginning after December 31, 1969. Any excess losses are carried back (or carried forward) as short-term capital losses. They can only be offset against capital gains (short or long) in the carryback year. Of course, to the extent possible, corporations will wish to incur losses in years where they can be carried back and offset against short-term gains (on which the regular corporate rates would otherwise apply), rather than having them offset against long-term gains which would be subject to the alternative tax.

IV. TRANSFERS OF FRANCHISES, TRADEMARKS, AND TRADE NAMES—NEW CODE SECTION 1253

The Tax Reform Act added a new section 1253 to the Code. The new section relates to transfers of franchises, trademarks, and trade names, and deals with the tax consequences of both sides of such transfers—i.e., with the taxability of payments received by the transferor, and with the deductability of payments made by the transferee. The Committee Reports appear to suggest a laudable desire on the part of Congress to clarify the various factual and legal issues raised by the existing court decisions in this area—frequently referred to as the Dairy Queen cases.17 A close reading of the statute, however, shows that what the Congress actually did is much more limited in scope than the problems described in the Committee report.

The new section applies to a transfer of "a franchise, trademark or trade name." A franchise is defined (§ 1253(b)(1)) to include "an agreement which gives one of the parties . . . the right to distribute, sell, or provide goods, services, or facilities, within a specified area." A distributorship or other exclusive right to operate a business within a specified geographical area would be an example of such franchise.

17 See e.g., Estate of Gowdey v. Commissioner, 307 F.2d 816 (4th Cir. 1962); Moberg v. Commissioner, 305 F.2d 800 (5th Cir. 1962); Dairy Queen of Oklahoma, Inc. v. Commissioner, 250 F.2d 503 (10th Cir. 1957).
Under the new section (1253(a)), if the transferor of a franchise, or of a trademark or trade name, "retains any significant power, right, or continuing interest with respect to the subject matter," the transfer is not treated as a sale or exchange of a capital asset, with the result that the transferor's gain is taxable at ordinary income rates. The statute defines (I.R.C. § 1253(b)(2)) the term "significant power" to include the following rights, retention of any one of which would be sufficient to preclude capital gains treatment:

1. A right to disapprove any assignment of such interest (or any part thereof);
2. A right to terminate at will;
3. A right to prescribe standards of quality of products used or sold, of services furnished, and of equipment and facilities used to promote such products or services;
4. A right to require the transferee to sell or advertise only the transferor's products or services;
5. A right to require the transferee to purchase substantially all of his supplies and equipment from the transferor; and
6. A right to payment contingent on productivity, use or disposition if such payments constitute "a substantial element" under the transfer agreement.

Even if the transferor can leap all the foregoing hurdles (including that described in (6) above), section 1253(c) may still come into play and tax as ordinary income any "nonsubstantial" payments received by the transferor which are contingent on productivity, use or disposition.

Section 1253, insofar as it deals with the transferor's side of the picture, only tells us when a transfer of a franchise, etc., is to be taxed at ordinary income rates. It is not like section 1235, relating to patents, which tells us how to find the high road to capital gain. Nor can a taxpayer be sure that if he escapes section 1253 he will necessarily have capital gains treatment. For example, the Senate Committee Report dwells at some length on the uncertainties as to whether a franchise is property held primarily for sale in the ordinary course of business, and so excluded from the capital asset category.\(^8\) Section 1253 does not answer this question. All the Committee Reports do is to point up the dealership issue.

Section 1253 also deals with the franchisee's side of the transaction. Here, the new section operates to assist the taxpayer. Several rules are provided. Again, they are incomplete. Amounts paid to the transferor which are contingent on productivity, use or disposition are allowed as a business deduction.\(^9\) Lump sum or installment payments

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\(^8\) S. Rep. 209.
\(^9\) I.R.C. § 1253(d)(1).
are deductible by the transferee (if the transfer is not treated as a sale or exchange of a capital asset by reason of the new section 1253) pursuant to the following rules:

(1) A single payment made to discharge a principal sum may be deducted ratably over the shorter of a ten-year period, or the period of the agreement.

(2) If the payment is one of a series of approximately equal payments which are payable either over the period of the agreement or a period of more than ten years, whether ending before or after the end of the period of the agreement, then the payments are deductible in the year made.\(^20\)

The foregoing rules with respect to the deductibility of noncontingent payments apply only where ordinary income treatment is accorded the transferor by reason of the application of the new section 1253. If the transferor is entitled to capital gains treatment (because he is deemed to have sold a franchise which was a capital asset in his hands, and has escaped section 1253), the question whether the transferee will be able to deduct fixed payments made for the franchise is not answered by the new section. If the transferee is deemed to have purchased an intangible asset without an ascertainable useful life, no deductions for lump-sum payments would be allowable. However, if the transferee can demonstrate that the franchise "has an ascertainable life in the circumstances of a particular case," amortization may be permitted.\(^21\)

Another circumstance under which section 1253 would not be applicable is where the transferor reports ordinary income because he is a dealer in franchises. Since section 1253 would not apply in that situation, a transferee who makes fixed payments in such a case would not be granted a deduction by section 1253, and so the deductibility of the noncontingent payments made by the transferee here also would have to be determined under existing law.

V. SALES OF LIFE ESTATES, ETC.—AMENDMENT OF SECTION 1001

Another amendment made by the Tax Reform Act relates to sales and other dispositions of what are called "term interests in property". These interests are defined in new section 1001(e) to mean life interests in property, interests in property for a term of years, and income interests in trusts.

This amendment does not purport to involve capital gains treatment, yet appears to rest impliedly upon a grant of capital gains treatment to a type of transaction which, if further litigated in the current judicial

\(^{20}\) I.R.C. §§ 1253(d)(2).

atmosphere, might have produced an ordinary income result. This leads one to wonder—will the new law be construed as a Congressional blessing for capital gains treatment, and so help shore up a somewhat shaky legal issue, or will the courts ultimately undermine the amendment by answering the basic legal issue in a different way?

When a life estate and a remainder interest in property are acquired by gift, bequest or inheritance, a "uniform basis" rule is applied, with the basis of the property being divided between the life estate and the remainder. As the life estate is used up each year, its basis is reduced, and the basis of the remainder interest is increased in the same amount.\(^2\) Thus, putting to one side the effects of depreciation etc. (which reduce the total basis to be allocated) the combined basis of the life estate and the remainder interest remain the same from year to year, although the division of the basis as between the two interests constantly changes. Under Code section 273, the life tenant is not permitted to amortize his basis over the length of his life estate and thereby reduce for tax purposes the amount of income he receives. However, if the life tenant sold his interest in a transaction qualifying for capital gains treatment his basis in the property could, prior to the Tax Reform Act, be used to reduce the gain he received on the sale. The purchaser of the life estate, furthermore, is allowed to amortize his basis (i.e., his purchase price) and thereby offset it against the income which the purchaser receives.

Thus, almost all of the income from a life estate or similar interest acquired by gift, bequest or inheritance could escape taxation completely, since the life tenant was not taxed on the income to the extent of his basis when he sold it and, in addition, the purchaser of the life estate was not taxed on most of the income because he was allowed to reduce his income by amortizing his basis (his purchase price) in the life estate.\(^2\) This result seemed too rich for both the House and Senate Tax Committees. Their answer was an amendment to section 1001, providing, in effect, that the entire amount received on the sale or other disposition of a life estate (or other term interest in property) which was acquired by gift, bequest, inheritance or a transfer in trust, is to be taxable, rather than merely the excess of the amount received over the seller's basis for his interest. This is accomplished by the addition of language (§ 1001(e)(1)) providing that the portion of the life tenant's adjusted basis determined under section 1014 or 1015 shall be disregarded upon a sale. Since the latter sections are the life tenant's source of his entire basis in the case of transfers by gift, from a de-

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\(^2\) Reg. § 1.1014-4 and -5.

\(^2\) See e.g. William N. Fry, Jr., 31 T.C. 522 (1958), aff'd mem., 283 F.2d 869 (6th Cir. 1960), and Bell v. Harrison, 212 F.2d 253 (7th Cir. 1954), both of which cases involved purchases by remaindermen. The Service announced it would follow them in Rev. Rul. 62-132, 1962-2 C.B. 73.
cedent, or by transfer in trust, the effect of the amendment is to take away the transferor's basis entirely.

The foregoing amendment does not apply where there is a sale or other disposition of a term interest as a part of a transaction in which the entire interest in the property is transferred to another person or to two or more other persons jointly. For example, if a life tenant and the remainderman simultaneously sell their interests in a single transaction the amendment will not apply and the life tenant's gain will be measured by the excess of the proceeds received on the sale over his adjusted basis in the life estate, as determined under existing law.

The curious thing about the life estate amendment is that it does not really deal with the basic issue involved, which is whether the entire amount received on the transfer of such an interest should be taxable as ordinary income, as "essentially a substitute for what would otherwise be received at a future time as ordinary income."24 To be sure, there have been a number of cases (most of which were pre-Lake) which have granted capital gains treatment to sales of life estates,25 but there have been rumblings, both in the learned journals26 and in the recent cases,27 suggesting that if the issue were litigated today it might be answered differently.

The Senate Finance Committee appears to have realized it was treading on thin ice, since while the Senate adopted the House version of this amendment verbatim (except for a change in effective date), it deleted from the Senate Report a statement which had appeared in the House Report to the effect that life estates were "frequently" treated by the courts as capital assets, and any amount received upon their sale treated as a capital gain.28 Senator Gore's "Individual Views" appended to the Senate Finance Committee Report touched on this issue more directly, but still erroneously. He put his finger on the capital gains question, but suggested that the proper rule "is to give the taxpayer the benefit of any basis, but to tax all gain as ordinary-income under regular rules dealing with transfer of future rights to receive income."29 Senator Gore's solution is really no solution at all,

25 See, e.g., McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947), and Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943).
26 See e.g., Lyon & Eustice, "Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case," 17 Tax L. Rev. 293 (1962).
for if the holder is given the full benefit of his basis there is little or no income to tax, either as ordinary income or as capital gains.

The real question here is whether, on a sale or other disposition of a term interest, the entire amount received should be deemed taxable at ordinary income rates, under the rationale of the Supreme Court's decision in *Lake*, as a lump sum consideration for what would otherwise be received in the future as ordinary income. Had Congress done nothing in 1969 there was a distinct possibility (although no certainty) that the prior cases allowing capital gains treatment might have been reversed. Now the answer is even less clear. The amendment to section 1001 is clearly predicated on the Congressional assumption that capital gains treatment may be afforded to a transfer of a life estate. Yet the Senate Finance Committee deliberately refrained from saying so. This may mean that there is still a risk, assuming the Revenue Service were to attempt to litigate the issue, that a court might yet step in and hold that the sale of a life estate or similar interest is not entitled to capital gains treatment at all, and that the entire amount of the proceeds received by the seller are taxable at ordinary income rates without regard to the 1969 agreement, thereby rendering that amendment a nullity.

VI. COLLECTIONS OF LETTERS, MEMORANDUMS, ETC.

Concrete proof of the fact that Congress regards the work product of inventors with higher esteem than that of authors can be found in the fact that whereas inventors are specifically granted capital gains treatment by the terms of section 1235, authors are just as specifically denied such treatment. The denial in the case of authors is accomplished by section 1221(3), which specifically excludes from the capital asset category "a copyright, a literary, musical, or artistic composition . . . held by a taxpayer whose personal efforts created such property" (or by a person who acquired the property as a gift from the person who created it). In the Tax Reform Act of 1969, Congress appears to have placed politicians and others in the public spotlight in the same disfavored category as authors. That is to say, it is now specifically provided that letters, memorandums, and similar property (or collections thereof) are not to be treated as capital assets if they are held by a taxpayer whose personal efforts created the property, or for whom the property was prepared or produced (or if they are held

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80 Cf. President Kennedy's 1963 legislative proposal relating to this same matter, which would have treated the sale of a life interest as an anticipatory realization of income, taxing the proceeds as ordinary income unreduced by the basis of the property (but allowing the life tenant to use the new general averaging provision to afford relief from income bunching). *Hearing before House Ways and Means Committee on President's 1963 Tax Measure, 88th Cong., 1st Sess. pt. 1, at 156-7 (1963).*
by a person who received the property as a gift from such a person). An important collateral effect of this amendment is on the charitable contributions deduction. In the case of charitable contributions of ordinary income property, the unrealized appreciation in the contribution has the effect of limiting the charitable contribution deduction to the cost or other basis of the property. Since papers, memoranda, and the like generally have no cost basis, the consequence of characterizing them as ordinary income assets is that no charitable contribution deduction will be available with respect to gifts of such property.

VII. AMENDMENTS TO SECTION 1231 INVOLUNTARY CONVERSIONS AND LIVESTOCK

The Tax Reform Act of 1969 made two changes in section 1231, the first relating to involuntary conversions and the second to livestock. Section 1231 lumps together two categories of long-term gains and losses: (1) those from sales or exchanges of depreciable property and real estate used in a trade or business; and (2) those from the compulsory or involuntary conversion of depreciable property and real estate used in a trade or business, and of capital assets. If the gains from all such dispositions exceed the losses, then capital gain or loss treatment is provided; whereas if the losses exceed the gains, all gains and losses are ordinary.

Congress made an exception to these rules in 1958: an uninsured loss on property which resulted from fire, storm, shipwreck or other casualty, or from theft, was not classified as a section 1231 loss if the property was used in a taxpayer's trade or business, or was a capital asset held for more than six months and held for the production of income. As a result of this amendment, uninsured casualty losses were deductible against ordinary income and were not required to be offset against gains which might otherwise be treated as long-term capital gains.

The purpose of the 1958 amendment was to benefit business taxpayers who self-insured their business properties, and was in recognition of the fact that the self-insurer, unlike the taxpayer who pays ordinary insurance premiums which are fully deductible, is not permitted to deduct the amounts added to self-insurance reserves.

The 1958 amendment, however, produced several anomalous results: first, a business taxpayer with a casualty loss on two similar business properties, one of which was insured and the other was not, was

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81 For this purpose, letters and memoranda addressed to an individual are to be considered as prepared for him. S. Rep. 199. Proposed Reg. § 1.1221-1(c) (2) (The proposed regulations define the phrase “similar property” to include oral recordings made for dictation purposes, drawings and photographs, and even “a corporate archive, including a corporate charter.”) Ibid.
82 I.R.C. § 170(e), as amended by Tax Reform Act of 1969.
allowed to deduct the loss on the uninsured property in full against ordinary income, and at the same time was allowed to treat the gain on the insured property as capital gain. A second anomaly arose where a business taxpayer only partially insured a business property. In this case, if a business taxpayer had a casualty loss on business property only 5% insured, say, the deductibility of the loss was determined by the basic section 1231 rules, which turn on the overall gain or loss position of the taxpayer; whereas, if the property had not been insured at all, the loss would have been fully deductible against ordinary income without regard to the taxpayer’s overall gain or loss position under section 1231. A third problem which had arisen under section 1231 related to whether that section applied to casualty losses on uninsured personal assets, such as a taxpayer’s personal residence or non-business automobile. Section 1231 had been interpreted by some courts to mean that a casualty loss is not subject to the provisions of section 1231 unless the taxpayer receives some property or money as compensation for the loss. The leading case here was Maurer v. United States. The effect of the Maurer line of reasoning was that uninsured losses with respect to a taxpayer’s personal assets were fully deductible against ordinary income without being subject to the section 1231 netting rules. While other courts had refused to follow the Maurer result, Congress felt, in 1969, that the statute should be clarified on this point.

Congress therefore amended section 1231 to create an additional tier or category for all casualty gains and losses. That is to say, casualty gains and losses with respect to depreciable property, real estate used in a trade or business, capital assets held for the production of income and personal use assets are all placed in one new category, and it makes no difference whether the casualty property is uninsured, partially insured, or totally insured. If the casualty losses exceed the casualty gains, then the net loss will in effect be treated as an ordinary loss without regard to section 1231. On the other hand, if the casualty gains equal or exceed the casualty losses, then the gains or losses will be treated as section 1231 gains and losses which must then be consolidated with other gains and losses under that section. Thus, we now have a two-tier system under section 1231. All casualty gains and losses are compared and if the losses exceed the gains, such gains and losses are ordinary. If, however, the gains equal or exceed the losses, then all gains and losses will be taken into account along with the other section 1231 dispositions in the second-tier computations.

83 284 F.2d 122 (10th Cir. 1960). The Revenue Service announced it would not follow Maurer in Rev. Rul. 61-54, 1961-1 C.B. 398.

The second amendment made to section 1231 relates to the holding period for livestock. Prior to amendment, the sale of livestock held by the taxpayer for draft, breeding or dairy purposes, and held for twelve months or more, gave rise to long-term capital gain treatment under section 1231. Congress felt that a one-year holding period allows taxpayers to make short-term, tax-motivated investments in cattle and horses. It therefore extended the holding period, in the case of cattle and horses held for draft, breeding, dairy or sporting purposes, to twenty-four months from the date of acquisition. (The holding period was kept at twelve months for other livestock.) The Senate Finance Committee Report threw out a very important warning, however, couched in the following language:

The Committee also agrees with the House that the mere satisfaction of the holding period requirement in the case of livestock should not, in itself, be considered to conclusively demonstrate that the animals were held for breeding purposes (or any of the other specified purposes). Thus, even though a taxpayer holds livestock for the necessary period, he should not, merely because of that fact, be treated as having held the animal for one of the specified purposes. This determination should be made on the basis of all the facts and circumstances which indicate the purpose for which the animal is held.\textsuperscript{85}

So here we have another example, similar to those discussed in connection with the amendments relating to franchises, where, although Congress enacted new rules to deal with tax abuses or clarify the law, it has at the same time made it clear that the legislation is not all inclusive, but that other facts and circumstances—not specified in the legislation—may also have to be considered.

\textsuperscript{85} S. Rep. 101.