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ALL TAX DECISIONS, COURT ACTIONS, REVENUE RULINGS ISSUED EACH MONTH ARE SUMMARIZED IN THE DEPARTMENT COVERING THE POINT AT ISSUE

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Personal tax problems

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Distributions under Securities Investor Protection Act may not be capital gain

by BARRY LEIBOWICZ

Congress has provided investors with substantial protection against losses resulting from the bankruptcy or liquidation of firms holding their securities in safekeeping or on loan. In some instances, this protection can result in a taxable gain which may, although the securities constituted a capital asset, be treated as ordinary income. Mr. Leibowicz discusses the provisions of the Act and indicates the types of distributions that may be affected.

The Securities Investor Protection Act of 1970 (SIPA) has as its primary purpose the protection of individual investors by insuring them against losses arising from financial difficulty or failure of brokerage firms.[1] The Act accomplishes this by establishing the Securities Investor Protection Corporation (SIPC) which provides customers of its member firms with protection against losses as a result of the firm's liquidation.[2]

Liquidation of a brokerage firm under SIPA would occur in circumstances which would, absent the Act, result in normal bankruptcy proceedings, and the relatively small distributions which normally attend them. In the event of liquidation of a member firm, a trustee appointed by the appropriate Federal district court will, to the extent possible, return specifically identifiable securities held by the firm to their owners.[3] Such securities are, in general, fully-paid securities in cash accounts and excess securities in margin accounts which have been segregated as the customer's specific property. The return of such securities would, of course, be without tax effect.

However, to the extent claims for securities cannot be satisfied out of the remaining assets of the liquidating firm, the owners will be compensated at fair market values as of the liquidation date, up to a maximum sum of $50,000.[4] It is this insurance feature which, although offering the investor much-needed protection, produces the possibility of a realization of gain in circumstances under which only losses would have previously been realized.

Like kind exchange aspect

Stock delivered to a customer by a brokerage firm which had previously held such stock for safekeeping is frequently represented by certificates other than those originally held by the customer. The receipt of such different certificates is entitled to treatment as a like-kind exchange, upon which the realization of gain is not recognized pursuant to Section 1036.[5] When the realization of gain or loss results from a distribution of other than like-kind property, as compensation for undelivered stock, Section 1036 is no longer applicable and accordingly does not produce non-recognition.

Involuntary conversion aspect

It would seem at first glance that the receipt of cash compensation for unreturned securities, stemming from a brokerage firm's insolvency and subsequent liquidation under SIPA, would qualify for the benefits accorded involuntary conversions under Sections 1033 and 1231. After all, the securities have been "converted" into cash in a transaction which is definitely involuntary. Regardless of the nature of the conversion, however, if it is one which falls outside of the specific circumstances enumerated in the limiting clauses of the particular sections, it is ineligible for the special tax benefit provided by them.

The involuntary conversions enumerated in Sections 1033 and 1231 are limited to destruction in whole or in part, theft, seizure, requisition, condemnation, or threat or imminence thereof. If the conversion is so qualified the proceeds may be rolled over tax free under Section 1033, or granted special characterization pursuant to Section 1231.

The element of governmental authority present in the liquidation of a brokerage firm and subsequent compensation of its customers, thereby extinguishing all further claims by them, is not sufficient to bring the conversion within the purview of the involuntary-conversion provisions. In a situation in which stock was disposed of as the result of a court-ordered divestiture, a district court construed the words "requisition or condemnation" to mean "a taking of property by public authority for public use . . . " "The presence of the element of governmental action . . . is not alone enough to satisfy the statute."

The conversion must take place "as a result of . . . requisition or condemnation or threat or imminence thereof."[6] The stock there, said the court, was not taken by "public authority for public use." Once the conversion occurs it merely becomes necessary for governmental action to be taken to minimize the disruption inherent in the conversion, and compensate victims of the conversion for their lost property. None of the property ever passes to, or is used by, the government. Neither is it destroyed, stolen, or seized. Its conversion into cash is involuntary. But it is not by such an occurrence as is required by the limiting clauses of the two sections. Being outside of the scope of both Sections 1033 and 1231, realized gains or losses upon conversion of the stock pursuant to a SIPC liquidation are not entitled to the special treatment provided by these sections. The gain or loss is therefore both realized and recognized, without benefit of any special characterization under Section 1231.

Once it is determined that the transaction is one which produces gain or loss which is both realized and recognized, problems of characterization arise. In the case of losses, in addition to the questions of characterization, their deductibility is at issue.

Ordinary loss aspect

Several choices present themselves in the event that losses arise as the result of a liquidation under SIPC. Such possibilities include denial of the loss deduction as personal, bad debt characterization, allowance of an ordinary loss under 165(c), or treatment as a capital loss under 165(f).

The question of whether a loss on a "loaned" security creates a deductible bad debt or loss was presented in *Stahl*, 441 F.2d 999 (CA-DC, 1970) *aff'g.* 294 F. Supp. 243 (DC-DC., 1969). The taxpayer in *Stahl* turned over securities with a substantial value to a brokerage firm for use by them in meeting SEC capital requirements. Pursuant to an agreement with the firm Mrs. Stahl was to receive all dividends and interest generated by the securities and an additional 1% per quarter fee until the eventual return of the securities under the agreement. The agreement required that Mrs. Stahl's rights were to be subordinate to all other creditors, current or future. As a result of bankruptcy of the firm Mrs. Stahl "lost" the securities. Both the taxpayer and the Government agreed that the loss was deductible. The character of the loss was in dispute, however. The Government sought to characterize the loss as one arising from a debtor-creditor relationship which, since not meeting the narrow interpretation of a business bad debt, was a short-term capital loss under Section 166(d). Mrs. Stahl argued that, rather than being a debt, the relationship created by the agreement was one of bailee-bailor, as providing personality for a particular purpose and subsequent return, and was deductible as an ordinary loss under Section 165 (c).

The Circuit Court, in concurring with the taxpayer, seized upon Reg. 1.166-1 (c)'s requirement of an obligation to pay a "fixed or determinable sum of money" and held that a bailee-bailor relationship was created. An absolute liability to pay such sum of money was held to be a "sine qua non of the debtor-creditor relationship." Since such an absolute liability was not present, no debtor-creditor relationship, and therefore no bad debt, could exist. Any deduction must accordingly result from a loss as defined in Section 165. In finding that the expectation of compensation for the use of the securities in the transaction made it "plainly one entered into for profit," the court determined ordinary loss treatment under Section 165(c)(2) to be applicable. The Circuit Court thus made a determination as to the specific subsection of Section 165(c) under which the loss would be deductible, despite an earlier determination by the district court that such specificity was unnecessary.

Accordingly, the decision in *Stahl*, although contrary to the views expressed by some commentators,[7] provides a rule that losses resulting from transactions in which securities are converted are limited to treatment under Section 165. For individuals, allowable ordinary losses are further limited by Section 165(c). Safekeeping agreements would not constitute a sufficient "trade or business" as to prevail against the Supreme Court's consistently narrow interpretation of Section 165(c)(1).[8] Neither would conversion of stock held under such an arrangement qualify as a casualty loss under Section 165(c)(3) for reasons similar to those discussed above in reference to the involuntary conversion provisions applicability. The only possibility of deduction for such conversion losses would therefore be under Section 165(c)(2), as a transaction entered into for profit.

Mrs. Stahl's relationship to the brokerage firm was as a subordinated "creditor" rather than as a customer. In such a situation, an owner commonly deposits securities with a firm under an agreement whereby the firm uses such securities to meet SEC capital requirements. The subordinated creditor retains legal and beneficial title to the securities and is entitled to vote all shares and receive any dividends upon them for as long as they continue to be held by the firm. The agreement provides that the firm will return the securities to their owner upon termination of the appropriate period, subject however to the risk that they will be appropriated by the firm to pay the claims of its general creditors. In return for the deposit of securities the owner of such securities is entitled to compensation, usually based upon a percentage of the value of the securities. Such compensation "fees" are ordinary income to the owner-recipient.[9]

In the event pledged securities are liquidated by the firm under the agreement, such liquidation constitutes a sale by or on behalf of the owner resulting in the recognition of gain or loss (usually capital in nature) in the year of sale by the firm.[10] Owners of securities who participate in such subordination agreements are not customers in regard to such securities for the purposes of SIPA and, therefore, unlike customers, are extended no insurance protection by the Act.[11] In the event of a firm's liquidation under SIPA they are limited to the receipt of proceeds as subordinated creditors in the general estate, which rarely produces any substantial recoveries to them. A customer, however, being entitled to the insurance protection of SIPA, has an almost assured right to recovery.

In *Stahl*, the court found Section 165(c)(2) applicable, since Mrs. Stahl expected to derive interest and profits from the arrangement. But the court also said that in such cases the burden is on the taxpayer to establish that the loss was incurred in a transaction entered into for profit. In *Stahl* the profit motive was direct and obvious. In a purely safekeeping arrangement it is not. The purchase of stock and its retention is a transaction entered into for profit. If the safekeeping arrangement is considered an integral part of such transaction any resulting loss would qualify for deduction under Section 165 (c)(2). However, if the safekeeping transaction is treated independently, Section 165(c)(2) would not apply. The safekeeping arrangement alone produces no profit to the taxpayer. It is entered into for convenience. Thus, loss on conversion of stock held in safekeeping may produce a deductible ordinary loss under Section 165(c)(2) as part of the overall profit transaction, or no 165(c) loss at all as being part of an independent transaction entered into solely for personal convenience. Qualification for capital treatment would create a possibility that the otherwise allowable loss under Section 165(c)(2) would be further limited to capital loss treatment under

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[1] S. Rep't. No. 1218, H. Rep't. No. 1613, 91st Cong. 2d Sess. (1970).
[2] See 73 *Colum. L. Rev.* 802, 807 (1973).
[3] SIPA, Section 6(c) (2) (C).
[4] SIPA, Section 6(f).
[5] *Rev. Rul.* 57-451, 1957-2 CB 295.
[6] *Behr-Manning Corp.*, 196 F.Supp. 129 (DC Mass. 1961).
[7] See 70 *Mich. L. Rev.* 400 (1971).
[8] *Whipple*, 373 U.S. 193 (1963).
[9] *Rev. Rul.* 69-456, 1969-2 CB 9.
[10] *Rev. Rul.* 74-301, IRB 1974-25, 21.
[11] *S.E.C. V. F. O. Baroff Company, Inc.*, 497 F.2d 280 (CA-2, 1974).

Section 165(f). However, for reasons enumerated below, capital treatment is inapplicable in the purely safekeeping type of arrangement.

Accordingly, any loss in a safekeeping situation in which stock has been converted will produce either a deductible ordinary loss, or one which is disallowed in its entirety as personal, depending upon the "profit" characterization of the transaction.

Capital gain or loss

In the event a gain is realized upon receipt of SIPC compensation, or a loss qualifying for deduction under Section 165(c), a question as to the character of such gain or loss arises. If a gain is capital, it qualifies for the substantially lower capital gains rates. If a loss is capital the otherwise ordinary deduction would be limited to the less advantageous capital loss rules. It is in this area of characterization where SIPC compensation presents the most difficulty.

Section 1222 provides that capital gains or losses result from the "sale or exchange" of a capital asset. Two conditions must be met, therefore, absent coverage by any special characterization statute, for capital treatment. They are that (1) there be a capital asset and (2) that realization occur by "sale or exchange" of that asset. The first of the conditions for capital treatment is met in most situations covered by SIPC. The stock converted is a capital asset. Thus, the basic question presented by the distribution under SIPC of funds for lost stock is whether or not the transaction constitutes a sale or exchange.

Not every gain which arises upon a transaction which concerns a capital asset benefits from a capital characterization. "Those are limited by definition to gains from the sale or exchange of capital assets."[12] To the extent that gain or loss is realized, through other than a "sale or exchange," realization is by "other disposition," under Section 1001, and results in ordinary gain or loss.

Congress has never provided a definition for the term "sale or exchange" as used in Section 1222. The Supreme Court was thus presented with the necessity of defining the term in a manner consistent with Congressional intent in *William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941).

In *Flaccus*, insurance proceeds were received as the result of the destruction of property by fire. The Court held that there had been no "sale or exchange," and the resultant income therefore was ordinary. The *Flaccus* Court said "generally speaking the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words "sale" or "exchange" are not to be read any differently." Neither the demolition of the property, nor compensation for it, constituted a sale under that ordinary meaning. Neither was it an exchange since "exchange" "implies reciprocal transfers of capital assets, not a single transfer to compensate for the destruction of the transferee's asset."

The sale or exchange test has been characterized as the Court's "guiding light" in cases such as *Spray Water Power and Land Co.*, TCM 1961-73. In *Spray*, insight was provided into the view of the courts with respect to deciding whether or not a "sale or exchange" has in fact occurred. The court suggested that where there is a sufficient transfer of property to bring the capital asset transaction within the plain meaning of a sale or exchange, the courts have historically allowed capital gains treatment. Where nothing has been transferred and the respective rights of the parties merely extinguished as a result of the transaction, courts find a sale or exchange lacking and hold gains or losses realized to be ordinary.

A long line of cases makes it clear that neither the collection of an obligation, nor the settlement of a claim constitute a sale or exchange. To constitute a sale or exchange, there must be a "transfer of property in goods."[13]

Additionally, a sale or exchange of the asset must be the event which produces the realization in question. In *Pounds*, 372 F.2d 342 (CA-5, 1967), the Fifth Circuit stated that "a mere sale or exchange somewhere in the history of the asset will not do." Pounds, a real estate broker, acquired an interest in net profits from the eventual sale of land by purchase. There was a "sale or exchange" of the underlying land. But that "sale or exchange" did not produce the realization in question. Rather, the realization occurred on collection of Pound's contractual share. Since a collection is not a "sale or exchange," and since the realization obtained by Pound resulted directly from the collection, the realization upon the contract right, admittedly a capital asset in his hands, was held to constitute ordinary gain. Despite the presence of a capital asset, the failure to realize the gain directly from a "sale or exchange" produced ordinary, rather than capital gain.

Contract rights may, in certain circumstances, constitute capital assets. The right to compensation which is held by an investor under SIPA is such a capital asset. This right is not, however, received in exchange for the lost stock. Rather, from the moment an investor obtains stock and deposits it with a SIPC member firm the act grants him the right. The right to compensation is an attribute of SIPA and arises concurrently with the appropriate stock ownership, and is merely subject to the operative condition that there be an actual liquidation and loss. Realization occurs only upon compensation under the act. An award resulting from collection of a claim under a compensatory act has been held to be other than a sale or exchange, producing ordinary income.[14]

Accordingly, when the act producing realization is a sale or exchange, no characterization problem is presented. The gain or loss, being realized through sale or exchange of a capital asset, is capital. When amounts distributed to the investor are in essence the net proceeds of stock in a margin account sold on his behalf by a trustee in liquidation, resulting losses have been held to be capital in nature.[15] It would seem that capital characterization is proper since amounts distributed are actually the proceeds of a sale or exchange.

This differs significantly from the situation in which a trustee in a SIPC liquidation, being unable to locate and distribute securities to their owners in kind, compensates them for their loss. The fact that the shortage of securities, and therefore the claim to compensation, may result from a prior conversion through sale or exchange by the liquidating firm does not alter the essential character of the realization. It is the collection of a SIPC claim, not a sale or exchange, which produces the realization. What is received is not the proceeds of a sale or exchange, but rather compensation by "insurance" for loss.

Realization of gain or loss in the event of a SIPA liquidation is completely involuntary. Distributions made under the act are solely the result of Federal law and purely compensatory in nature. They arise from contractual obligations of the government contingent upon the occurrence of a brokerage

[12] *Dobson*, 321 U.S. 231 (1944).
[13] *Hort*, 313 U.S. 28 (1941).
[14] *Estate of Bary*, 368 F.2d 844 (CA-2, 1966).
[15] *Rev. Rul.* 74-293, IRB 1974-25, 11.

firm's insolvency and a concurrent stock loss by the investor. The various events which culminate in a distribution under the Act are in no way the result of investor action. In most cases, absent the intervening liquidation, the investor would have disposed on his stock in a sale or exchange, thereby producing capital gain or loss. But whatever the investors would have done, it is clear that what they actually did do is controlling, and what they did was collect an obligation, not make a sale or exchange.

Regardless of the merits of an investor's cause, if there has been no sale or exchange, there can be no capital gain or loss. Furthermore, the courts are not free to create such a sale or exchange by analogy. In *Pounds* while hesitating to rely upon the silence of Congress in failing to take a particular transaction into account, the court stated that "the Supreme Court has held that implication of a sale or exchange is impossible." The very fact that Congress has spoken and thereby provided special characterization for certain specific transactions is indicative of the very strict express requirement of sale or exchange in order to secure capital gain or loss treatment.

The courts, as in the *Pounds* case, have recognized that to deny capital treatment to transactions solely for want of a formal sale or exchange transaction, all other criteria for capital characterization having been met, would seem a superficial and overly-formalistic approach to resolution of the issue at hand. Despite such appearances however, the distinction between transactions encompassing within them a sale or exchange, and the mere collection of contract obligations strikes at the heart of the reason for affording capital treatment at all. *Pounds* held that a basic underlying reason for according special beneficial tax treatment to capital sale or exchange transaction was to "facilitate the disposal of appreciated property."

Until the liquidation of the investor's brokerage firm, he has complete control over the timing of realization upon his stock. This is the case despite such stock being in the care and custody of the firm. The reduced tax burden provided by special treatment afforded capital gains may minimize the tax considerations which would enter into the making of a decision to effect such a realization. The disposition of such capital asset securities would therefore occur more readily. And it is this encouragement to enter into transactions which produce realization through disposal and conversion of certain assets which is a basic premise of the capital gains provisions. It benefits the revenues by accelerating taxable realizations. Additionally, it produces an active marketplace, which is beneficial to the economy.

In any event, when there has been an event which deprives the investor of control over the timing of his realization, there is no longer any need for the beneficial rates which have been provided as incentive. Special tax treatment is at once no longer necessary or even relevant. Control over the timing of realization is unavailable, and it does not benefit the revenues to reduce the tax on such realization. When a brokerage firm is liquidated, the timing of realization is fixed. The customer is powerless to alter it. Under the rationale of the *Pounds* court, therefore, such realization would not be entitled to capital gain or loss treatment under the provisions of the code. ☆

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