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Chapter Title: Background Of The Controversy

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Chapter 1

Background of the Controversy

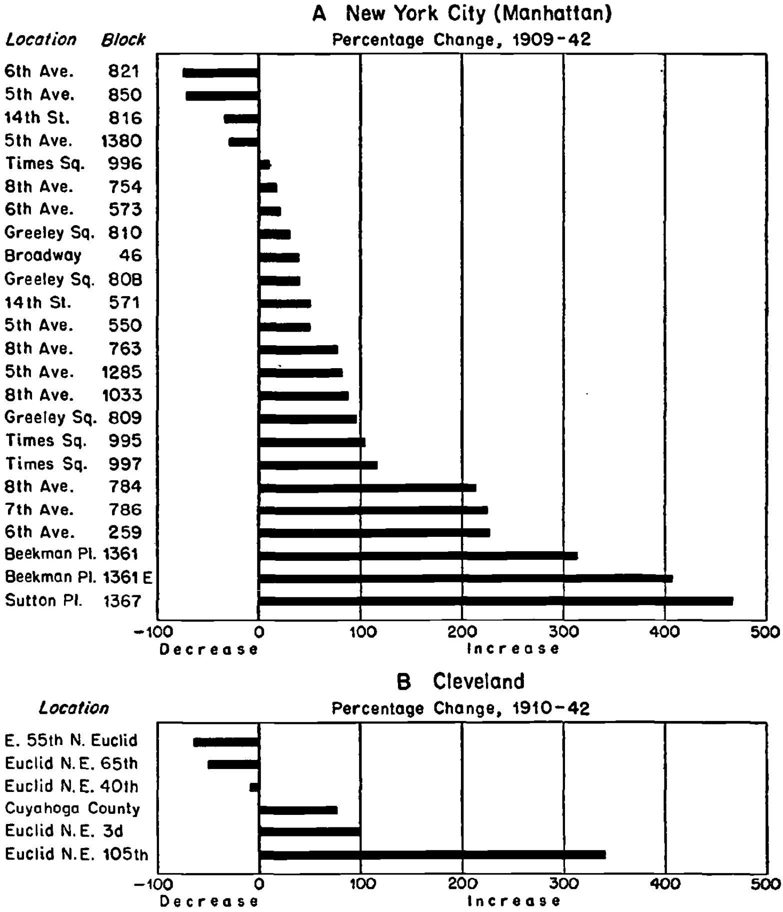
1 What are capital gains and losses?

In every decade a considerable number of able, venturesome, and/or lucky persons experience substantial additions to their private fortunes not by receiving, saving, and investing ordinary income but through increases in the market value of investments they have made in real estate, business enterprises, or other property. Such gains are known as 'capital gains' or 'capital profits'. Landowners may make fortunes because a new highway or bus line is built or an urban area becomes fashionable for specialty shops or apartment houses. For example, land values in the Sutton Place area of Manhattan (York Avenue, between East 54th and 59th Streets, New York) soared from $300 a front foot in 1924 to $2,000 in 1929.[1] An investor who bought 100 feet for $30,000 in 1924, perhaps with a down payment of $10,000, could sell it for $200,000 five years later. Similar examples of Dame Fortune's goodwill, as well as appalling illustrations of her illwill, can be cited by real estate men in most of the large cities of the country. Various examples of both can be found in the value changes of selected sites in New York City and Cleveland presented in Chart I and Table 91. While some sites rose in value upwards of 300 percent, others rose only moderately, and still others lost heavily.

The stock market offers endless illustrations of such gains and losses. A man who bought 200 shares of Pepsi Cola Company common stock at $6 a share in 1939 could sell his holdings for more than $225,000 in 1945. A man who invested $3,000 in American and Foreign Power Company $7 cumulative second preferred stock in 1941 could have sold out for more than $100,000 in 1945. The market value of 2,500 shares of Northern States Power Company Class A stock rose from $5,000 in 1942 to more than $180,000 in

[1] As measured by assessment values, which tend to lag behind market changes in both directions, and are often only rough approximations to market values.

Chart 1
Change in Assessed Values of Various Groundsites
New York City, 1909-42; Cleveland, 1910-42



Source: Table 91.

May 1946, the price per share rising from $2 to $73. A prescient or lucky investor could have multiplied his capital by 12 during 1945 alone by investing in the $4 preferred stock of Standard Gas & Electric Company.

On the other hand, some investors paid $300 a share in 1929 for Northern States Power Class A stock which fell to $2 a share by 1942. The common stock of Philip Morris & Company fell 30 percent in the 6 months ended March 1, 1946. In the 4 months ended September 30, 1946, the aggregate market value of all stocks listed on the New York Stock Exchange fell $18 billion or a fifth; between September 1929 and March 1933, in the most disastrous decline on record, from $90 to $20 billion.

Capital gains vs. ordinary profits

In both law and common speech, capital gains are generally regarded as the profits realized from increases in the market value of any assets that are not a part of the owner's stock-in-trade or that he does not regularly offer for sale; and capital losses, as the losses realized from declines in the market value of such assets. *Ordinary* profits and losses, in contrast, are realized on the sale of goods and services that *are* a part of the seller's stock-in-trade or that he regularly offers for sale. The profit earned by a manufacturing company through the operation of its plants and machinery may be contrasted with the gain it would make if it sold some of its investment securities for more than they had cost it. The former is an ordinary business profit, the latter a capital gain.

Ordinary profits are commonly the result of buying goods in one market and selling them in another, that is, in a different form, in different quantities, at a different season, or in a different place. The manufacturer earns ordinary profits by converting raw materials and semifinished goods into new forms, which he sells to other manufacturers, wholesalers, retailers, or consumers. The wholesaler buys in large quantities from the manufacturer and relieves the latter of the task of finding and supplying scores of retail outlets. The retailer earns ordinary income by buying his wares from wholesalers, jobbers, and manufacturers, and selling them to his customers in much smaller unit-quantities, together with packaging, and perhaps delivery and credit services. Capital gains or losses, on the other hand, are most commonly the result of changes in prices in the same market. They are realized most characteristically when one investor or speculator sells his holdings to another. The profit made by a real estate company that buys raw acreage, subdivides it into streets and building lots, and sells plots, is regarded as an ordinary business profit; but the gain made by the farmer or long term speculator who sells the acreage to the real estate company, or by the factory worker who purchases a single lot and subsequently resells it, is regarded as a capital gain.

The major sources of capital gains and losses are capital assets; that is, property acquired for income-making rather than consumption purposes — corporation securities, real estate, government bonds, and interests in partnerships, leases, and contracts. In 1936, the only year for which the relevant data are available, approximately four-fifths of the aggregate net capital gains reported on federal income tax returns were derived from stocks and bonds (Table 69). In the broadest sense, personal and other nonbusiness possessions such as jewelry, paintings, and houses may also give rise to capital gains and losses. During World War II and the period immediately following, many persons were able to sell automobiles, houses, cameras, and certain other articles they had previously purchased for their own use at much higher prices than these goods had cost them. The United States recognizes capital gains so derived and taxes them as such, but it does not allow deductions from taxable income for losses sustained on assets not acquired for a 'gainful', i.e., money-making, purpose.

Realized vs. unrealized capital gains and losses

Most commonly, in both law and ordinary speech, a distinction is made between 'realized' and 'unrealized' capital gains or losses. An owner who does not sell or enter into an exchange legally equivalent to a sale is said not to 'realize' a capital gain or loss, however big the change in the market value of his holdings, however marketable they are, and regardless how long he has owned them. The change in market value, commonly referred to as an 'unrealized' capital gain or loss, is not taken into account in computing taxable income. Very substantial proportions of the increases in the value of lands and corporate securities are never 'realized' in the current legal sense because the law does not regard transfers of property at death as occasioning 'realization'. The difference between the cost of the property to a decedent and its value on the date of his death is not regarded as a capital gain or loss to either the decedent or his heirs. The latter put the property on their books at the value on the date of transfer (or other date chosen by the executor for the purpose of the estate tax) and measure their capital gains or losses on it from the value on that date.

Distinction between capital gains and ordinary income often blurred

While the broad distinction we have made between capital gains and ordinary profits is useful in a general way, it cannot be pressed far for purposes of either economic analysis or law. As we shall find upon further examination, ordinary business profits often contain large amounts of what are essentially capital gains, while large amounts of so-called capital gains are little or no different from ordinary profits, or arise indirectly from the accumulation of ordinary income.

Moreover, although the general distinction offers a rough guide to the legal concept of capital gains and losses, the effective legal definition has varied from time to time in the United States and in other countries. The profits and losses arising from short term transactions in capital assets, for example, have frequently been excluded from the legal category of capital gains and losses. In addition, the dividing line between short and long term transactions has at different times been 24, 18, 12, and 6 months in the United States. In Sweden the dividing line is 10 years for real estate and 5 years for other capital assets. The point at which the owner of any kind of capital assets ceases to be merely an investor and becomes, in the eyes of the law, engaged in buying and selling them (and his capital gains become, for tax purposes, ordinary profits), is by no means always clear and has been the subject of much litigation. What constitutes 'realization' has also been altered by the statutes and courts from time to time. The legal form of the transaction rather than its substance is sometimes decisive. The successive changes in the statutory definition of capital assets in the United States are described briefly at the end of this chapter.

2 CAPITAL GAINS AN IMPORTANT SOURCE OF PRIVATE FORTUNES

For many persons capital gains have supplied prodigious short-cuts to tremendous riches. Some of the biggest family fortunes in the United States – the Astor, Goelet, Rhinelander, Schermerhorn, and Marshall Field – have come mainly from increases in land values. These fortunes were not due primarily to the receipt and accumulation of land rents and other forms of ordinary income but to the growth in the earning power of real estate that had been acquired at prices reflecting a much smaller earning power. If the market was appraising similar properties at ten times their annual earnings, a rise in the net rent of a piece of real estate from $10,000 to $100,000 a year was equivalent to an increase of $900,000 in the owner's fortune. If the owner sold, he formally 'realized' a capital gain; if he did not, he was nevertheless worth $900,000 more. Large capital gains came to men who discovered or exploited various mineral resources of the country, such as coal mines, gold, copper, silver, lead, and other mineral ores, and oil and natural gas formations. Other men acquired huge fortunes from the capital gains arising from the creation or expansion of the earning power of public utility and industrial enterprises. The fortunes accumulated by Rockefeller, Harriman, Mellon, Guggenheim, Carnegie, Morgan, Baruch, and many others were not built primarily by the year by year receipt, saving, and reinvestment of ordinary income, but by 'realized' and 'unrealized' capital gains. In fact, capital gains have played such an outstanding role in the creation of large fortunes as to suggest that they have been their main source.

Nor have they been insignificant elsewhere. They have been major sources of wealth for numerous farmers and their heirs whose lands happened to lie close to the centers of growing towns and cities; for many urban land speculators and investors; and for many active and passive investors in big and small enterprises. The capital gains arising in connection with the enlargement of corporate earning power did not all accrue to the dominant personalities whose enterprise, daring, energy, imagination, and other personal qualities were often immediately responsible for them, but were shared by numerous less active risk-takers and investors.

Realized capital gains a major source of large incomes

The records provide us with only fragmentary information on the amounts of capital gains and losses that occurred before figures from the federal income tax became available. We know that appreciation in the value of real estate was enormous. According to the Federal Trade Commission, the value of privately owned taxable land exclusive of improvements was approximately $100 billion in 1922.[2] A very large part of this entire sum, which by itself constituted nearly one-third of the estimated total private wealth of the country in 1922, was clearly due to increases in market value from the time the land was first purchased or appropriated from the Indians. Some was doubtless due to draining, grading, and similar cost-entailing actions by the owners; and a good deal more, to the construction of roads, railroads, schools, factories, etc. whose costs were borne only in part by those who owned the surrounding land; but the mere scarcity of land in all sections that became thickly settled was doubtless a potent factor causing values to rise. In any event, considerable amounts of the total appreciation were enjoyed by individuals whose investment of effort and money was relatively small.

The realized capital gains minus realized capital losses reported

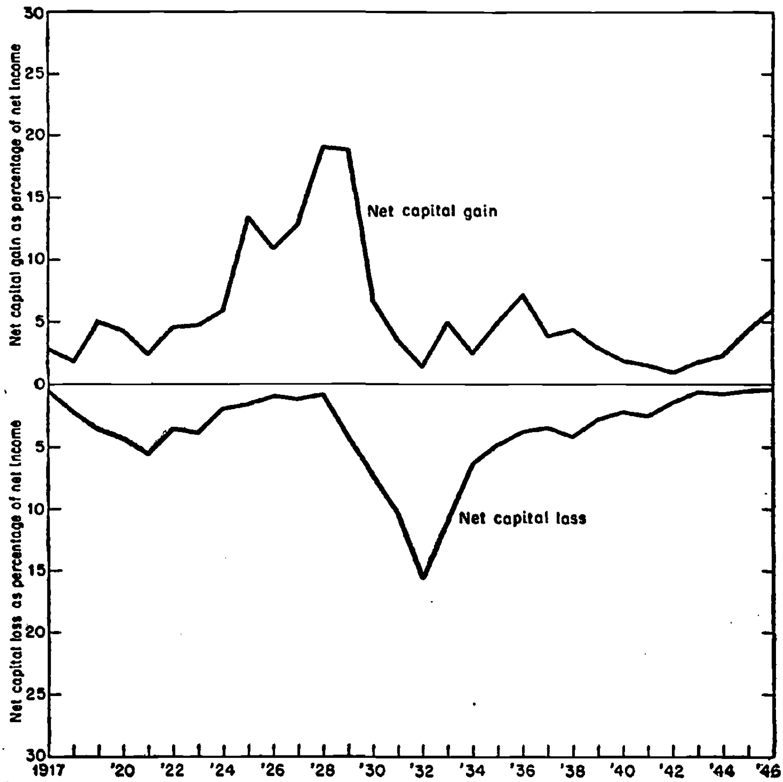
[2] *National Wealth and Income,* 69th Cong., 1st Sess., Senate Document 126, p. 34.

each year by individuals filing income tax returns are analyzed in considerable detail in several subsequent chapters and Appendix One. For 1917-46 the net gains of those with net incomes totaled $50 billion, about 11 percent of their total income from property, i.e., sources other than wages and salaries, before deductions, and 5 percent of their aggregate net income including wages and salaries.[3] In

[3] 'Net capital gains' refers to the sum of the annual excesses of capital gains over capital losses of all individuals who reported such an excess in any year. The figure cited does not cover the net capital gains of those who were not required to file income tax returns because their gross or net incomes were smaller than the minima for which returns had to be filed under the successive statutes, or 'unrealized' gains and losses, such as those embodied in property transferred at death or received in tax-free exchanges, or in property that did not change hands.

Chart 2

Net Capital Gains and Losses as Percentages of Net Income
Individuals with Net Incomes, 1917-1946



Source: Table 5.

boom years net capital gains were sometimes very much larger. They constituted approximately 19 percent of the aggregate net income of those filing tax returns with net income in 1928 and 1929, and about 13 percent in 1925 and 1927 (Chart 2 and Table 5).

Capital gains have regularly been a bigger proportion of larger than of smaller incomes, on the average. For the 30 years as a whole they were a major source of very large incomes, accounting for about a third of the aggregate net income of individuals with statutory net incomes of $100,000 or over, and for half of the aggregate net income of those reporting $1 million or over (Chart 3 and Table 6). The individuals comprising these groups were not the same, of course, throughout the period.

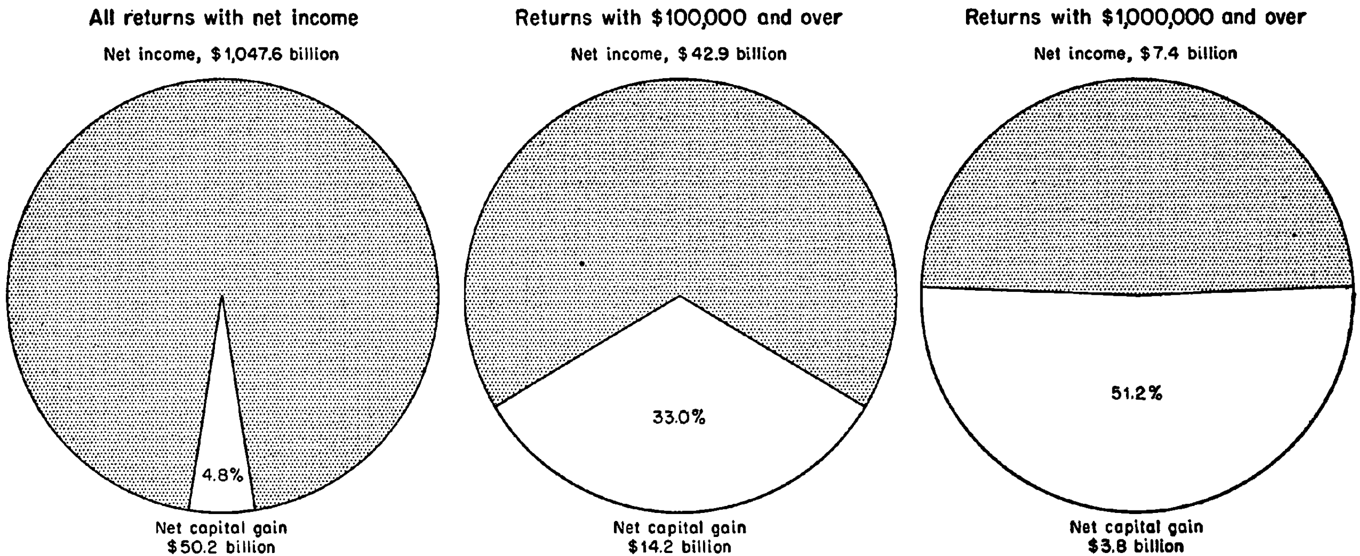
3 ARE CAPITAL GAINS INCOME?

Whether capital gains should be taxed as ordinary income, taxed at lower rates, or excluded from taxable income has been the subject of more or less continuous controversy in the United States. In favor of taxing capital gains like ordinary income it has been argued that they produce an equal increase in an individual's economic power: the ability to command economic resources and direct them into channels of his own choosing. Like ordinary income, realized capital gains may be spent or saved. Used for consumption, they enhance the ability of a man to build or buy a bigger house, to give his family more expensive clothes, food, and amusements, and to provide his children with superior educational opportunities. As savings, capital gains can be converted into bank balances, bonds, stocks, and other titles to wealth in precisely the same manner and degree as wages and salaries, interest, rent, and ordinary profits. Even when capital gains have not yet been 'realized' by sale – while they are still in the form of paper profits, so-called – they constitute additions to the economic resources of those who enjoy them. For even in this form they supply approximately the same increase in economic power, excluding the effects of taxes, as an equal amount of wealth obtained by accumulating and investing ordinary income. In analagous ways, capital losses may be said to reduce the economic power of those who suffer them and, therefore, to be valid deductions from ordinary income.

But no less positive have been the protests of those who hold that capital gains and losses should be completely excluded from income tax on the ground that they are not true elements of income. Unlike most kinds of ordinary income, capital gains occur irregularly in the

Chart 3

Net Capital Gains as Percentages of Net Income 3 Statutory Net Income Groups, 1917-1946



Source: Table 6.

lives of most individuals. A prudent man does not consider them available for ordinary consumption purposes both because they cannot confidently be expected to recur and because they may well be followed by sporadic losses. A capital gain, therefore, is commonly regarded as a direct addition or accretion to a man's capital, not a part of his disposable income.

Moreover, capital assets derive their value from the incomes that are expected from them, and these incomes are subject to tax when received. A rise in the value of a capital asset often reflects merely a rise in the income expected from it. To tax both the increase in income when it is received and the rise in the market value which merely reflects this expected increase in income is really to tax the same thing twice, it is argued. Of course, the owner gives up the enlarged prospective income from the capital asset when he sells it to 'realize' his gain; but he will presumably reinvest the entire proceeds, minus taxes, at the going rate of return and will therefore continue to obtain and pay taxes on the enlarged income reflected by his capital gain.

Also, if we tax the seller's capital gain as income, are we not treating him unfairly as compared with the owner who does not sell but who equally enjoys the enlarged income?

Further, most capital gains arise over periods longer than 1 year, often many years. To treat them as the income of the single year in which they are realized subjects the recipient to a higher tax than would be payable on an equal amount of income spread over the number of years in which the gain developed.

Finally, to mention only one of several other aspects in which capital gains differ from ordinary income (aspects which, together with those just cited, will be discussed in more detail presently), it is contended that capital gains do not represent as much taxpaying capacity as an equal amount of ordinary income because they are sporadic, as compared with the recurring character of most types of ordinary income.

The last two points can be illustrated by a comparison. The annual income of James Peters of Cleveland, Ohio hovered about $3,000 for many years. In 1951, besides his ordinary income of $3,000, he realizes a capital gain of $15,000 by selling the house he bought 30 years before to a company that plans to erect an automobile service station on the land. Should Mr. Peters be taxed in 1951 as if his income were $18,000? Does his taxpaying capacity equal that of his sister whose 1951 income of $18,000 was derived wholly from $720,000 par value of 2½ percent Treasury bonds bequeathed her by her husband?

Powerfully supporting the view that capital gains and losses are not true elements of income has been the example of Great Britain, Canada, Australia, and most European countries with respect to capital gains realized by individuals outside the course of their ordinary business activities. A long tradition in European thought and law has excluded most casual and irregular gains, particularly from the sale of capital assets, from the prevailing concept of personal income and, therefore, from the taxable income of individuals. Besides the force of example, some of the same historical influences and logical considerations that produced this attitude in Europe have been influential in the United States.

But some capital gains are different only in form from ordinary income. An investor who buys a 30-year 3 percent corporation bond at 90 is actually getting an interest return of about 3.55 percent annually; but his return will take the *form* of an interest income of 3 percent a year and a capital gain of about $100 per $1,000 bond at maturity.

Reinvested corporate profits

Capital gains that appear to reflect the direct reinvestment of profits by corporations have raised an especially troublesome question. Because the law conceives a business corporation as an entity separate and distinct from its stockholders, corporate profits are not regarded as the income of the latter unless and until they receive them in dividends. Consequently, stockholders can postpone or avoid the ordinary personal income taxes upon their proportionate shares of retained corporate earnings. But if these retained earnings are profitably employed by the corporation, stockholders can reasonably expect to obtain some proportion of them – though often only a surprisingly small proportion – in the form of a capital gain taxable at a preferentially low rate when they sell the stock. Meanwhile, they can expect to enjoy a rise in the earning power and market value of their holdings. Even the capital gains tax will be avoided and the share of these stockholders in the accumulated earnings of the corporation will never be subjected to personal income taxes if they never sell the stock but leave it to their heirs or give it away during their lifetimes to charitable or other tax-exempt institutions or to persons who leave it to *their* heirs. (Persons who sell property received by gift are subject to tax on the proceeds over the excess of the donor's cost or other basis.)

On the other hand, some reinvestment of earnings may be essential to enable an enterprise merely to maintain its competitive position and its earning power. Accounting charges for obsolescence are often absent or insufficient, with the consequence that the reported earnings often overstate what later are seen to have been the true earnings. Most individual shareholders in large corporations cannot expect to influence dividend policies greatly. They seldom regard their *pro rata* share in the undistributed earnings of their corporations as a part of their individual incomes. They cannot confidently expect their holdings to increase in market value by the exact amount of earnings reinvested on their behalf. Even if such an increase occurs, the stockholder may find it impracticable to convert it into disposable income by selling one or a few shares and regarding the enhanced market value of the remainder as a measure of the maintenance of the principal of his investment. The scale of brokers' commission charges makes the sale of a few shares of stock relatively expensive, and the market value of a single share may greatly exceed the amount of corporate earnings being reinvested on behalf of the remainder of the investor's holdings. For these and other reasons, the market is likely in many cases to appraise reinvested corporate earnings at less than face value.[4] The question of the proper tax treatment of capital gains comes into contact at this point with the whole question of the tax treatment of corporate profits.

4 SPECIAL TREATMENT OF CAPITAL GAINS IN INCOME TAXATION

One major practical effect of the distinction between capital gains and ordinary income is that many countries exempt the former from income taxes under certain conditions or, like the United States, tax them at very much lower rates. In Great Britain, Canada, Australia, and South Africa capital gains are exempt from income tax, whether realized by individuals or corporations, unless they are received "in the ordinary course of trade."

In Belgium they are exempt when realized by individuals outside the course of their business but are taxable as ordinary income when received by corporations or by firms or individuals in the course of

[4] Cf. John Burr Williams, *Theory of Investment Value* (Harvard University Press, 1938), pp. 80-1; Alfred Cowles, 3rd, and Associates, *Common Stock Indexes* (Principia Press, 1938), pp. 40-3.

business. This is also the situation in the Netherlands, except that the nonbusiness capital gains of individuals are counted as ordinary income if from sales of real estate held less than 2 years or marketable securities held less than 1 year.

Capital gains in France were treated substantially the same as in Belgium until 1949, when France adopted the recent American practice of subjecting half of the net capital gains of individuals to the regular schedule of income surtaxes, though without the American ceiling rate of 25 percent. The capital gains of business enterprises and those realized by individuals in the course of their business remain taxable in full.

In Norway they are exempt for both individuals and corporations unless derived from property that had been purchased with the intention of reselling or from property used in business or from patents, copyrights, or building sites, or from other real estate held less than 10 years.

In Sweden they are exempt for both individuals and corporations if derived from real estate held 10 years or more, or from securities or other property held 5 years or more.

Capital losses are usually treated similarly; that is, when the gains are fully taxable, the losses, in most countries, are fully deductible, and when the gains are exempt, the losses are not permitted to be deducted from ordinary income for the purposes of the income tax.[5]

In the United States capital gains were taxed as ordinary income in the first several income tax laws enacted after the adoption of the 16th Amendment in 1913.[6] But in 1922, when the ordinary income of individuals was subject to tax rates ranging up to 70 percent, Congress placed an upper limit of 12½ percent upon the rates applicable to their gains from capital assets held more than 2 years, regardless of the amount of ordinary income or capital gains of the taxpayer, and in 1924 Congress limited the allowance for the net losses of individuals on capital assets held more than 2 years to a maximum of 12½ percent of the loss. These ceilings remained in force until the end of 1933. For corporations the original full taxation of capital gains was continued until 1942, and the full deductibility of capital losses from ordinary income until 1932.

[5] See Chapter 10 for a fuller discussion of the tax treatment of capital gains and losses in these and other countries.

[6] The 16th Amendment reads: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

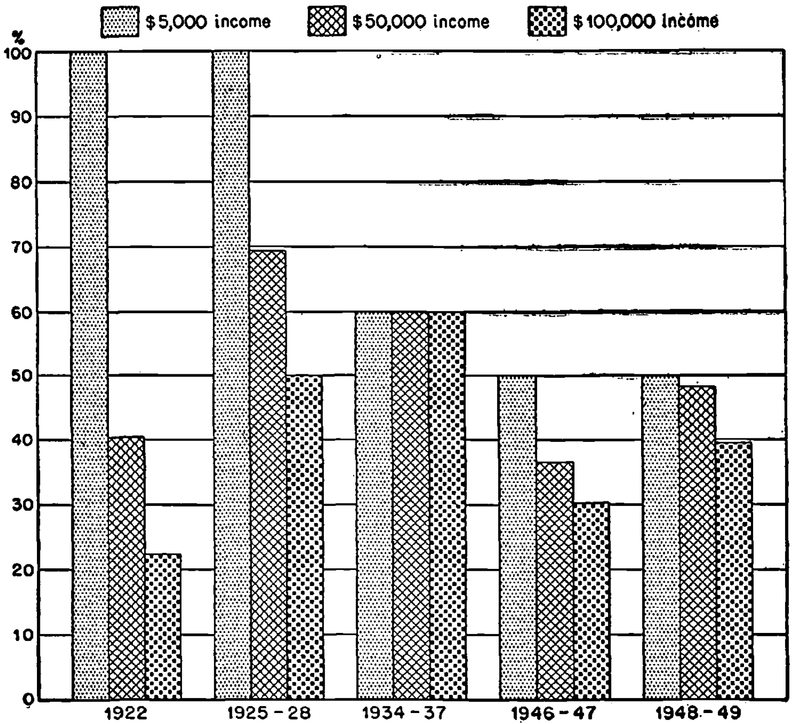
In 1934-37 the preferential tax treatment of capital gains reported by individuals took the form of excluding varying proportions from taxable income. The excluded fraction ranged from 10 percent for capital assets held more than 1 but less than 2 years to 70 percent for those held more than 10 years. In 1938-41 this method, with altered proportions and time periods, was combined with the reestablishment of a ceiling rate on capital gains – this time 15 percent. In 1942-50 individuals were given the option of including in taxable income only half of their net gains from capital assets held more than 6 months or of separately computing the tax on such capital gains at the flat rate of 25 percent,[7] regardless of the amount of their ordinary income, if by so doing they would pay a smaller tax. At the same time, a ceiling rate – of 25 percent – was for the first time extended to the capital gains of corporations.

The markedly preferential tax treatment of long term capital gains as compared with ordinary income in 1922-50, particularly for individuals with sizeable incomes, is illustrated in Table 88 and Chart 4. For a man with a net income of $100,000 from ordinary sources, the effective tax rate on a capital gain from an asset held more than 2 years was less than a third the rate on an additional dollar of ordinary income in 18 of the 29 years 1922-50, and was in no year more than three-fifths of the ordinary rate. In 1922 a married man with 2 dependents and an ordinary net income of $100,000 was subject to a tax rate of 56 percent on the next dollar of ordinary income, but could realize any amount of capital gains at a tax cost of only 12½ percent. By reason of successive reductions in surtax rates during the 'twenties, the disparity between taxes on capital gains and on ordinary income was reduced for a time, but even when the top surtax rate reached its lowest level, 20 percent in 1929, the combined normal and surtax of 24 percent was nearly twice as high as the maximum capital gains tax rate. Since 1937 the effective tax rates on an additional dollar of ordinary income for individuals with statutory net incomes of $5,000 or more have been from 2 to 5 times as high as those on capital gains.

The successive tax ceilings and partial exemptions for capital gains have usually been accompanied by similar ceilings and partial exclusions for capital losses. Beyond such parallel treatment, however, the deductibility of net capital losses from taxable income

[7] Nominally, the flat rate was 50 percent but was applicable only to half of long term net gains minus the entire amount of short term net losses.

Chart 4
Capital Gains Tax Rate as a Percentage of Tax Rate on Ordinary Income, 3 Income Levels



Effective tax rate on first dollar of additional income from long term capital gains as a percentage of effective tax rate on first dollar of additional ordinary income; married person with 2 dependents besides his wife and with maximum earned income credit.
Rates assume assets had been held 2-5 years in 1934-37 and that joint returns were filed in 1948-49.
Source: Table 88.

(losses in excess of gains) has been arbitrarily limited at various times since 1934 to $2,000 or $1,000 or, for short term net losses, has at times been eliminated altogether.

In consequence of their preferential tax treatment, capital gains appear to enjoy a privileged status as a source of funds for both the taxpayer's current consumption spending and his accumulation of wealth. A business man with a net income of $50,000 in 1947 from salaries, dividends, and other forms of ordinary income could add more, for current spending or savings, after paying his income tax, from a capital gain of $50,000 than from an increase of $225,000 in his salary, dividends, and ordinary profits. Similarly, a $50,000 capital gain would net a $25,000 a year man more than an $185,000 increase in ordinary income. Even the $5,000 a year man would realize more after income tax from a capital gain of $50,000 than from an increase of nearly 3 times that amount in his ordinary income. The change in the tax law, beginning in 1948, that permitted husbands and wives to divide their combined incomes equally on joint returns, materially reduced the effective rates of tax on larger incomes, and, therefore, diminished the preference accorded capital gains in the middle and upper income brackets. Nevertheless, the superior tax position of capital gains remained substantial. In 1950 a married taxpayer with ordinary net income of $50,000 who filed a joint return could retain more after taxes from a long term capital gain of $50,000 than from an increase of more than $100,000 in salaries, dividends, interest, etc. If his income was otherwise $25,000, a long term capital gain of $50,000 would be worth more to him than an increase of over $83,000 in ordinary income; and if his income was otherwise $5,000, he could keep as much from a long term capital gain of $50,000 as from an increase of something more than $65,000 in ordinary income.

5 DOES THE TAXATION OF CAPITAL GAINS HAVE BAD PRACTICAL EFFECTS?

As we have noted, under the prevailing concept of realization, a capital gain or loss is not recognized by the law until the asset is sold. Hence by deferring its sale the taxpayer can postpone incurring a tax liability on the appreciation in value. If he realizes the gain, the tax absorbs a portion of his resources. If he defers the realization, he is permitted to retain without cost the use of funds that would otherwise go to the government in taxes. If he never sells, the income tax liability will be avoided altogether, for transfers at death do not legally constitute realization, and neither his estate nor the heirs will be liable for income tax on the gain.[8] As a result, any substantial taxation of capital gains gives taxpayers a motive for avoiding sales.

Ordinarily an individual taxpayer to whom wages and salaries, interest, rents, and profits are due has only limited opportunities to choose the year in which to take them into his income account. Usually he becomes subject to taxation on these types of income in the

[8] If the amount of the income tax avoided is not spent or given away during the life of the decedent, the taxable estate will be correspondingly larger (if the total exceeds the statutory exemption), and a higher estate tax will be levied. But as long as the rate of the estate tax is less than 100 percent, the addition to the estate tax cannot equal the saving in income tax.

year he obtains the right to receive them.[9] But the taxpayer commonly has unrestricted power to choose whether and when to convert an 'unrealized' rise in the market value of an investment into a realized capital gain – subject to the risk, however, that the gain will shrink or vanish if he delays. Moreover, he may obtain many of the advantages of this increase in value without selling the assets and paying a tax on the gain. If the rise reflects an actual or prospective increase in dividend income, the larger dividends will be his to enjoy without payment of a capital gains tax. If it reflects merely an improvement in the stability and security of the prospective dividends, he will similarly enjoy this enhanced security. Meanwhile, his ability to sell his asset at the new market price gives him substantially the same enlarged command over cash for contingency needs or for future investment opportunities as he would obtain by actually selling his asset now. It is true that by retaining his asset he subjects his capital to investment risks. If he sells, he obtains a new range of choice. He may retain the proceeds in liquid form, after providing for the capital gains tax. But if he expects to reinvest the proceeds, he faces new investment risks that may differ only in small degree, if at all, from his present ones. Hence any substantial tax on realized capital gains may readily dissuade him from selling assets he would otherwise be disposed to sell.

Because of this factor, it has been repeatedly contended, the capital gains taxes that have actually been in force in the United States have seriously impaired the mobility of capital assets and the efficiency with which they are used. For somewhat similar reasons, taxes on capital gains and allowances for capital losses are also charged with causing sharper fluctuations in the prices of securities

[9] If he can arrange to have these incomes technically earned by a corporation that he controls, he can regulate the flow of income to himself in considerable measure by regulating the dividend policy of the corporation, though at the expense of corporate income and other taxes and at the risk of violating the law against the improper accumulation of surplus. Individuals who receive fees and related compensation on the basis of bills to their clients, patients, or other purchasers of their services can, by delaying the presentation of the bills until after the end of the calendar or fiscal year, defer the receipt of such income by one tax year. Individuals operating a business enterprise can affect the timing of income to some extent by arranging shipments and billings so that collections will occur before the expiration of a tax year or just after it. The receipt of interest can be postponed and converted into a capital gain by buying a bond at a discount from its redemption value and refraining from amortizing the discount before redemption. For other examples, see Chapter 9.

and other capital assets than would otherwise occur. The ability of an investor or speculator to avoid the tax by refraining from selling when he has a profit is said to cause a scarcity in the supply of stocks when prices are rising, thereby accentuating the rise; while the allowance for losses accentuates a decline by encouraging selling when prices are falling. In addition, the charge generally made against all substantial taxes on profits, that they seriously impair incentives to risky investment, is made also against the tax on capital gains. We shall examine the evidence and the considerations bearing upon these contentions in Chapters 6-7.

6 ARE THE FEDERAL REVENUES FROM CAPITAL GAINS WORTH THEIR ADMINISTRATIVE COST?

The federal government's net revenues from its capital gains taxes and loss allowances have been highly erratic, bulking large at times and dwindling to relatively small proportions or negative figures at other times. They averaged $380 million a year, considering taxable returns alone, during the great stock market boom, 1926-29. In the next 3 years a net revenue loss averaging $61 million annually is estimated to have been sustained. In the decade 1935-44 the net revenues are estimated to have averaged $90 million annually (Table 90). The estimated net revenues for 1926-34 are overstated as compared with those for later years because cruder statistical procedures were employed in the earlier period and because returns reporting net deficits were excluded.

Since capital gains are realized mainly in years of high prosperity, and capital losses in years of depression, it has been argued that the inclusion of capital gains and losses in taxable income not only contributes little net revenue in the long run but also accentuates fluctuations in the government's revenues and is undesirable (though to some desirable) on this account as well.

Moreover, it is charged that even the modest revenue that has been obtained is attributable to arbitrary and inequitable limitations upon the recognition of capital losses. This argument starts with the contention that capital gains and losses tend to be equal over a period of years, for both individual taxpayers and taxpayers as a whole. In this event, the revenues produced by taxation of capital gains would be roughly offset in the long run by the revenue reductions from capital losses, if full deductibility were allowed for the latter. The complete exclusion of capital gains and losses from taxable income would be a great boon on the added account, some contend, that it would enormously reduce the litigation and administrative difficulties now encountered by the government and by taxpayers because of the difficulty of drawing a clear line between ordinary income and capital gains and losses.

7 OTHER ISSUES

In addition to the central questions whether capital gains can logically and equitably be taxed as income, and whether in any event the bad practical effects of taxing them calls for their exemption or highly preferential treatment, a number of subsidiary questions merit attention:

1) Is the taxation of capital gains an appropriate and effective method of reaching the shares of stockholders in the reinvested earnings of corporations, which are not now counted as part of the income of their stockholders?

2) How long a holding period, if any, should be required before the gain from the sale of a capital asset is treated as a capital gain rather than as ordinary income?

3) How can tax avoidance through the deliberate conversion of ordinary income into capital gains be prevented?

4) Should the tax treatment of capital losses always parallel that of capital gains, or may it properly differ in important respects?

5) Should the capital gains and losses of corporations and of individuals be treated differently?

6) If capital gains are to be taxed in some measure, should they be included in whole or in part in the ordinary income tax schedule or should they be taxed separately.

7) Should the effective tax rates for capital gains vary inversely with the period the asset is held?

8) Should any attempt be made to tax unrealized capital gains and allow deductions for unrealized capital losses?

8 AIM OF THE BOOK

We shall attempt in the following pages to throw what light we can on both the central and subsidiary questions. In connection with many points our detailed survey of the records should enable the reader to substitute knowledge for guesses or mere assertions, and in this way improve his understanding of the problems. In connection with some questions comprehensive quantitative and other factual data are not available. In these cases, as well as in those in which our quantitative data are serviceable, we seek to present an objective, critical analysis of the opposing contentions. Our purpose is not to arrive at specific recommendations concerning public policy but to provide the reader with the kind of analysis upon which he can come to a more informed judgment of his own.

NOTE: STATUTORY DEFINITION OF CAPITAL ASSETS UNDER THE SUCCESSIVE REVENUE ACTS, 1913-1950

1913-1921

From 1913 to 1921 capital assets were not expressly distinguished in the income tax laws from other kinds of property. Gains from the sale of all kinds of property were taxable in full as ordinary income. But losses from sales of property were deductible in 1913-15 only if the property had been used in the trade or business of the taxpayer. In 1916 this limitation was somewhat liberalized to provide that losses from sales of property were deductible if the transaction had been entered into for profit.

1922-1933

The Revenue Act of 1921 (which was applicable to the income years 1922-23) was the first to define capital assets and to provide a special treatment for gains realized upon their sales by individuals. These special provisions did not affect corporations, whose capital gains continued to be treated as ordinary income until 1942.[10] Capital assets were defined as property acquired and held by the taxpayer for profit or investment more than 2 years (whether or not connected with his trade or business), exclusive of property held for the personal use or consumption of the taxpayer or his family, and exclusive of stock-in-trade or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

In 1924 Congress modified this definition by eliminating the requirement that the property must be held for profit or investment, and the previous exclusion of property held for personal use or consumption. These changes permitted individuals to obtain the benefit of the preferentially low capital gains tax rates on their gains from sales of houses and other property purchased for reasons other than profit. This definition remained in force from 1924 through 1933.

[10] Under the Revenue Act of 1932 and subsequent revenue acts, however, corporations became subject to limitations upon the deductibility of their capital losses.

1934-1937

In 1934 Congress narrowed the exclusions from the category of capital assets. Instead of excluding all "property held by the taxpayer primarily for sale in the course of his business" it excluded "property held by the taxpayer primarily for sale *to customers* in the ordinary course of his business." (Italics ours.) At the same time, the previous exclusion of assets held 2 years or less was removed. A major purpose of these changes was to take away from professional traders and speculators in securities and commodities their former right to deduct their trading losses in full as ordinary losses. The assets in which they regularly traded had been ruled to constitute noncapital assets under the definition in effect in 1924-33 (*Donander Co.,* 29 B.T.A. 312; *Oil Shares, Inc.,* 29 B.T.A. 664). This status of their trading assets permitted them not only to deduct their trading losses in full as ordinary losses (*Ignaz Schwinn,* 9 B.T.A. 1304), but also to avoid, partly or wholly, the special disallowance of all short term net losses from securities contained in the Revenue Act of 1932, applicable to the income years 1932 and 1933. Under it losses from sales of stocks and bonds held 2 years or less were allowed only to the extent of gains from such securities. Professional traders could avoid this limitation in varying measure by offsetting their gains on their 'noncapital' assets held more than 2 years against their losses on securities held 2 years or less which were also 'noncapital' assets (*Charles Wesley Purdy,* 36 B.T.A. 572). The changed wording in the Revenue Act of 1934 had the effect of subjecting the losses of professional traders and speculators to the limited deductibility of net capital losses. On the other hand, the change did not make their gains eligible for the preferential treatment accorded long term capital gains, in most cases, because the preferential treatment was confined to gains on assets held more than 1 year, whereas the gains of professional traders and speculators are characteristically realized on assets held a shorter period.

1938-1941

From the time of the imposition of severe restrictions upon the deductibility of net capital losses, in the Revenue Act of 1934, protests were made against applying such restrictions to depreciable property. It was argued that the loss limitation unfairly penalized taxpayers who took conservative depreciation deductions and tended to prolong the use of antiquated or obsolete factories, machinery, and equipment. Before 1934 any loss incurred on the sale of machinery or buildings at a price below the depreciated value could be deducted in full from corporate income. Under the Revenue Act of 1934 such losses were allowable only up to $2,000 plus capital gains. Refusal to allow a loss upon the sale of depreciable property, while permitting depreciation to be claimed in full if the property was retained, was inconsistent and unfair, it was charged. In the Revenue Act of 1938, in response to protests of this character, Congress added depreciable property used in the trade or business of the taxpayer to the classes of goods excluded from the statutory category of capital assets. In consequence, both corporations and individuals were permitted to charge off against ordinary income the full amount of losses on the sale of buildings, machinery, and other depreciable property used in the taxpayer's trade or business. Land, however, including sites on which business buildings stood, continued to be classed as a capital asset.

The separate and unlike tax treatment of land and buildings under the Revenue Act of 1938 aroused considerable dissatisfaction. Administrative difficulties, as well as some attempts to evade taxes, resulted from the necessity of allocating the proceeds of a sale of improved property between the building, a noncapital asset, and the land, a capital asset. A loss allocated to the site could be deducted only up to $2,000 plus capital gains; a loss allocated to the building, on the contrary, could be deducted in full. In hearings before the House Ways and Means Committee during the consideration of the Revenue Act of 1939 the National Association of Manufacturers urged that the law be amended to treat all capital gains and losses of corporations as ordinary income and loss for the purpose of taxation. Other representatives of business urged that the $2,000 limitation on capital losses of corporations be removed; this position was supported by the Treasury.[11]

Congress did not adopt either proposal but provided that, beginning in 1940, the long term capital losses of corporations (losses on capital assets held more than 18 months) should be fully deductible under the corporate income tax. This provision, which applied until it was revised by the Revenue Act of 1942, did not alter the separate classification of land and real estate improvements but made the tax treatment of long term losses therefrom uniform for corporations. In addition, the Second Revenue Act of 1940, which imposed the Excess Profits Tax, provided that excess profits net income should

[11] *Revenue Revision – 1939,* Hearings, Ways and Means Committee, 76th Cong., 1st Sess., pp. 6, 148, 251, and 265.

exclude both long term net capital gains and net gains from sales of depreciable assets held more than 18 months, although net losses from sales of such depreciable assets were made fully deductible.

Since 1942

The continued necessity of determining separately the gain or loss on a building and on its site, and the continued taxability in full of any gain ascribed to buildings and other depreciable improvements to real property, led to renewed protests. Sales involving gains on such property had been relatively few in the bad business climate of 1938, but became much more conspicuous in the rearmament and war conditions of 1941 and 1942. Many properties were changing hands for conversion into armament and related production, but it was feared that other transfers were being discouraged by the full taxability of any gain ascribed to the buildings and other depreciable assets. Moreover, many sales were taking place under conditions akin to government seizure or requisition, for in addition to direct requisition of various properties under the government's war powers, the sale of others were only a little less compulsory when their owners were denied essential materials and supplies under priority and rationing restrictions.

Congress met these problems in the Revenue Act of 1942 by enacting Sections 117 (a)(1) and 117 (j) of the Internal Revenue Code. The former provided that depreciable property and real property used in a trade or business are not capital assets; hence, a net loss realized on the sale, exchange, or involuntary conversion of such an asset was made fully deductible for both income and excess profits tax purposes. The latter nevertheless provided that if the taxpayer realizes a net gain, on the whole, from sales, exchanges, or involuntary conversions of depreciable and real property used in a trade or business and owned longer than 6 months, and from long term capital assets, the gain shall be taxed as a capital gain; i.e., be subject to a maximum income tax rate of 25 percent and be exempt from excess profits tax.

The depreciable property affected by these provisions consists only of such property as is used in a trade or business of a taxpayer or is held for the production of income. The provisions do "not apply to inventories or stock in trade, or to land apart from the improvements or physical development added to it" (*Reg.* 111, Sec. 29.23)(1)-2. Nor do they apply "to bodies of minerals which through the process of removal suffer depreciation". Depreciable property includes not merely tangible assets that are subject to wear and tear — building, plant, machinery, and transportation facilities — but also certain intangible assets with a limited life — patents, licenses, copyrights, and franchises. It does not include securities or goodwill, neither of which may be depreciated (Internal Revenue Bulletin 'F', rev. Jan. 1942, pp. 85 and 88). Livestock used for draft, breeding, or dairy purposes is depreciable property.

Property 'used' in the taxpayer's trade or business is restricted to property so used at the time of the sale, exchange, or involuntary conversion. However, the property need not be in active use when sold: it may be in current use as a reserve even if it is physically idle. In stipulating that the use must be current, the Regulation merely aims to exclude properties that may once have been used in the taxpayer's trade or business but are currently not so used or are currently devoted to a different use, such as a former factory subsequently devoted to a nonbusiness use. The use qualification means also that a given article may be subject to depreciation in the hands of one owner but not in the hands of another: finished machines produced by a concern making them for sale comprise a part of the inventories of the producer, while similar machines may be part of the depreciable property of another concern.

Trade or business seems never to have been defined in the income tax statutes or the regulations issued by the Bureau of Internal Revenue. In *Ignaz Schwinn v. Commissioner,* 9 B.T.A. 1304 (1928), the Board of Tax Appeals declared: "When the expression 'trade or business' is used in the statutes in connection with losses it would seem to refer to a regular occupation or calling of the taxpayer for the purpose of livelihood or profit. . . .

It has been recognized by the courts and the Bureau of Internal Revenue that a person can be engaged in more than one trade or business."