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Chapter 8

EFFECTS OF THE CHANGING TAX TREATMENT UPON FEDERAL REVENUES

1 REVENUES HIGHLY ERRATIC

The federal government's net revenues from its tax treatment of capital gains and losses have been highly erratic. Individuals with net incomes paid more than $1.5 billion in such taxes in the 4 years of the stock boom, 1926-29; in the next 5 years their tax reductions because of the allowances for capital losses exceeded the taxes paid on their gains by $151 million. This figure does not measure the full revenue loss from this source during the 5 years because it does not include the taxes saved on their ordinary income by persons who, because of net capital losses, were enabled to report no taxable income. Their returns were excluded from the Treasury's estimates of net tax receipts from capital transactions before 1935, though they have been included for subsequent years. Capital gains and losses of individuals again returned negative revenues in 1940 and 1941, and the net positive yield for 1935-41, including deficit returns, averaged only $30 million a year. But after a modest recovery, to $68 million in 1942, the net receipts from this source soared to roughly $2.2 billion in the 4 years 1943-46, or 44 percent more than in 1926-29, and preliminary estimates indicated $500 million in 1947.[1]

[1] Table 90. In estimating net revenues from the tax treatment of capital gains and losses for 1926-34 the Treasury's method was as follows: To the surtax net income in each net income group, the statutory amounts of the net capital losses were added back and the statutory amounts of the net capital gains were subtracted, yielding a figure for statutory net income other than capital gains and losses. To this figure the Treasury applied the average tax rate for each net income group; the product is the estimate of tax revenues on income exclusive of capital gains and losses.

There was no attempt to weight the estimate for each income group by the dispersion around the average, and no allowance was made for the revenue losses occasioned when individuals with net incomes from other sources were enabled to report net deficits on their operations as a whole because of net

The proportion of total individual income tax receipts attributable to capital gains taxes has also varied greatly. In 1928 such taxes accounted for nearly half of the total, and the proportion exceeded 40 percent in the 4 years 1926-29 as a whole. This situation changed abruptly with the onset of the depression. In 1930-32, and again in 1940-41, as noted above, tax reductions resulting from the allowances for capital losses exceeded tax receipts from capital gains. In the other years between 1933 and 1942 the proportion of total individual income tax revenues contributed by capital gains and losses ranged from 14.1 percent in 1936 to less than .5 percent in 1939. With the tremendous rise of incomes and income tax rates during the war and early postwar years, even the large capital gains revenues of 1943-47 constituted only 1.8 to 5.2 percent of the annual individual income tax receipts.

Those who regard stability of yield as an essential characteristic of a satisfactory revenue source will obviously find that capital gains have been badly wanting in this respect. Congress has gone far since 1933 to reduce one cause of the instability by severely restricting the deductibility of net capital losses from other income. In consequence, even though taxpayers in the aggregate reported more capital losses than gains in all except 1 of the 10 years 1933-42, and reported an aggregate loss excess of $3,961 million for the decade as a whole, the Treasury obtained a positive net revenue from its tax treatment of these items.

The present restrictions ensure that the net revenues will rarely if ever be negative for taxpayers as a whole and that, at worst, an occasional negative yield will be held to a very small figure. By limiting the deductibility of a taxpayer's net capital loss from other income to $1,000 in any one year and by permitting his excess of capital losses to be offset against his capital gains of the succeeding 5 years, the treatment in force since 1942 makes for a more stable flow of revenue. This carryforward provision makes for a significant degree of averaging losses against gains. Not only are net losses prevented from making serious inroads on the tax revenues of the year in which they occur; in addition, the taxes otherwise payable on the

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capital losses. Both these deficiencies in the Treasury's estimates for 1926-34 were severely criticized in an unpublished study, Capital Gains Tax, made for the New York Stock Exchange in 1947 by L. Robert Driver. For the years since 1935, the Treasury has used more refined procedures and included deficit returns. Consequently the estimated net revenues for 1926-34 in Table 90 are higher than they would be if made on the same basis as those for subsequent years.

net gains of prosperous years are reduced by the allowance for losses carried over from preceding years.

But this partial averaging is open only to those who first incur net capital losses and in subsequent years realize net gains. It does nothing to even out the taxable incomes of those whose years of net gains precede their years of net losses, or of those whose net gains vary widely from year to year. In the absence of more complete averaging, the possibilities of which are discussed in Chapter 11, continuing great irregularity in the tax receipts from capital transactions seems inevitable.

Instability of yield in a source of revenue has traditionally been regarded as a serious defect because it makes budget balancing difficult and may therefore endanger the government's credit. Since the depression of the 1930's, however, the desirability of stable revenues for a central government has been seriously and widely questioned. Indeed, many have urged a compensatory instability to offset opposite fluctuations in the private sector of the economy. A central government that insists upon collecting substantially the same amount of tax revenues in years of bad business as in good will, it is argued, accentuate the economy's difficulties in bad years by absorbing a larger proportion of the reduced private incomes, and exaggerate the prosperity of good years by taking a smaller proportion of the enlarged private incomes. Many persons who strongly oppose the view that a central government can usefully or safely incur a prolonged succession of budgetary deficits nevertheless favor seeking a balanced budget only for a business cycle rather than for each and every year. They would have the government deliberately incur deficits by reducing tax collections or spending more in bad years and collecting exceptionally large revenues or sharply reducing expenditures in good years.

And among those who share this general viewpoint a large number see certain advantages in varying tax receipts rather than public expenditures as far as possible: the former better protects the private sector of the economy from encroachment by the government; through a heavy use of taxes that are highly responsive in yield to changes in national income, such as graduated income taxes, it lends itself to automatic operation in considerable degree; and adjustments in either direction can be made with less delay, administrative cost, and political controversy, it is contended, than are involved in government spending programs. For those who hold any variant of the view that a central government's taxing policy should attempt to compensate for fluctuations in private spending, the instability of yield of capital gains taxation may appear benign, for a large excess of net capital gains tends to be realized in good years and smaller gains or net losses in bad, with the result that private incomes are reduced in prosperity and better maintained in depression.

It is doubtful, however, that capital gains will ever again contribute as big a proportion of total income tax revenues as they did in 1926-29. Although another stock market boom of the same or greater intensity and duration may well occur, our changed tax structure will alter its revenue significance. In 1926-29 personal exemptions and credits for dependents were so generous that only a few hundred thousand persons paid income taxes, and the individual income tax, including taxes on capital gains, yielded only slightly more than $1 billion in the best year. Taxes on ordinary income did not reach $600 million in any year.

In 1948, in contrast, more than 36 million individuals and fiduciaries filed taxable returns and their aggregate income tax liability approximated $16 billion. The amount of capital gains tax revenues that constituted nearly half of total individual income tax receipts in 1928 constituted less than 4 percent in 1948. In 1947 the actual proportion was about 2.7 percent. This percentage was raised somewhat under the Revenue Act of 1948 which, for individuals with sizeable incomes, reduced the effective tax rates on ordinary income much more sharply than on capital gains. The bracket rates on ordinary incomes were cut, and division of income between husband and wife was permitted, but the ceiling tax rate of 25 percent on long term capital gains was not altered. The rearmament program that was set in motion by the invasion of South Korea in June 1950 substituted the certainty of early and heavy tax increases for any possibility of further tax reductions. Some of these were made late in 1950, and additional tax revenues of $16.5 billion were requested by the President for the fiscal year beginning July 1, 1952. Hence, though taxes on capital gains may be expected to produce substantial absolute amounts of receipts in good years and small sums in bad years, the fluctuations are likely to have a relatively minor impact upon total federal revenues. For this reason the fluctuating character of capital gains tax revenues is now quantitatively unimportant, whether regarded as a defect or virtue.

2 WOULD A LOW TAX RATE INCREASE THE REVENUE YIELD?

The contention has been frequently advanced before Congressional committees that the revenue from capital transactions would be vastly increased if capital gains, both short and long term, were subject only to a uniform low flat rate of about 10 percent, and all allowances for net capital losses against ordinary income eliminated. In 1942 one witness presented calculations purporting to show that such a treatment might be expected to produce annual revenues of $200-600 million, as against the actual average annual yield of about $30 million in 1931-40.[2]

Such estimates are based upon two assumptions: that the volume of transactions and of realized gains is extremely sensitive to tax rates and that any significant allowance for net losses must drastically reduce revenue.

The first assumption is not supported by the data reviewed in Chapters 6 and 7. We found that although the changing tax treatment doubtless influenced the amounts of gains and losses realized, other forces, such as the trend and level of stock prices, have been of greater aggregate significance and have commonly swamped the influence of tax changes. The practical effect of these other forces is to reduce the responsiveness of capital gains and losses to tax changes: because of them, reductions in tax rates have a smaller stimulating effect and increases a smaller depressing effect upon the gains realized. The tax treatment was unchanged in 1926-31, yet the revenue yield ranged from $576 million in 1928 to a revenue loss of $89 million in 1931 (Table 90). In the face of increases in tax rates in 1936 over 1935, the realized net gains of individuals with net incomes nearly doubled. The reduction to 15 percent in the maximum tax rate in 1938-41 on gains from assets held more than 18 months produced no semblance of the huge revenues derived from long term gains during the late 1920's, when a 12.5 percent maximum rate was in force. Under a 25 percent maximum rate in 1945 and 1946, net capital gains exceeded the high levels of the late 1920's and net revenues from transactions in capital assets were higher than in any preceding year. Although total net capital gains in 1945 for individuals with net incomes were about equal to those in 1928, the tax revenue from them was about 25 percent larger.

The long run revenue cost of the present allowance for net capital losses cannot be estimated with confidence until we have had more experience with it. Its chief impact upon revenues is likely to come from the full deductibility of such losses against the capital gains

[2] Elisha M. Friedman, *Revenue Revision of 1942*, Hearings, Ways and Means Committee, p. 1656. The $30 million average yield cited by Mr. Friedman is reduced to $16 million by later Treasury estimates.

of the succeeding 5 years, rather than from the $1,000 allowance against ordinary income in the current and each of the succeeding 5 years. The 5-year carryforward can accumulate to a huge sum during a series of bad years. The net capital losses reported by individuals in 1930-34, for example, totaled $11.7 billion, while net gains were only $2.9 billion. In every year 1918-45 except 1927-29 net capital gains were less than the aggregate net capital losses of the preceding 5 years, but in 1946 net capital gains exceeded the aggregate net capital losses of the preceding 5 years.

But these figures do not mean that taxable capital gains would have been extinguished if the present carryforward had been in force. They pool the results of the divergent experiences of different persons, while taxes are assessed on an individual basis. Many taxpayers who had incurred heavy losses in 1930 or 1931 did not share in the capital gains subsequently enjoyed by some individuals, while not all the latter had previously sustained capital losses. The credit for losses carried forward by the one would not have reduced the tax liabilities of the other. Death, as well as ill-fortune in speculation, may remove the tax-reducing power of a taxpayer's loss carryforward. For these reasons, ready and precise inferences about the revenue results cannot be drawn from the totals of gains and losses of taxpayers as a whole. Nevertheless, these aggregates indicate that very substantial remissions of taxes in good years are likely from the credits for losses carried forward.

The reduction in revenue resulting from a taxpayer's actual use of such credits will, in a sense, merely prevent an overpayment of taxes. It will only reflect the use of a period longer than 1 year in which to measure the net gain from his transactions in capital assets, provided his losses precede his gains. And because the remission in taxes otherwise payable is confined to those who have actually incurred previous losses, the net loss carryforward is a more selective provision than alternative proposals that would deal with capital losses categorically without discriminating among taxpayers, such as completely disallowing capital losses.

The net revenues from the tax treatment of capital gains and losses reflect not only the volume of capital transactions and tax rates but also the opportunities for tax avoidance and the extent to which they are used. The technical realization of artificial losses and the technical avoidance of realizing gains by various legal devices, some of which are noted in the next chapter, as well as the taxpayer's ability to time many transactions with an eye to tax advantage, all take their toll of possible tax revenues. What is probably the largest single source of revenue loss in connection with capital gains is the elimination, by the owner's death of all tax liability for previous unrealized increases in the value of his property. And, as we have noted, the opportunity to avoid completely the capital gains tax by leaving the sale of appreciated property to one's heirs doubtless inhibits many transactions. Even a capital gains tax of only 10 or 15 percent, while low relative to income tax rates, appears costly to many investors when compared with the zero rate of tax on the gains embodied in property transferred at death.

3 REVENUES FROM CAPITAL GAINS AND THEIR ADMINISTRATIVE COST

Although revenues were large in some years, the average annual net tax revenues from capital gains and losses in the entire period 1917-47 have been small, and may even have been negative. The Treasury's estimates, we have noted, do not cover years before 1926, and do not include deficit returns for years before 1935. Capital losses were heavy in 1920 and 1921, when they were fully deductible from ordinary income and when the latter was taxed at high rates; and no absolute limit existed on the deductibility, at a maximum rate of 12½ percent of the loss, of the huge long term net capital losses reported in 1929-33. Even if we disregard deficit returns before 1935, the average annual net revenue from capital gains and losses in 1926-47 was only about $200 million. While tax rates on capital gains are now much higher, they do not ensure larger average revenues for a long period because of the possibility that the revenues otherwise arising from the gains of good years may now be largely offset by net losses carried forward from the preceding 5 years.

In view of the small, uncertain, and fluctuating revenues derived from capital gains and losses, the question has repeatedly been asked whether they are worth their administrative and legal costs. Driver (see note 1) has charged that no other sections of the Internal Revenue Code are so difficult to interpret and enforce, and that these sections deter or distort numerous business transactions, including various kinds of corporate reorganizations and exchanges. The conclusion is usually drawn that if capital gains and losses were excluded from the calculation of taxable income, these frictions and wastes would be greatly reduced or eliminated.

In the main this conclusion is fallacious. Some difficulties of taxpayer compliance and administrative costs and litigation might well be reduced. But the chief source of controversy and of tax-motivated legal expedients on the part of taxpayers and their lawyers would remain. The present elaborate enforcement efforts and controversies in this connection arise, for the most part, precisely because capital gains are taxed at lower rates than ordinary income. It is this preferential treatment that necessitates a nice distinction on the part of taxpayers, tax administrators, and the courts between capital gains and ordinary income. To exempt capital gains from income taxes would mean to put a zero rate of tax on them as compared with the substantial rates on ordinary income. Such a change would *increase,* not diminish, the inducement offered taxpayers to attempt to make their ordinary income take the form of capital gains as far as possible.

The same considerations apply to capital losses. At present, when capital losses are allowed only in part, the taxpayer has a motive to cause capital losses to assume the form of ordinary losses, and to contend that all borderline cases are cases of ordinary rather than capital losses. But the exclusion of capital losses from taxable income would not remove this motive. On the contrary, to deny all allowance for capital losses would give taxpayers a stronger motive than ever for contending that all losses are ordinary losses.

It may well be argued, therefore, that the mere enforcement of the graduated taxes on ordinary income would require careful definition of capital gains and losses, and administrative scrutiny of the transactions from which they are reported to arise. To the extent that the administrative costs incurred in connection with the capital gains tax provisions are essential to minimize avoidance and evasion of the ordinary income tax, they are properly chargeable to the latter.

In short, the exclusion of capital gains and losses from taxable income would not remove the main source of administrative and compliance difficulties because it would still be necessary for both the taxpayer and the Treasury to distinguish sharply between ordinary gains and losses and capital gains and losses. Indeed, if the elimination of such difficulties were our primary objective, it would be logical to move in the opposite direction: to reduce, rather than to increase, differences in the tax treatment of ordinary income and of capital gains and losses. The obliteration of all distinctions, for example, would eliminate these difficulties, though it would be open to objections of other kinds already noted.