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FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES

SUPPLEMENT TO STATEMENT BY SECRETARY OF TREASURY ON TAX REVISION ACT OF 1951, H. R. 4473, BEFORE THE COMMITTEE ON FINANCE ON JUNE 28, 1951

Prepared by the Tax Advisory Staff of the Secretary, Treasury Department, and printed as a committee print for purpose of information and discussion.

(This study has not been approved by the Committee on Finance and the conclusions therein do not necessarily represent the views of the committee or any member thereof.)

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FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES

The provisions of the Federal income tax laws levying special low rates on capital gains and limiting the deductibility of capital losses frequently receive attention in connection with possible tax revision. This study examines the present capital gain and loss provisions, traces their historical development, and analyzes their revenue, equity, and economic effects. It is confined to providing factual and analytical background material and contains no policy recommendations.

The study takes into consideration legislation to and including the Revenue Act of 1950 but does not cover the pending proposed revisions in the taxation of capital gains.

TAX ADVISORY STAFF OF THE SECRETARY,
United States Treasury Department.

JUNE 1951.

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FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES

Summary

Throughout the history of the income tax the provisions pertaining to capital gains and losses have been controversial and often misunderstood. The frequency with which these provisions have been changed suggests that a settled policy concerning the treatment of capital gains and losses as components of taxable income has not been established.

Capital gains and losses result primarily from the sale or exchange of property which the tax laws define as capital assets. According to present law, capital assets are all property except certain exempt classes, namely, (1) stock in trade, (2) depreciable assets, (3) real estate used for business purposes, (4) a copyright, literary, musical or artistic composition, and (5) certain types of Government securities. The principal types of property constituting capital assets, therefore, are securities representing ownership or creditor interests in corporations, real estate (not used for business), partnership interests in business enterprises, patents, and contracts of various types.

Property held by individuals for consumption rather than investment, such as owner-occupied residences, automobiles, and durable household equipment, falls within the legal definition of capital assets. However, the main form of capital assets held by individuals is corporation securities. Gains from stock and bond sales probably account for three-fourths or more of all taxable capital gains.[1]

I. PROVISIONS OF EXISTING LAW

Gain from sale or exchange of capital assets is taxed in one of two ways depending on the length of time the asset has been held. If held less than 6 months the gain is considered short-term and is taxed like other income. If held more than 6 months the gain is considered long-term and is taxed in a preferential manner, i. e. at lower effective rates than ordinary income.

At present, only one-half of long-term capital gains need be taken into account for tax purposes in the case of individuals.[2] This percentage exclusion of long-term capital gains from the income tax base means that tax rates on long-term capital gains are, in fact, one-half the rates on ordinary income. In addition, the law provides an alternative flat rate applicable to long-term capital gains at the taxpayer's option; this further reduces the tax for individuals with large

[1] The exact proportion is unknown since capital gains are not reported by types of property on tax returns; they have not been so reported since 1936.

[2] Corporations are required to take 100 percent of long-term capital gains into account but the rate of tax is limited to 25 percent.

incomes. A single person having taxable income of more than $18,000 and a married couple having taxable income of more than $36,000 will save tax by using the alternative rate computation. This alternative rate is 50 percent of the amount of long-term gain taken into account or 25 percent (50 percent × 50 percent) of the entire amount.

Preferential tax treatment of capital gains has been in force since 1922. Since 1924 it has been accompanied by limitations on the deductibility of capital losses from ordinary income. At present individuals may deduct no more than $1,000 of capital net loss from other income in any single year. Unused losses, however, may be carried forward for 5 years; in effect, therefore, $6,000 of capital loss from a single transaction may be offset against ordinary income. There are at present no limitations on the extent to which capital losses may be offset against capital gains within any taxable year.

II. HISTORICAL BACKGROUND

The legislative history of the capital gain and loss provisions is a record of frequent shifting and experimentation in an effort to reach an acceptable compromise solution to the conflicting tax equity, revenue, and incentive considerations involved. From enactment of the modern income tax in 1913 through 1921, capital gains were taxed like ordinary income. From 1913 to 1916 no provision was made for deducting capital losses. From 1916 to 1918 capital losses might be offset against capital gains and from 1918 through 1923 capital losses might be offset without limit against taxable income of any kind.

In the Revenue Act of 1921 Congress first decided to allow preferential treatment to long-term capital gains, largely in an effort to stimulate sales of appreciated property. Special low capital gains rates have remained in the tax laws down to the present time although the method of extending this preferential treatment has changed several times.

From 1922 through 1933 the taxpayer had the option of segregating long-term capital gains from ordinary income and applying a flat rate of 12½ percent to the segregated gains. In 1924 deductibility of losses was limited to the same 12½-percent rate that was applied to gains.

Capital loss limitation, originally conceived in 1924 as a method of balancing the special low rate applied to gains, was tightened following the 1929 decline in security prices. These further limitations were believed desirable to protect tax revenue in the face of the falling stock market and to limit tax avoidance. In 1932 it was provided that short-term losses from transactions in stocks and bonds might be offset only against gains from similar transactions.

The year 1934 saw a general recasting of the capital gain and loss provisions and the adoption of a new approach to the problem. In place of the alternative flat rate Congress substituted provisions for taking progressively smaller percentages of capital gains into account the longer capital assets had been held, declining to 30 percent on assets held more than 10 years.

This substitution of graduated percentage exclusion for the alternative flat rate of tax was justified largely on the ground that it provided a method of extending preferential treatment to all taxpayers having long-term capital gains rather than merely to those having sufficiently high ordinary income to benefit from the alternative rate. Moreover, the step-down system was believed at the time to be a more precise method of adjusting the tax to the period capital gains had accrued prior to realization by sale or exchange.

The year 1934 also saw a change in tax policy respecting capital losses. Allowance of net losses up to the tax rate applied to gains (parallel treatment) was abandoned in favor of a uniform loss limitation for all taxpayers. Capital net losses might be deducted only up to $2,000 of ordinary income per year.

In 1938, the capital gain and loss provisions began to assume their present form. Provisions for percentage exclusion of long-term gains were simplified and the alternative rate reintroduced. The 1938 act, however, distinguished two classes of long-term gains and provided two different percentages of exclusion.[3] This was reduced to a single class of long-term gain (50 percent included) in 1942; this latter system has remained in force until the present time.

On the loss side, the 1938 act reintroduced parallel treatment of long-term losses but provided that long-term and short-term capital losses be kept separate; each might be offset only against its own type of gain. The final change in the loss provisions was made in 1942 when taxpayers were again allowed to merge long- and short-term losses but were restricted in the loss offset against ordinary income to $1,000 per year. At that time, the 5-year carry-forward privilege was added to relieve hardship.

Throughout the legislative history preferential treatment has been denied short-term capital gains, largely because of the belief that many such gains are of speculative origin. Although recognizing that an arbitrary holding period dividing short- from long-term gains for tax purposes will yield only a crude separation of speculative from nonspeculative profits, this arbitrary separation has been considered the only practical method of drawing a distinction believed essential for limiting the application of the capital gains tax. However, the holding period necessary to qualify capital gains as long-term has been steadily shortened from 2 years (1922) down to 6 months (1942).

III. REVENUE ASPECTS

The estimated revenue from capital gains taxation has varied widely both in absolute amounts and in relation to total income taxes (text, table 2). The net yield of the capital gains tax on individuals over the period 1926–51 is estimated at about $7.2 billion. Capital gains have declined in relative importance as a source of tax revenue as the personal income tax base has been broadened and the rates increased.

For the year 1951, the yield from capital gains taxation of individuals has been estimated at approximately $0.9 billion or 3.7 percent of the total yield from individual income taxation. The relative importance of capital gains revenue rose to a postwar peak in 1946 when it amounted to 5.5 percent of total individual income taxes.

[3] Gains from assets held more than 18 but less than 24 months were 66⅔ percent taken into account; gains from assets held more than 24 months were 50 percent taken into account.

Capital gain as a source of income has always been highly concentrated among middle and upper income recipients. The available statistics dealing with the distribution of capital gains and losses by income size classes show that capital gains are an increasing fraction of total income as the size of total income increases. Capital losses are more widely distributed among lower incomes than capital gains.

In recent years, only about 4 to 5 percent of individual income taxpayers on the average have been affected by the capital gain and loss provisions. The number of taxpayers with sufficient ordinary income to benefit from the alternative tax is only a small percentage of the total number of taxpayers having capital gains, although these alternative tax returns account for a fairly large portion of the total gains reported and an even larger portion of the total tax.

In recent years, short-term capital gains have been extremely small, largely because of the short holding period. For example, in 1945, short-term gains reported on individual income tax returns were less than 7 percent of the long-term gains reported. In 1946, they were less than 4 percent. Most taxpayers apparently find it possible to hold capital assets at least 6 months before realizing their gains and thereby obtain the lower rates of tax applicable to long-term gains.

IV. RATE AND HOLDING PERIOD PROBLEMS

The taxation of capital gains confronts the difficulty that, under the established concept of taxable income, such gains are taxable only when realized by sale or exchange. Both because price changes are uneven and because investors have the option to sell or to hold capital assets, realization of capital gains tends to occur irregularly.

Two consequences of the irregular character of realization have played an important part in the development of preferential tax treatment for long-term capital gains: (1) When the entire capital gain accrued over a period of years is taxed in the year of realization, the progressive rates of the individual income tax may result in a larger tax than would be assessed if the gain were prorated to the years of accrual or some arbitrary period, and (2) high rates of tax on capital gain tend to discourage some taxpayers from selling their appreciated investments. The first consideration is primarily one of tax equity, while the second concerns the maintenance of fluidity in the capital market.

This type of problem is not limited to the taxation of capital gains. There are other types of income that are variable and irregular. It has been proposed that irregular types of income be taxed on the basis of the average income of several years rather than on income of each year separately. This is a possible alternative to the existing type of special capital gains tax treatment.

Partially offsetting the consequences of irregular realization is the ability of taxpayers to postpone the tax on appreciated assets. The holder of an appreciating security benefits from the use of the funds he would have paid in tax had he sold.

Because the experience of different taxpayers with capital gains and losses varies widely, no simple general formula of percentage inclusion or alternative rate can be applied uniformly to all taxpayers to make appropriate tax adjustment. Generally speaking, taxpayers with small ordinary incomes will have their tax liabilities increased more in relative terms by the addition of a given capital gain than will those whose incomes are higher. This is because brackets are narrower and the rate of progression steeper at the bottom than at the top of the income-tax rate schedule. A flat percentage exclusion and the alternative rate are rough methods for achieving equitable treatment of a type of income that is difficult to tax since taxpayers can voluntarily withhold it from the tax base by not selling their appreciated assets.

A graduated percentage-exclusion method was employed for a short period during the years 1934-37. The system in force at that time provided for five age classes of capital gains and for large increases in percentages of exclusion between classes in relation to the holding period. This complicated the statute without necessarily producing more equitable results. The 1934-37 plan operated to postpone selling appreciated investments because of the tax advantage of the longer holding period.

The present 6-month holding period results in discrimination against ordinary income which is assessed on an annual basis. From an equity standpoint a holding period of 1 year would appear to be more logical.

The belief that the tax rates applicable to ordinary income might act as deterrents to sales and exchanges of capital assets has been an important factor in capital-gains legislation. It has frequently been argued that a low flat rate of tax on capital gains would, by stimulating sales, actually increase the revenue attributable to this source of income. It is doubtful, however, whether most taxpayers time their transactions in capital assets primarily with the view toward minimizing tax liability.

The table on page 6 and chart on page 7 suggest that the year-to-year movements in the amount of capital gains reported on individual income-tax returns is more closely associated with changes in security prices than with changes in the capital-gains tax.

V. CAPITAL LOSS OFFSETS

Equitable treatment of the majority of taxpayers having capital losses cannot be attained without allowing some offset of capital net loss against ordinary income. How liberal such an income offset should be depends on the type of loss situation for which it is desired to provide relief, on the aggregate amount of capital losses and their distribution among taxpayers, and on the extent to which the tax structure contains proper safeguards against tax avoidance through loss manipulation.

In general, the more limited is the loss offset allowed against income, the longer will be the carry-over period needed for equitable tax results. For some taxpayers, a long carry-over period against capital gains may serve as a substitute for a more liberal offset of capital loss against ordinary income; for other taxpayers this will not hold true. Some taxpayers have only isolated transactions in capital assets and would obtain little or no relief from carry-overs against past or future gains no matter how long the carry-over period. For these taxpayers, income offset is the only effective relief.

Offsetting capital losses against ordinary income, however, raises the question of whether capital losses should be allowed to reduce tax liability without limit when gains are taxed at reduced rates. This has given rise to the suggestion of parallel tax treatment of capital gains and losses, which is usually interpreted to mean that a capital loss should be permitted to reduce tax by the same amount that a gain of corresponding size would have increased it. Parallel treatment would be most equitable in its impact upon taxpayers who make gains in some years and losses in others. When some taxpayers have only gains while others have only losses, greater inequities would result from this treatment.

Capital gains and stock prices, 1917–51 [1]

Year	Excess of net capital gain over net capital loss reported on individual and fiduciary income tax returns [2] (millions of dollars)	Stock prices index (Standard & Poor's price of 416 stocks) (1935–39=100)	Year	Excess of net capital gain over net capital loss reported on individual and fiduciary income tax returns [2] (millions of dollars)	Stock prices index (Standard & Poor's price of 416 stocks) (1935–39=100)
1917	218.2	72.2	1935	37.5	82.9
1918	−68.1	64.1	1936	661.3	117.5
1919	392.8	71.6	1937	75.6	117.5
1920	−16.5	67.8	1938	30.8	88.2
1921	−139.1	58.3	1939	31.2	94.2
1922	241.8	71.5	1940	−79.7	88.1
1923	191.7	72.9	1941	−482.0	80.0
1924	1,036.9	76.9	1942	−301.1	69.4
1925	2,372.5	94.8	1943	1,122.6	91.9
1926	2,165.8	105.6	1944	[2] 1,656.3	99.8
1927	2,018.5	121.9	1945	[2] 4,290.2	121.5
1928	4,295.2	158.3	1946	[2] 6,665.7	139.9
1929	3,641.9	200.9	1947	[2] 4,377.8	123.0
1930	−130.6	158.2	1948	(3)	124.4
1931	−929.0	90.3	1949	(3)	121.4
1932	−1,651.7	51.2	1950	(3)	146.4
1933	−654.3	67.0	1951	(3)	[4] 171.2
1934	−459.3	76.6			

[1] The figures shown include gains and losses from sale or exchange of property other than capital assets, since before 1938 such property was defined as capital assets.

[2] Long-term gains and losses before percentage reduction for returns with net income for the years up to and inclusive of 1943 and for returns with adjusted gross income beginning with the year 1944.

[3] Not available.

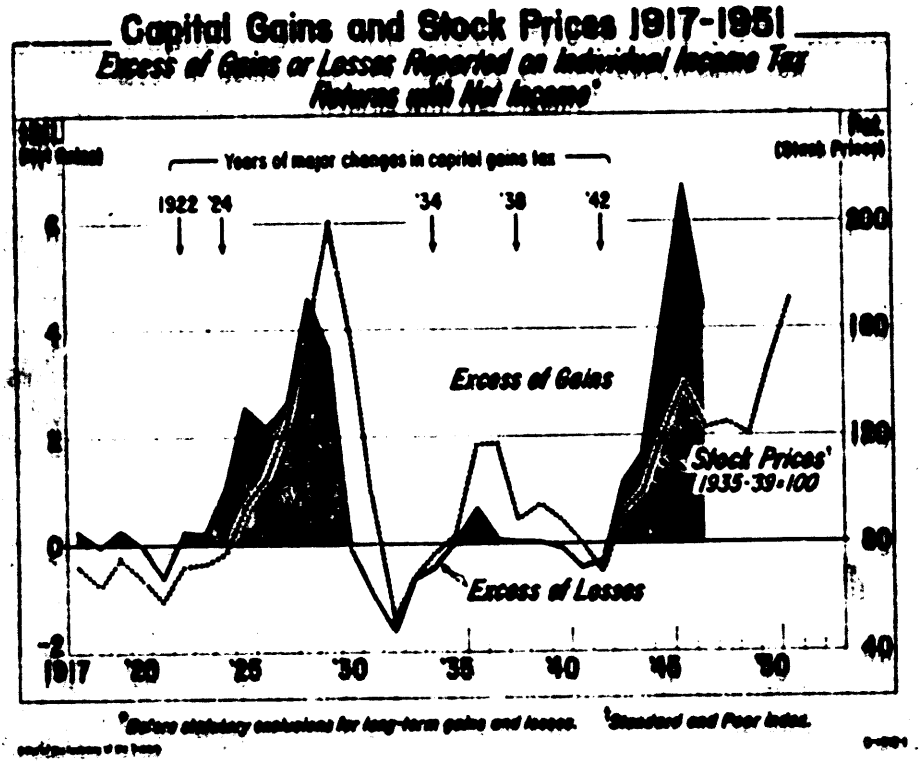
[4] Average first 3 months.

Sources: Excess of gains over losses 1917–41, unpublished manuscript by Lawrence H. Seltzer (since published in The Nature and Tax Treatment of Capital Gains and Losses, National Bureau of Economic Research); 1942–47, published and unpublished data from Statistics of Income, Part 1. Prices: Standard & Poor's Corp.

The present limitation of the offset of capital losses against ordinary income, but not against capital gains, favors taxpayers with frequent transactions in capital assets over those having only occasional transactions. Available statistical evidence shows that higher income taxpayers not only have more frequent transactions in capital assets but also, on the average, more favorable ratios of gain to loss than lower-income taxpayers. However, larger losses can be less effectively offset against income than smaller losses under the present limitation of $1,000 per year. During recent years, net losses have been small in the aggregate and in most cases fairly well provided for by the 5-year carry-over provision.

Limitations on the deductibility of capital losses from ordinary income have been deemed necessary to protect tax revenue. Moreover, they provide protection against tax avoidance where loopholes are not closed by specific measures. Loss limitations, also, perform the function of encouraging some taxpayers to sell appreciated property which they might otherwise hold in order to postpone tax.

A fairly long period for carry-over of losses appears to be essential in conjunction with the limitation of the annual offset against ordinary



income. Longer carry-overs spread out the revenue effects of declining price years while higher income offsets concentrate these revenue effects. Carry-forwards are of greater benefit to taxpayers with rising incomes, while carry-backs would help taxpayers in declining income situations.

VI. GIFT AND DEATH TRANSFERS OF CAPITAL ASSETS

The tax treatment of accrued capital gains transferred from one person to another by gift or at death has been considered by some observers one of the principal defects in existing capital gain and loss tax provisions. Accrued capital gains and losses included in an estate are not subject to income tax. The basis for determining gain or loss on probated property is usually fair market value at date of death.

Failure of our present tax laws to apply income tax to the unrealized capital gains in an estate greatly deters older taxpayers from selling appreciated investments and permits escape from the capital gains tax of a large amount of taxpaying capacity.

A partial offset to the failure to tax as income the element of appreciation on capital assets in an estate may be present in the fact that a higher estate tax will be due from the estate containing appreciated property than would be due if these assets had been sold and tax paid prior to death. This recovery of the capital gains tax varies with the applicable estate tax rates and would be complete only if the rate were 100 percent.

In case of capital assets transferred by gift, the provisions governing basis for gain or loss are somewhat different. Under present law, the donee takes the donor's original cost or other basis for determining gain and the lower of donor's cost or fair market value at time of transfer for determining loss.

Transfer of appreciated property by gift thus permits tax postponement for more than one lifetime and frequently results in a lower tax when gain is finally realized, because the income of the donee, and hence his rate of tax, will generally be less than that of the donor. This also means that the gain is not taxed to the person in whose hands it accrued.

Several approaches to the problem of taxing capital gains accrued to gift or death are possible. One method might be to amend the law to define transfer by gift or death as a realization. It seems probable that the courts would uphold this as a reasonable extension of the realization concept.

Treating gift or death transfers as realizations of any accrued capital gain or loss would appear to give more equitable tax results than the present system. Allowance of the capital-gains tax as a deduction for estate- or gift-tax purposes would prevent an overlapping of these taxes. The coincidence in timing of the income and estate taxes might create further problems of estate liquidity. However, such a provision would remove an important type of tax avoidance and a deterrent to the sale of appreciated property during the taxpayer's lifetime. This might modify substantially some objections to taxation of capital gains.

Another alternative would be to treat death transfers of capital assets like gifts and require heirs to assume the decedent's basis for determining gain or loss. This method would be a less effective check to tax postponement than outright definition of transfer as realization but would reduce tax avoidance compared to the present system.

A third possibility might be imposition of special supplementary estate or gift taxes only on that part of transferred property which represented accrued capital gains. This alternative amounts to an indirect method of obtaining the effect of treating transfer as realization.

VII. ALTERNATIVE APPROACHES TO TAXATION OF CAPITAL GAINS

In place of the present system which taxes capital gains only when realized and then applies special low rates, several basically different approaches to the problem have been suggested.

One approach is the annual inventory or accrual method. Under this system, taxpayers would be required to report each year the current value of any capital assets owned; they would be taxed or credited on changes in their inventory of capital assets regardless of whether gain or loss had been realized by sale or exchange. In principle, it would solve most of the problems that now arise because gains are taxed only when realized. It might, however, raise a constitutional problem of redefinition of taxable income. Moreover, it would greatly complicate tax compliance and administration because of the necessity for determining and checking a large number of individual valuations of capital assets in the absence of market transactions.

Another method would be to prorate all gains or losses accrued over more than 1 year to the years of accrual for the purpose of determining the rate of tax; tax would not be due, however, until the gain or loss was realized. Although given serious consideration when preferential treatment for capital gains was first enacted, this method was considered too complex, particularly in cases where both gains and losses were involved.

A third approach to the problem is income averaging either of all taxable income or of a limited category of income items that are most variable, including capital gains and losses. Averaging provisions for capital gains would avoid taxation in one year of gains accrued over many years and would make unnecessary the existing provisions for special rates. As in the case of annual accrual, averaging would complicate tax administration in order to increase the equity of tax results for a limited number of taxpayers.

A general averaging system for income taxation would handle the capital gains problems as well as the problem of insuring equitable treatment between recipients of fixed and fluctuating incomes.

I. Introduction

The capital gain and loss provisions of the Federal taxes on individual and corporate income have been controversial since their enactment. Opinion concerning these provisions has ranged from one extreme, that capital gains and losses should be completely excluded from the bases for income taxation, to the other, that these gains and losses should be treated for tax purposes precisely like any other positive or negative elements of ordinary income.

Prior discussion regarding taxation of capital gains has devoted considerable attention to the question whether these gains are capital or income. Opponents of the tax state that capital gains are not income and therefore should not be subject to income tax. Proponents of capital gains taxation believe these gains are sufficiently indicative of taxpaying ability, at least when realized, to be properly subject to income tax.

Since 1922, Congress, while consistently upholding the general principle that capital gains are proper objects of income taxation, has followed an intermediate course in determining the rates of tax to be applied. Although varying in detail, this has included the following main characteristics: (1) Inclusion of capital gains and losses for tax purposes only when realized by sale or exchange; (2) application of special low tax rates to capital gains accrued over more than a minimum period prior to realization;[4] and (3) limitations on deductibility of capital losses from ordinary income.

A. THE CATEGORY "CAPITAL ASSETS"

The area covered by the capital gain and loss provisions of the Internal Revenue Code is determined by the language used in the statute to define exclusions from and inclusions in the category "capital assets."[5] As defined in the Internal Revenue Code, the term "capital assets" includes all property held by a taxpayer, whether or not connected with his trade or business, except certain specified classes: (*a*) stock in trade or property of a kind includible in inventory, (*b*) properties held primarily for sale to customers in the ordinary course of trade or business, (*c*) property used in trade or business and subject to allowance for depreciation, (*d*) real property used in trade or business,[6] (*e*) a copyright, literary, musical, or artistic composition (but not a patent), and (*f*) certain Government securities.[7]

The effect of these exclusions is to so limit capital assets that, so far as individuals are concerned, securities are the main component, accounting for perhaps three-fourths or more of the total.[8] In addition to securities, other important types of capital assets are real estate not used for business purposes (including personal residences), partnership interests in business enterprises, patents, and contracts of various sorts.

Because of the negative manner in which it is defined, the term capital assets also includes durable consumption goods of all types, such as personal automobiles, household appliances, and the like. These consumption goods raise a special problem in achieving equitable capital gain and loss tax provisions. Because our income-tax laws do not allow deduction of personal, family, or living expenses, depreciation on these durable consumption goods cannot be taken for tax purposes. Gains from sale or exchange of owner-occupied residences, automobiles, or other personal property are taxable as capital gain, the gain being the difference between the original cost and selling price. Losses on consumer goods, however, are not deductible like other capital losses since they are considered to be personal expenditures. The result is a one-sided treatment in which gains are taxed but losses are disallowed.

Gains realized from sale of assets that do not qualify as capital assets are treated as ordinary income and taxed accordingly rather than under the special-tax provisions applicable to capital gains.

B. PROVISIONS OF EXISTING LAW

Present law distinguishes two classes of capital gains and losses: (1) short-term gains or losses resulting from sale or exchange of capital assets held not more than 6 months and (2) long-term gains and losses

[4] This preferential treatment has been provided by means of an alternative maximum effective rate of tax applicable to capital gains and also (since 1934) by means of an arbitrary percentage reduction in long-term capital gain taken into account for income tax purposes.

[5] The definition of capital assets appears in the Internal Revenue Code at sec. 117 (a).

[6] Although not capital assets, depreciable property and real property used in trade or business are treated under sec. 117 (*j*) like capital assets if held more than 6 months and if there is a net gain for the year.

[7] Specifically, obligations of the United States Government or of a State or local government issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not more than 1 year from date of issue.

[8] No current statistics allocating capital gains and losses to different classes of capital assets are available. This information has not been required on tax returns since 1936.

from assets held more than 6 months. Short-term gains realized by individuals or corporations from sale or exchange of capital assets are taxed as ordinary income. Long-term gains realized by individuals are taken into account for tax purposes at 50 percent of their face amount. These reduced or statutory amounts are taxed as ordinary income with the additional limitation that the marginal rate of tax, that is, the rate applicable to an increment of capital gain when added to ordinary income, need not exceed 50 percent of the gain taken into account.[9] Long-term capital gains realized by corporations are 100 percent taken into account and the nominal maximum or alternative rate of tax is 25 percent rather than 50 percent.

In substance, the individual income-tax effective rates on long-term capital gains are one-half the corresponding rates on ordinary income up to the point where the alternative rate on long-term gains applies. Above this point, which is currently $18,000 of taxable income for a single individual or a married person filing a separate return and $36,000 for a married couple filing a joint return, the effective rate of tax on long-term capital gains is a flat 25 percent regardless of the amount of ordinary taxable income. At higher income levels, therefore, the capital-gains rate becomes progressively less than one-half the corresponding rate on ordinary income.

The following table illustrates, for a married couple filing a joint income-tax return, the rates of tax applicable to an additional dollar of ordinary income and to an additional dollar of long-term capital gain, respectively, starting from taxable incomes of different sizes. The rates are those provided for 1951 income by the Revenue Act of 1950.

Surtax net income	Rate of tax on 1 additional dollar of—	
	Ordinary income	Long-term capital gains
	Percent	*Percent*
$5,000	22	11.0
$10,000	26	13.0
$25,000	43	21.5
$50,000	59	25.0
$100,000	75	25.0
$500,000	91	25.0

For a taxpayer having more than $200,000 of taxable income if single and more than $400,000 if married (and, therefore, falling in the maximum surtax rate bracket of 91 percent), the effective rate of tax on long-term capital gains is less than 28 percent of the rate on ordinary income.

Under the corporation income tax, effective rates on long-term capital gains are the same as on ordinary income for corporations having net income below $25,000. Above this point, the alternative rate on capital gains in effect exempts these gains from surtax. Capital gains are also exempt from excess profits tax.

Deductibility of capital losses from ordinary income under the individual income tax has been limited in various ways since 1924. At present, taxpayers are permitted to merge short-term and long-term

[9] Thus the maximum effective rate of tax for individuals on long-term capital gains is 50 percent (the nominal alternative flat rate) multiplied by 50 percent (the proportion of gain taken into account), or 25 percent.

gains and losses, after percentage reduction of the latter. Hence a short-term loss will offset twice its amount of long-term gain and a long-term loss will offset only half its amount of short-term gain. There is no statutory limit on the amount of capital loss a taxpayer may set off against capital gain but the law does impose a limit on the amount of capital loss that may be deducted from ordinary income. The excess of statutory net capital losses (over gains) may be offset against ordinary income in any taxable year up to a maximum of $1,000. Any remaining unused capital loss may be carried forward into the five succeeding years as a short-term loss.[10] Consequently, the maximum amount of net capital loss on one transaction that can be offset against ordinary income is $6,000.

Different rules govern deductibility of capital losses under the corporation income tax. Since there is no arbitrary reduction in the amount of long-term gains or losses taken into account, short-term and long-term gains and losses may be merged without producing fictitious balances. Corporation capital losses may not be set off against ordiordinary income but only against capital gains. Corporations, like individuals, are permitted to carry over capital losses that cannot be offset against capital gains of the same year into the succeeding 5-year period.[11]

The policy of taxing capital gains only when realized by sale or exchange means that appreciation involved in transfers of property by gift or at death is not now taxed as income to the transferring party. Likewise, no income-tax deduction is allowed for the decline in value of any capital assets involved in such transfers. In death transfers of capital assets, accrued gains and losses of the decedent disappear completely from the income-tax base. In gift transfers the donee takes over the donor's basis for determining gain and hence acquires potential income-tax liability for accrued capital gain (but not potential tax credit for accrued loss).[12] When a donee sells donated capital assets and realizes a gain, he becomes liable for tax on the entire gain including that portion accrued prior to his acquisition of the property by gift.

C. NATURE OF THE PROBLEM OF CAPITAL-GAINS TAXATION

Basically, the problem of capital-gains taxation is difficult because of the realization criterion of taxability. Under this rule, the taxpayer himself determines when his gains and losses shall be brought to account. Thus taxpayers have the option to postpone tax liability simply by holding gains unrealized, i. e., by not selling or exchanging their appreciated property. Conversely, they can obtain immediate tax reduction (subject to the limitations already described) by the sale or exchange of capital assets on which losses have accrued. Tax considerations, therefore, reinforce the normal tendency of investors to take losses promptly while letting gains accumulate.

[10] Where more than one net capital loss larger than can be set off against ordinary income occurs within a 5-year period, the oldest net loss must be recovered from income first.

[11] The economic significance of the corporate capital loss carry-over privilege might be considered less than that of the individual capital loss carry-over privilege in view of the absence of income offset in the case of corporations. Whether this judgment is, in fact, warranted obviously depends on the relative frequency of occurrence of capital gains and losses among corporate and individual taxpayers, respectively, and also on the average size of the gains and losses among the two groups of taxpayers, corporate and individual.

[12] A donee's basis for determining loss is the lower of the donor's cost or fair market value at time of transfer rather than in all cases the original basis for valuation of property in the hands of the donor.

The aggregate of capital gains realized by sale or exchange in any given year will have accrued over a broad range of holding periods—from a few days to many years. There has been widespread acceptance of the general principle that it is unfair to tax at progressive rates, in a single year, capital gains which have accrued over a number of previous years. Concentration of such long accrued capital gains for tax purposes in the year of realization tends to push some taxpayers into higher rate brackets and to make effective tax rates on some gains higher than would have been the case had the taxpayer been allowed to apportion his gains back, either to the actual years of accrual or to some arbitrary period, such as 5 years. Preferential tax treatment for long-term capital gains has always been justified in part by this effect. However, the amount of tax preference given long-term gains has generally been substantially greater than the amount of tax rate adjustment required by this equity consideration.

In addition to the averaging objective in preferential treatment of long-term capital gains, a low rate of tax is often deemed necessary to encourage prompter realization of these gains. The desire to avoid income tax strengthens the natural tendency to hold on to investments. If existing provisions for capital gains taxation have the effect of unduly retarding realization, this may be due as much to defects in the capital gains tax structure, for example, to the fact that capital gains may be transferred free of income tax at death, as to the mere existence of the tax.

The holder of an appreciated capital asset who would like to switch to some other investment must find an alternative that he considers sufficiently preferable to his present holding to offset the tax and other costs (brokerage, etc.) of the exchange. The tax cost is dependent on the rates of capital gains taxation; these in turn vary with the amount of accumulated gain and with the size of the taxpayer's ordinary income. Any significant tax on capital gains levied at the time of realization will undoubtedly tend somewhat to discourage sales of appreciated property. The higher the tax rate, the stronger this effect will be. However, the tax factor is only one among a number of considerations influencing investment decisions. It may be much less important to a given investor than his forecast of future price and other economic trends.

The question of the proper levels of preferential rates to apply to long-term gains is complicated by the conflicting considerations involved. In general and unless capital gains are very large relative to ordinary income, only moderately preferential rates are usually needed for the majority of long-term capital gains in order to make appropriately equitable adjustments for the greater lumpiness and more sporadic nature of these gains compared with ordinary income. On the other hand, if minimum interference with markets for capital assets rather than tax equity is the standard, a relatively low set of tax rates for long-term capital gains may be indicated. If maximum revenue from capital gains taxation is the standard, an intermediate schedule of rates, which does not too greatly restrict transactions and at the same time does not encourage an excessive amount of conversion of ordinary income into preferentially taxed long-term capital gains, may be desirable. Moreover, intermediate rates may be held to effect a reasonable compromise between the conflicting equity and market considerations.

Finally, any generally acceptable solution of the capital-gains tax problem might require complex tax provisions. It is important for administration and compliance that these complications be kept to a minimum. In the past, Congress has sought as much simplicity as was consistent with prevailing views concerning the objectives of capital-gains taxation.

II. Concepts of Capital, Income, and Capital Gain

Controversy in the field of capital-gains taxation has arisen in part from the different meanings assigned to the terms "capital" and "income."

A. THE NATURE OF CAPITAL

Capital has been defined in a general sense as a store of wealth that may be used to obtain future income.[13] Economists sometimes identify capital with physical plant and equipment, the value of which depends on the amount of its prospective income. This is expressed as the present worth of the expected yield from capital goods.

The wealth or capital of an individual may consist, in whole or in part, of tangible capital goods, such as factories or machinery, or of intangible capital claims, such as corporate securities or evidences of indebtedness. The wealth of an individual at any point of time may be thought of most conveniently as his net worth or the sum of his assets less liabilities.

"Capital assets" as employed for tax purposes is a technical legal term referring specifically to those types of property comprehended within the statutory definition and not to all forms of wealth owned by an individual. In many cases, capital assets may account for only a small part of an individual's net worth or wealth. For example, although corporate securities are capital assets to most people, changes in the values of securities owned by a dealer do not give rise to capital gains or losses but to ordinary income or business losses.

B. THE NATURE OF INCOME

Income has been defined as the maximum amount a person might consume during a given period of time, such as a year, and still be as well off at the end of the year as he was at the beginning.[14] This definition describes real, rather than money, income. Conventional accounting practices, on which income taxation is based, do not, in general, attempt to measure real income. Personal income defined either in the foregoing manner or in other conventional ways may be broken down into two parts, namely, consumption and the net change in value of assets and liabilities.[15]

Although income is ordinarily thought of as a flow of goods and services or their monetary equivalents between two points of time, and capital or wealth as a stock existing at a particular point of time, the capital and income of an individual are in practice not always easy to distinguish. One source of capital to an individual is saving from his

[13] American Institute of Accountants, A Statement of Accounting Principles, New York, 1938, p. 11.
[14] See, for example, J. R. Hicks, Value and Capital, Oxford, 1939, p. 172.
[15] For example, Henry C. Simons has defined personal income as "the algebraic sum of a person's consumption and the change in value of his property rights during a period." Personal Income Taxation, University of Chicago Press, 1938, pp. 51 and 125.

personal income. Other sources are inheritance, gift, and appreciation in value of property already owned.

The maximum consumption definition of "income" cited above measures the net accretion to or deterioration in an individual's economic position within a given period of time in "real" or economically significant terms.[16] Real net income is a theoretical standard useful in analyzing problems that must be resolved to achieve tax equity. However, real net income has no exact counterpart either in tax administration or in business accounting. It differs from taxable income as defined by statutory law and conventional accounting practices in that real income is concerned primarily with relative valuations and present worth whereas taxable income is concerned more with nominal or book valuations and historical costs.

For business-accounting purposes income has been defined as—

> 1. * * * the increment in wealth arising from the use of capital wealth, and from services rendered.
>
> 2. Income, in the narrow sense, is the owner's share of this increment. This is the income which it is sought to define as "net income" in the income statement.[17]

Another definition of "income" includes only consumption and excludes savings.[18] This income concept leads away from a net income tax toward a spendings tax.

The employment for tax purposes of economically significant definitions of capital and income is limited by the impracticality of ascertaining present real value in an objective and economical way and by the consequent necessity of substituting original cost less, in the case of wasting assets, a formalized kind of depreciation.

C. NATURE AND SOURCES OF CAPITAL GAINS AND LOSSES

Capital gains and capital losses are simply increases or decreases in the value of those portions of personal or corporate wealth which are comprehended within the class of "capital assets." For tax purposes these gains and losses include only such changes in values of capital assets as are "realized" by sale or exchange. Since capital values reflect the present worth of expected future receipts, a capital gain or loss may indicate changed expectations concerning future real income.

Changed income expectations may mean (*a*) that a different amount or duration of future yield is expected,[19] (*b*) that the probability of its receipt is higher or lower, or (*c*) that the relative values of a given amount of future and present income are appraised differently. This latter type of change in expectation means a change in the rate of discount or capitalization factor used to reduce future receipts to present value.[20]

Capital gains and losses may arise from a diversity of sources. An especially important source of capital gain is corporate saving—reinvestment of corporate earnings in business expansion. The "plowing back" of corporate profits gives rise not only to growth in the value

[16] Cf. R. N. Haig's definition of income as the "money value of the net accretion to one's economic power between two points of time." The Federal Income Tax, Columbia, 1921, p. 7.

[17] A Statement of Accounting Principles, loc. cit. See also Accounting Research Bulletin No. 32, American Institute of Accountants, December 1947.

[18] Cf. Irving Fisher, The Nature of Capital and Income, Macmillan, 1912, pp. 51–2; 134–5; 246–55.

[19] That is, either a different aggregate sum of income over the same period of time or the same aggregate sum of income over a different period of time.

[20] A change in the rate of interest used for capitalization may mean a changed forecast of the purchasing power of a dollar of income at some or all future dates.

of corporation capital accounts but also to appreciation in the value of corporate securities.[21] A significant relationship exists between undistributed corporate earnings and capital gains, although the form of this relationship is undoubtedly complex.

A second source of capital gain is population growth. This factor may be reflected in urban real estate, for example. Changes in urban land values and rents are often traceable to expansion or redistribution of population.

A third source of capital gain is new or unexpected developments. If a manufacturing concern successfully markets a new product, this will enhance the firm's earning power and the value of its securities. Similar examples of capital gains result from other innovations and from various types of discoveries. Capital losses may also result from innovations which fail to win public acceptance.

A fourth source of capital gain is simply increases in earning power not necessarily associated with discovery or innovation. Such increases may come about for many different reasons. For example, a business firm's earning power may rise because management has become seasoned.[22] Earning power may also grow because a firm has gained competitive advantages over its rivals or has succeeded partially in monopolizing the market for its product. Capital gains also result from the fact that productivity has increased, due, for example, to more efficient labor or to a more even flow of raw materials.

A fifth source of capital gain or loss is change in the general levels of economic activity or prices. During a period of economic expansion, business firms are able to operate at or even beyond rated capacities, thus spreading overhead thinner and leading to larger profits per unit of investment. Increases in earning power resulting from a general improvement in business conditions will distribute capital gains broadly though unevenly. This is apparent from the experience of many firms during World War II and from the elementary observation that during an economic upswing the prices of nearly all corporate securities will rise, though by varying relative amounts.

Capital gains may result either from specific or from general price changes. Specific price changes may reflect, on the demand side, changes in buyer acceptance of the product, on the supply side, changes in cost resulting from discoveries and innovations or from increases in efficiency. General price increases, on the other hand, while by no means uniform, are nevertheless thought of as associated with monetary expansion and as affecting most business firms and individuals, though in varying degrees.[23]

Another source of capital gain closely related to general price changes is reductions in interest rates. Insofar as claims to future income are capitalized at lower rates, capital values will advance. Such an advance in capital values, being general in nature, has characteristics somewhat similar to capital gains flowing from an increase in the general price level.[24]

A sixth and final class of capital gains cannot be traced in quite the same manner to underlying sources. These gains may be called ran-

[21] Appreciation in the market values of a corporation's securities need not correspond with the amount of its self-financed capital formation; market values of securities presumably reflect expected income rather than book values. In practice, the correlation between market and book values of many corporate securities is poor.

[22] See the symposium of the Tax Institute, Inc. on Capital Gains Taxation, 1946, p. 70.

[23] Ibid., pp. 73-77.

[24] Ibid., pp. 71-72.

dom gains; some of them are essentially windfalls. Random gains may result from such factors as a general increase in confidence concerning the future. This would operate, for example, to increase market prices of securities and to distribute gains to individuals in proportion to their security holdings. Likewise, natural factors such as climatic conditions and rainfall variations, or political disturbances such as wars may be important sources of random gains. Unexpected changes in tax rates or other tax provisions may be capitalized into windfall gains. For example, a reduction in capital-gains-tax rates would mean windfall gains to owners of securities and other capital assets.

Most, if not all, of these factors are, of course, capable of operating in reverse of the manner described; they then produce not capital gains but losses.

The variety of sources of capital gain and the fact that in practice most capital gains derive not from one but several sources indicate one reason why capital gains tax policy is sometimes considered difficult to formulate. Some gains are real and others are illusory; some are permanent, others temporary. Some accrue gradually and tend to be recurrent like wages, interest, dividends, etc. Others accrue sporadically and quite suddenly, in large amounts without likelihood of recurrence. For tax purposes it might be considered desirable, for example, to deal with capital gains traceable to corporate saving and with pure windfalls in quite different fashion. But to devise tax provisions to make such separations accurately and equitably would doubtless be administratively difficult.

D. ARE CAPITAL GAINS CAPITAL OR INCOME FOR TAX PURPOSES?

Economic analysis of the nature of capital gains indicates that some at least of these gains are essentially indistinguishable from income during the year in which the gains accrue. However, they are clearly capital during subsequent years. Moreover, past years' accruals of capital gains may be a peculiar kind of capital in that their source was saving which was never subject to income taxation.

This peculiarity arises because the income tax, as we know it, is not imposed on income defined according to a present real value perfect accrual basis. Rather the income-tax base is income measured essentially on a nominal money value-realization basis. Tax accounting is not primarily concerned with keeping asset values continually at or near present worth. Instead, the tentative valuation of original cost is allowed to stand unchanged until disposition, at which time a single net correction is made for all the past income effects of under- and over-asset valuation.

Because some capital gains are not unlike income while accruing but are clearly capital when realized, the main question for tax policy is not simply whether capital gains, in general, are capital or income. Rather a more significant question would appear to be whether, under an annual net income tax, it is more or less equitable to include all, some, or none of capital appreciation and depreciation in the tax base. One aspect of this problem may be illustrated by the following example:

Suppose two corporations begin business on the same date with identical amounts of invested capital. Suppose, furthermore, that they earn identical annual profits over a period of 10 years and both increase their capital investment each year by an amount equal to net profit. The first corporation, however, pays out all its profits after tax in dividends to stockholders and obtains annually from external sources an equal amount of new equity capital for expansion. The second corporation distributes no dividends but reinvests all its profits after tax in business expansion and does not resort to the capital market.

Under these assumptions both the dollar amounts of annual net income and each corporation's rate of return on total investment will be identical each year. Each firm will pay the same amount of corporation income tax annually.

Under existing tax arrangements, stockholders in the first firm, which financed expansion externally, receive their shares in the corporation's earnings as dividend income each year and are liable for personal income tax at full rates. Stockholders in the second corporation, which financed expansion internally, receive no dividends and hence are not liable for any personal income taxes on their respective shares in the profits of their corporation. Instead, the value of their stock increases. Any stockholder in the second corporation may realize his approximate share in the corporation's profits by selling his securities.[25] This makes him eligible for capital-gains tax treatment.

In this example, while profits of the first corporation will enter the tax base annually as individual income, profits of the second corporation will not, so long as stockholders of the second corporation hold their shares. Instead, their profits become liable for taxes only when and if stock is sold and capital gains realized. Furthermore, the tax liability in the second case, because of preferential capital gains treatment, is not similar to the tax liability in the first case where the annual distributions of corporate profits were treated as ordinary income.

This example also illustrates the fact that if capital gains were not subject to taxation, the tax system might be considered incomplete because stockholders of the nondistributing company would be able completely to avoid taxation on their shares in corporate profits. In view of the fact that undistributed profits are a major source of capital gains, some students of taxation take the view that capital gains provisions in an income tax are essential, if for no other purpose than to limit this area of potential tax avoidance.[26]

Even though the capital gains accruing to owners of securities in the second corporation are taxed as under present law (when realized), the tax system in effect makes a distinction in tax liability on the basis of the form in which individuals draw their profits. However, under an annual income tax with graduated rates, taxing realized gains as ordinary income also produces different amounts of tax for these two taxpayers.

The above example outlines a problem of tax equity arising in connection with capital gains attributable to one particular source, namely, corporate saving. Other sources of capital gains are productive of different but equally difficult issues of tax equity.

[25] Provided, of course, that book and market values of the corporation's stock are not too greatly at variance.

[26] An alternative solution to the problem might be to tax undistributed corporate earnings at rates approximating the rates for which taxpayers would be liable if the earnings were distributed. Such an approximation would be practically impossible, however, in the case of separate personal and corporation income taxes with differently graduated rate structures. If the personal and corporate income taxes were integrated and partnership treatment applied, this solution would be less difficult.

Most individuals who believe that capital gains should be treated as ordinary income for tax purposes nevertheless recognize that capital gains possess certain distinctive features. One of these is that capital gains flowing from price or interest rate changes may not measure real changes in an individual's income or economic position. This thought is often expressed in the statement that many capital gains are not real but illusory.

There can be but little doubt that during a period of inflationary price increases many capital gains are illusory, either entirely or in part. The illusion arises because conventional accounting techniques do not measure real income. However, the illusion occurs to some degree in all types of income and is by no means peculiar to capital gains.

Even though it be recognized that capital gains flowing from inflationary price increases may be illusory, in practice it is impossible accurately to separate illusory from real gain.[27] The only method of doing this, even approximately, would involve the use of "stabilized" or "index number" accounting in place of the conventional accounting practices now employed.

Although one might advocate that an income tax based on net income defined by stabilized accounting would be more nearly equitable than an income tax based on income defined by conventional accounting, to change the tax base in this way would involve many difficult conceptual, administrative, and enforcement problems.[28] In practice, stabilized accounting would not necessarily produce more nearly equitable tax results because of the difficult administrative problems it would raise. Thus, the mere fact that capital gains are in part illusory neither differentiates these gains from other income, except perhaps in degree, nor indicates what tax policy toward them should be.

If the illusory portion of capital gains cannot be measured, the usefulness of the distinction between real and illusory capital gain is definitely limited. Capital appreciation resulting from an inflationary price trend will affect different individuals unequally. Consequently, excluding capital gains from taxation simply because they are in some measure illusory would give nonuniform treatment to different income-tax payers. It may, of course, be maintained that they already are subject to nonuniform treatment. However, including capital gains of different degrees of "realness" more or less fully in income for tax purposes might be held merely to add another dimension of nonuniformity to the treatment of taxpayers. The question really is whether complicating administration of the revenue laws significantly might be expected to produce a balancing improvement in tax equity.

Moreover, the fact that capital gains may be illusory takes account of only half the problem. Losses may be equally illusory. Although taxation of illusory capital gains may be considered a hardship, allowing offset of illusory capital losses against real capital gains or income implies a windfall tax concession or benefit. An income tax on illusory capital gains is less inequitable in broad effect provided loss offsets are nearly perfect. However, this concept of equity to taxpayers as a

[27] See Capital Gains Taxation, op. cit., pp. 77–81.

[28] For some of the fiscal policy considerations, see Walter Froehlich, The Role of Income Determination in Reinvestment and Investment, American Economic Review, vol. XXXVIII, No. 1, pp. 78–91; also K. Lacey, Profit Measurement and the Trade Cycle, Economic Journal, vol. LVII, No. 228, pp. 456–474. For some of the problems involved in the conventional accounting definition of income, see the address of Earle C. King before the New York State CPA Society, May 10, 1948.

group does not allow for the fact that even actuarially perfect loss offsets will not produce equitable tax results when illusory gains and losses are realized in different amounts by different individuals.

III. Historical Background

The history of the capital gain and loss provisions under the modern income tax may conveniently be divided into four periods. During the first period, from the enactment of the 1913 law through 1921, capital gains of all types were subject to the same normal tax and surtax rates as other income. There was considerable variation in the tax treatment of capital losses, beginning with no allowance,[29] but gradually widening loss deductibility, first to the extent of capital gains[30] and finally to full offset against income of any kind.[31]

During the second period, covering the income years 1922 through 1933, capital gains from long-term transactions could (at the taxpayer's option) be segregated from ordinary income and a maximum rate of 12½ percent applied to them. This period also was characterized by an unstable policy in the treatment of losses. It started with full allowance against income of any kind[32] but was characterized principally by the so-called parallel treatment. This treatment restricted capital-loss offsets against ordinary income to the same flat rate (12½ percent) that was applied to gains.[33]

A third period began with the Revenue Act of 1934 and continued until 1938. This period was featured by the step-scale plan for percentage inclusion of capital gains and losses (according to the length of time capital assets had been held). Under this plan, gains taken into account, that is, stepped down according to time held, were included in net income and subjected to full normal tax and surtax rates; capital losses taken into account were deductible only to the extent of recognized gains plus $2,000.

The fourth or present period, beginning with 1938, combines some features of the two preceding periods, namely, percentage inclusion of gains and losses and an alternative flat-rate tax. The treatment of losses during this latter period has also fluctuated between a policy of rather severe restriction and a policy of more liberal allowances.

The Revenue Act of 1938 provided for complete segregation of short-term from long-term gains and losses. Short-term gains were fully taxable as ordinary income and short-term losses could be offset only to the extent of short-term gains (but with a 1-year carry-forward of unused losses). Long-term gains, taken into account at percentages varying according to time held, were also subject to a maximum flat-rate-tax limitation; long-term losses, taken into account at similar percentages, were also subject to the same flat-rate limitation (as to reduction of tax).

The Revenue Act of 1942, which is the currently controlling act, retains both percentage inclusion of long-term gains and losses and the maximum tax-rate limitation for long-term gains. Short-term and long-term losses may be merged and are allowed to the extent of short- and long-term gain and other income up to $1,000. The excess of loss may be carried forward for 5 years as short-term loss.

29 Revenue Act of 1913.
30 Revenue Act of 1916.
31 Revenue Act of 1918.
32 Revenue Act of 1921.
33 Revenue Act of 1924.

This outline of capital-gains-tax history is organized topically rather than chronologically.[34] The topical basis of organization has been adopted here in order to relate the historical background material to the analysis of current law contained in succeeding chapters.

Despite continuing opposition on the part of some to the principle of a capital-gains tax and repeated presentation of proposals to abolish this levy completely for revenue or alleged incentive reasons, tax legislation since the adoption of the sixteenth amendment has consistently regarded these gains as taxable income. However, beginning with the Revenue Act of 1921 (effective in the income year 1922), long-term capital gains have been regarded as a special kind of income and have been granted preferential tax treatment in several different ways.

A. REASONS FOR PREFERENTIAL TREATMENT

Preferential treatment of capital gains has been justified on several grounds, namely, equity, incentive, and revenue yield.[35]

With respect to equity, it has been pointed out that it is unfair to include with other income and to tax at progressive rates in the year of realization capital gains which have accrued over a number of previous years. It has become more or less generally accepted that an equitable principle of taxation for capital appreciation under an annual income tax would be one under which the tax on capital gains levied upon realization would approximate that which would have been paid if the gain or loss, treated as ordinary income or loss, had been realized as it accrued annually.

One of the earliest proposals for special treatment of capital gains which received the serious consideration of Congress provided for prorating realized capital gains, together with certain other types of income, over the years during which the capital asset had been held or the other income earned.[36] This method was rejected, however, as too complicated for administration.[37]

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[34] For a chronological history see Anita Wells' article in the National Tax Journal, March 1949.

[35] The various arguments for preferential treatment of capital gains were well summarized in a report of the Ways and Means Committee in 1923. The report, submitted by Mr. Ogden L. Mills, described the effects of the pre-1921 system of full taxation of capital gains and full deduction of capital losses as follows: "This system did not prove satisfactory. It involved an injustice to the taxpayer, in that an increment frequently accumulated over a period of many years was taxed at a high surtax rate because the property was converted into cash in a given year and the net profit arbitrarily attributed to the year in which the sale took place. But of much greater importance was the decided interference with the normal course of business and commerce. With a maximum tax of 77 percent there was a severe artificial restraint on sales at a profit, and many transfers of property extremely desirable from the standpoint of economic development and general public welfare were not only retarded but actually prevented. In addition, there was a serious loss of revenue, in that the initiative, as is always the case, remained with the taxpayer, who refrained from taking a profit but who did not hesitate to take a loss which could be deducted in full from his taxable income" (Committee on Ways and Means, report on H. R. 13770 (a proposed amendment to the Revenue Act of 1921), House Report No. 1388, 67th Cong., 4th sess., Jan. 12, 1923, pp. 1-2).

[36] H. R. 14198, 66th Cong., 2d sess., which passed the House on May 27, 1920, but failed to receive the approval of the Senate, included the following proration plan for "extraordinary net income" (defined to include (1) compensation for personal services rendered during a period of more than 3 years and (2) gains from sales of capital assets held for more than 3 years): If the "extraordinary net income" amounted to more than 20 percent of the taxpayer's entire gross income for the taxable year, the "extraordinary net income" could be apportioned ratably to the years during which the service was rendered or the assets held and the amount thus apportioned to any year would be added to the other income for that year and the tax redetermined upon the corrected amount at the rates applicable to that year (sec. 3 of H. R. 14198).

[37] Dr. T. S. Adams, tax adviser to the Secretary of the Treasury, explained in 1921 that the proration method had been discarded because of its administrative complexity: "I think that provision [proration] had the approval of the Treasury Department in the past. But it would be cumbersome in operation. It would require amended returns and a very elaborate procedure. The critics, almost all of whom welcomed the proposal, criticized, I think, the complexity of the procedure. It therefore seemed advisable to try to simplify it and to adopt a single rate" (statement of Dr. Adams, hearings before the Committee on Ways and Means on internal-revenue revision, August 1921, p. 105). Mr. Frederick R. Kellogg in his statement before the Senate Finance Committee hearings on the proposed Revenue Act of 1921, May 1921, p. 542, quoted a friend in the Internal Revenue Commissioner's office as saying that the plan was administratively impossible: "The thing is utterly impossible. Those men are driven to death. Think of their having to revise all these income-tax returns for previous years. It would stop the business of the Treasury."

Consideration has also been given at various times to such proposals as (1) the inclusion in taxable income of annually accrued though unrealized gains and losses, and (2) proration or averaging of realized capital gains, either separately or with other income, over several years—not necessarily the number of years the capital assets have been held.[38] These methods were likewise rejected largely because of administrative and compliance complexities, but also in part because of constitutional questions and fear of causing taxpayer hardship.

Throughout the history of capital-gains taxation, continuous concern about the effects of the tax on (*a*) sales and exchanges, (*b*) security and other property prices, and (*c*) revenue yield has been apparent. It was the belief that a moderate tax rate would encourage the sale of much appreciated property which otherwise would not be sold that provided the main foundation of the case for the introduction of preferential treatment in 1921.[39]

Congress has tried time and again to find a method, both practicable and equitable, of taxing capital gains. Such a method has been conceived to be one which would interfere as little as possible with realization of gains and at the same time would not stimulate loss realization too much.

But finding satisfactory formulas for achieving the divergent equity and incentive objectives that are entwined in the philosophy of capital-gains taxation and at the same time protecting the revenue has been a difficult problem. Consequently, the history of the legal provisions has been a record of compromise and change without satisfactory solution.

B. ELIGIBILITY FOR PREFERENTIAL TREATMENT (HOLDING-PERIOD REQUIREMENTS)

The following eligibility tests of capital gains for preferential tax treatment have, at various times since 1913, been used: (1) length of holding period, (2) size of taxable income,[40] and (3) character of property.[41] It is desirable to examine these different eligibility tests separately.

Differentiation between short- and long-term capital gains and losses has come to be an integral part of the system of providing preferential tax treatment to some capital gains. This short- versus long-term distinction has been drawn primarily with the intention of limiting the benefits of preferential tax treatment to bona fide investment

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[38] See, for example, subcommittee of the Committee on Ways and Means, report on proposed revision of the Revenue Laws, 1938, p. 32.

[39] The Ways and Means Committee in commenting on the capital-gains provision in 1921 said: "The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law" (Committee on Ways and Means, report on the revenue bill of 1921, H. Rept. No. 350, 67th Cong., 1st sess., pp. 10-11).

[40] This latter is not a direct requirement but is indirectly a prerequisite for favorable treatment under the alternative flat rate method. The special alternative flat rate is of no benefit to the lower income levels.

[41] For example, under sec. 117 (j), gains from depreciable and real properties used in trade or business are eligible for capital gains treatment. This is true in spite of the fact that these properties are expressly excluded from the definition of capital assets.

transactions. It has consistently been the stated policy of Congress to extend no special tax concessions to speculative gains.[42]

Use of the holding period as a test of eligibility for special treatment has been based on the assumption that assets held over a long period of time are more likely to be of an investment character than those held for a short time.[43] It has generally been recognized that a holding period, while only an arbitrary method of drawing the line between speculative and investment transactions, is nevertheless about the only feasible method of distinguishing between the two types of transactions.

Prior to 1942 there was fairly general agreement that a holding period of 1 year or more was necessary to qualify capital gains for special tax treatment. During the 12-year period 1922 through 1933, special treatment was allowed only to assets held over 2 years. Under the 1934 act (applicable to income years 1934 through 1937) special treatment began at 1 year, but under the 1938 act (applicable to income years 1938 through 1941) assets did not qualify for special treatment until they had been held 18 months. The 1942 act drastically modified former practice when it drew the line between short- and long-term gains at 6 months.

To meet the complaint that the 2-year holding period unduly interfered with transactions, the step-scale plan of percentage inclusion of capital gains and losses was adopted in 1934. Under this method, capital assets were divided into several classes according to the length of time held. The percentage of gain or loss taken into account for tax purposes declined as the length of the holding period increased. But the step-scale plan was also criticized on the ground that the sharp step-downs between the specified holding periods in the percentage of gain or loss taken into account accentuated the effects of the tax on timing of capital transactions.

The desirability of more gradual step-downs with a larger number of steps as a method of minimizing the tax inducement to hold gains unrealized but to realize losses promptly was considered by Congress in 1938 but rejected as too complicated.

Extensive congressional consideration was given to a proposal to abolish the holding period in connection with the Revenue Act of 1942.[44] In the hearings, assertions were made that the distinction between long- and short-term gains was artificial and unsound and that, therefore, the holding period should be eliminated entirely as the worst feature of the capital gains tax because it interfered with

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[42] A subcommittee of the Ways and Means Committee in 1938 stated this policy as follows: "It has always been the settled policy of the Congress to tax speculative gains in general in the same manner and to the same extent as earned income and business profits. * * * Your subcommittee believes that this policy is wise and should be adhered to. It would be against sound public policy to make any changes in the revenue law whose tendency would be affirmatively to encourage speculation by preferential taxation. * * * Your subcommittee recognizes that a classification based solely upon the period of holding is not an exact method for segregating speculative from investment transactions, but it appears to be the only practicable method and is believed to be a sufficiently fair criterion for practical purposes" (subcommittee of the Committee on Ways and Means, report on proposed revision of the Revenue Laws, 1938, 75th Cong., 3d sess., p. 37).

[43] The holding-period requirement came into the Revenue Act of 1921 as an amendment offered on the floor of the Senate by Senator Walsh of Massachusetts. In opposition to the bill under consideration which proposed that preferential treatment be extended to all capital gains, Senator Walsh said, "There is no distinction made between increased value * * * extending over a long period of years and that sudden and speculative increase that develops within a short period of time." As a means of excluding speculative gains from favorable treatment, he proposed a 3-year holding period. When asked if a 1-year requirement would meet his objection, he stated that 1 year was too short, but offered to compromise on 2 years (Congressional Record, vol. 61, pt. 7, 67th Cong., 1st sess., pp. 6575 6576).

[44] This proposal was contained in H. R. 6358, the Boland bill, which would have erased the distinction between short- and long-term gains and losses and would have completely segregated capital gains and losses from other income and taxed net capital gains at a flat rate of 10 percent for both individuals and corporations.

investment and the free flow of capital funds and reduced the revenue by preventing transactions.[45] Particular objection was made to the then existing holding period (18 months) on the ground that it was longer than required to separate speculation from investment. Congress decided against abolition of the holding period but reduced it from 18 months to 6 months.

In connection with the Revenue Act of 1950, the bill as originally approved by the House and as reported by the Senate Finance Committee provided for reduction of the holding period from 6 months to 3 months. However, an amendment introduced on the Senate floor, approved by the Senate, and subsequently agreed upon by the conference committee provided for retention of the 6-month holding period.

C. METHODS OF EXTENDING PREFERENTIAL TREATMENT TO INDIVIDUALS

Preferential treatment has been made available to the eligible classes of capital assets in three ways: alternative low flat rate tax, percentage inclusion or scaling down the proportion of gains taken into account as ordinary income, and a combination of flat rate and percentage inclusion.

1. *Alternative flat rate tax*

During the development of the Revenue Act of 1921, different methods of extending preferential treatment to capital gains were offered in the House and Senate bills. The House proposed favorable treatment through an alternative 12½-percent flat rate tax. The Senate would have given special treatment by taking into account only 40 percent of capital net gains in computing taxable net income. To this 40 percent the regular income tax rates would apply.

The basic difference between these two approaches was that the low flat rate tax would benefit only a limited number of taxpayers with capital gains, namely, those with net incomes subject to bracket rates above the level of the alternative capital gains tax rate, whereas percentage inclusion would extend benefits to all taxpayers with capital gains. The House view prevailed in conference and the low flat rate tax plan was adopted. Not until 13 years later (in 1934) was a percentage-inclusion plan adopted.

No change was made in the 12½-percent rate throughout the entire 12-year period 1922–33, although significant fluctuations, both upward and downward, occurred in ordinary income tax rates. When first adopted, the 12½-percent rate was associated with a top combined normal and surtax rate of 58 percent. The latter was reduced to 46 percent for the income year 1924, and then to 25 percent for the income years 1925 through 1931;[46] it was then increased to 63 percent for 1932 and 1933.

For most of the period during which the 12½-percent rate was in effect, the top ordinary rate was 25 percent. Although suggestions were made that the 12½-percent rate should be reduced along with re-

[45] See, for example, the statement of Elisha Friedman, hearings before Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d sess., vol. 1, p. 943; also the statement of Emil Schram, president of the New York Stock Exchange, hearings before the Senate Committee on Finance on the Revenue Act of 1942, 77th Cong., 2d sess., vol. 1, p. 1187.

[46] With the exception of 1929 when it was 24 percent.

ductions in ordinary income tax rates, no action in this direction was taken.[47]

The income level at which the optional 12½-percent rate became effective varied as individual income tax rate schedules were revised. Under the rate schedule in effect when the 12½-percent rate was adopted, only persons with surtax net income of $16,000 or more received benefits from the special rate. As individual income tax rates were reduced, the minimum income level at which the 12½-percent rate became effective increased to $24,000 for the income year 1924, and to $28,000 for income years 1925 through 1931 (with the exception of 1929 when it was $32,000). With reversal of the downward trend of individual income tax rates in 1932, the effective level again became $16,000.

Maintenance of the special capital gains rate throughout the 1922–33 period at the 12½-percent level, in spite of changes in regular income tax rates and resulting variations in the income requirement for preferential treatment, implies that more concern was felt for the alleged market price and incentive effects of the absolute level of the capital gains rate than for the maintenance of an equitable relationship between the capital gains rate and the changing rates on ordinary income. The record indicates that during this period the dominant concern was so to tax capital gains as not seriously to deter realization of capital appreciation.[48]

In 1927, the staff of the Joint Committee on Internal Revenue Taxation reported in favor of retaining the existing treatment of capital gains, observing in this connection that "A fair inference may be drawn that the lowering of the rate (to 12½ percent by the Revenue Act of 1921) largely contributed to bring activity to the sale of property."[49] This report concluded, however, that the existing method of taxing capital gains was not satisfactory and should be continued only until a better and more equitable method could be found.

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[47] The United States Chamber of Commerce at its annual meeting in 1931 adopted a resolution urging that the capital gains rate be reduced. The report of the chamber's committee on Federal taxation set forth the reasons for "materially reducing the tax on capital gains" as follows: "Since this provision [the 12½-percent rate] was made, the normal individual rate has been reduced from 8 percent to 5 percent, and the maximum surtax from 50 percent to 20 percent. The rate on capital gains, however, still remains at 12½ percent. Obviously, this provision no longer affords the needed relief which it was originally intended to give, and the present rate is out of line with other rates which have been materially reduced since the capital gains provision was enacted by Congress. * * * If the present rates of taxation on capital gains were reduced to a moderate figure, of, say, 5 or 6 percent, it is believed that the greater part of the adverse economic effects of the tax would be avoided" (hearings before the Committee on Ways and Means on revenue revision, 1932, 72d Cong., 1st sess., p. 218).

[48] Under Secretary of the Treasury Ogden L. Mills, in his testimony before the Ways and Means Committee in 1932, said: "* * * we adopted the 12.5 percent provision because it was the opinion, I think, of everyone at that time that, if we applied the very highest surtax rates to gains from property held over a long period of time, that there was a very real tendency to impede normal business transactions that would otherwise take place. In the period of high surtaxes, we decided that it was unwise, uneconomical, and, in the long run, not profitable for the Federal Government; and, therefore, we reduced the rate to the rather arbitrary figure of 12.5 percent. Twelve and five-tenths percent was taken at that time because it was the rate on corporations; and, while there is no direct relationship between the two, that was the figure selected, and that was the reason that particular figure was suggested." When asked by the chairman of the committee whether it was not to the disadvantage of the Treasury to retain the 12½-percent limitation when the maximum surtax rates were under 20 percent, Mr. Mills replied, "* * * you must remember that if men are going to be taxed 20 percent on their profits they may hesitate a long time before they take those profits." He later added, "I think that, when you are not certain as to the economic justification for a tax and uncertain as to its results, the best way to cure it is to lower the rates; because a low rate will cure a very bad tax" (hearings before the Committee on Ways and Means on revenue revision, 1932, 72d Cong., 1st sess., pp. 41–42).

[49] Report of the staff of the Joint Committee on Internal Revenue Taxation, vol. I, 1927, p. 44. Secretary Mellon in 1924 had expressed the same opinion as to the incentive effects of the 12½-percent rate: "Prior to the insertion of the capital gains section in the law, investments did not change hands, property was tied up, and the Government collected little revenue from this source. When the rate of tax was reduced to 12½ percent, however, the Government opened up a vein of revenue which in that one year yielded over $31,000,000 in taxes. It is quite obviously of as much advantage to the Government that the tax on capital gains be reduced as to the taxpayer and to business. Most of all is the moderate taxpayer benefited by removing some of the load from him. The rate was such as permitted the traffic to move, and it did move, to everybody's advantage" (Annual Report of the Secretary of the Treasury, fiscal year 1924, p. 9).

2. *Percentage inclusion*

A later report by the staff of the Joint Committee on Internal Revenue Taxation, published in 1929, again pointed out the inequities of the existing method of taxing capital gains and undertook to develop a method which would meet the tests of equity.[50] The inequities particularly stressed were (1) the failure to give tax benefit to all taxpayers with gains,[51] and (2) the failure to make proper tax rate distinctions among gains held for different periods of time.[52]

Reasoning from the assumption that the fundamental difference between capital gains and ordinary income lies in the time of realization, this report concluded that an equitable method of taxing capital gains would be one under which the tax would approximate that which would have been paid if the gain had been realized in equal annual amounts over the period during which the asset was held.

In an attempt to achieve this objective, a plan was developed under which capital assets were (*a*) divided into several classes according to the length of time the asset had been held by the taxpayer, with (*b*) a declining percentage of gain or loss included in ordinary income as the holding period increased. The ordinary normal and surtax rates were applied to such partially included gains.

In 1921, during development of the initial legislation extending preferential treatment to capital gains, the Senate had proposed a plan of percentage inclusion instead of the flat rate tax. The Senate's 1921 proposal differed from that offered in the report to the joint committee only in that the former proposed one class of long-term assets (those held over 2 years) with the same percentage of gains being included in income regardless of how long the assets were held beyond 2 years, whereas the latter proposed several classes of assets with a step-scale plan of inclusion.

The step-scale plan of inclusion was presented to the Ways and Means Committee's Subcommittee on Prevention of Tax Avoidance in 1933 and the subcommittee recommended its adoption.[53] The general features of the plan, after some significant adjustments in the classes of assets and percentages of gains to be included in ordinary income, were incorporated in the 1934 Revenue Act.[54]

The joint committee's staff had set out to find an equitable formula which would have the effect of prorating capital gains, but not ordinary income, to the period of accrual. The percentage-inclusion plan did not accomplish this objective. When the plan was under consideration by the congressional committees, critics pointed out that it could not be considered to approximate either the results of proration or

[50] Supplemental Report on Capital Gains and Losses, report to the Joint Committee on Internal Revenue Taxation, 71st Cong., vol. I, pt. 7, submitted November 26, 1928, and published June 8, 1929.

[51] Under the ordinary rates then in effect, the 12½-percent capital gains rate was of no benefit to 98½ percent of individual income taxpayers, and of substantial benefit to less than one-fourth of 1 percent of them.

[52] The same tax benefit was given to gains realized from assets held just over 2 years as to those from assets held 20 or more years.

[53] Prevention of Tax Avoidance, preliminary report of a subcommittee of the Committee on Ways and Means, 73d Cong., 2d sess., House committee print, 1933, p. 6.

[54] The plan as enacted in 1934 included the following steps:

Period assets are held—	*Percentage of gain included in ordinary income*
1 year or less	
Over 1 year but not over 2 years	100
Over 2 years but not over 5 years	80
Over 5 years but not over 10 years	60
Over 10 years	40
	30

averaging.[55] The plan, however, did introduce more equity of a limited sort. It adjusted the capital gains tax among taxpayers reporting net gains, first, by extending preferential treatment to all such taxpayers, and, second, by differentiating taxwise among taxpayers with net gains accrued over different periods.

The plan was regarded as raising certain difficulties, however, with respect to the market price and incentive objectives of capital gains taxation. The 2-year holding-period requirement for preferential treatment had been criticized as interfering with transactions. Taxpayers tended to take their losses within the 2-year period in order to get full benefit from them and delayed taking their gains until the 2-year period had expired in order to reduce their taxes. Proponents of the step-scale plan argued that the step-downs in the percentages of gains included in income would result in less interference with transactions. Critics of the plan contended that, on the contrary, it would put a premium on holding appreciated assets long enough to get maximum benefit, thus putting an even greater brake upon realization of gains.[56]

Following its enactment, the step-scale plan became the subject of severe criticism. A subcommittee of the Ways and Means Committee which was appointed in August 1937 to consider possible changes in the Federal revenue laws devoted considerable attention to proposals for revision of the capital gains tax.[57] This subcommittee labored to evolve some method which would meet the objection that the sharp step-downs in the percentage of gain or loss included in income encouraged taxpayers to delay taking gains and stimulated them to realize losses.

As a means of minimizing the effects of the step-down plan on transactions, the subcommittee proposed a revision under which the percentages would decline on a monthly rather than an annual basis. For this purpose, it suggested 49 age classes of assets instead of the five classes in the then existing law. The House incorporated this plan in its draft of the 1938 revenue bill but the Senate rejected it as too complex. Moreover, the Senate recommended complete abandonment of the step-scale plan in favor of a single class of long-term gains (those from assets held more than 18 months). These long-term gains would be included in income to the extent of 50 percent.[58] The 1938 act, as finally approved, retained two classes of long-term capital gains: $66\frac{2}{3}$ percent inclusion was provided for gains from assets held more than 18 months but not over 24 months, and 50 percent inclusion was of gains from assets held more than provided for 2 years

The 1942 act eliminated the multiple holding period—percentage inclusion provisions of prior law and reverted to a single class of long-term capital gains with the added feature of 50-percent inclusion.

[55] In the hearings before the Ways and Means Committee, Mr. Roswell Magill, representing the Treasury Department, criticized the plan and pointed out that a taxpayer selling a 6-year investment at a $60,000 profit under the plan would be taxed at 20 percent of the profit or $12,000 at the then current rates while in fact he had a gain accruing at the average rate of $10,000 per year for 6 years and might reasonably be subjected to six taxes on an item of $10,000 instead of a single tax on $12,000 (hearings before the Committee on Ways and Means on Revenue Revision 1934, 73d Cong., 2d sess., p. 40).

[56] Mr. Roswell Magill pointed out in his testimony before the Ways and Means Committee that under the plan which they were then considering there would be a tendency to hold assets 5 years, in which case only 20 percent of the gains would be included in income (hearings on revenue revision 1934, op. cit., p. 39).

[57] See Proposed Revision of the Revenue Laws, 1938, report of a subcommittee of the Committee on Ways and Means, 75th Cong., 3d sess.

[58] This was along the lines of the Senate's original proposal for 40-percent inclusion in 1921.

3. *Combination of percentage inclusion and flat rate tax*

From 1938 until the present time, preferential treatment of capital gains has been provided through a combination of the two methods previously used separately. This combination features both an alternative flat rate tax for some taxpayers and percentage inclusion for all taxpayers reporting capital gains.

The use of percentage inclusion alone had been criticized on the ground that, despite the arbitrary reduction of capital gains for tax assessment purposes, application of ordinary income tax rates produced levies so high in the upper income brackets that investments became frozen and few transactions took place.[59] To meet this complaint that effective rates were too high, the alternative maximum flat rate tax was reintroduced.[60] Under the 1938 act, an alternative rate of 30 percent was provided. When coupled with the then existing scale for percentage inclusion, this was the equivalent of a maximum effective rate of 15 percent of the gain on assets held over 24 months, and 20 percent of the gain on assets held more than 18 but not more than 24 months.

In the 1942 hearings, consideration was given to the question whether the alternative rate on capital gains should be increased. The Treasury recommended an alternative tax rate on statutory net capital gains of 60 percent (equivalent to a 30-percent effective rate at 50-percent inclusion). It was pointed out in the Treasury's brief that the capital gains rate had been left at 1938 levels while rates on other income had been substantially increased and further increases were being proposed at that time as a wartime anti-inflation measure. The suggested increase in the alternative rate was intended to bring taxes on long-term capital gains into closer harmony with the increased rates on ordinary income.[61]

The Ways and Means Committee at that time approved an increase in the alternative rate to 50 percent (or an effective rate of 25 percent when account is taken of the 50-percent inclusion).

In its report on the bill, the committee said in justification of this increase:

> * * * since the rates of tax on individuals have been increased drastically so far as wages and other fixed or determinable income is concerned, it is believed only proper that some additional tax should be derived in this emergency from capital gains. However, your committee realizes that since the realization of a capital gain is solely a matter within the discretion of the taxpayer a too high capital-gain tax rate will lose rather than gain revenue for the Government. With a top normal and surtax rate of 88 percent it is not believed that a moderate increase in the capital-gain rate will retard capital transactions.[62]

Objections to an increase in the maximum capital-gains rate were voiced by a number of witnesses testifying before the congressional hearings on the revenue bill. Opponents of the rate increase contended that under a low rate the volume of transactions, and consequently the revenue, would be much greater than under a higher rate. It was also argued once again that higher rates on other income do not justify

[59] Committee on Ways and Means, report on the revenue bill of 1938, House Report No. 1860, 75th Cong., 3d sess., p. 7.
[60] Ibid., p. 37.
[61] Statement of Randolph E. Paul, hearings before the Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d sess., vol. 1, pp. 85–86.
[62] Committee on Ways and Means, report on the revenue bill of 1942, House Report No. 2333, 77th Cong., 2d sess., p. 30.

higher rates on capital gains since the latter are not income and are realized only at the choice of the taxpayer.[63]

The Revenue Act of 1942 increased the alternative rate to 50 percent. In view of 50-percent inclusion of long-term gains, this amounted, in effect, to a maximum rate of 25 percent on net long-term capital gains.

The income level at which the benefits of the alternative rate begin has varied considerably during the period since 1938 in which the combination of percentage inclusion and the alternative rate has been in effect. The level at which the ordinary income tax rate (the marginal combined normal and surtax) exceeded the maximum rate on net capital gains has varied from a high of $44,000 for 1939 (and again in 1948 and 1949 for a married person filing a joint return) to a low of $12,000 for 1941.[64]

4. *Results of preferential treatment*

None of the methods used in the past to extend preferential treatment to some capital gains has met at one time all the requirements of tax equity and revenue adequacy as well as those special market and other objectives involved in using the capital gain and loss provisions as a vehicle for incentive taxation.

The alternative low flat-rate tax of the twenties, for example, failed to meet even the most rudimentary equity objective, that of extending preferential treatment to all taxpayers with capital gains.

Percentage inclusion, and particularly the step-scale plan of the 1934 act, introduced a more refined concept of equity within the group of taxpayers with gains but it was held to be unsatisfactory from the viewpoints of prices, incentives, and revenue. It tended to discourage realization of gains and to stimulate realization of losses.

The combination of percentage inclusion and the alternative flat rate that is incorporated in existing law represents an attempt to compromise between the equity and incentive objectives.

None of these methods, however, has allowed precisely for the special characteristics of capital gains and provided equity among all taxpayers (that is, those who do not have as well as those who do have capital gains). All have provided primarily a lower maximum rate of tax for incentive purposes. Since 1934, the methods also have provided somewhat greater equity among taxpayers with capital gains.

In broad summary, the historical record indicates that preferential capital gains tax rates have been set low so as not unduly to induce taxpayers owning appreciated assets to continue to hold them, thus postponing tax. Equitable relations between capital gains and ordinary income tax rates have been given less weight than other objectives.

[63] See, for example, the testimony before the Senate Committee on Finance of Emil Schram, president of the New York Stock Exchange; W. J. Schieffelin, Jr., Chamber of Commerce of the State of New York; and Elisha Friedman (hearings before the Senate Committee on Finance on the Revenue Act of 1942, 77th Cong., 2d sess.).

[64] It was $22,000 for 1940, $18,000 for 1942 and 1943, $16,000 for 1944 and 1945. As a result of the postwar tax reduction under the Revenue Act of 1945, it was $18,000 for 1946 and 1947. For a single person or a married couple filing separate returns, it was $22,000 for 1948 and 1949, $20,000 for 1950, and $18,000 for 1951; for a married person filing a joint return it was $44,000 for 1948 and 1949, $40,000 for 1950, and $36,000 for 1951.

D. TREATMENT OF CAPITAL LOSSES OF INDIVIDUALS

The income tax treatment accorded capital losses of individuals has varied even more than has the treatment of capital gains. During the period 1913 through 1921, when capital gains of all types were subject to full normal tax and surtax rates like other income, there was a steady extension of the tax credit allowed capital losses. Beginning with no allowance, Congress next provided loss allowance limited to the extent of capital gains. Finally, it permitted unlimited allowance for capital losses against income of any kind.

Since the introduction of preferential tax treatment of capital gains in 1922, the general view seems to have been that favorable treatment of gains should be accompanied, as a matter of equity, by some limitations on deductibility of losses. The desire to protect Government revenue and to prevent tax avoidance made possible by offsetting speculative short-term losses against actual long-term gains has also influenced Congress to limit deductions of capital losses.

Throughout a considerable portion of the legislative history, the accepted idea of the way to achieve equity was through so-called parallel treatment of losses and gains. According to this principle, the tax benefits from deduction of capital losses should be limited to the same extent that taxation of gains is made preferential.

When preferential treatment was first considered in connection with the 1921 act, it was proposed that the 12½-percent maximum rate on gains be accompanied by a parallel limitation on losses. The limitation on losses was not then adopted, however. The revenue effects of the failure to limit deduction of losses were soon recognized. Immediate efforts were then made to place a parallel limitation on losses.

The Secretary of the Treasury in his annual report for 1922 referred to the serious effects of capital losses upon the revenue and urged that a limitation, comparable to the rate limitation applicable to gains, be placed on losses.[65] In 1922, Mr. Ogden Mills, then a member of the Ways and Means Committee, sponsored an amendment to the Revenue Act of 1921 which provided such a limitation. Mr. Mills emphasized the injustice to the Government of allowing full deduction of losses while taxing gains at a maximum rate of 12½ percent. He pointed out that under the then existing rates the Government could collect only 12½ percent of a gain but was compelled to lighten the burden of the taxpayer to the extent of 58 percent of his losses if his income was in the top surtax bracket.[66] The Mills amendment was not enacted.

A parallel limitation was finally placed on losses by the Revenue Act of 1924. This limitation seemed to be satisfactory during the boom years prior to 1930, but in the early thirties, when as a result of the collapse of security prices, capital losses were used on a large

[65] Secretary Mellon said, "The situation is particularly serious under the Revenue Act of 1921, which limits the tax on capital gains to 12½ percent but puts no limit on the deduction of capital losses. This means that capital losses may entirely cancel real income, while capital gains will not be realized at all, or, if realized, are taxed at only 12½ percent. Under the present system the Government is being whipsawed, and the Treasury, therefore, strongly urges that the existing provision as to capital gains be made to apply conversely to capital losses and that the amount by which the tax may be reduced on account of losses from the sale of capital assets should not exceed 12½ percent of the amount of the loss. This would, to a large extent, check one of the methods widely used by taxpayers at the present time for decreasing their yearly income. The alternative is to refuse to recognize either capital gains or capital losses for income-tax purposes, and if the present situation were allowed to continue there is no doubt that it would save revenue to adopt this course * * *" (Annual Report of the Secretary of the Treasury, 1922, p. 14).

[66] Committee on Ways and Means, report on H. R. 13770, House Report No. 1388, 67th Cong., 4th sess., January 12, 1923, p. 2.

scale to wipe out tax liability on ordinary income, Congress considered placing further limitations upon capital losses, particularly on those from security sales.[67] As first proposed, in the House version of the revenue bill of 1932, the limitation would have provided that gains and losses from all transactions in stocks and bonds might be offset only against one another; but as finally adopted, the limitation applied only to short-term transactions in stocks and bonds.

The Senate Finance Committee, in justifying the application of the limitation to short-term transactions only, stated the purposes of the limitation to be: (1) To protect the revenue from the growing practice of reducing tax liabilities by the sale of securities on which losses had accrued; and (2) to prevent the wiping out of ordinary income, which represented real taxpaying ability, by the use of speculative losses.[68] The Senate committee felt that the corrective action proposed by the House was too severe since losses on securities held for more than 2 years were considered real investment losses. Accordingly, no additional limitation was placed on long-term securities transactions.

To avoid hardships which might result from the limitation on short-term losses, it was provided that losses disallowed in one year might be carried forward (to an amount not in excess of the net income of the current year) and offset against short-term gains in the subsequent year. The privilege of loss carry-over in the 1932 act never actually went into effect, but was repealed by the National Industrial Recovery Act in 1933.

Congressional consideration of the NIRA occurred at the same time that the Senate Committee on Banking and Currency was investigating stock exchange practices in 1933. The latter hearings made public some spectacular examples of the effect of security transactions upon the income tax liabilities of certain wealthy individuals during the early thirties. Following these revelations, the Congress withdrew the carry-over privilege.

When the percentage-inclusion plan of preferential treatment was introduced in 1934, the pre-1932 policy of parallel treatment of losses was not carried over into the new plan. Under the 1934 act, losses could be taken into account only to the extent of offsetting gains plus $2,000 of ordinary income. Thus, the policy of preventing substantial reductions of ordinary income by capital-loss offsets, which had been introduced in 1932 with respect to losses from short-term transactions in stocks and bonds, was extended to all capital losses. The provision for allowance of $2,000 of net capital losses against ordinary income was a concession to the small taxpayer with infrequent capital transactions.

The capital-loss limitations of the 1934 act were severely criticized. It was contended that much of the incentive for investing capital in new enterprises was removed by the prospect that a large part of the gains, if any, would be taken by taxes while the losses, if any, would be allowed only in part as a deduction from taxable income.

The subcommittee of the Ways and Means Committee which reviewed the treatment of capital gains and losses in 1937 expressed

[67] The Committee on Ways and Means in its report on the revenue bill of 1932 said, "Many taxpayers have been completely or partially eliminating from tax their income from salaries, dividends, rents, etc., by deducting therefrom losses sustained in the stock and bond markets, with serious effects upon the revenue. Your committee is of the opinion that some limitation ought to be placed on the allowance of such losses" (H. Rept. No. 708, 72d Cong., 1st sess., p. 12).

[68] Senate Committee on Finance, Report on Revenue Bill of 1932, Senate Report No. 665, 72d Cong., 1st sess., p. 10.

a desire to provide more liberal loss deductions in the interest of greater equity and also in order to minimize the undesirable incentive effects of the tax on investment in new enterprises. At the same time, the subcommittee stressed the necessity of preventing undue revenue losses which would result if such deductions were applied extensively against income from sources other than capital gains.[69] It therefore recommended continuing the 1934 act principle of denying capital net loss as an offset against ordinary income beyond $2,000 of ordinary income. It also recommended segregation of short-term gain and loss from long-term gain and loss to prevent short-term speculative losses from wiping out long-term investment gains.[70]

The subcommittee recognized that some hardships and inequities undoubtedly would result from its recommended capital-loss limitations but pointed out that these hardships would be at least partly attributable to the fact that capital gains and losses, like other income, are admitted to the tax base on an annual basis. As a result, an individual may be required to pay a heavy tax on a large capital net gain in a given year despite the fact that in the preceding year he may have sustained a heavy capital net loss from which he did not derive a full tax benefit. The subcommittee sought some method of minimizing these hardships without seriously reducing revenues or reopening loopholes for avoidance of tax. After consideration of various alternatives, it decided upon the allowance of a 1-year carry-over for unused net capital losses.[71]

The 1938 act, in an attempt to limit further the effects of speculative losses on tax revenue, adopted the principle of segregating short-term from long-term losses and of allowing each type of loss to offset only its own type of gain. However, this act also provided a 1-year carry-over for net short-term losses, with the limitation that the amount of carry-over should not exceed the net income of the taxable year in which the loss was realized. It will be recalled that this same limitation, with respect to losses from short-term securities transactions, had been applied when the carry-over principle was first introduced in 1932. The reason given for the 1938 limitation was that net income of the taxable year measured the extent to which the taxpayer was deprived of the use of his net short-term loss in reducing his tax liability.[72]

The treatment of long-term capital losses under the 1938 act was designed to parallel the alternative flat-rate tax on gains which was reintroduced at this time. The alternative rate on long-term gains was 30 percent of the proportion of gains taken into account.[73] Similarly, the maximum credit in any year against ordinary income tax on account of long-term capital losses could not exceed 30 percent of the included losses. No carry-over of long-term losses was allowed.

The 1942 act eased the limitation on capital-loss deductions by eliminating the segregation of short-term from long-term losses, but it continued to limit the deductibility of net capital losses from ordi-

[69] Proposed Revision of the Revenue Laws, 1938, report of a subcommittee of the Committee on Ways and Means, 75th Cong., 3d sess., p. 33.

[70] The Ways and Means Committee in adopting this recommendation pointed out that statistics presented to the committee showed that 85 percent of all capital gains and losses arose from transactions involving securities and that approximately 35 percent of the total transactions in securities fell into the short-term category. Such transactions were considered predominantly speculative in character (H. Rept. No. 1860, 75th Cong., 3d sess., op. cit., p. 7).

[71] Proposed Revision of the Revenue Laws, 1938, op. cit., p. 41.

[72] Ibid., p. 42.

[73] These percentages were 66⅔ for gains from assets held more than 18 months but not more than 24 months, and 50 for assets held more than 24 months.

nary income by permitting only a $1,000 offset). The congressional view apparently was that capital losses should be offset primarily against gains, either of the current year or a subsequent year. In this case, however, a long carry-over was provided. The excess of combined short- and long-term net loss of any taxable year could be carried forward for five succeeding years as short-term loss.

In broad summary, the trends in the capital-loss provisions have been mixed. On the one hand, Congress has repeatedly sought to limit the tax-reduction value of capital losses to the same proportion of the loss as would have been taken in tax had the loss been a gain of corresponding size. This is the essence of the so-called parallel treatment. On the other hand, the desirability of parallel treatment broke down during the great depression of the thirties, at least insofar as net short-term losses were concerned. At that time, the ability of taxpayers to minimize their taxes on ordinary income by taking short-term losses, some of which appeared to be of questionable validity, was regarded as having too grave an effect on Federal tax revenue when the bottom dropped out of the securities market. Moreover, this desire of Congress to insulate income-tax yield from the impact of concentrated decreases in the value of capital assets finally led to almost complete elimination of any capital-loss offset against current ordinary income and the substitution therefor of loss carry-forwards against future capital gains.

E. CAPITAL LOSS AND "NET LOSS"

With the introduction of the "net loss" carry-over (in the 1918 act), the question arose whether capital net losses should be treated like net operating losses. The 1918 act did not extend the loss carry-over privilege to capital losses in general, but did allow carry-over of losses resulting from sales of assets used in the production of articles contributing to the war effort. The 1921 act extended the carry-over privilege to losses on sales of any capital assets used in the trade or business. This privilege was only short-lived, however.

At the same time that the 12½-percent limitation was placed on loss deductions in the 1924 act, the "net loss" provision was amended to prevent any part of a capital net loss from being carried forward and applied against the income of a succeeding year. In recommending this change, the Ways and Means Committee indicated that they intended to allow the carry-over privilege only against losses resulting from the operation of a trade or business; therefore, such "net losses" should not include capital losses.

The carry-over of net capital losses has developed for all practical purposes, completely apart from the net operating loss carry-over. The length of carry-over for the former apparently has no necessary relation to that provided for the latter. Furthermore, capital losses thus far have been allowed only in the form of a carry-forward whereas net operating loss allowances have taken the form both of carry-forwards and carry-backs.

F. LOOPHOLES

In addition to the general limitations placed on deduction of capital losses, Congress has directed legislation toward specific types of transactions involving losses that permit tax avoidance. Some of these are discussed below.

(a) *Wash sales.*—In these transactions the taxpayer sold securities at a price less than he paid for them, thus incurring a loss which he deducted for income-tax purposes. He then bought back the same or similar securities of approximately the same value, thereby maintaining substantially the same position as before the sale but, in the meantime, having realized a loss for tax purposes.

To prevent this type of tax avoidance, the Revenue Act of 1921 added the "wash sales" clause denying the deduction of a loss on a security transaction in which the taxpayer within 30 days before or after the date of the sale acquired "substantially identical property."[74]

The 1924 act strengthened the "wash sales" provision by providing for disallowance of loss where, within 30 days before or after the date of sale, the taxpayer has acquired or has entered into a contract or option to acquire substantially identical stock or securities.

(b) *Basis for determination of gain or loss on gifts.*—Prior to the 1921 Revenue Act the statute contained no explicit rule for determining gain or loss on property acquired by gift. In the absence of legislation, the Bureau of Internal Revenue had held the proper basis to be the fair market value of such property at the time of transfer. The Ways and Means Committee in its report on the revenue bill of 1921 pointed out that this rule had been the source of serious abuse.[75] Taxpayers owning property which had come to be worth more than it cost were encouraged to give such property to wives or relatives. It could then be sold without realizing a taxable gain unless the selling price was in excess of the value of the property at the time of the gift.

The Revenue Act of 1921 provided a new rule, namely, that in case of property acquired by gift after December 31, 1920, the basis for computing gain or loss should be the same as the property would have in the hands of the donor (or the last preceding owner by whom it was not acquired by gift).

This rule was not altogether satisfactory either, because it made possible the transfer of accrued capital losses from a taxpayer with insufficient gains or income to realize full tax benefit therefrom to a relative who had large enough gains or income against which to offset the entire loss.

To prevent tax avoidance of this type, the 1934 act provided that, in computing losses, the lower of the fair market value at the time of gift or the donor's basis should be used.[76] This rule has been carried forward unchanged except for a clarifying amendment in the 1942 act pertaining to gifts in trust. Under prior law, the basis for gifts in trust had been governed by the section dealing with transfers in trust and not by the section dealing with gifts. On the grounds that there is no substantial difference between a gift in trust and other gifts for purpose of basis, the law was amended by the 1942 act so that the basis of property acquired by gift should be the same whether the gift is in trust or otherwise.

(c) *Transactions between members of a family, etc.*—The Ways and Means Committee's Subcommittee on the Prevention of Tax Avoidance in 1933 called attention to the practice of creating losses by means of transactions among members of a family, and between closely held corporations and their owners. In an attempt to close

[74] Sec. 214 (a) (5) (now sec. 118 I. R. C.).

[75] Committee on Ways and Means, Report on the Revenue Bill of 1921, H. Rept. No. 350, 67th Cong., 1st sess., p. 9.

[76] Sec. 113 (a) 2.

this loophole, Congress, in the Revenue Act of 1934, prohibited the deduction of losses arising from property transactions among members of a family and between an individual and a corporation in which the individual owned a majority of the voting stock.[77]

(*d*) *Partnerships.*—The Subcommittee on Tax Avoidance also called attention to the then common practice of offsetting losses sustained by a partnership against the partners' ordinary income. The Senate Committee on Banking and Currency, in its investigation of stock-market practices in 1933, had brought out the fact that wealthy partners, particularly those engaged in the banking and security business, had applied partnership losses from sales of securities against their individual incomes from all sources. As a result, they incurred little or no income-tax liability in certain years. The general limitation on capital-loss deductions provided by the 1934 act (which limited loss deductibility to capital gains plus not more than $2,000 of ordinary income) was considered a partial solution to this problem.

Two other provisions of the 1934 act dealing with basis for determining gain or loss were specifically directed at the partnership as a medium of tax avoidance in cases of sales of property which had appreciated in value. One of these provisions provided that (*a*) cost was the basis for determining gain or loss on property purchased by a partnership, but (*b*) the basis for property paid in by a partner was its cost or other basis to the partner.[78] The other provision established the basis of property distributed in kind by a partnership to a partner as his proportionate share of the cost or other basis to him of his interest in the partnership.

(*e*) *Short sales.*—The Revenue Act of 1950 established rules intended to remove a loophole in the capital-gains tax provisions arising from the use of the short-sale device. Short sales were used extensively by traders in securities and commodities to convert short-term into long-term capital gains. The 1950 act provided that where a short sale of securities or commodity futures is made, and thereafter simultaneous "long" and "short" positions are maintained so as to give an actual short-term transaction the appearance of a long-term transaction, any resulting gain will be treated for tax purposes as short-term gain.

(*f*) *Collapsible corporations.*—Provisions were also added by the Revenue Act of 1950 to close the loophole resulting from use of the "collapsible" corporation device to convert ordinary income into long-term capital gain. "Collapsible" corporations were formed for a single project, such as the production of a movie or the construction of an apartment house, and then dissolved by distributing to the stockholders rights to receive income from the project. Thus, the corporation-income tax was avoided and royalty or rental income was converted into capital gain.

The 1950 act provided that gains from the sale or exchange (including liquidation) of stock in "collapsible" corporations will be taxed as ordinary income if (*a*) the stockholder owns 10 percent or more of the stock, (*b*) more than 70 percent of the gain on the stock is attributable to the property produced by the corporation, and (*c*) the gain is realized within 3 years after the property is produced.

(*g*) *Capital gains of nonresident aliens.*—The Revenue Act of 1950 provided for taxation, at a rate of 30 percent, of capital gains of non-

[77] Sec. 24 (a) 6.
[78] Sec. 113 (a) (13).

resident aliens not engaged in trade or business in the United States but temporarily in this country. Those present in the United States for less than 90 days in the year will be taxed only on gains realized during this period. Those present for more than 90 days will be taxed on all their gains from transactions in this country during the taxable year.

G. DEFINITION OF CAPITAL ASSETS

The 1913 income-tax law included in the definition of net income—

> gains, profits, and income derived from * * * sales, or dealings in property whether real or personal * * *.

Under this provision, the Treasury treated all gains from the sale of property exactly as other items of income, imposing upon them the full normal and surtax rates.

Congress first defined the term "capital assets" in the 1921 Revenue Act, which introduced the special capital-gains provisions of the income tax. "Capital assets" at that time were defined as—

> property held for profit or investment for more than 2 years (whether or not connected with trade or business) but does not include property held for the personal use or consumption of the taxpayer or his family, stock in trade, or other property which would be included in inventory.

Several changes were made in the definition of capital assets by the Revenue Act of 1924, the most important being that it was no longer required that assets must have been acquired for profit or investment to be included. Thus, durable consumer goods became capital assets. This restriction was removed to permit a taxpayer selling residential property to be taxed on the profits therefrom under the preferential capital-gains provisions instead of the ordinary income tax.[79]

Added to the exclusions from capital assets, for purposes of clarification, was "property held primarily for sale in the course of trade or business." The purpose of this change was to make it clear that property held primarily for resale did not constitute a capital asset, regardless of whether it was the type of property included in inventory under conventional accounting practice.[80]

In 1934 this provision was revised to read "property held primarily for sale to customers in the ordinary course of trade or business." The effect of adding the words "to customers" and "ordinary" was to make a "trader" in securities (one who buys and sells for his own account) subject to the capital gain and loss provisions. Under prior law, it had been held that a "trader" (although not a "dealer") in securities was nevertheless engaged in a trade or business. Therefore, the capital gain and loss provisions did not apply.

The stated purpose of this change in 1934 was to prevent tax avoidance through unlimited deduction of losses by the stock speculator trading on his own account. Although intended to close a tax-avoidance loophole, this provision in recent years has been criticized as providing an avenue of tax avoidance since it allows the gains of a trader in securities on his own account to fall within the preferential capital-gains provisions, whereas the ordinary income-tax provisions apply to sales by a dealer.

[79] Senate Committee on Finance report on the internal revenue bill of 1924, S. Rept. No. 398, 68th Cong., 1st sess., p. 22.
[80] Loc. cit., p. 22.

The Revenue Act of 1941 amended the definition of "capital assets" to exclude certain short-term Federal, State, and local government obligations issued on a discount basis after March 1, 1941. This amendment, which applied primarily to Treasury bills of the United States, provided that the issuing discount on such obligations should not be deemed to accrue until the obligations are paid at maturity or disposed of, and that such obligations should not be treated as capital assets. The principal effect of this amendment was to eliminate the necessity (except in the case of life-insurance companies) of making an allocation between interest and capital gain or loss on the disposition of the obligation and also the necessity for including any portion of the discount in income for any taxable year other than that in which the obligation matures or is disposed of.[31]

Another change of considerable importance in the definition of "capital assets" was made by the Revenue Acts of 1938 and 1942. This revision dealt with the treatment of depreciable and real properties used in trade or business. The sections of the Internal Revenue Code involved are 117 (a) and 117 (j). The former provides that depreciable and real properties used in trade or business are not capital assets; the latter provides that they shall nevertheless be treated as capital assets when held over 6 months if the taxpayer realizes a net gain on the transactions covered by the section as a whole.

The transactions included in determining whether there has been a net gain are sales and exchanges of depreciable and real properties used in a trade or business held over 6 months and involuntary conversions of such property or of capital assets held over 6 months. A net gain on these transactions, by being treated as a net long-term capital gain, is subject to the 25-percent rate limitation. On the other hand, if these transactions result in a net loss, the loss is treated as an operating loss and is deductible in full from ordinary income of the current year or in other years by virtue of the carry-backs or carry-overs allowed net operating losses.

Depreciable property used in trade or business was excluded from the category of capital assets by the Revenue Act of 1938. This amendment was traceable in large part to the limitations on deductibility of corporate capital losses provided for the first time by the Revenue Act of 1934. This act permitted corporations to deduct capital losses only to the extent of capital gains plus $2,000. This limitation was criticized as being unfair when, at the same time, net capital gains of corporations continued to be taxed in full.

It was considered particularly unfair in the case of sales of depreciable property such as machinery, plant, and equipment used in the trade or business. If the taxpayer kept such property or abandoned it, he would be allowed the loss in full in the form of deductions for depreciation and obsolescence or as an abandonment loss. As a consequence, it was contended that taxpayers either continued to use less efficient machines until the full costs had been recovered through depreciation allowances or else, instead of selling on the open market, junked the old machines and thereby obtained a full deduction. Congress, in the Revenue Act of 1938, therefore provided for the full deduction of losses on sales of depreciable property used in trade or

[31] Conference report on the revenue bill of 1941, 77th Cong., 1st sess., H. Rept. No. 1203, p. 11; also Senate Committee on Finance report on the revenue bill of 1941, S. Rept. No. 673, pt. 1, pp. 30–31.

business by excluding it from the definition of "capital assets" under section 117 (a).

As a result of the exclusion of depreciable property from capital assets, buildings and other depreciable real-estate improvements attached to the land were not treated as capital assets but land continued to be treated as a capital asset. Difficult administrative problems involving allocation of sale prices between land and improvements arose from this nonuniform classification. The 1939 Revenue Act maintained the nonuniform definition of capital assets, but made the tax treatment of capital losses more uniform for corporations by making all long-term corporate capital losses fully deductible under the income tax. This rule continued until the Revenue Act of 1942.

During development of the Revenue Act of 1942, two different methods of restoring uniform tax treatment for these depreciable and nondepreciable assets were considered. The House proposed that depreciable real estate improvements be restored to capital asset status. In support of this proposal it was argued that the 1938 provision, treating depreciable property as a noncapital asset, was inserted primarily to allow deductions for losses on assets such as obsolescent machinery and not for losses on assets such as buildings and similar real estate improvements.

The Senate, however, proposed to achieve uniformity by retaining the existing classification of depreciable real property as a noncapital asset and, in addition, making land and any nondepreciable improvements used in the trade or business also noncapital assets.

The Senate approach was finally adopted and "real property used in the trade or business of the taxpayer" was excluded from the definition of capital assets.

Considered alone, this provision was advantageous to taxpayers in the event of loss, but was disadvantageous in the event of gain since the gain would be taxed as ordinary income. Sales involving gain were not as unusual or infrequent in 1942 as they had been in 1938, for sales of used machinery, ships, and other business properties as a result of wartime demands were frequently resulting in large gains. At the same time, the increase in involuntary conversions during the war, chiefly shipping losses and condemnation of property for military purposes, had raised the general problem of special tax treatment for involuntary conversions.

In order to take care of these special situations, the income tax classification of real property as a noncapital asset was altered completely by enactment of section 117 (j). In effect, this subsection provided that, for the transactions covered, net losses would be considered ordinary loss but net gains would be considered capital gain. At first designed to take care only of gains and losses from compulsory or involuntary conversions, section 117 (j) was extended during development of the 1942 act to cover all sales and exchanges of depreciable property and, finally, to cover also all real property used in the trade or business, whether depreciable or not. Thus, section 117 (j) of the 1942 act was made to apply to all sales and exchanges of both depreciable and real property used in a taxpayer's trade or business if held over 6 months, as well as to involuntary conversions of property used in the trade or business and capital assets held more than 6 months. It has since been extended by the Revenue Act of 1943 to include also dealings in timber covered by section 117 (k).

Under section 117 (k), taxpayers owning timber, or having the contract right to cut timber from the property of another, are permitted to elect to treat net proceeds from the cutting of timber in any taxable year as long-term gain from a capital asset rather than as ordinary income. The same favorable treatment is also granted to a timber owner who disposes of timber under a contract allowing him to retain an economic interest in the timber. Gain or loss from these types of transactions respecting the cutting of timber are considered together with gains or losses treated under section 117 (j) in arriving at the net gain or net loss for tax purposes.

Prior to 1942, the changes made in the definition of capital assets reflected a tendency to limit the items of income to which preferential capital gains treatment should be given. The 1942 and 1943 Revenue Acts, particularly through sections 117 (j) and 117 (k), moved in the direction of broadening the category of capital assets. Section 117 (k) in particular appears to be an effort to deal with a special problem involving lumpy income by giving capital gains treatment instead of allowing income averaging.

The 1950 Revenue Act included several technical changes in the definition of capital assets. One of these in effect provided an exception to section 117 (j) with respect to sales of emergency facilities. In order to prevent taxpayers from gaining too great an advantage from the special amortization privileges allowed under this act with respect to emergency facilities completed after December 31, 1949, and certified as essential to national defense, gains from sale of such facilities are subjected to tax at ordinary rates, rather than at capital gains rates, to the extent that they represent the difference between the special amortization deductions and ordinary depreciation.

The Revenue Act of 1950 also added to the definition of capital assets an exclusion which bars amateur artists and authors from receiving capital gains treatment on the sale of their work. Prior to 1950, if an amateur sold his book or other artistic work outright, such a sale was treated as the sale of a capital asset (property not held primarily for sale to customers in the ordinary course of trade or business). The bill, as approved by the House, provided that income from these transactions, as well as from similar transactions of amateur inventors, should be taxed at ordinary income tax rates instead of receiving capital gains treatment. The bill, as revised by the Senate and as finally enacted, however, limited the provision to artists and authors.

The 1950 act contained a special provision dealing with restricted employee stock options. This allows part of the gain from options granted employees to purchase stock of the employing corporation to be treated as capital gain rather than ordinary compensation. This provision was represented as an incentive device for management.

H. CAPITAL GAINS AND LOSSES OF CORPORATIONS

When special treatment was first extended to sales and exchanges of corporate capital assets, it came in the form of restrictions on capital loss deductions and not in the form of preferential treatment of gains.

When preferential treatment was first provided for capital gains of individuals under the Revenue Act of 1921, the special flat rate chosen

(12½ percent) was the then existing corporation rate.[82] At that time when the question concerning special treatment for capital gains of corporations was raised in congressional committees, it was pointed out that no necessity existed for applying it to corporations since the preferential rate had been arranged to place the same rate on capital gains of both individuals and corporations.[83] The revenue bill of 1921 as passed by the Senate had included corporations as well as individuals in the provision for special treatment of capital gains. But it should be noted that the special treatment there proposed was not the flat rate tax but 40-percent inclusion of capital net gain in the computation of net income.[84] The policy of considering capital gains and losses of corporations as ordinary business income or losses continued until 1932.

When the limitation on losses from short-term stock and bond transactions was adopted in 1932 with respect to individuals, the same restriction was applied to corporate losses from such transactions.[85] Specific exemption from these restrictions was provided for (1) a dealer in securities (whether an individual, partnership, or corporation) as to stocks and bonds acquired for resale to customers in the ordinary course of his business, and (2) banks and trust companies.[86] Again in 1934, when the policy of offsetting capital losses of individuals only against capital gains and $2,000 of ordinary income was adopted, it was also applied to net capital losses of corporations. The graduated percentage reduction of gains and losses to be included in ordinary income did not apply to corporations, however.[87]

The $2,000 limitation on corporation net capital losses which might be deducted from ordinary income was severely criticized as unfair when, at the same time, net capital gains of corporations continued to be taxed in full. It was considered particularly unfair in the case of

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[82] The Revenue Act of 1921 increased the corporation income tax rate from 10 to 12½ percent at the same time that it repealed the wartime excess profits tax.

[83] In commenting on the flat rate proposed in the bill under consideration in the Ways and Means Committee, Dr. T. S. Adams, tax adviser to the Treasury Department, said: "Assuming that the corporation tax rate will be 15 percent, we suggest in section 407, that you consider the question of limiting the tax on capital gains to 15 percent in the case of individuals. That section does not apply to corporations, and it is not necessary, because the maximum rate is the corporation rate, and it is to be applicable to the amount derived from the sale of capital transactions, which transactions are now being stopped by the operation of the present tax itself" (hearings before the Committee on Ways and Means on internal-revenue revision, 1921, p. 405).

[84] Sec. 206 (b) of H. R. 8245, 67th Cong., 1st sess., as approved by the Senate, November 4, 1921.

[85] Such losses could be deducted only to the extent of gains from similar transactions but losses disallowed in 1 year might be carried forward (to an amount not in excess of the net income) and offset against short-term gains in the subsequent year. The provision for carry-forward of disallowed losses was repealed, however, before it became effective by the National Industrial Recovery Act.

[86] In recommending the exemption of banks from the loss limitation provisions, the Secretary of the Treasury (Ogden L. Mills) said: "The Treasury was disposed to agree that it was not unreasonable under present conditions to deny to taxpayers the privilege of offsetting forms of ordinary income through security losses. I think, however, that banks should be expected [exempted]. Banks, as a part of their regular business, purchase securities for investment purposes, which become an important element in their necessary secondary reserves. Speculation is not involved, nor is the question of protecting the revenues from improper deductions. It is my opinion that, particularly in the case of banks, a tax upon the gains and a denial of the losses is not necessary and cannot be justified." * * * When Senator Hull inquired of Mr. Mills where to "draw the line between banks that are performing a legitimate banking business and banks that have security affiliates and all kinds of security connections," Mr. Mills replied, "Well, banks are inevitably in the business of buying and selling securities to some extent. Their income from buying and selling securities is normal business income, and I think they are entitled to take losses on their normal business income. But the fellow we are trying to hit is the man who is wiping out his normal income from dividends and business profits by taking paper losses on the sale of stocks. We are perfectly willing to give him a deduction on his normal business losses and to tax him on his normal business gains. But we are unwilling to allow him to wipe out his normal business gains by this arbitrary taking of losses on outside transactions. I do not think that is true of banks. It is a part of their normal business to buy and sell securities and therefore their losses arise in the normal course of events and they are not arbitrary or fictitious losses made for the purpose of wiping out the normal income" (hearings before the Senate Committee on Finance, on Revenue Act of 1932, 72d Cong., 1st sess., pp. 31-32).

[87] The joint committee staff which drafted the percentage-inclusion plan stated with respect to the application of the plan to corporations, "The method here proposed is designed especially for individuals. However, it is recommended that consideration be given to applying the same method to corporations in case tax-free reorganizations are eliminated * * * " (Prevention of Tax Avoidance, preliminary report of a subcommittee of the Committee on Ways and Means, 73d Cong., 2d sess., 1933, exhibit C, Memorandum on Capital Gains and Losses, p. 37).

sales of depreciable property such as machinery or plant and equipment used in the trade or business. Primarily to take care of this latter situation, Congress, in the Revenue Act of 1938, provided for the full deduction of losses on sales of depreciable property used in the trade or business by excluding such property from the definition of capital assets.

The $2,000 limitation continued to apply to corporate losses on sales of property not subject to depreciation, including losses arising from the sale of real property, to the extent that the loss was allocable to the land as distinguished from depreciable improvements upon the land. As already mentioned, difficult administrative problems involving allocation of the sale price between land and improvements arose from this nonuniform classification.[88]

The 1939 Revenue Act, by making long-term capital losses of corporations fully deductible under the income tax, eliminated the necessity, insofar as corporations were concerned, of allocating losses between depreciable and nondepreciable property.[89] Short-term corporate capital losses, however, were subject to the same limitations that were then applied (under the Revenue Act of 1938) to individuals. In other words, short-term losses of corporations could be offset only against short-term gains, and a 1-year carry-over of the excess of losses was allowed but only to the extent of the ordinary income in the year of the net short-term loss. Thus, for the first time a distinction was made between short- and long-term capital losses of corporations.[90]

Both long-term and short-term net capital gains of corporations continued to be included in ordinary income and subject to regular income tax rates until 1942.

Under the World War II excess profits tax, enacted in 1940, long-term capital gains and losses of corporations were excluded from the computation of excess profits net income. But short-term gains and losses of corporations were given the same treatment for purposes of the excess profits tax as the income tax.[91] Net gains from the sale or exchange of depreciable assets held over 18 months were excluded from excess profits net income although net losses were deductible in full.[92]

The treatment of capital gains and losses of corporations under the Excess Profits Tax Act of 1950 differs from that provided under the World War II tax. Under the 1950 act both long- and short-term gains and losses are excluded in determining net income for the excess profits tax year and for base period years. Net losses from assets falling within the scope of section 117 (j) are included in the determination of income in the excess profits tax year but are excluded

[88] See the discussion of sec. 117 (j) above for a more detailed account of this problem.

[89] The $2,000 limitation was retained with respect to losses of personal holding companies.

[90] In explanation of the 1939 revision, the Ways and Means Committee said, "Your committee's proposal will remove a tax irritant which has handicapped many corporations. It will have the effect, in general, of placing corporations more nearly on a parity with individuals with respect to capital losses. By the removal of the $2,000 limitation, the necessity of allocating losses between depreciable and nondepreciable property will be eliminated. Traders and other corporations that buy and sell property on their own account will be entitled to offset their net long-term losses against their ordinary income. The speculator will be prevented from offsetting speculative gains against ordinary income for the reason that losses from the sale or exchange of property held for 18 months or less can only be applied against gains from the sale or exchange of such property held for the same period" (Committee on Ways and Means report on the revenue bill of 1939, H. Rept. No. 855, 76th Cong., 1st sess., p. 11).

[91] That is, net short-term gain was included in income and fully subject to tax and short-term loss was allowed only to the extent of short-term gain but with a 1-year carry-over (to an amount not in excess of net income) as short-term loss.

[92] This latter provision was replaced by sec. 117 (j) of the 1942 Revenue Act which had the same effect on gains and losses from such holdings. Under the 1942 Revenue Act (sec. 208) the excess of gains over losses from involuntary conversions of depreciable property held more than 18 months was also excluded retroactively from the excess profits net income for 1940 and 1941.

from the taxpayer's base period net income. This means in effect that net losses are fully deductible in the excess profits tax year, but are excluded in the computation of base period net income.

In connection with the 1942 Revenue Act, proposals were made to abolish the distinction between short- and long-term losses of corporations. Instead of eliminating this distinction, Congress moved in the opposite direction of treating corporate capital gains and losses more nearly like those of individuals. Not only was the long- versus short-term distinction retained but the 6-month holding period adopted for individuals was also applied to corporations and a special preferential rate was provided for capital gains of corporations for the first time. The maximum rate of tax on corporate net long-term capital gains was fixed at 25 percent—equivalent to the effective alternative rate on net long-term capital gains of individuals.[93] The 1942 act also provided that long-term losses of corporations could no longer be applied against ordinary income.[94] As in the case of individuals, short- and long-term losses must be merged and offset against capital gains (whether long- or short-term). Unlike individuals, however, corporations are required to take into account 100 percent of the gain and 100 percent of the loss realized on long-term assets and are not allowed to apply any excess of capital losses over capital gains against their ordinary income. The excess of losses over gains can be carried forward, however, as a short-term loss for 5 years, as in the case of individuals.

IV. Revenue Considerations

Appraisal of the capital gains tax requires consideration of its capabilities and deficiencies as a revenue producer. This consideration, unfortunately, is complicated by the fact that much of the relevant information concerning the direct and indirect revenue effects of this tax is not readily available. Largely for want of facts the fiscal significance of the capital gains tax has remained the subject of considerable controversy.

It has been pointed out that, over years of prosperity and depression taken together, its revenue contribution is slight and is secured at the expense of disproportionate cost of administration as well as effort and expense incurred by taxpayers in compliance. Supporters of the tax reply that, although the yield from capital gains taxation is now small compared with the total yield from income taxation, it is by no means insignificant. Furthermore, they contend that it is not appropriate to evaluate the tax solely or even primarily on the narrow basis of direct revenue yield. In their view capital gains taxation is primarily a matter of equity.

In the past, Congress has paid close attention to estimates of the probable revenue effects of contemplated changes in the capital gains and loss provisions. In particular, the case for limiting deductibility of net capital losses historically has rested heavily on revenue con-

[93] The Senate Finance Committee in commenting on this provision said: "While at present corporations are not accorded a similar alternative tax, due to the increase in corporate taxes, sec. 117 (c) is further revised so as to provide for an alternative rate of 25 percent on their net long-term capital gains" (Senate Committee on Finance report on revenue bill of 1942, S. Rept. No. 1631, 77th Cong., 2d sess., p. 117).

[94] Special treatment was allowed, however, for banks. Banks may treat the excess of losses from sales or exchanges of bonds, debentures, notes or certificates, or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision) with interest coupons or in registered form as ordinary losses deductible in full from ordinary income subject to the corporation normal and surtax rates. However, the excesses of gains from sales and exchanges by banks of the indicated types of debt securities may be treated as capital gains (sec. 117 (i), I. R. C.).

siderations. It is important to study the revenue yield for such indications as may be gained about the tax's effect under different economic conditions.

A. DIRECT REVENUE YIELD

The direct revenue yield from capital gains taxation is that portion of income tax revenue attributable to capital gains and losses actually taken into account under provisions of the revenue act in force. This annual yield depends on a number of factors: First, on the trend of prices which determines the over-all balance between gross appreciation and depreciation in value of capital assets during a year, regardless of whether or not these changes in asset values are realized; second, on the extent to which individuals and corporations choose to realize these or prior year changes in asset values;[95] third, on the number and average size of realized capital gains and losses and their distribution among taxpayers with different amounts of ordinary incomes; and fourth, on the legal terms (percentage exclusion, etc.) under which realized capital gains and losses are taken into account in the tax base. Variations in any of these factors will tend to produce variations in yield.

Table 1 gives a summary of the aggregate amounts of net statutory capital gains and losses that have been admitted to the tax base in past years. These figures are by no means comparable from year to year since they are affected by changes in provisions governing their admissibility to the tax base. For example, capital losses of individuals are shown in the table to have been relatively large in 1930 and 1931. These were, of course, heavy loss years but the statutory amounts shown are large partly because, at that time, short-term net losses could be taken into account without limit. Similarly, statutory net capital gains of individuals since 1934 are understated in comparison with prior years because the post-1934 amounts are affected by the provisions for percentage exclusion of long-term gains which have been in force since that time.

All figures in table 1 are net balances of statutory gain or loss after each individual or corporation has balanced gross realized gains against gross losses to whatever extent was permitted by the statute. The losses therefore represent the tax returns of different taxpayers than do the gains.

The purpose of table 1 is not to show trends in aggregate amounts of realized capital gain and loss. Considered as time series, the figures are lacking in homogeneity. Rather the purpose of table 1 is to indicate, by way of background, the absolute size of the statutory capital gain and loss component of the income tax base in different years.

In 1928, the record year, the individual income tax base was increased by a $4.5 billion excess of net capital gains over net losses. In 1931, the worst year, net realized capital losses of individuals exceeded gains by $2.7 billion. The net capital gains component of the individual income tax base, which by 1946 had recovered to an excess of $3.3 billion over losses, amounted to only $2.3 billion in 1947 and 1948, under a statute which took only 50 percent of long-term gains and losses into account.

Since the data in table 1 do not include capital gains and losses realized by individuals not required to file income tax returns, they afford a less complete picture for earlier than for later years. As the

[95] Tax provisions in turn are one factor influencing these realization choices.

individual income requirement for filing has been lowered, an unknown amount of gain and loss attributable to the additional coverage of smaller incomes has appeared in the total amounts reported.

In order to pass from data of the sort shown in table 1 to actual revenue estimates, it is necessary to determine the effective rates at which the net statutory capital gains admitted to the tax base are taxed and the effective rates at which net statutory capital losses are allowed. This is simple for net long-term gains realized by taxpayers using the alternative computation, since the amount of tax attributable to such gains has usually been tabulated. For all net short-term gains and for those net long-term gains realized by taxpayers not using the alternative computation, however, the determination is difficult. These taxpayers merge their statutory net capital gains and deductible losses with other items of ordinary income and compute tax liability on the total statutory income. It is necessary, therefore, to estimate the effective rates applied to capital gains and losses in these returns from tabulations showing the structure of reported gains and losses by their own size and by size of the net income of taxpayers. Unfortunately, the information available for determining these effective rates is not as complete as might be desired.

TABLE 1.—*Net statutory capital gains and losses included in income tax returns*

[In millions of dollars]

Calendar year	Individuals and taxable fiduciaries [1]		Corporations [2]	
	Net capital gain	Net capital loss	Net capital gain	Net capital loss
1922	$991	(3)	(3)	(3)
1923	1,168	(3)	(3)	(3)
1924	1,514	(3)	(3)	(3)
1925	2,932	(3)	(3)	(3)
1926	2,379	$213	(3)	(3)
1927	2,895	276	(3)	(3)
1928	4,862	357	(3)	(3)
1929	4,769	1,877	$1,315	(3)
1930	1,261	2,621	646	$936
1931	501	3,219	299	1,702
1932	183	2,043	142	1,705
1933	621	1,694	262	1,686
1934	229	211	243	297
1935	530	167	470	239
1936	990	145	581	142
1937	451	293	305	165
1938	491	588	207	75
1939	410	468	212	65
1940	403	562	188	703
1941	514	905	163	1,006
1942	369	257	179	(4)
1943	893	203	294	(4)
1944	1,238	227	428	(4)
1945	2,508	196	923	(4)
1946	3,573	252	1,211	(4)
1947	2,599	301	925	(4)
1948 [5]	2,644	302	849	(4)

[1] The data for 1922-27 are restricted to returns with net income, whereas deficit returns are included in subsequent years. For the years 1922-33 gains and losses on assets held 2 years or less are included. Varying percentages of gain or loss were taken into account in 1934-37 and 1938-45. Net losses were limited to $2,000 in 1934-37, and to $1,000 in 1942-48 with a 5-year carry-over of the excess.

[2] For the years 1930-31, losses from sale of capital assets were allowed in full against income of any kind. For the years 1932-33, losses from sales of stocks and bonds held 2 years or less were limited to gains from such sales; for the years 1934-39, losses from sales of capital assets were limited to gains from such sales plus $2,000; and for 1940-41, losses from sales of assets held 18 months or less were limited to gains from such sales. Beginning with 1942, capital losses incurred in any year may be offset against capital gains for that year, a net capital loss being subject to a 5-year carry-forward as an offset against net capital gains.

[3] Not available.

[4] Net capital losses of the current year are not reported since they are carried forward to be applied against net capital gains of the subsequent 5 years.

[5] Preliminary.

Source: Statistics of Income.

Inasmuch as the needed information concerning the structure of capital gains and losses is not always available, it must be estimated for some years on the basis of analogies with other years in which different aggregate amounts of capital gain and loss were realized, and in some cases, where different statutory provisions existed for taking gain or loss into account. It is therefore unavoidable that the estimates of revenue yield from capital-gains taxation should be subject to a relatively large margin of error.[28]

Estimates of the net tax revenue derived directly from capital gains and losses, both of individuals and corporations, are given in table 2. This table indicates, as would be expected, that the yield from capital-gains taxation is extremely variable from year to year. In fact, the capital-gains tax is the most sensitive element to economic changes in the entire Federal tax structure.

TABLE 2.—*Estimated revenue yield from capital gains and income taxation, 1926–51*

[Dollar amounts in millions]

Year of liability	Individuals			Corporations			Individuals and corporations		
	Total individual income taxes [1]	Estimated tax on capital gains and losses		Total corporation income and excess profits taxes [1]	Estimated tax on capital gains and losses		Total income and excess profits taxes [1]	Estimated tax on capital gains and losses	
		Amount [2]	Percent of total tax		Amount [2]	Percent of total tax		Amount [2]	Percent of total tax
1926	$732	$225	30.7	--------	--------	--------	--------	--------	--------
1927	831	297	35.7	--------	--------	--------	--------	--------	--------
1928	1,164	576	49.5	--------	--------	--------	--------	--------	--------
1929	1,002	421	42.0	--------	--------	--------	--------	--------	--------
1930	477	−15	−3.1	$712	−$5	−0.7	$1,189	−$20	−1.7
1931	246	−89	−36.2	399	−77	−19.3	645	−166	−25.7
1932	330	−80	−24.2	286	−93	−32.5	616	−173	−28.1
1933	374	16	4.3	423	−87	−20.6	797	−71	−8.9
1934	511	17	3.4	596	2	.3	1,107	19	1.7
1935	657	72	11.0	735	31	4.2	1,392	103	7.4
1936	1,214	171	14.1	1,191	67	5.6	2,405	238	9.9
1937	1,142	41	3.6	1,276	25	2.0	2,418	66	2.7
1938	766	12	1.6	860	22	2.6	1,626	35	2.2
1939	929	4	.4	1,232	25	2.0	2,161	29	1.3
1940	1,496	−7	−.5	2,549	−49	−1.9	4,045	−56	−1.4
1941	3,908	−86	−2.2	7,168	−164	−2.3	11,076	−250	−2.3
1942	8,927	68	.8	12,256	42	.3	21,183	110	.5
1943	[3] 14,590	266	1.8	15,926	69	.4	30,516	335	1.1
1944	16,347	354	2.2	14,884	100	.7	31,231	454	1.5
1945	17,226	721	4.2	10,795	214	2.0	28,021	935	3.3
1946	16,281	893	5.5	8,875	270	3.0	25,156	1,163	4.6
1947	18,249	644	3.5	10,981	210	1.9	29,230	854	2.9
1948	[4] 15,618	528	3.4	11,920	190	1.6	27,538	718	2.6
1949	[5] 15,430	475	3.1	9,800	190	1.9	25,230	665	2.6
1950	[5] 18,700	780	4.2	17,000	270	1.6	35,700	1,050	2.9
1951	[5] 24,100	890	3.7	22,600	330	1.5	46,700	1,220	2.6

[1] As reported in Statistics of Income.

[2] The estimated tax on capital gains and losses is not intended to show the difference in tax revenue resulting from taxing capital gains and losses as compared with not levying such a tax in the specified year. The estimated tax on capital gains and losses for each of the specified years is the difference between (1) the total individual and corporation income taxes reported in Statistics of Income; and (2) the total of such taxes which would have been realized if capital gains and losses had been entirely excluded from the tax computation.

[3] Excludes additions to liability under the Current Tax Payment Act of 1943 amounting to $2,555,894,000.

[4] Preliminary.

[5] Estimated.

NOTE.—It should be borne in mind, when interpreting this table, that the estimates of revenue yield from capital gains taxation of individuals during the period 1926–34 are not strictly comparable with those for 1935 and later years. In preparation of the estimates for the earlier period, no account was taken of deficit returns; averages of capital gains by income size classes were used to approximate the effective rates at which gains were presumed to have been taxed. For the period since 1935 deficit returns have been included and better account has been taken of the dispersion of capital gains and losses within income size classes. Therefore, it is believed that the estimates since 1935 are much more nearly accurate than those for the preceding period. Lack of proper information makes it inadvisable to attempt to put the estimates before 1935 on the same basis as those subsequent. In general, the effect of including deficit returns is consistently to diminish gains and increase losses. The 1926-34 estimates of capital gains tax revenue from individuals are therefore overstated in comparison with later years.

Source: Office of the Technical Staff, Treasury Department.

[28] Less structural information exists for deficit returns than for returns with net income. Consequently, the estimates for deficit returns are subject to the largest errors.

As the base of the personal income tax has been broadened and rates increased, the relative importance of capital gains as a revenue source has declined. In the period 1926 through 1929, the tax yield from realized capital gains of individuals was more than $1.5 billion, or roughly 40 percent of the total yield from individual income taxation during that 4-year period. In the year 1928, capital gains were responsible for virtually as much tax revenue as all taxable ordinary incomes. In contrast to this experience, during the 10-year period 1938 through 1947, the total yield from capital-gains taxation of individuals was approximately $2.9 billion, which is less than 3 percent of the total yield from personal income taxation.

The substantial yield, in dollar amounts, from capital gains taxation of individuals during recent years reflects mainly the impact of war and postwar economic expansion and inflation on values of capital assets. To some degree this yield also reflects the limitations on deduction of net capital losses from ordinary income in effect since 1934.

Although loss limitations serve to maintain yield, the possibility of postponing realizations of capital gains is also a factor tending to reduce this tax's yield. Since liability may be avoided simply by holding capital gains unrealized, many taxpayers, particularly in the upper income brackets, tend to hold appreciated assets for long periods of time. These taxpayers tend to hold their gains either until they may be offset against losses or, presumably, often for life because under present law accrued capital gains are transferable free of income tax at death. Such statistics as are available concerning the age distribution of capital assets at time of realization support the fact that longer holding is characteristic of higher income.

In the year 1936, for example, 36 percent of the capital gains realized by taxpayers with less than $5,000 of net income had been held for less than 1 year, and only 17 percent of the capital gains of this income group were attributable to capital assets held more than 10 years. On the other hand, taxpayers with more than $1,000,000 of net income in that same year realized less than 3 percent of their capital gains on assets held less than 1 year and 84 percent of their capital gains on assets held more than 10 years.[97] The average age of capital gains realized increases steadily as one goes up the income scale.[97]

Corporation capital gains have been a consistent source of net revenue since 1934, when loss limitations were first imposed, and a less volatile revenue source than the capital gains of individuals. Traditionally, the capital gains of corporations have been treated more nearly like ordinary income and taxed without percentage-exclusion provisions.

B. SIZE AND STRUCTURE OF THE CAPITAL GAINS TAX BASE

In analyzing revenue as well as other aspects of the capital-gains tax, it is desirable to examine briefly such quantitative background information as is available concerning the size and structure of the tax base. Information of this sort is given below for 1945, 1946, and 1947, the latest years for which tabulations are available. The special tabulations do not cover fiduciary returns.

[97] Statistics of Income Supplement Compiled from Income Tax Returns for 1936, sec. IV, Capital Gains and Losses, pp. 31 and 32. The above percentages are based on the actual net capital gains realized before the application of percentage-exclusion provisions.

Details concerning the number of individual income tax returns with net gain or loss from sale or exchange of capital assets are given in table 3. About 50 million returns were filed in 1945, almost 53 million in 1946, and 55 million in 1947. Net capital gains or losses were reported on 2.1 million returns in 1945, on 2.7 million in 1946, and on 2.5 million in 1947, between 4 and 5 percent of the total number.

TABLE 3.—*Number of individual income-tax returns with net statutory capital gains or losses, 1945, 1946, and 1947*

	1945 returns with net—		1946 returns with net—		1947 returns with net—	
	Gains	Losses	Gains	Losses	Gains	Losses
Taxable returns	1,583,347	345,524	1,975,105	416,587	1,624,931	507,678
Adjusted gross income under $5,000	1,040,721	229,839	1,266,883	236,621	1,023,116	275,541
Adjusted gross income of $5,000 and over	542,626	115,685	708,222	179,966	601,815	232,137
Returns using alternative tax	88,485	....	84,021	....	69,444	....
Nontaxable returns	87,845	46,037	269,833	85,870	241,922	102,671
Total returns with capital gain or loss	1,671,192	391,561	2,244,938	502,457	1,866,853	601,349

Source: Preliminary tabulations, Bureau of Internal Revenue.

The large majority of returns with capital gains or losses were taxable. In 1945, 95 percent of the tax returns containing net gains and 88 percent of those containing net losses were taxable. The total number of nontaxable returns rose between 1945 and 1946 and, as a consequence, the number of nontaxable returns with gains and losses also increased.[98] In 1947, the number of nontaxable returns, although lower than in 1946, still exceeded the 1945 figure.

A very small proportion of the total number of returns with net gains had sufficient ordinary income to be affected by the 25-percent maximum effective rate limitation under the alternative capital gains tax computation. In 1945, the number of returns with capital gains subject to the alternative tax was 88,000 or less than 6 percent of the total number with gains; in 1946 and 1947 the number decreased to 84,000 and 69,000, respectively, or to about 4 percent of the number with gains. This decrease was attributable in part at least to the fact that the alternative rate was applicable at a lower point on the income scale in the earlier year than in the two latter years ($16,000 of surtax net income in 1945 as compared with $18,000 in 1946 and 1947).[99]

More than four times as many individual taxpayers reported net capital gains in 1945 and 1946 as reported net capital losses, while in 1947 one return with net losses was filed for every three returns with net gains. Over 60 percent of the taxable returns containing either net gains or net losses in all 3 years had adjusted gross incomes of less than $5,000. Thus, the majority of capital gains and losses, in number if not in amount, were realized by relatively small investors.

The aggregate of net statutory capital gains included in adjusted gross income of individuals totaled $2.3 billion in 1945, $3.3 billion in 1946, and $2.5 billion in 1947. The preponderant part of this

[98] The increase in the number of nontaxable returns was probably due to the higher normal tax exemptions for married couples in 1946 and 1947. In 1945, the normal tax exemption was a flat $500 or $500 plus the income of the spouse on joint returns with a maximum of $1,000. In 1946, the normal tax exemption was raised to $500 for each exemption claimed on the return.

[99] The higher breaking point resulted from the reduction in ordinary individual income tax rates applicable to the years 1946 and 1947.

statutory gain was long-term which is only 50 percent taken into account for tax purposes the excess of long-term gains over long-term losses before the 50-percent exclusion, reported on all individual returns was $4.2 billion in 1945, $6.8 billion in 1946, and $4.8 billion in 1947. These amounts are larger than the aggregate long-term capital gains reported by individuals in either 1928 or 1929, due primarily to the longer holding period in force during the earlier years.[1] Details concerning the distribution of these gains in 1945, 1946, and 1947, between long- and short-term, along with a similar distribution of net capital losses, are presented in table 4.

TABLE 4.—*Amounts of net capital gain and loss in individual income-tax returns, 1945, 1946, and 1947*

[Dollar amounts in millions]

	1945		1946		1947	
	Net gain	Net loss	Net gain	Net loss	Net gain	Net loss
Returns with net gains:						
Short-term [1]	$286.6	$26.6	$247.7	$181.7	$151.6	$39.7
Long-term:						
Statutory amount	2,078.8	3.6	3,278.1	5.9	2,361.2	6.0
Face value [2]	4,157.6	7.1	6,556.2	11.8	4,722.5	12.0
Capital loss carry-over [3]	....	27.2	....	19.6	....	14.9
Returns with net losses:						
Short-term [1]	9.3	61.0	8.9	257.1	13.1	168.3
Long-term:						
Statutory amount	34.1	245.3	111.4	241.6	60.3	333.2
Face value [2]	68.2	490.7	222.8	483.2	120.6	666.4
Capital loss carry-over [3]	....	251.3	....	278.2	....	331.9

[1] Short-term gains and losses are current-year net short-term capital gains and losses exclusive of loss carry-overs which are shown separately.
[2] Before application of 50-percent exclusion allowed long-term gains and losses under present law.
[3] Capital-loss carry-over from previous years.

Source: Preliminary tabulations, Bureau of Internal Revenue.

Among returns with net capital gains, the relative smallness of aggregate short-term gains is noteworthy. This is doubtless due in part to the shortness of the present 6 months' holding period necessary to qualify gains as long-term. Most taxpayers find it expedient to hold appreciated assets more than 6 months.

Among returns showing net losses, statutory short-term losses (which include unrecovered losses carried over from prior years) were larger than statutory long-term losses (not including carry-over). However, if the carry-overs are deducted from short-term losses and the long-term losses are corrected for the 50-percent exclusion, long-term losses exceeded short-term losses for such returns in 1945 and 1947.

Among returns showing net gains, long- and short-term losses were small in 1945 and 1947. There seems to have been very little offsetting in those years of long-term losses against short-term gains and of short-term losses against long-term gains. However, short-term losses for returns with net gains were substantially higher in 1946 than in the other 2 years. Nonetheless, by comparison with long-term gains, 1946 short-term losses were still relatively small.

The figures in table 4 are net balances remaining after matching of current-year short-term loss and the loss carry-over against short-

[1] In 1928 and 1929, total individual net capital gains were larger than in 1945; short-term gains accounted for about 60 percent of the total in 1928 and about 50 percent in 1929. The holding period was 2 years. In 1945, with a holding period of only 6 months, short-term gains were of negligible importance.

term gain and current-year long-term loss against long-term gain, although they are gross balances before cross matching of short-term loss against long-term gain and vice versa. Consequently, table 4 gives no indication of the extent of offsetting by individuals of gain against loss within the short- and long-term categories, respectively; this offsetting may have been substantial in aggregate amount.

An indication of the concentration of capital gains among larger incomes may be seen in the fact that, although less than 4 percent of the taxpayers reporting capital gains in 1946 and 1947 had sufficient other income to benefit from use of the alternative tax, these taxpayers accounted for about 28 percent of all statutory net capital gains realized by individuals.[2]

More information concerning the structure of capital gains and losses may be gained from table 5 which shows 1945, 1946, and 1947 realizations by income size classes. As the table indicates, net statutory capital gains of individuals were more concentrated among larger incomes than were net capital losses. Moreover, the higher the income level the smaller were aggregate capital losses relative to gains. This is consistent with the pattern which has been observed for earlier years.[3]

TABLE 5.—*Net statutory capital gains of individuals and net capital losses before statutory limitations, 1945, 1946, and 1947*

Adjusted gross income size class	Statutory net capital gains		Net capital losses before statutory limitation	
	Amount	Percent distribution	Amount	Percent distribution
1945	*Millions*		*Millions*	
Under $5,000	$600.2	26.0	$172.8	33.6
$5,000 to $10,000	374.5	16.2	80.3	15.6
$10,000 to $25,000	427.2	18.5	100.4	19.5
$25,000 to $100,000	475.5	20.6	70.8	13.8
Over $100,000	368.0	16.0	20.8	4.0
Total taxable	2,245.6	97.3	445.0	86.5
Nontaxable	62.4	2.7	69.2	13.5
Grand total	2,308.0	100.0	514.2	100.0
1946				
Under $5,000	964.8	29.1	185.3	28.2
$5,000 to $10,000	585.2	17.6	105.2	16.0
$10,000 to $25,000	550.3	16.6	136.1	20.7
$25,000 to $100,000	550.8	16.6	98.5	15.0
Over $100,000	506.7	15.3	23.5	3.6
Total taxable	3,157.8	95.2	548.5	83.5
Nontaxable	160.8	4.8	108.0	16.5
Grand total	3,318.6	100.0	656.5	100.0
1947				
Under $5,000	719.3	29.3	200.3	26.4
$5,000 to $10,000	425.1	17.3	123.0	16.2
$10,000 to $25,000	374.9	15.3	151.7	20.0
$25,000 to $100,000	377.8	15.4	114.4	15.1
Over $100,000	393.6	16.1	26.7	3.5
Total taxable	2,290.7	93.4	616.0	81.1
Nontaxable	161.6	6.6	144.0	18.9
Grand total	2,452.3	100.0	760.0	100.0

NOTE.—Figures are rounded and will not necessarily add to totals.

Source: Preliminary tabulations, Bureau of Internal Revenue.

[2] These figures are based on preliminary tabulations by the Bureau of Internal Revenue of 1946 and 1947 income tax data.

[3] Statistics of Capital Gains and Losses, op. cit.

Additional significant distributions relating to individuals reporting net capital losses on their 1945, 1946, and 1947 tax returns are given in table 6. This table shows net capital losses reported in 1945 before and after the statutory limitation and those carried forward from years 1942 through 1944. Similarly, for 1946 and 1947 the table shows the net losses before and after the statutory limitation and those carried forward from years 1942 through 1945 and 1946, respectively.[4]

TABLE 6.—*Net capital losses of individuals reported in 1945, 1946, and 1947, after statutory limitation and net capital losses carried over from previous years*

Adjusted gross income size class	Net capital losses: Before statutory limitation	Net capital losses: After statutory limitation	Carry-over from previous years [1]
1945	*Millions*	*Millions*	*Millions*
Under $5,000	$172.8	$96.4	$54.2
$5,000 to $10,000	80.3	29.5	41.0
$10,000 to $25,000	100.4	27.0	61.4
$25,000 to $100,000	70.8	11.5	52.9
Over $100,000	20.8	1.1	15.4
Total taxable	445.0	165.5	225.0
Nontaxable	69.2	28.1	26.3
Grand total	514.2	193.5	251.3
1946			
Under $5,000	185.3	97.5	47.1
$5,000 to $10,000	105.2	44.1	44.8
$10,000 to $25,000	136.1	41.4	66.0
$25,000 to $100,000	98.5	19.1	56.8
Over $100,000	23.5	1.5	15.9
Total taxable	548.5	203.7	230.6
Nontaxable	108.0	46.4	47.7
Grand total	656.5	250.1	278.2
1947			
Under $5,000	200.3	110.4	55.3
$5,000 to $10,000	123.0	53.0	48.4
$10,000 to $25,000	151.7	49.0	75.1
$25,000 to $100,000	114.4	23.7	64.6
Over $100,000	26.7	2.0	21.6
Total taxable	616.0	238.1	265.0
Nontaxable	144.0	59.4	66.9
Grand total	760.0	297.6	331.9

[1] Includes amounts reported on individual returns with net capital losses only.

Source: Preliminary tabulations, Bureau of Internal Revenue.
NOTE.—Figures are rounded and will not necessarily add to totals.

Table 6 indicates that individuals with lower incomes (and on the average smaller capital losses) were able in 1945, 1946, and 1947 to recover a substantial part of the tax value of their capital losses through offset against ordinary income. Naturally, the larger capital losses associated with larger incomes depend more heavily for relief upon carry-forward against future capital gains than upon income offset. In view of the greater frequency of capital transactions among individuals with larger incomes, the carry-over privilege has greater

[4] Losses may be carried forward for 5 years. This change was made beginning with 1942, so that 1947 is the first year with a full 5-year carry-over period.

value to higher income taxpayers, and tends partly to offset for them the stringency of the prevailing loss limitation against income.

It is impossible on the basis of data for a 3-year period to judge the adequacy of existing provisions for recovery of capital losses. However, the relatively small size of the aggregate capital-loss carry-over and the substantial portion of smaller net capital losses offsettable against ordinary income in 1945, 1946, and 1947 suggest that existing loss limitations are not unduly burdensome to the majority of taxpayers in a period of rising prices. At the same time, for a minority of taxpayers existing law provides something less than perfect loss treatment—even during a period of capital expansion and inflation.

C. INDIRECT REVENUE EFFECTS

The indirect revenue effects of the capital-gains tax are of two types. First, the preferential rate encourages conversion of ordinary income into long-term capital gain. The amount of revenue loss attending this tax avoidance, while not readily measurable, is clearly substantial. It depends on the size of the differential in the tax rates applicable to ordinary income and capital gains and on the number of technical means available to accomplish this conversion.[5] Second, the capital gain and loss provisions exercise some influence on taxpayer decisions to hold or to sell capital assets. By encouraging or retarding realization of capital gains and losses, the provisions affect tax yields.

V. Rate and Holding-Period Problems

The existing provisions for preferential treatment of long-term capital gains represent a blend of past policies—policies of giving this preferential treatment in two distinct forms—namely, (1) by a flat alternative rate (which benefits only those taxpayers who have large ordinary incomes and also realize capital gains) and (2) by allowing the exclusion of a percentage of long-term capital gains realized (which benefits all taxpayers realizing gains regardless of the size of their incomes).

Historically, rates of tax applied to long-term capital gains have varied considerably in relation to tax rates on ordinary income. No final agreement has yet been reached as to the proper relationship between these two rate schedules. The degree of preferential treatment applied to long-term capital gains, therefore, has varied both as a result of changes in the rates of tax on ordinary income and modifications in the alternative rate on capital gains.

If the rates on long-term capital gains were fixed primarily with reference to some equitable standard, they should move proportionately with the rates on ordinary income. The fact that capital-gains rates have not so moved is perhaps indicative of the concern which has been felt for devising rates which would not interfere unduly with operation of the capital market.

In analyzing preferential treatment of long-term capital gains, it is desirable to distinguish the general objectives of preferential treatment from the specific objectives of present methods for furnishing

[5] Such losses in revenue are greatest when net gains are given favorable tax treatment and net losses are given ordinary loss treatment. This treatment was the general rule under the Revenue Act of 1921. It is now limited to sales and exchanges of assets falling under secs. 117 (j), 117 (k), and 117 (l).

that preferential treatment. The general case for preferential treatment rests largely on the equity and market problems that arise when capital gains are not taxed until realized. The case for the existing type of preferential treatment turns in large measure on administrative considerations.

A. PURPOSES OF RATE AND HOLDING-PERIOD PROVISIONS

1. General purposes of preferential treatment

The first objective of preferential rates for long-term gains is to reduce the impact of the progressive rate structure of the individual income tax on those bunched gains of individuals who have only infrequent transactions in capital assets. If properly implemented, this purpose might be served by provisions which would tend, for individuals with similar net incomes, to equalize tax rates on similar-sized annual accruals of capital gain.

A second general purpose of preferential treatment for long-term capital gains might be to provide a specific tax incentive to investment in capital assets. In connection with this purpose, the holding-period requirement is often considered essential; many who might favor granting a tax concession to investment in capital assets for incentive reasons would not wish to extend this concession also to gains resulting from speculative dealings.

A third purpose of preferential capital-gains tax provisions is to reduce the deterrent influences of the tax on sales of capital assets. This consideration arises as a consequence of the rule that only realized gains are taxable.

The second and third purposes just mentioned have most regularly been served by providing an alternative rate of tax available to individuals with ordinary incomes above a minimum size. Under the alternative rate, the amount of preference provided varies directly with the ordinary income tax rate structure and the size of a person's ordinary income.

2. Purpose of the present type of capital gains tax structure

Administrative and legal considerations have played a major part in shaping the present type of preferential tax treatment for long-term gains and in causing the rejection of more nearly equitable methods of handling capital gains such as (*a*) the annual accrual method, (*b*) proration of capital gains at time of realization over the years of accrual, or (*c*) averaging capital gains, either alone or as part of a program for comprehensive income averaging. The present type of preferential treatment is undoubtedly defective on equity grounds but it does avoid some of the procedural and administrative complexities characteristic of the alternative methods.

If tax equity were the only consideration, either the annual accrual method or some method of distributing capital gains at the time of realization to prior years might be preferable to the existing type of tax provisions. Although the present combination of percentage exclusion and a flat alternative rate for extending preferential tax treatment to long-term gains has evolved as a compromise and possesses the force of familiarity derived from past usage, the amounts of preference and the area of preferential treatment might call for modification as economic conditions or tax policies change.

B. LENGTH OF THE HOLDING PERIOD

1. Distinguishing speculation from investment

Experience with holding periods reveals, from the very beginning of preferential treatment in 1922, a legislative intention to tax capital gains from speculation and from investment differently. This intention has persisted despite the fact that logical and workable definitions necessary to permit drawing a clear line between the two have not been developed. Congress has realized this and consequently has followed the general proposition that the difference between speculation and investment is related to the time an asset is held.

If the difference between an investor and a speculator is conceived to be that the former is primarily interested in the income possibilities of his investment whereas the latter is primarily concerned with resale price, the holding period is important because, the longer one holds, the less important resale price tends to be in relation to total yield over the lifetime of the investment. Similarly the shorter the period of asset ownership, the more important is likely to be the contribution of resale price to total yield and the smaller the contribution of annual yield. These relations, however, are rough and numerous exceptions may be found.

One reason the above generalizations do not hold in all cases is that the distinction between income and appreciation is by no means clear-cut. One might own a security for 20 years and realize no current income since all profits were reinvested. At the other extreme, income might outweigh appreciation in a security or other investment owned for a very brief period.

In place of the distinction between speculation and investment based on the period of holding assets, some analysts would say that the difference between the two functions is primarily one of intent; but such a distinction is neither objective nor decisive. For example, one may buy a capital asset with every intention of holding it for a long period, yet actually sell it within a week due to some unforeseen change in specific investment prospects or personal position. Similarly, one may purchase an asset as a speculation with every intention of reselling within a few days, yet actually hold it for a considerable period of time.

Since speculation and investment differ primarily in degree, a holding period merely draws an arbitrary line beyond which taxation (on investment income) is more lenient. Opinion as to where this line should be drawn differs.[6] Some maintain that a relatively short holding period, for example 6 months or in extreme cases as little as 1 month, is sufficient. Others maintain that a longer holding period, for example 18 or 24 months, is desirable.

In spite of its inadequacies, a distinction between speculation and investment based on the period of holding is probably the most objective and workable one available. A 1-year holding period, however, might be justified solely on the ground that income taxation is an annual affair, and without any reference to the speculation versus investment distinction.

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[6] Cf. Capital Gains Taxation, Tax Institute, Inc., 1946, pp. 51, 60, 83-89, 96, 98.

2. Equalizing tax on capital gains of varying age

It has frequently been conceded that taxpayers with capital gains that have accrued over more than 1 year should be given some sort of special tax treatment upon realization of these long-accrued gains. This equity consideration has led to several attempts at tax differentiation by age of gain at the time of realization.

From the beginning of special taxation of capital gains in 1922, the statute has consistently incorporated a provision for at least one holding period. This period has distinguished between short-term capital gains, accrued over too brief a period to warrant preferential treatment, and long-term capital gains requiring special treatment. During the thirties the desire to provide equitable tax treatment for long-accrued gains led to legislative acceptance of the idea of graduating percentage inclusion by age of asset.

Any attempt to graduate the capital-gains tax on an age basis will require either several separate rate schedules or more than one holding period with different percentages of inclusion. A structure that provides substantial tax reduction on older gains will also provide a substantial incentive to postpone realization of gains until such time as the advantages of lower effective rates can be obtained. Moreover, several holding periods, each with decreasing percentage inclusion of gains and losses, may also produce loss offset problems. A short-term loss will offset more than its amount of long-term gain. This was the case, for example, under the 1934 legislation. It is also true of present law which takes 100 percent of short-term loss but only 50 percent of long-term gain into account.

The amount of preference that should be provided to overcome this age-of-gain consideration is probably considerably smaller, in most cases, than it has often been conceived to be. This is because the effect of concentration of capital gains in the year of realization depends on the size of the gain in relation to the taxpayer's location within a surtax bracket and also on the amount of rate graduation between brackets. Moreover, in many cases the tax-increasing effect of concentrating a large capital gain accrued over several years in the year of realization may be offset, or more than offset, by implicit interest on the tax postponed until realization. Even if the interest-on-tax-postponement factor be disregarded, it is practically impossible to devise any general percentage-inclusion formula for all taxpayers with gains that will accurately take account of the effect upon tax liabilities of bunching taxable gains in the year of sale or exchange. In other words, a percentage-exclusion formula may be designed to fit the case of taxpayers with large gains and small incomes, small gains and large incomes, or some other combination, but no simple formula will fit all cases.

The percentages of exclusion allowed capital gains of various ages in the past have borne no discernible relationship to the amount of additional tax resulting from concentration of capital gains in the year of realization for a representative taxpayer. Such a relationship might be worked out for a taxpayer with an income of a certain size and a certain amount of capital gain. In most cases the result would probably be nearer to the formula that the typical taxpayer should be allowed to exclude (say) 1 or 2 percent of any gain for each year over one it had accrued, than to the usual percentage-exclusion formulas of prior or present law.

Use of large percentages of exclusion, either in connection with single or multiple holding periods, has provided significant inducements to continued holding of appreciated investments. For this reason, the use of a number of holding periods, with only a slight rate graduation for each, might be desirable. Moreover, slight rather than sudden drops in rates between holding periods might produce more equitable tax results.

3. Proposals to eliminate holding periods

It has been proposed, on grounds that the holding-period provisions of the capital-gains tax were believed to have undesirable market effects, that these provisions be eliminated. The outstanding proposal of this type was the Boland bill, considered by Congress in 1942.[7] This bill would have subjected all capital gains, regardless of the length of time capital assets had been held, to a flat rate tax of 10 percent. Proponents of the measure not only argued that it would reduce the undesirable market effects they attributed to capital gains taxation, but also that it would encourage realization of accrued gains sufficiently to produce a net increase in revenue yield. Opponents of the measure (including the Treasury) regarded it as inequitable and were not willing to concede that it would increase tax yield.

The two proposals (flat rate and no holding period) contained in the Boland bill may be analyzed separately. The holding-period requirement might be eliminated without imposing a uniform flat rate of tax. In this case preferential treatment, in the form of percentage exclusion and (where applicable) the alternative rate, might be extended to all capital gains regardless of their period of accrual. Likewise the 10-percent rate might be considered either as a uniform flat rate or merely as an alternative rate lower than that now in existence. It could be coupled with existing holding-period provisions.

Eliminating the holding period altogether while retaining existing rates would simplify the capital gains tax provisions and would undoubtedly be convenient from a taxpayer compliance standpoint. It might produce some additional revenue compared with existing provisions. At present short-term losses, 50 percent of which would be disallowed, are larger than short-term gains.

Extending preferential treatment to all capital gains would, however, encourage additional taxpayer efforts to convert ordinary income into capital gains. Eliminating the holding period would also reverse the established policy of Congress that some distinction between speculation and investment is desirable, however rough this distinction may be.

A uniform flat rate of tax on capital gains, such as proposed by the Boland bill, would, depending on its level, either raise the rate applicable to some individuals while reducing it for others or lower the effective rate for all taxpayers (though by different relative amounts in individual cases). Use of a flat rate would amount to splitting taxpaying ability into two separate categories and to denying the applicability of progressive rates, elsewhere accepted, to capital gains. Likewise, a flat rate tax would foreclose any solution to the problem of

[7] H. R. 6358, introduced Jan. 12, 1942.

equalizing the rate of tax on annual accruals of capital gains. Since all gains would be taxed alike, those accrued over many years would, in effect, be taxed less on an annual rate of accrual basis than would gains accrued over shorter periods of time.

If the holding-period device is to be maintained, a one-year holding period might be reconsidered. This would deny favorable treatment to all gains realized within the year and would tax at least some speculative activity more heavily than it is taxed at present. It would also be consistent with the annual basis of the individual income tax which, to date and apart from net operating loss carry-over, takes only very limited account of fluctuations in incomes from year to year.[8] The mere fact that a one-year period has some obvious recommendations does not mean that the older 18-month and 2-year periods are without merit.

C. ANALYSIS OF EXISTING PROVISIONS FOR PREFERENTIAL TREATMENT

Acceptance of the principle that capital gains are taxable only at time of realization furnishes the main equity argument for preferential treatment. But there are divided views regarding the proper degree of preferential treatment. It has been held that a tax rate structure for long-term capital gains which is equitable may unduly restrict the realization of gains and induce an undesirable amount of tax postponement. At the other extreme, a rate structure which will interfere comparatively little with realization is often considered inequitable and as placing a premium on income-tax avoidance.

1. Equity

Once the principle of preferential treatment for capital gains accrued over longer than a year is accepted, the amount of preference necessary to give equitable tax results can be appraised from two distinct though related viewpoints. One of these is how to maintain reasonably equitable relationships between taxpayers who have only ordinary incomes and other taxpayers who have both ordinary incomes and capital gains. The other is how to maintain tolerably fair treatment within the group of taxpayers having both capital gains and ordinary incomes, but ranging all the way from large gains accrued over a long period and low incomes to small short-term gains and high incomes.

The percentage-exclusion treatment is one method of extending preferential tax treatment to long-term capital gains but has been subject to some misunderstanding. When originally introduced in 1934, it was claimed that percentage exclusion produced results similar to proration of capital gains to their period of accrual, without raising the well-known administrative difficulties connected with proration. However, it can have such results only coincidentally. The tax effect of apportioning capital gains, either to the years of holding or some arbitrary period, could be duplicated only by application of different percentages of exclusion to different taxpayers, depending on their income positions and the size and ages of their respective capital gains. No set of provisions for uniformly scaling down capital

[8] Sec. 107 treatment of lump-sum income earned over 36 months or more and the provisions for carry-over of both capital losses and operating losses are the only relief features, aside from the capital gains provisions available for fluctuating incomes under present law.

gains on the basis of their age alone and irrespective of either their size or the income position of the taxpayer can possibly produce the effects of apportionment.

If the main purpose of percentage-exclusion provisions is equitable taxation of lumpy capital gains, this objective might better be attained by averaging of realized capital gains but not necessarily averaging of all sources of income. Averaging provisions and holding-period provisions for percentage exclusion of longer term capital gains will not produce similar tax results. Averaging does not allow exclusion of any portion of realized gains.

The percentage exclusion method of preferential treatment is more equitable than the flat alternative rate. Percentage exclusion is a convenient method of extending to all taxpayers realizing capital gains some measure of the preferential treatment. The alternative rate is less defensible on strict equity grounds since it splits off one segment of taxpaying ability and grants a varying degree of tax preference to different taxpayers.

The amount of additional tax due to concentrating capital gains in a single year depends on the size of gain relative to the width of income-tax brackets and also on the amount of graduation in income-tax rates between brackets. Under the existing personal income-tax structure, the amount of additional tax due to this concentration diminishes as the size of income increases both (*a*) because tax brackets are wider at higher than at lower income levels and (*b*) because rate differences from bracket to bracket are smaller. Thus, the need for preferential tax treatment is greatest for taxpayers with small and middle incomes. For a taxpayer with sufficient ordinary income to place him continually in the maximum surtax bracket, lumping of capital gain in the year of realization is not a factor increasing tax liability. Only gains which are large in relation to ordinary income and are realized by taxpayers in the lower and middle surtax brackets tend to increase tax liability disproportionately.

Equitable tax treatment for capital gains can only be devised in the light of knowledge concerning the patterns of capital gains and losses relative to the patterns of individual incomes. Although such knowledge is incomplete, due to gaps and heterogeneity in the statistical materials, a few generalizations may safely be drawn from the recorded experience. For example, (*a*) capital gains tend to be more unequally distributed than ordinary incomes; (*b*) individuals with larger statutory net incomes generally report more favorable ratios between capital gains and losses than individuals with lower net incomes; and (*c*) capital gains are an important source of the largest incomes, but the pattern of capital losses by income size classes is less stable than the pattern of gains relative to income.[9]

Available data also indicate that the aggregate volume of realized capital gain and loss depends heavily on what happens to security prices in any year. Stock market transactions are the predominant source of capital gains and losses.

The majority of capital gains and losses, in number if not in value, are realized by relatively small investors. For example, in 1945, 1946, and 1947 about two-thirds of the taxable individual returns

[9] From an unpublished tabulation by Lawrence H. Seltzer, for the Conference on Fiscal Policy of the National Bureau of Economic Research. (Since published in The Nature and Tax Treatment of Capital Gains and Losses, National Bureau of Economic Research.)

containing either net gain or net loss had adjusted gross incomes of less than $5,000. In 1946, less than 85,000 of the more than 2 million individual income-tax returns reporting either net capital gains or net capital losses had sufficient ordinary income to use the alternative tax. However, this small group of taxpayers, less than 4 percent of those reporting gains in 1946, accounted for more than 28 percent of all statutory net capital gains realized by individuals. Under the Revenue Act of 1948, the proportion of taxpayers having capital gains who can benefit from the alternative rate is even smaller since the minimum income requirement for the alternative rate has been increased by the rate reduction and by income splitting. The Revenue Act of 1950, by raising rates on ordinary income but leaving the alternative rate unchanged, enlarged the area of advantage under the alternative rate.

2. *Timing of realization*

The present holding-period provision in the capital gains tax encourages holding of capital gain unrealized for at least 6 months and realization of losses within 6 months. The incentive to hold gains unrealized, to the extent that this incentive is responsive to tax provisions, depends on the length of the statutory holding period and the amount of decrease in tax liability obtainable from holding beyond that statutory period. Under present law this decrease in tax is often sufficient to make a smaller long-term capital gain equal in value after tax to a larger short-term capital gain.

This is illustrated in table 7 which shows, for different-sized capital gains and different levels of ordinary income, the relative amounts of short- and long-term capital gain that are equal after tax. For example, a long-term gain of $5,195 leaves a taxpayer with $50,000 of ordinary net income as much after tax as does a short-term gain of $10,000. The table shows that the tax inducement to hold gains until they become long-term increases as the level of a taxpayer's income rises.

TABLE 7.—*Amounts of long-term capital gains which would yield the same income after tax as specified amounts of short-term capital gains, by selected ordinary net income levels* [1]

MARRIED PERSON—NO DEPENDENTS

Ordinary net income before personal exemptions	If short-term gain is— $5,000	$10,000	$25,000	$50,000
	The following long-term gains would be equivalent after tax			
$5,000	$4,346	$8,423	$19,252	$32,751
$10,000	4,170	8,104	18,280	31,297
$15,000	3,986	7,769	17,333	30,131
$25,000	3,590	6,897	15,626	28,087
$50,000	2,661	5,195	12,403	22,421
$100,000	1,715	3,381	8,229	15,211
$500,000	600	1,200	3,000	6,000

[1] Under the Revenue Act of 1950, rates for calendar year 1951.

Although the normal tendency under present law is to realize losses and to postpone realizing gains and although this tendency is strengthened by 100-percent inclusion of loss on short-term transactions against only 50-percent inclusion of gain on long-term transactions, there are several other tax and nontax factors operating simultaneously to modify this tendency. Obviously, taxpayers will realize gains regardless of tax if convinced they are likely to maximize their net gains by selling rather than waiting until later when markets may be less favorable. Furthermore, if a taxpayer has either unused capital loss carry-overs from prior years or realized losses in the current year, he will have a motive for realizing some gains in order to offset his losses. This motive will be strengthened the more the permissible loss offset against ordinary income is limited.

A further indication of the effects of length of the holding period on realization may be seen in the following comparison: In 1941, when the holding period was 18 months, approximately 27 percent of reported net capital gains of individuals with net incomes were short term.[10] In 1943, after the holding period had been reduced to 6 months and segregation of short-term capital gain and loss eliminated, only 16 percent of reported net capital gains of individuals with net incomes were short term.[11] Since that time the ratio of short- to long-term capital gains reported has continued to diminish. A similar comparison of the distribution of net capital losses realized in 1941 and 1943 is not possible from available data.[12]

3. Conversion of ordinary income into long-term capital gains

The preferential tax treatment granted long-term capital gains encourages taxpayers to convert ordinary income into this tax-favored form. A number of devices are used in attempts to accomplish this conversion and tax saving. The methods available differ depending on the type of income involved.

So long as capital gains tax rates remain well below the rates on corresponding amounts of ordinary income, conversion of ordinary income will be attempted and will raise difficult problems of tax administration.

VI. Capital Loss Offsets

The central problem concerning the treatment of capital losses has been one of effecting a proper compromise between two conflicting considerations.

Advocates of liberal allowances for capital losses have contended that such liberalization would prevent income taxes from having too undesirable impacts on capital, insure more equitable treatment of taxpayers suffering losses, and improve incentives to investment.

Proponents of capital loss limitations, in turn, have expressed opinions that these limitations are necessary to protect income tax revenue during depression periods, to limit tax avoidance, and to balance the fact that long-term capital gains are taxed at preferential effective rates.

[10] Reported net short-term gains in 1941 were net of current year short-term loss and preceding year net short-term loss carry-over.

[11] Figures are derived from basic tables in Statistics of Income, pt. 1, 1941 and 1943. The 1943 tabulations are final. No doubt part of the percentage reduction in short-term gains is attributable to the ease with which short-term gains could be converted into long-term gains through the short-sale device. Thus, the percentage reduction indicated above is not entirely attributable to the shorter holding period.

[12] No short-term losses were tabulated separately in 1941 due to provisions of the revenue act in force which prohibited offset of short-term loss against either long-term gains or ordinary incomes, but permitted such losses to be carried forward 1 year. Consequently, only the carry-over from 1940 was tabulated in 1941. Short-term net capital losses for 1941 cannot be identified in the 1942 tabulations which are on a different basis due to a change in the revenue act in that year. Segregation of short-term capital gain and loss in 1941 tended to restrict the amount of short-term loss reported, at least relative to a period such as 1943 when short-term loss was not segregated.

A. PURPOSES OF CAPITAL LOSS PROVISIONS

Although proposals for revising the income tax treatment of capital losses differ in a number of important respects, there exists a considerable measure of agreement concerning the major objectives of the policy of allowing some tax credit to those who sustain capital losses. A brief review of these may contribute toward better understanding the need for capital loss offsets and may provide a broader perspective for judging the relative merits of specific proposals.

1. Prevent income tax from bearing on capital

The primary purpose of allowing an income tax deduction for realized capital losses is to avoid taxing capital as income.

According to the definition generally accepted, net income is whatever a taxpayer receives in a given year over and above maintenance of his capital. A true net income tax should thus logically allow appropriate deductions for whatever losses the taxpayer may sustain; these losses, in effect, reduce his net income as defined above. If loss provisions in an annual net income tax are inadequate, part of the impact of the income tax will necessarily fall on capital.

According to the theory of net income taxation, when a taxpayer suffers a loss, what is required is an adjustment of his taxable income, either for the current year, previous years, or subsequent years. A net loss deduction is essentially a tax adjustment between a taxpayer and the Government. This applies both to operating losses and capital losses, though it does not necessarily imply that the nature or amount of the tax adjustment permitted should be similar in the two cases.

Inadequate provision in the personal income tax for capital losses is, from the standpoint of the taxpayer realizing both gains and losses, the equivalent of a higher effective rate of tax on gains. For a taxpayer with no gains but only losses, inadequate loss provisions mean a higher effective rate of tax on ordinary income. Proper loss provisions, which from one standpoint avoid taxing capital as income, may from another standpoint be regarded as minimizing undesired tax rate differences among different individuals.

Since the Government shares in the taxpayer's gains, it has been strongly urged that the Government should also share in his losses by granting him appropriate tax concessions. However, what constitutes a reasonable partnership relationship between the investor and the Government is a difficult question. In the case of capital gains and losses, it has sometimes been pointed out that the terms of partnership are inevitably weighted in favor of the taxpayer by the fact that the Government has no voice in the decision as to when to realize gains or losses. This consideration implies that the nominal tax terms of the partnership might appropriately be weighted slightly in favor of the Government in order to counterbalance the control that the taxpayer exercises over timing of realizations. However, the taxpayer's decisions to buy or sell are sometimes made on the basis of factors over which he has no control. Severe loss limitations may, therefore, produce serious hardships in individual cases.

Another view is that the partnership should be parallel on the gain and loss sides of the investment account. Losses should reduce tax liability by the same percentage that a gain of corresponding size would have increased it. This principle will be discussed in detail at a later point in this chapter. It is sufficient here to note that parallelism as thus defined cannot be applied consistently under a progressive rate structure. Many proposals for so-called parallel loss treatment do not in fact approximate this result even roughly.

2. Limit unwillingness to assume risk

A second and also generally agreed objective of tax relief for net capital losses is to minimize undesirable impediments to risk taking. This requires that tax provisions be neutral toward the form which individuals' investments take. Inadequate loss offsets may, in effect, operate to reduce the net yield after tax of the more risky investments. This may shift investments away from new, risky undertakings and equity issues toward more seasoned, stable ventures and debt securities.

In practice, it is difficult to approximate the standard of neutrality since any tax on property income inevitably affects incentives to invest. However, the closer loss offset provisions approach technical perfection, the fewer will be the cases in which capital is actually impaired as a direct consequence of taxation.

3. Increase taxpayer liquidity and ability to reinvest following loss

A third significant purpose that income tax provisions for net capital losses can serve is to ease the financial strain on taxpayers that may accompany realization of losses.

In the area of investment incentives, considerable importance attaches not only to the amount of tax benefit allowed an investor who suffers loss, but also to the timing of this tax benefit. Prompt tax concessions to losses would help restore the ability and willingness of taxpayers to reinvest more quickly than would otherwise be the case.

B. PURPOSES OF LOSS LIMITATIONS

Despite the equity and economic considerations favoring generous allowances for net capital losses in the individual and corporation income taxes, another set of considerations suggests limitations on the deductibility of capital losses from ordinary income.

1. Timing of realization

Limiting the amount that may be deducted from ordinary income on account of capital losses forces some taxpayers to realize gains, if they wish to avoid wasting the tax value of their losses. If losses could be charged more liberally against ordinary income, taxpayers holding portfolios showing both accrued gains and losses might be under less pressure to realize their gains and might continue to postpone tax liability by retaining only their appreciated investments.

Thus, loss limitations influence the timing of realization. They help control postponement of capital-gains tax and tend to increase income-tax revenue. The tax-conscious investor, regardless of loss limitations, will attempt to time realizations of capital gains and loss in such a manner as to minimize his tax liability and to maximize his net gain after tax.

Limiting the extent to which capital losses may be taken against ordinary income but allowing losses to be deducted without limitation from capital gains tends to favor holders of diversified portfolios of capital assets over those who hold only a few properties. Investors who hold only a single capital asset are able, under present law, to offset no more than $6,000 of a net capital loss and that in no more than $1,000 annual installments over a period of 6 years beginning with the year in which the loss is sustained. In some cases, this may not be effective in meeting the taxpayer's financial difficulties. Strict loss limitations are likely (*a*) to produce hardship for some taxpayers with moderate resources and (*b*) to delay or prevent reentry into the capital market by small investors who are forced to liquidate their only asset at a loss.

2. Revenue considerations

The belief that Federal tax revenue should be protected in the event of a severe price decline is the principal basis for the loss limitation provision of existing law. However, with the decline in relative fiscal importance of the capital-gains tax this consideration has become less important. Nevertheless, any of the proposals for substantially more liberal offset of capital losses against current income would undoubtedly have to overcome this revenue objection.

The year 1931 was illustrative of the type of situation out of which the revenue protection reason for capital-loss limitation emerged. In 1931 the tax-reduction value of short-term capital losses was unlimited, but that of long-term losses was restricted to 12½ percent. Due to the precipitous decline in security prices in that year, the net direct revenue loss attributable to net capital losses of individuals is estimated to have been $89 million. That loss represented a much greater threat to tax revenue at a time when all other individual income yielded only $335 million,[13] than it would now when personal-income-tax yield has multiplied many times.

3. Structural defects and tax-avoidance problems

The third reason for imposing limitations on deductibility of capital losses has been to forestall income-tax avoidance likely to result from structural imperfections and unanticipated defects in the technical tax provisions governing capital gains and losses.

Throughout the period of the modern income tax, but especially since the early 1930's, many have felt that short-term capital losses are apt to be more speculative in origin, and more subject to manipulation than are long-term losses. Concern over tax avoidance has resulted not only in special limitations on short-term capital-loss offsets (by requiring, for example, that taxpayers keep these losses segregated from long-term gains and losses, as in 1938–41) but also in provisions for denying income-tax deductions to losses arising from intrafamily sales of capital assets. Special concern has developed over allowing tax deductions in cases of fictitious loss—arising in such transactions as short sales of securities.

The effort to cope with avoidance problems through technical revisions in the tax law has continued.[14] To the extent that these problems can be met directly, it would be more feasible to allow investors with net capital losses equitable terms in which to recover the tax value of their losses. However, more serious problems of tax

[13] See ch. IV, table 2.

[14] For example, the Revenue Act of 1950 made one such revision covering short sales of capital assets. This amendment provided that where a short sale of securities or commodity futures is made and thereafter simultaneous "long" and "short" positions are maintained, so as to give an actual short-term gain the appearance of a long-term gain, the gain will be treated for tax purposes as short-term.

avoidance might develop as a result of allowing larger capital-loss offsets against ordinary income.

C. METHODS OF PROVIDING FOR CAPITAL LOSSES

Alternative methods of providing tax adjustment for capital losses have somewhat different objectives and effects, as the following analysis will indicate.

1. Parallel treatment

A number of proposals for revised tax treatment of net capital losses seek to modify the existing loss limitation by moving once again toward loss provisions more nearly parallel or analogous to the tax rates applied to capital gains. In the case of each such proposal, it is clear that the primary concern is with parallelism for long-term capital gains and losses. There is much less agreement that the treatment applied to short-term gains should be paralleled in case of short-term losses.

Many of the current proposals for postwar revision of the capital-gains tax contemplate a return to parallel treatment of long-term gains and losses. For example, the majority report of the Special Tax Study Committee to the House Ways and Means Committee recommended that, since long-term gains are now effectively taxed at a maximum of 25 percent, long-term capital losses should be allowed to reduce tax liability by 25 percent of the loss.[15]

The persistent opinion that long-term capital gains and losses should be treated in a parallel manner for tax purposes probably stems partly from the belief that the patterns of gains and losses, respectively, are somewhat similar. To a large extent, however, this is not the case. By income-size classes, capital gains tend to be distributed in a manner closely paralleling dividends.[16] This means that as one goes up the income scale, capital gains are consistently a higher percentage of the larger incomes.

Capital losses, on the other hand, are much less concentrated among the larger incomes. In the period 1934–41, approximately 40 percent of aggregate realized capital losses fell on statutory net incomes below $5,000. Another 40 percent fell on incomes between $5,000 and $25,000; hence only 20 percent were realized by individuals with incomes above $25,000.[17]

As previously indicated, the phrase "parallel treatment for capital gains and losses" usually refers to a set of tax provisions under which losses will reduce tax liability by the same percentage that a gain of corresponding size would increase it. This type of parallelism can be achieved only with a flat-rate tax and tax credit; for example, if a taxpayer's ordinary income is high enough to place him continuously in brackets where the maximum alternative rate on capital gains is applied. In this situation a tax credit equal to the maximum rate on gains for capital losses would provide parallel treatment.

[15] Revenue Revision, 1947–48 (hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st sess., pt. 5, p. 3624).

[16] Seltzer, op. cit. This parallel between the income distributions of capital gains and dividends suggests both that security transactions are a major part of the transactions in capital assets on which gains are realized and also that retained earnings are a major source of capital gain.

[17] Ibid. The significance of this distribution must be qualified by the fact that deductible capital losses were limited during this period. It is believed, however, that this does not too greatly exaggerate the concentration of losses among smaller incomes.

This effect is not achieved when capital gains and losses are included in taxable income that is subject to graduated rates. Under a graduated rate structure, since gains taken into account are added to ordinary income and losses are deducted from ordinary income, a taxpayer with a stable ordinary income will tend to pay a higher rate of tax on gains than he receives in tax credit on losses, if the gains and losses are sufficiently large to move him into different tax brackets. When both ordinary incomes and income-tax rates are variable, taxpayers may receive either higher or lower tax benefits from losses than the rate of tax paid on capital gains. However, because gains are more likely to be realized during high-income years and losses during low-income years, the tendency would be for taxpayers to be subject to relatively higher rates on gains. Moreover, under an annual income tax, some portion of the deduction for large capital losses may be wasted unless capital-loss carry-overs are provided.

There is no remedy for this lack of parallelism in the treatment of capital gains and losses under a graduated rate structure, if parallelism is defined as equal amounts of tax or tax credit for equal amounts of gain or loss. The same lack of parallelism exists when ordinary income varies; it is an accompaniment of graduated tax rates and is not peculiar to capital gains and losses. Differences between the tax and tax credit on equal amounts of net gain and loss may be minimized, however, either under a limited system of income averaging that would apply to realized capital gains and losses (100 percent taken into account) and to other sporadic and variable elements of income, or under a general averaging system applicable to all incomes.

The tax on net gains would be minimized and the tax credit for net losses would be maximized, if (*a*) fluctuations in ordinary income over a period of years were averaged out, (*b*) capital losses realized during the period were offset against capital gains realized in the same period, and (*c*) the average net excess of gains over losses were added to average ordinary income or the average excess of losses over gains were deducted from average ordinary income.

The usual type of proposal which purports to provide parallel treatment for gains and losses is therefore defective primarily because of the effect of graduated rates. The tax-reduction value of a loss accrued over several years but realized in a single year will be less than if equal parts of the loss were apportioned to the years of accrual. Just as the lumping of capital gains in a single year tends to push taxpayers into higher surtax brackets and to increase their tax liabilities beyond what they would have been had (*a*) increments of gain been taxed prior to realization or (*b*) the whole gain at time of realization apportioned back to years of accrual, so lumping of losses in a single year tends to push taxpayers into lower brackets and to reduce the tax value of the loss below what it would have been under either accrual or apportionment.

This type of reasoning would appear to point toward a percentage-inclusion structure for long-term losses different both from that provided under present law and from that ordinarily specified in so-called parallel treatment proposals. It would probably be more equitable from this standpoint to allow more than 100 percent of a net capital loss as a deduction from ordinary income, rather than less.

2. Income limitations

The reason for allowing net capital losses to be offset against ordinary income is that since many taxpayers have only isolated transactions in capital assets, the amount of tax relief for capital losses provided by offset against gains alone may be inadequate in these cases. Conversely, the greater the relief available as a result of offsetting capital losses against capital gains, the less will be the need for offset against ordinary income.

Taxpayers with larger ordinary incomes tend to have larger and more frequent capital gains and generally a more favorable relationship between capital gain and loss than do taxpayers with smaller ordinary incomes. It is primarily the lower and middle income taxpayers who require income offset in order to recover the tax value of their capital losses.

The smaller losses are already fairly well provided for in spite of the existing income limitation. Raising the income limitation would affect primarily those middle-income investors who receive inadequate relief under present law. Whether the present $1,000 annual limit of loss that can be taken against income should be maintained, raised to $5,000, as the New York Stock Exchange has proposed,[18] or increased to some intermediate figure is a question which should be determined, in part at least, by deciding on the distinguishing characteristics of the representative taxpayer for whom it is desired to provide a complete loss offset.

Raising the limitation on deductibility of net capital losses from ordinary income would tend to diminish the number of cases in which losses would need to be carried over and thus might not be inconsistent with some shortening of the carry-over period. On the basis of the legislative history of the capital gain and loss provisions, carry-over and income offset have been regarded as essentially substitutes for one another. However, these alternative methods of tax relief are by no means perfect substitutes, due to marked differences in the experience of particular taxpayers with gain and loss. The more frequent a taxpayer's transactions in capital assets and the more successful his investment decisions, the more benefit will he derive from loss carry-over and the less will he require income offset.

Raising the permissible offset of net capital losses against ordinary income would involve some revenue loss directly on account of the better loss recovery allowed taxpayers whose relief is now inadequate. Indirectly, even larger losses in revenue might be involved in the postponement of realizations of gains on appreciated investments by taxpayers who could, under the higher income offsets, recover capital losses against income but otherwise would have done so by cashing capital gains.

If an increased income offset for net capital losses is considered desirable but, at the same time, a uniform maximum income offset for all taxpayers is considered less equitable than one which will vary in accordance with the different circumstances of various taxpayers, consideration might be given to allowing unlimited offset of net capital losses against certain selected elements of ordinary income if

[18] Economic Progress: Tax Revision and the Capital Markets, a tax study submitted by the New York Stock Exchange, October 1947, p. 25.

not against the total. For example, it has been proposed that taxpayers be allowed to offset capital losses against dividends without a limitation just as they can now offset capital losses against capital gains up to any amount.[19]

This proposal would favor those taxpayers who have relatively large amounts of dividend income compared to their capital losses and would discriminate against other taxpayers who do not. It might be preferable to merge all property income (rather than dividends alone) with capital losses if this theory were to be followed. Even this treatment, however, would be unfair to those taxpayers who happened to suffer relatively large capital losses but had insufficient property income to offset them. In general, therefore, liberalization of the offset of capital losses against certain elements of income only is apt to be less equitable than programs for raising the income limitation without regard to the income source.

3. *Carry-over provisions*

The third general method of providing for capital losses is through allowing unused losses to be carried over against capital gains and ordinary income of other years. Carry-overs serve to spread the revenue cost of loss allowances over several years rather than concentrating them in a single year. They also provide more equitable treatment for those taxpayers whose bunched losses would otherwise receive severely limited recognition for tax purposes.

(*a*) *Carry-forwards versus carry-backs.*—From the economic standpoint, adequate carry-over provisions for losses may not only prevent taxation from striking an investor's capital, but may also help the investor to overcome the illiquidity accompanying an unsuccessful investment. Either a carry-back or a carry-forward may provide equitably for taxpayers with fairly stable income. However, carry-backs will favor taxpayers whose incomes are declining, while carry-forwards will favor taxpayers whose incomes are rising.

If a taxpayer is allowed to carry a capital loss backward, that is, to adjust his taxable income for previous years downward, his current position will tend to be made more liquid by prompt refund of an amount of past tax payments based on the size of his capital loss. Carry-forward of losses does not extend this element of current liquidity directly to private investors, although some may nevertheless be motivated to reinvest currently in anticipation of the future tax benefit to be realized from the loss carry-forward.[20]

The economic effects of these alternative policies turn on such questions as (*a*) are private investors or the Government better able to bear the illiquidity that accompanies declining prices and realization of capital losses? and (*b*) how much better will taxpayers respond with new investments if their liquidity is increased by current tax refunds?

So far as the first question is concerned, there would seem to be but little doubt that the Federal Government will be better able to command credit during a time of depression than will the private investor. The second question requires weighing intangibles, but it is conceivable that adding to a taxpayer's liquidity by way of tax refunds may increase his willingness to invest. In other words, current tax refunds

[19] Cf. Lewis H. Kimmel, Postwar Tax Policy and Business Expansion, Brookings Institution, 1943, p. 38.
[20] It may also be noted that, the longer the carry-forward period, the larger the amount of interest lost by the taxpayer on the deferred tax credit. See ch. IX, sec. B.

for capital losses might well operate to increase current investment, although the quantitative relationships involved are unknown.

Generally speaking, provisions that allow capital losses to be carried back will imply a greater administrative burden (opening up returns for previous years, etc.) than provisions that allow losses to be carried forward. Administrative considerations, then, are likely to be in conflict with economic considerations in this connection.

(*b*) *Length of carry-over period.*—If the main reliance for recovery of net capital losses is placed on carry-over rather than on income offset it would seem clearly desirable that the carry-over period be long enough to provide reasonably complete recovery of the tax value of capital losses by a substantial majority of the taxpayers who sustain losses. The exact period that will do this is uncertain. Some indication of the adequacy of different time periods may be obtained, however, from such limited information as is available concerning the year-to-year experience with capital gains and losses of an identical group of taxpayers.

A study of the income-tax returns of more than 13,000 identical families in Wisconsin covering the 7 years 1929 through 1935 reveals that, although nearly 1,500 of these families realized capital gains at some time during the period, a majority of this group, 62 percent, reported gains for only 1 year. Less than 5 percent of the families reported gains for 4 years, and only 1 percent reported capital gains for each of the 7 years.[21] Clearly most persons realized gains infrequently.

Among the more than 1,800 Wisconsin families in this identical returns sample reporting capital losses at some time during this 7-year period, less than half—only 42½ percent—also reported gains. Among the families who reported capital gains for only one year of the seven, 60 percent reported no capital losses.

This evidence is not conclusive, both because the group studied may not be representative of the Nation and the period covered not typical of other periods. Nevertheless, it suggests that, during a relatively short period, capital gains and losses are to a considerable extent realized by different individuals. This in turn suggests that, under a policy of segregating capital losses from ordinary income, no relatively short carry-over period will provide for full recovery of the tax value of capital losses of many taxpayers. In the cases where carry-over will work, a fairly long carry-over period seems to be required.

If gains and losses were to be segregated from income, and losses allowed only to the extent of gains, another method of determining a desirable length of the capital-loss carry-over period might be with reference to the duration of a relatively long business cycle. Not all individuals will find their capital losses compensated by capital gains over a complete business cycle. However, such a carry-over period will provide, in a rough way, for that group of capital losses that are cyclical in origin and "illusory" in nature. Clearly, capital losses resulting from noncyclical price changes might not be fully offset against gains if the carry-over period were limited to one business cycle.

If capital losses are not segregated, but allowed in whole or in part against ordinary income, a carry-over period shorter than the business

[21] Data based on tabulations of Wisconsin State income-tax returns, quoted in Harold M. Groves, Postwar Taxation and Economic Progress, McGraw-Hill, 1946, pp. 213-214.

cycle may suffice to prevent impairment of capital for most taxpayers with moderate portfolios.

On balance, a rather long carry-forward period for unrecovered net capital losses appears not unreasonable either on equity or administrative grounds, so long as the existing limitation on income offset stands. Moreover, a short carry-back, of one or at most 2 years, would assist some taxpayers unable to make effective use of the carry-forward and would increase the proportion of cases in which complete loss offset is possible.

Although the objectives of tax provisions allowing carry-overs of capital losses and of losses from business operations are similar in some respects, the periods used for the two carry-overs need not necessarily be identical. To obtain the same proportion of capital loss utilization as is achieved under the net operating loss carry-over provisions, the two periods should be adjusted to the particular experience of taxpayers sustaining the two types of losses.

The relationship between the carry-over periods for capital and business losses will depend on the frequency of occurrence and the amount of gains available in prior or subsequent years to offset the losses in each case. In view of the Wisconsin experience cited above, segregation of capital losses from ordinary income would require a relatively long carry-over period for such losses to assure full offset. Whether or not this period should be longer or shorter than the business loss carry-over period cannot accurately be determined on the basis of information presently available.

It is known, however, that taxpayers in the lower- and middle-income brackets reporting incomes or losses from business usually receive little or no income from other sources. On the other hand, taxpayers with moderate incomes who report capital gains and losses usually receive them in conjunction with other types of income.[22] Consequently, if capital losses realized by taxpayers with limited capital holdings were allowed to be substantially offset against ordinary income, the length of the carry-over period for such losses need not exceed that allowed for net operating loss purposes, and might even be shorter.

4. *Percentage exclusion and segregation*

Since 1934 preferential tax treatment has been extended to long-term capital gains by scaling down the percentage of gain taken into account for tax purposes. Long-term losses have been similarly reduced by percentage exclusion. In the case of long-term capital gains, percentage exclusion has been justified partly by the desire to reduce the impact of progressive rates on gains accrued over several years but made taxable only in the year of realization. The reasons for applying the same percentage exclusion to long-term losses are less clear but probably derive from the idea of parallel treatment.

Percentage exclusion of long-term capital gains and losses has some definite repercussions on income accounting for tax purposes when the results of all transactions in capital assets are merged. For example, it has meant that the tax-reduction value of net long-term losses to be offset against ordinary income has tended to be less than that of short-term losses of equal size. It has also meant that, when a tax-

[22] See, for example, Studies in Income and Wealth, vol. 9, Analysis of Wisconsin Income, pt. II, pp. 86-90 and 134-136.

payer offsets a long-term capital gain against a short-term capital loss or vice versa, the statutory net balance of capital gain or loss may be fictitious and not representative of the actual result of his transactions in capital assets.

Thus, under present law, a taxpayer who, in a given year, realizes $5,000 of short-term loss and $10,000 of long-term gain, is considered to have neither gain nor loss. If his position should be reversed, so that the $5,000 loss is long-term and the $10,000 gain short-term, his taxable net capital gain is considered to be $7,500 and not the $5,000 which it actually is on a straight accounting basis.

This distortion arising from cross-offsetting the gains and losses from sales or exchanges of capital assets held less and more than 6 months, respectively, would be prevented if taxpayers were required to keep the results of short- and long-term capital transactions separate instead of merging them. It would also be prevented if all gains and losses were 100 percent taken into account and percentage exclusion applied only to the excess of long-term gain over short-term loss.

Tax provisions requiring that short-term capital gain or loss be kept separate from long-term gain or loss would naturally tend to impose an additional limitation on loss offsets, compared to otherwise similar provisions that allow merging of all capital gains and losses when computing tax liability. Hence, as already noted, if segregation is reintroduced, it might be considered desirable at the same time to liberalize income offsets.

Conceivably, taxpayers might be allowed two separate income offsets, for short- and long-term capital losses, respectively, in place of the one now granted. These separate income offsets would not need to be similar in magnitude but might differ depending (*a*) on the amount of relief believed necessary in the case of long-term and short-term capital losses, respectively, and (*b*) on the extent to which it was desired to influence the timing of realization of capital gains by tax provisions.

Historically, segregation of short-term capital losses has been regarded as a method of loss limitation calculated to protect tax revenue, prevent tax avoidance, and extend less favorable tax treatment to the results of speculative activity.

During 1932–33, when losses from the sale of stocks and bonds held less than 2 years could be offset only against gains from such sales, revenue and avoidance seem to have been regarded as more significant considerations than equitable treatment of taxpayers suffering losses. In 1938–41, when short-term losses were again segregated, the intent seems to have been primarily to avoid extending to losses believed to be largely speculative in origin the income offset granted investment losses.

VII. Gift and Death Transfers

Securities, real estate, or other capital assets on which unrealized gains or losses have accrued frequently pass from one individual to another by gift or as a result of death. The tax treatment of these gains and losses is broader than the question of appropriate capital gain and loss provisions in the individual income-tax statute. It also involves the relation of the income tax to gift and estate taxes.

Some students of taxation emphasize that failure of existing law to adjust, at time of transfer, the income-tax liability of the person in whose hands capital gains or losses accrued prior to transfer leaves a gap in the existing tax system. Others either are less concerned about this gap or believe that to close it would raise a constitutional problem concerning the definition of taxable income.

The aggregate volume of capital gain or loss transferred by gift or at death cannot be determined from currently available data; no reporting of amounts of accrued capital gain and loss thus transferred has ever been required for tax purposes.

During the 10-year period 1933–42, gross estates reported for tax purposes averaged more than $2.5 billion per year, while total gifts reported averaged more than $0.7 billion per year.[23] Not all property thus transferred by gift or death represented "capital assets" as the term is used in the Internal Revenue Code but, at the same time, many smaller gift and death transfers of capital assets required no estate or gift tax returns.[24] Hence, these transfers are not included in the figures cited.

Under existing law it is probable that gains transferred greatly outweigh losses in the aggregate. Higher grade investments are more likely to be transferred to heirs while tax considerations favor the transfer of appreciated property and the sale prior to transfer of property that has declined in value. In particular cases, for example, in the intergeneration transfer of ownership of successful family business enterprises, unrealized capital gains may account for the major part of the total value of assets transferred.

A. PRESENT LAW TREATMENT AND PROBLEMS IT RAISES

In accordance with the rule of *Eisner* v. *Macomber* that only realization of gain or loss is a taxable event, under existing law no income tax adjustment is required of a donor or of a decedent's estate for accrued capital gain; likewise, none is allowed for accrued loss included in a gift or death transfer of capital assets. This accrued gain or loss will, however, be reflected in the bases for estate or gift taxation (value at time of transfer). Thus, the gain or loss will affect the amount of gift or estate tax liability, provided the transfer is large enough to come within the scope of these taxes. As will presently be demonstrated, however, omission of gain or loss from the income tax base and inclusion instead in the gift or estate tax base does not leave tax liabilities unaffected.

1. *Basis for determining gain or loss*

Present law provides that the basis for determining gain on property acquired by gift after December 31, 1920, shall be the same in the hands of the donee as the donor, but the basis for determining loss on such property shall be the donor's basis or the fair market value at time of transfer, whichever is lower.[25] In many cases, therefore,

[23] Statistics of Income for 1942, pt. 1, tables, pp. 294 and 309.

[24] Estate-tax returns were required where estates had a value at time of death of $50,000 if death was prior to August 31, 1935, and $40,000 if death was on or after such date. Gift-tax returns were required for 1933–38 where gifts to a single donee within a year exceeded $5,000 and for 1939–42 where such gifts exceeded $4,000. Present-day requirements for filing estate and gift tax returns are $60,000 and $3,000, respectively.

[25] I. R. C., sec. 113 (a) (2). This provision was designed to prevent a person unable to make the most effective use of a capital loss from giving the asset with accrued loss to some other person, usually in the same family, who could use the loss to greater tax advantage. This provision first appeared in the Revenue Act of 1934.

donors will be encouraged to realize accrued losses prior to gift, unless the loss cannot be utilized because of the loss limitation or unless continued family control over the property held is desired more than the tax value of the loss to the donor.

In case of transfers of property at death the adjusted basis to the estate for determining gain or loss is fair market value at time of death or optionally at a later date.[26] Thus, both accrued capital gains and losses are eliminated at death for income tax purposes. This implies a windfall tax benefit to the estates of decedents who transfer properties which contain net capital gains and a tax hardship to estates of decedents who transfer properties which contain net capital losses. The final income tax settlement with a taxpayer at time of death may be considered incomplete, since no account is taken of his accrued gains and losses as of that date.

2. Tax postponement and avoidance

One effect of existing law, therefore, is to furnish owners of appreciated capital assets with an incentive to transfer these assets by gift or at death rather than to realize their accumulated capital gains through sale or exchange prior to disposition of their property and to transfer the proceeds. By transferring appreciated assets, the donor or decedent escapes income tax on the appreciation altogether, although he may, if the transfer is of sufficient size, incur larger gift or estate tax liability which will partially offset his income tax saving. The gift and estate taxes, however, also reach property that has been saved from ordinary income after payment of tax. Thus, despite the fact that higher gift and estate taxes in a sense recover some previously untaxed capital appreciation, capital gains are still favored compared to ordinary income no matter how high gift and estate tax rates may be.

In case of transfers at death, accrued capital gains and losses are not taken into account under the income tax.

In cases of gift of appreciated property, there occurs a shift in the ownership of capital assets and potential continued postponement of tax liability but not complete disappearance of accrued gain from the income tax base. However, the tax liability on the accrued gains will be modified, and in many cases probably reduced, where the donee has a substantially different income position than the donor, provided both are not above the point where the alternative rate on capital gains applies. Moreover, the donee will acquire property subject to potential income-tax liability depending on its previous history. Thus, equal gifts by a donor to separate donees may have different net values after tax even though liquidated simultaneously at the same price.

Postponement of tax on appreciated capital assets in effect reduces the rate of tax on annual accruals of gain by an interest factor and therefore increases the resources of the taxpayer during the interim by the amount of tax postponed plus interest, compared with what these resources would have been if the tax had been levied on an accrual basis.

Although postponement is inherent in the system of taxing capital gain only upon realization, gift transfers greatly lengthen the time

[26] I. R. C., sec. 113 (a) (5). Basis is fair market value at date of death unless executor elects for estate tax purposes under sec. 811 (j), I. R. C., in which case basis is generally the value as of 1 year after death or as of some intermediate date if disposed of during the year.

period over which postponement is possible. In extreme cases, securities or real estate may be passed by gift from generation to generation without ever being brought to account under the capital gains tax. The finality of the opportunity to escape tax by transfer at death undoubtedly discourages older investors from switching out of assets that have appreciated in value.

In general, an owner of appreciated capital assets will find it advantageous to switch investments only if the present value of the excess in prospective yield on an alternative investment over the yield on his present investment exceeds the tax cost of switching. The ability to transfer appreciated assets by gift or death without incurring tax liability tends to reduce the attractiveness of alternative investments even if their prospective yields are substantial.

The preferential features of the existing system of capital gains taxation, namely percentage exclusion and the flat alternative rate, are in a sense amplified by the rules governing realization and basis for determining gain or loss in case of gift and death transfers of capital assets. In substance, a zero rate of tax applies to capital gains on assets held until death. This may be considered inequitable to investors who hold appreciating capital assets either for shorter periods or longer periods that do not terminate in death.

In cases of gift, the carry-over of basis and potential tax liability from donor to donee affords a measure of equity and protects tax revenue somewhat against avoidance. However, it provides for no final income tax settlement with the donor-taxpayer. Moreover, the carry-over of potential tax liability from one person to another in case of gifts is considered by some analysts to be at variance with the basic concept of the individual income tax as a tax on persons according to their net incomes.

If the criterion of realization were set aside and annual or other periodic accruals of capital gains and losses were treated as ordinary income, the degree of tax postponement or avoidance involved in gift and death transfers would be substantially reduced. It would then be limited to the tax value of gain or loss accrued either within the year of transfer or during the longer period elapsing since the latest accrual and tentative tax settlement date. However, if annual or other periodic accruals of capital gain were taxed as ordinary income, transfer of capital assets by gift or death would seem logically to require a final adjustment of the tentative taxes previously levied under the accrual plan.

Because it encourages individuals planning disposition of their property not to sell appreciated assets, present law has been criticized on the grounds that it impedes the free circulation of invested capital funds, freezes older investors into continued holding of assets they might otherwise prefer to dispose of, thus limiting their willingness to undertake different risks, and restricts the supply of securities which have appreciated substantially.[27] Alternative to the view just cited is the opinion that the gift and death gaps in the capital gains tax rather than the tax itself may be responsible for some of the criticisms made against it; according to this view, the existing imperfections in the capital gains tax may also contribute their share to the alleged interference of capital gains taxation with fluidity of capital funds and the claimed destabilizing effects of the tax on prices of capital assets.

[27] See New York Stock Exchange pamphlet, Economic Progress: Tax Revision and the Capital Markets, October 1947, p. 23.

3. Charitable gifts

A special situation exists under present law governing gifts of appreciated capital assets to charity. Not only is no accrued gain recognized to the donor but he is also allowed to deduct the full market value of the donated property at time of transfer up to 15 percent of adjusted gross income for purposes of determining income tax liability. Thus, in an extreme case it is conceivable that a taxpayer might be better off to give an appreciated asset to charity for the resultant income tax reduction than to sell the asset and pay additional tax on his gain.[28]

In general, the effect of present law in ignoring, for income tax purposes, the accrued capital gain embodied in a charitable gift favors taxpayers making such gifts in the form of appreciated property over those giving cash or other property saved from income which was taxed. One method of correcting this discrepancy might be to define gift as falling within the concept of realization. This would require the donor to pay tax on accrued capital gain when he made the gift. Another method might be to require taxpayers giving property to charities to use either their basis for figuring gain or market value at time of transfer, whichever is lower, in determining the value of their income tax deductions on account of charitable gifts.

4. Relation to gift and estate taxes

Although capital gains accrued to date of gift or death are not now taxed as income to the transferring party, a partial offset results from increased estate or gift taxes on appreciated property. The greater the value of appreciated property transferred and the higher the rate of gift or estate tax applicable thereto, the larger is the proportion of the unrealized and hence untaxed capital gain recovered by transfer taxes. This may be illustrated by the following examples.

If a person leaves a total estate of $500,000 (half to his wife and half to his children) of which $400,000 is unrealized capital gain, his estate tax is $45,300.[29] Had he realized his accrued capital gains prior to death and paid tax at the alternative rate,[30] this would have reduced his estate to $400,000 and his estate tax to $31,500. The additional $13,800 in estate tax would represent a partial recovery (in this illustration, 13.8 percent) of the capital gains tax not collected when the gains were transferred unrealized and disappeared from the income tax base.

If this individual's estate were larger and his marginal rate of estate tax therefore higher, relatively more of the "missing" capital gains tax would be recovered. For example, the tax on an estate of $5,000,-000, belonging entirely to a husband and containing $1,000,000 in unrealized capital gain (on which $250,000 tax is avoided by transfer)

[28] Under present law, a single taxpayer with surtax net income of more than $200,000 or a married couple with family income of more than $400,000 (after deduction of the maximum allowable charitable contribution) whose marginal rate of income tax is 91 percent would actually gain by giving capital assets they own which have appreciated as much as 60 percent or more to charity, up to the allowable limit. In these cases the savings in capital gains tax on the appreciation at 25 percent plus the reduction in income tax at 91 percent of the value of the donated asset amount to more than the value of the asset. Of course the taxpayer might be better off by continuing to hold the asset than by either selling it or giving it to charity. Attention was called to the fact that charitable gifts of appreciated capital assets might involve no cost or even a gain, in two pamphlets entitled "Tax Saving Plus Patriotism" and "Appreciated Assets," issued by Golden Rule Foundation in 1945.

[29] This amount is net after credit for inheritance and estate taxes paid to States equal to 80 percent of basic estate tax liability. Under the Revenue Act of 1948 it is the same in both common-law and community-property States.

[30] This assumes that the amount of gain realized by sale prior to transfer is the same as that transferred if no realization takes place.

under present law would be $830,000 (assuming half were transferred to his wife and half to children). Had the capital gains been taken and the tax paid prior to death, the estate tax would have been reduced to $778,750. The higher estate tax in this transfer of appreciated property includes a 20.5-percent offset against the amount of capital gains tax avoided.

The maximum likely offset via estate tax at existing rates is 61 percent of the potential capital gains tax.[31] For example, in the case of a $25,000,000 estate containing $4,000,000 of unrealized gain with a potential tax of $1,000,000, 61 percent of this potential capital-gains tax would be recovered in additional estate tax. As the examples illustrate, only in case of very large estates is the recovery of missing capital-gains tax substantial.

In a gift transfer the same sort of offset may operate. Where property that has appreciated is transferred, the value of the gift and hence the amount of gift tax may be larger than it would have been had the capital assets been sold, tax paid, and the proceeds given. However, since marginal rates of tax are lower on gift than on death transfers, the recovery in the form of additional gift tax of the capital gains tax liability avoided by the donor (but shifted to the donee) will be relatively smaller than in a death transfer of the same amount of gain. Moreover, because of the $3,000 annual exclusion provision in the gift tax, installment gift transfers will provide less offset to tax postponement on unrealized appreciation than will single transfers of the same aggregate size as the series of installments.

Because of the relatively high exemptions and exclusions in the gift and estate taxes, and because the marginal rates of these taxes can now be reduced greatly and the exemptions and exclusions effectively increased in the case of married couples by the property-splitting provisions of the Revenue Act of 1948,[32] in the aggregate only minor offset could be expected from additional transfer tax.

B. PROPOSALS FOR REVISED TAX TREATMENT OF TRANSFERRED CAPITAL ASSETS

1. Constructive realization

Several proposals for revised income tax treatment of gift and death transfers of capital assets have been advanced. One is that such transfers be treated as the equivalent of realization by sale or exchange (at the market values prevailing at time of transfer).[33] Thus, the transferor of capital assets would become liable for tax on any unrealized appreciation accumulated prior to transfer and would receive tax credit for any accrued losses contained in the transfer.

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[31] This takes no account of additional inheritance or estate tax paid to States because untaxed capital gains are transferred at death. These can hardly be considered an offset to the Federal tax on capital gains. The 61-percent maximum possible offset is based on the existing top marginal rate of 77 percent for tentative estate tax reduced by the maximum allowable credit of 80 percent of the basic estate tax (top marginal rate 20 percent) for inheritance or estate taxes paid to States. If State transfer taxes have marginal rates below 16 percent (80 percent times 20 percent), the maximum possible offset might exceed 61 percent.

[32] The Revenue Act of 1948 attempted to equalize the estate and gift tax treatment of property of married couples as between common-law and community-property States. With exceptions in the case of community-property States, transfers between spouses are generally free of tax to the extent of one-half the value of the estate or gift. Moreover, gifts by either spouse to third parties may be ascribed one-half to each spouse. Whether this treatment does in fact equalize treatment between common-law and community-property States may well be questioned.

[33] See, for example, H. M. Groves, Production, Jobs and Taxes, 1944, p. 75, also his Postwar Taxation and Economic Progress, 1946, p. 219; Committee for Economic Development, A Postwar Federal Tax Plan for High Employment, August 1944, p. 31; William Vickrey, Agenda for Progressive Taxation, 1947, pp. 140-141 and 396.

This proposal has usually been associated with programs for full taxation of capital gains as ordinary income and unlimited allowance of capital losses.[34] Despite this association, the treatment of gift and death transfers as realizations might be considered independently of the suggestions for abolition of preferential capital gains tax treatment and simply regarded as a possible revision calculated to reduce the amount of tax postponement and avoidance on capital appreciation occurring under present law, assuming that preferential treatment of long-term capital gains and limitations on the deductibility of capital losses continue.[35]

A variant of the proposal to treat transfers of capital assets as realization would make a donor or decedent's estate taxable on capital gains accrued but unrealized prior to transfer, but would limit tax credit for capital losses primarily to realized losses.[36] This admittedly nonparallel treatment was proposed as a method of checking postponement and avoidance of tax on capital gains transferred and, at the same time, preventing abuse of the device of intrafamily gifts of capital assets with accrued losses as a method of establishing tax deductions. Limited allowance for accrued capital losses at death would be permitted,[37] but no tax credit would be given the donor for accrued capital losses contained in a gift.[38]

In effect, these proposals to treat either accrued capital gains alone or both accrued capital gains and losses as though realized by the fact of transfer are analogous to partial application of the accrual or inventory method of capital gains taxation. Thus, these proposals raise the equity and administrative problems connected with the accrual method, though in a different manner than where accrual is applied either annually or periodically to all taxpayers owning capital assets rather than merely sporadically to those transferring such assets.[39]

Another possible variant of the proposal to treat transfers of capital assets as realizations of the accrued gain or loss would be to apply this principle only in case of death transfers, while continuing to treat gift transfers as under present law (requiring the donee to assume the donor's basis for determining gain). The case for a final income tax reconciliation with a taxpayer at death is perhaps stronger than at time of gift. Moreover, the tax avoidance danger of allowing constructive realization of capital losses is less at death than in the case of gifts.

This dual system would obviously not produce uniformity in the tax treatment of gift and death transfers of capital assets and might prove an undesirable barrier to integration of the two taxes on wealth transfers. The plan might encourage taxpayers holding appreciated assets to distribute them by gift instead of retaining them until death.

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[34] The recommendations of H. M. Groves and the CED (1944) for full taxation of capital gains as ordinary income are conditional upon some reduction of surtax rates and "adequate" provision for income averaging. Mr. Vickrey's proposals also include income averaging. In a more recent statement on tax policy, Taxes and the Budget, dated November 1947, the CED indicates (pp. 59-60) that since lower income tax rates and averaging seem unlikely to be attained in the near future, preferential taxation of capital gains should be retained as the one relief from existing tax deterrents to investment.

[35] This is apparently the thought of Randolph E. Paul. See his Taxation for Prosperity, 1947, pp. 275 and 276.

[36] Henry Simons, Personal Income Taxation, 1938, pp. 209-213.

[37] How this limit would be determined the late Professor Simons did not indicate.

[38] This would merely compel a donor to establish capital losses by sale or exchange in order to receive tax credit. The more limited the tax credit allowed for accrued capital losses at death, the greater would be the pressure on taxpayers to dispose of depreciated assets promptly.

[39] Because the valuation problem applies only to transfers not subject to estate and gift taxes; also because the period of accrual for gains will frequently be long in case of gifts and estates.

It would not restrict the postponement of capital gains tax which is now possible and which in some cases, by successive gifts, may be continued indefinitely, but it would prevent the complete avoidance of capital gains tax now possible through death transfers.

The proposals to tax accrued capital gain at gift or death as though realized raises the constitutional question whether such gain could properly be construed as taxable income within the meaning of the sixteenth amendment. Some attorneys feel that the courts might not uphold the taxation of capital gains accrued to gift or death, in view of the principle formulated by the Supreme Court in *Eisner* v. *Macomber*[40] (that appreciation in the value of capital assets is not income until realized). Others feel that the Supreme Court has already in some cases abandoned the requirement that only realized income is "income" within the meaning of the sixteenth amendment.[41]

Irrespective of the relative merits of such views, there is little doubt as to the constitutionality of imposing an excise tax on such accruals, since it has been held that gift and death are appropriate events for an excise tax which need not be apportioned among the States according to population. Imposition of the excise only with respect to that part of each gift or bequest which represents appreciation in the hands of the donor or decedent would seem to be a reasonable classification for the purpose of the tax. If so, the mere fact that Congress gives to the valid excise the title of an income tax should not render it void. Nor is the difficulty arising from the imposition of surtaxes upon a combination of capital gains at gift or death and admittedly taxable income an insurmountable one.[42]

2. *Transfer of basis*

Because of what some consider the constitutional problem and also the ability-to-make-payment problem involved in applying the doctrine of constructive realization to capital gains and losses accrued at gift or death, the proposal is sometimes made that bequests be treated like gifts and that beneficiaries be required to assume the original basis of the decedent for determining gain or loss.[43] This proposal would restore consistency between the income tax treatment of gift and death transfers of capital assets and would prevent the removal of accrued capital gains at death. However, it would be inferior to constructive realization of gains at gift or death as a curb on tax postponement. Moreover, this proposal would be an additional step away from the basic concept of the individual income tax as a direct personal tax. It would not provide the final income tax reconciliation at death which some consider desirable.

In the event it should be regarded as impractical or undesirable to revise the income tax provisions governing gift and death transfers of capital assets so as to reduce postponement or avoidance of tax on transferred capital gains, strengthening the gift and estate tax structure might help to recover some of the potential tax revenue now lost when appreciated capital assets are transferred. As already pointed

[40] 252 U. S. 189, 40 Sup. Ct. 189 (1920).

[41] See, for example, Capital Gains Taxation, op. cit., pp. 41, 42. Also Stanley S. Surrey, The Supreme Court and the Federal Income Tax, Ill. L. Rev., March 1941, pp. 779-817.

[42] Cf. Powell, Stock Dividends, Direct Taxes and the Sixteenth Amendment, 20 Colum. L. Rev. (1920), pp. 536, 539.

[43] See for example, Capital Gains Taxation, op. cit., p. 37, or Vickrey, op. cit., p. 141. In 1942, a Treasury suggestion would have required the legatee to take the decedent's basis, but would have allowed that basis to be adjusted upward by the amount of estate tax paid on assets which had appreciated. This still appears a not wholly unreasonable formula.

out, where these transfer taxes apply, they provide an incomplete tax adjustment for the unrealized gains and losses transferred. If exemptions and exclusions under the gift and estate taxes were reduced and the rate schedules revised upward, more inclusive and substantial offsets would be realized.

As a partial measure special supplementary estate or gift taxes to apply only to accrued capital gains contained in a transfer might be developed as an alternative to amending the income tax provisions. Transferred capital losses under this scheme would presumably require a supplementary gift or estate tax credit.

C. EFFECTS OF PROPOSALS FOR REVISED TAX TREATMENT OF GIFT AND DEATH TRANSFERS OF CAPITAL ASSETS

1. *Revenue effects*

Since it is probable under present law that larger aggregate amounts of accrued gains than losses are normally involved in gift and death transfers of capital assets, treating these transfers as realizations should produce a net increase in the income tax revenue attributable to the capital gain and loss provisions. It would be difficult to estimate the amount of this increase, however, in the absence of data concerning aggregate capital asset transfers and the structure, by income size classes, of the capital gains and losses included.

Some taxpayers, either after balancing other considerations against the tax incentive to sell capital assets with accrued losses promptly, or in ignorance of tax provisions, undoubtedly do transfer assets with unrealized losses even under present law which allows them no income tax concession for such losses.

If transfers were defined as realizations, not only would loss-taking be delayed in some cases [44] but also some additional net revenue cost would be involved in granting additional income tax deductions to taxpayers who transfer properties on which there are accrued losses. But the revenue increment obtained by reaching capital appreciation which now either escapes income tax altogether (death transfers), or by taxing more promptly that appreciation which becomes subject to income tax now only after postponement (gift transfers), should be substantially larger than the additional loss deductions, thus producing a net increase in income tax yield.

This increase would derive not only from the probability that relatively more capital gains than losses not now covered would be included in the tax base under the broader definition of realization, but also that the additional gains would tend to be more concentrated among larger incomes than the additional losses.

Requiring the donor or the estate of a decedent to pay income tax on capital appreciation contained in his transfer would tend to reduce the total volume of capital assets passed on through gift or death by the amount of this income tax. Thus, in the absence of rate adjustments, the additional income tax liability would tend to reduce gift and estate tax revenues by shrinking the bases of these transfer taxes. The amount of this reduction would, however, be substantially

[44] Because taxpayers would then have the option to take losses either by sale or by transfer. Any delay in loss realization would tend temporarily to increase capital gains tax revenue. At the same time, if this delay meant that fewer losses were wasted because of better opportunities to offset them against gains, revenue might be decreased in the final analysis by the redefinition of realization on the loss side.

smaller than the gain in income tax yield since, as already noted, gift and estate taxes provide only fractional offsets to the income tax not collected when appreciated assets are transferred.[44] The reduction in Federal estate tax base would also imply somewhat lower yields for State taxes on inheritances or estates.

The revenue effects of treating gift and death transfers of capital assets as realizations would naturally depend on whether this change were coupled with existing tax provisions for preferential rates on long-term gains and limited loss offsets or linked with the heavier taxation of capital gains and more liberal loss allowances implied under income averaging. The additional revenue from reaching those capital gains which now avoid tax will obviously be greater the higher are the rates applied to them. Analogously, the cost of allowing capital losses to be constructively realized by transfer will increase with the liberality of allowable loss offsets against ordinary income.

If capital gains accrued to gift or death were taxed but credit for capital losses were limited largely to realized losses, as Professor Simons has proposed, a slightly larger net increase in revenue yield might be expected than from provisions for treating transfers of both gain and loss as realizations. This would result from taxing gains not now reached at all or from reaching gains earlier or more frequently than they are now tapped while granting few, if any, additional deductions for capital losses. However, in many cases (if not in all) it may be feasible for the taxpayer to realize the loss and obtain the tax benefit by selling the asset and transferring the proceeds.

A smaller revenue gain might result from treating only death transfers as realizations, while continuing the existing treatment of gifts, compared with treating all transfers as realizations. This dual system would encourage distributions of property by gift rather than bequest in cases where holders of appreciated assets sought to postpone capital gains tax liability beyond death.

A still smaller revenue gain might be attained if death transfers of capital assets were treated like gifts and the heirs required to assume the decedent's basis for determining gain. In this case avoidance of tax on capital appreciation is controlled at the expense of additional postponement; also the tax value of accrued gains will often be scaled down when these gains are transferred, since transferees probably have lower incomes, on the average, than transferors.

2. *Equity effects*

Treating gift and death transfers as realizations would limit the possibility of income tax postponement on capital appreciation to one generation and would prevent the complete avoidance of capital gains tax possible through death transfers. Accruals of gain or loss that ended in transfer would be treated consistently with those that culminated in sale or exchange. An income tax settlement would be made with each taxpayer transferring property. This settlement would take into account accruals of gain or loss on the transferred property which had not previously affected income tax liability. No such settlement takes place under existing law.

Because all capital gains and losses would eventually be reached for tax adjustment if transfer were defined as realization, whereas

[44] Likewise, the offset to income tax reduction in the form of higher gift or estate tax when accrued capital losses are transferred will be only partial.

now many are not, the tax system as a result of this change might be considered more nearly equitable in effect, both between those taxpayers who have no capital gain or loss and those who do, and between taxpayers who realize capital gains or losses and those who transfer them unrealized. Estates of individuals dying unexpectedly with investment portfolios containing accrued capital losses would receive more favorable tax treatment than they do at present. Estates of individuals dying with investment portfolios containing large accumulations of capital gain would be taxed more heavily than under present law.

Existing law in reality discriminates against individuals who build up estates by saving from ordinary income (after payment of tax) in favor of individuals who save by holding appreciating property until death. The latter group can either amass more wealth over a series of years relative to their income tax liabilities than the former or spend more of their ordinary incomes on consumption and yet build up as large estates as those whose savings were taxed. Constructive realization of capital gains at gift or death would reduce the element of tax discrimination now applying to these two different methods of saving.

If gifts of capital assets were treated as realizations of the accrued gain or loss, certain problems having implications for tax equity would arise from the intrafamily nature of many of these gifts. For example, immediate income tax deductions could be established by the gift of property on which capital losses were accrued, without actually transferring control of the property outside the family.[46]

In the case of transfers at death, it would appear desirable for equity reasons formally to allow deduction of the tax on accrued gains from the value of the taxable estate, since in fact the beneficiaries should obtain bequests not reduced by double taxation. Similarly, the tax benefit of accrued capital losses at death should logically be added to the value of the taxable estate. It would seem less desirable, however, to extend the same treatment to accrued gains or losses transferred by gift.

If death transfers were treated like gifts and the heirs required to assume the decedent's basis for determining gain, the net value after tax of bequests would depend on the original cost or other basis of capital assets in the hands of the decedent. Prolonged postponement of tax liability on capital appreciation would continue to be possible, especially in the case of transfers to family trusts.

3. *Effects on markets for capital assets*

If, when property was transferred, an eventual tax adjustment for capital gain or loss were required, individuals might be more willing to realize capital gains prior to transfer. More shifting out of investments that have appreciated might be expected despite the tax cost involved in these shifts. Some capital in ventures that had once been risky but had turned out to be safe might be freed for another chance in the high-risk area. At the same time, some capital funds now frozen in risky undertakings, due to the tax avoidance possibilities inherent in contemplated transfers of these holdings, would be with-

[46] Unless the provisions of sec. 24 (b) which disallow losses from sale or exchange of property between members of a family were extended also to gifts in the event these were defined as realization and therefore analogous to sale or exchange. This is what is implied in Professor Simons' proposal to give tax credit only to losses realized by sale to a third party prior to gift.

drawn to safer havens. In general, invested capital funds that have appreciated should become somewhat more fluid.

At the same time, allowing income tax credit for capital losses accrued to transfer should reduce the incentive to realize losses by sale or exchange prior to transfer since there would be less possibility of wasting the tax value of the losses. By encouraging earlier realization of capital gains and later realization of capital losses, treating gift and death transfers as realizations should help to increase the supply of securities and other capital assets with increasing prices and to reduce the supply of assets with decreasing prices, thus contributing to greater relative price stability in capital asset markets. This contribution may be minor, however, since there will still remain a substantial tax incentive to realize losses by sale or transfer while holding gains unrealized.

If death transfers of capital assets were treated like gifts, substantially less tax incentive to realize capital gains by sale prior to death would be present. The stabilizing effect of this revision in tax law upon prices of capital assets would therefore be weaker than the effect of treating all transfers as realizations. However, some taxpayers might be reluctant to pass on potential income tax liability to heirs and thus encouraged to sell appreciated property before death, in spite of the opportunity to postpone tax further by transferring the appreciated property.

4. Administrative and compliance effects

Revised income tax treatment of gift and death transfers of capital assets would raise problems of tax administration and compliance that do not now exist. If these transfers were treated as realizations, it would become necessary to determine the original cost or other basis for capital assets contained in an estate. This might be difficult where the assets had been owned for some time and the original records of the decedent were either incomplete or nonexistent. This administrative problem already exists in connection with some gift transfers, with the difference that the living donor may still be available as a source of information when it becomes necessary to reconstruct the basis for determining gain or loss.

This problem of basis reconstruction would also arise if the gift rule concerning gain or loss, either as now written or modified to allow transfer of accrued losses to beneficiaries, were applied to death transfers. In particular cases, the problem of reconstructing the decedent's basis on capital assets in his estate might involve either more or less difficult administrative and compliance problems than the analogous problem now faced by the donee when he realizes gain or loss on the sale or exchange of property acquired by gift. From the administrative and compliance viewpoints, the realization rule would seem to be simpler than the gift rule insofar as the cost basis is concerned.

Treating gift and death transfers of capital assets as realizations of the accrued gain or loss would also raise substantial valuation problems with administrative and compliance implications. Where such transfers are large enough to come within the scope of the estate and gift taxes, valuation at time of transfer is already required and no additional problems would arise in this respect. Moreover, untaxed transfers of readily evaluated assets (such as listed securities) would create no particular difficulty, since fair market value at time of transfer in such cases could be readily determined and audited. It is the now untaxed transfers of such capital assets as real estate, closely held securities, and other forms of personal property, where appraisal is not now required for gift or estate tax purposes but would be for income tax purposes if transfers were considered realizations, that would add most significantly to the administrative and compliance burden.

Where an estate contains capital losses, as for example when an individual dies during a depression, an administrative problem—how to give income tax credit for the capital losses considered realized by death—will arise. The magnitude of this problem might be reduced somewhat by increasing the allowable offset of capital losses against current income in case of death, thus diminishing the number of cases in which settlement with the estate would involve carry-over of unused losses to previous or later years. This change alone, however, would not provide similar relief for taxpayers dying at various times within the income year, and would probably be inadequate in some cases.

An income tax credit at a flat rate for net capital losses accrued at death, such credit either to apply against estate tax liability or to be accompanied by a tax refund, would be an administratively simple method of providing for those capital losses which cannot be offset against current income. Such a flat rate credit might not be considered equitable, however, in its treatment of different deceased taxpayers having varying amounts of net capital loss in proportion to ordinary income. It could also be considered to discriminate against taxpayers who realized large capital losses which were disallowed a few years prior to the dates of their deaths.

Estates might also be allowed the option either to carry unused capital losses backward, say, for 5 years, or forward for a similar period. The carry-back would be consistent with a final income tax settlement with the deceased taxpayer and would increase estate liquidity, but would be administratively inconvenient; it would involve reopening closed returns and recomputing tax liability for previous years. Such a carry-back is implied in proposals for averaging either all income or merely capital gains and other components of income peculiarly subject to fluctuation from year to year. In the event that the estate chooses to carry unused capital losses forward or is allowed only this method of loss recovery, it might be necessary to provide for apportionment of unused losses among the beneficiaries of the estate.

Where substantially appreciated assets are transferred by gift or death, some problems of taxpayer liquidity and ability to meet current tax liabilities might be raised by the fact that both capital gains tax hitherto postponed and transfer tax would be due. In case of gifts this would appear to present no special problem; the donor would always have the option either to increase his liquidity by realizing some of his gains through sale or exchange prior to transfer or to postpone gifts until his liquid assets were adequate to cover both the capital gains and transfer taxes due at time of transfer. In case of death, the possible illiquidity of estates relative to tax liabilities would be more of a problem than it is now. However, some provision for handling this problem already exists in the installment basis of settling estate tax liability. This might conceivably be extended also to income tax liability on account of capital gains.

VIII. Realization Versus Accrual

Under existing law, no tax is levied on capital gain and no tax credit is allowed for capital loss until the capital asset is sold or exchanged and the gain or loss realized. As a consequence, increases and decreases in the value of capital assets, even though attributable to prior years, enter the tax base only in the year of realization.

A. DESCRIPTION OF ACCRUAL PROPOSALS

The principle that capital gain, like ordinary income, becomes taxable only when realized is traditional in income tax procedure; it is rooted in court decisions, tax statutes, and administrative rulings. Despite these legal precedents, from time to time it has been suggested that realization be ignored as the basis for timing tax liability on capital gain or tax credit on capital loss.[47] Under this proposal, taxpayers would be required each year to include in or exclude from taxable income the net accrued gain or loss on capital assets owned, regardless of whether such gain or loss had been realized.[48]

In the past, this proposal contemplated taxation of any capital gain accrued within a year at the full progressive rates applicable to ordinary income. It also implied allowing full offset of currently accrued capital losses against ordinary income. Under this type of annual accrual proposal, all special provisions for handling capital gains and losses at the time of realization, such as percentage exclusion, holding periods, maximum alternative rates, and loss limitations would be eliminated.

In practice, the proposal for an annual tax accounting of capital gain and loss on an accrual basis would require that each taxpayer report, on his income tax return for a given year, the values—at both beginning and end of the year—of all capital assets owned. Any net change in value of his inventory of capital assets during the year would be added to or subtracted from ordinary taxable income.[49] Realizations of capital gains or loss within a year would also be included in the income tax base as a final settlement of the tentative tax adjustments previously made on the accrual basis.

The annual accrual approach to capital gains taxation is intended to achieve a degree of uniformity in tax treatment among recipients of capital gain and loss and recipients of ordinary income and loss which can never be achieved under the present type of capital gains provisions. It would eliminate the tax benefits of the preferential rates now applied to long-term capital gains and would also provide more adequate offsets for losses. Also, by virtue of the fact that gains would be taxed in full as they accrue, the method would prevent

[47] This would require an income accounting for tax purposes at variance with accepted accounting practices. These tend to be conservative about showing value appreciation prior to realization although less reluctant to anticipate losses. In general, the legal definition of taxable income has followed conventional accounting practice.

[48] See, for example, the report of a committee of the National Tax Association in Proceedings, 1915, p. 303 et seq.; the recommendation of the Committee on Taxation of the Twentieth Century Fund, in Facing the Tax Problem, 1937, p. 490; and the Tax Institute panel discussion of Capital Gains Taxation, 1946, pp. 26-28, 95.

[49] In substance, capital assets would be treated like inventories with the proviso that valuation must be on a current basis.

not only complete avoidance of capital gains tax liability but also tax postponement occurring under existing law because the tax settlement with respect to capital gains is deferred until realization.

The view has been expressed that full taxation of capital gains under the accrual plan or other proposals might lessen the need for a tax on corporation profits.[50] The reasoning appears to be that with existing tax provisions, individuals may accumulate wealth without being subject to ordinary income tax rates simply by retaining income in corporations they control. If capital gains (including those transferred by gift or at death) were made fully taxable, such accretions in wealth would be subject to personal income tax rates whether or not "realized" in the traditional accounting sense. In this connection, it is sometimes pointed out that the accrual method is superior to other methods of taxing gains in full at realization (or when transferred by gift or at death) because it eliminates the advantages of tax postponement as well as those of tax avoidance.[51]

B. EFFECTS OF ACCRUAL METHOD ON ASSET PRICES

One possible advantage of the annual accrual method is that it might eliminate some of the effects on prices of capital assets and on the distribution of investment risks attributable to a tax on capital gains levied at time of realization. Some analysts consider these effects undesirable. Others regard them as not strong enough to be significant.[52]

Under the accrual method, no additional tax cost would be involved in shifting from one investment to another. Tax would be due regardless of whether one held the same or different assets provided his portfolio had appreciated. Moreover, investors could not claim to be frozen into continued holding of appreciated assets.

Effects on market prices now attributable to the fact that certain groups of investors hold appreciated assets until they become subject to long-term rates would also be eliminated since these long-term rates would no longer be preferential. Thus, it is reasoned that under annual accrual, capital asset prices would be less subject to disturbance as a result of tax-motivated buying and selling and that capital funds would be more fluid.

It might be noted at this point, however, that the annual accrual proposal would increase tax on the bulk of net capital gains of individuals from at least two to more than three times, at present tax rates. Consequently, to the extent that individuals purchased the assets they now hold because of the tax-saving possibilities of the preferential rates on long-term gains, revaluations in portfolios and in relative market prices might occur. Individuals, who had bought assets for their appreciation prospects and also as a means of getting preferential tax treatment, might tend to shift out of this type of investment into assets with relatively low appreciation prospects and either more stable or higher income yields. A sufficient volume of such shifting would narrow the yield spread among assets of different types.

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[50] See, for example, Facing the Tax Problem, op. cit., p. 477 ff., and Henry C. Simons, Personal Income Taxation, 1938, chs. VII and IX.

[51] For a discussion of various methods of integrating the corporation and individual income taxes, see The Postwar Corporation Tax Structure, Division of Tax Research, Treasury Department (December 1946).

[52] Capital Gains Taxation, op. cit., p. 65.

Some economists would contend that a shift of investment from risky securities to those with relatively stable yields would discourage initiative and innovation and would, in the long run, retard economic progress. Others would maintain that a moderate readjustment in dispersion of yields would be indicative chiefly of a reduction in speculative activity; they would not consider such a development to bear any implication, favorable or unfavorable, for the total rate of capital formation.

The extent of the change in composition of investment portfolios would undoubtedly be less severe than might at first glance appear from contemplating only the increase in tax liability under this proposal. The following reasons appear to be significant in this connection:

In the first place, full deduction of losses from ordinary income under the annual accrual plan would compensate in some measure for the tax increase. This might tend to increase the attractiveness of risky securities for some investors despite the high rates.

Second, evaluations of the income and appreciation prospects of a given capital asset differ. Reductions in demand by one group of taxpayers for what they consider to be assets with high-appreciation prospects would tend to be offset by increases in demand by other groups of taxpayers who consider the same assets good investments for income purposes.

Third, the higher capital-gains tax under the accrual method would tend to be capitalized fairly rapidly, especially for assets traded in established markets. Although relative asset prices may change, such changes will tend to be limited to the transition period during which the adjustment to the new capital-gains tax would take place.

On balance, the accrual plan might result in a somewhat higher level of prices for assets with normal income yields, such as bonds and seasoned stocks, and a lower level for volatile stocks likely to be highly risky or speculative in character. To the extent such market effects appeared, the tax provisions themselves would be a factor originating capital gains and losses.

It is not clear whether total investment would be affected by adoption of the accrual method. Many who oppose the accrual method or other proposals to tax capital gains as ordinary income are concerned about the effects of a tax increase at high-income levels on savings and investment incentives. However, these effects could presumably be offset by a general reduction of ordinary income-tax rates. Proponents of full taxation of capital gains hold that it is sounder tax policy to provide parity treatment for capital gains and other income, and then to correct the rate structure, than to retain preferential treatment of capital gains and force higher taxation of income from investments received in the form of dividends, interest, proprietorship profits, or rents in order to obtain a given total revenue.[53]

C. NEED FOR INCOME AVERAGING UNDER THE ACCRUAL METHOD

The annual accrual method would tend to avoid the bunching of capital gains and losses in the year of realization but would not allow for fluctuations in annual accruals. Because of the progressive rate structure of the individual income tax, a series of tax liabilities and

[53] See Capital Gains Taxation, op. cit., p. 18.

credits on annual accruals of capital gain and loss might not cancel over a period of years even though the accrued gains and losses canceled out over the whole period a capital asset was held.

For example, consider a taxpayer with stable ordinary income, apart from capital gains and losses, who holds a capital asset several years. During some years it appreciates while in others its value declines, but over the total period of holding neither gain nor loss is realized. If tax rates and exemptions remained the same throughout the period, he might nevertheless incur some net tax liability as a result of his ownership of the capital asset. If his income did not put him continuously in the alternative tax area, the tax on the accrued gains might exceed the tax credit for the accrued losses. This follows because, under the assumptions of stable ordinary incomes and stable tax rates, the accrued gains would be taxed at rates equal to or higher than the rates at which the tax credit for accrued losses would be figured (since gains would be added to, while losses would be deducted from, ordinary income).

The foregoing illustration merely indicates that the annual accrual approach to capital gains taxation would not automatically provide perfectly symmetrical tax treatment of capital gains and losses. Furthermore, this imperfection of the annual accrual method would in practice be magnified by the tendency of capital losses to accrue in years of smaller than average ordinary incomes, whereas capital gains would accrue mainly in better than average income years. The accrual system, in other words, might tend to amplify already existing fluctuations in taxable income.

Annual accrual accounting for capital assets, however, would tend to reduce the "lumpiness" of gain and loss compared with inclusion of the full amount of this gain or loss only upon realization. Nevertheless, the application of higher marginal tax rates to gains accruing in high-income years and lower marginal rates to capital losses accruing in low-income years would probably increase the demand for individual income tax averaging.

If the annual accrual plan were in effect, income averaging would be desired both for the purpose of reducing the effective rate of tax on gains accumulated over a period of years and also for the purpose of according more nearly equitable treatment to losses. In the absence of adequate income averaging provisions, liberal carry-overs of unused capital losses might be considered a necessary adjunct of annual accrual since, during periods of falling prices, many taxpayers would have insufficient amounts of ordinary income annually to offset accrued capital losses. Many losses might be wasted during a deep depression.

D. ADMINISTRATIVE AND COMPLIANCE CONSIDERATIONS

The requirement of the accrual plan that capital assets be inventoried and given a current value each year end would raise a difficult valuation problem.

In the case of capital assets for which there are organized markets, such as listed securities, it would be quite simple to establish or verify year-end market values. In the case of other capital assets, such as unlisted and inactive securities, real estate, and durable consumption goods, valuation would be essentially a matter either of accepting current book values or of providing for appraisals. These would involve broad possibilities of controversy and would entail considerable effort and expense for tax administration.

As a practical matter, considerable tolerance might be allowed so far as the precision of the year-end values used to compute annual accruals of gains or loss is concerned. This tolerance could be permitted because valuation errors on any given capital asset would be subject to final adjustment at time of sale or transfer.[54]

Under a relatively stable income tax structure with rates and exemptions not varying greatly from year to year, the book values of capital assets used in business might be an adequate basis for annual accrual in the absence of acceptable market prices. On the other hand, under an income tax with frequent changes in rates and exemptions, the tax consequences of inadequate valuations might be so considerable as to make accurate independent appraisals a virtual necessity. The extent of error or arbitrariness in valuation that would be tolerable would also depend on whether the income tax remained on an annual or were changed to an average income basis. In general, the longer the length of the accounting period for tax purposes the larger the permissible tolerance in errors of valuation without unduly prejudicing the uniformity and equity of the individual income tax.

A tax compliance problem, attributable to the accrual method of accounting for capital gains and losses, would undoubtedly arise out of the burdensome annual inventorying of capital assets. Each taxpayer with one or more capital assets would be required to list on his income-tax return such information concerning capital assets as the descriptions of those held at the beginning of the year, those acquired during the year, those disposed of during the year, and those held at the end of the year. The definition of capital assets under present law is broad enough to include such items of personal wealth as furniture, clothing, automobiles, etc. It would probably be desirable to provide a specific exclusion for most of these items if the accrual method were adopted.

For some individuals the taxation of accrued capital gains as ordinary income would undoubtedly make the problem of meeting current tax payments difficult. The owners of rapidly appreciating capital assets would be required to meet the additional tax liability arising from this appreciation out of other income and borrowing or to realize some portion of their accrued gains in order to pay income tax. If accrued capital gains were very large relative to ordinary incomes the latter might not be adequate to cover living expenses as well as income and capital-gains tax liability.[55] Moreover, the appreciating capital assets might be of a sort, such as real estate, which cannot conveniently be liquidated in part to meet additional tax liability. During periods of substantial appreciation in the value of residential real estate, some owner-occupiers might be forced to refinance their housing or to sell their residences to pay the tax on accrued gains.[56] All of these difficulties may be said to exist in some degree already for ordinary income reported for tax purposes on an accrual rather than a cash basis.

[54] Capital Gains Taxation, op. cit., pp. 26-27.

[55] Under the present system of current tax payment, the accrual method would also raise problems in connection with declarations of estimated income and tax. A more liberal margin for errors of estimate than is allowed under present law would obviously be needed.

[56] Although gains from the sale or exchange of owner-occupied residences and other personal property are taxable under present law, deductions for losses on such property are not allowed. Under the accrual method, the entire tax approach with respect to taxation of gains and losses on such property would have to be changed.

Under annual accrual corporations generally might be under somewhat more stockholder pressure to pay larger dividends so as to provide the necessary liquid funds for taxpayers subject to high rates on accrued capital gains. If corporation dividend policy were sufficiently liberalized, inflated money profits during periods of rising prices might be distributed to a greater extent than warranted by the replacement costs of inventories, plant, and equipment. Growing businesses might be less able than at present to finance expansion by reinvesting earnings. Some possibly could not expand as rapidly as under present law if the owners of their stock could not postpone tax liability on the stock's appreciation.

In the past, securities have accounted for a large proportion of the realized gains and losses reported by individuals under the capital-gains tax. Accordingly, it has been suggested that it might be practicable to achieve most of the benefits of the accrual method by limiting its application to capital assets for which current market prices were available.[57]

Under such a limited application of the plan, a tax premium would be placed on removing presently listed securities from exchanges.[58] This effect would tend to limit the usefulness of the market standard of valuation and, of course, also to disorganize the exchanges. In addition, taxpayers would be encouraged to shift out of appreciated capital assets for which there were current market prices into unlisted securities and capital assets for which there would be no significant public price quotations. The amount of such shifting might be limited, however, by the fact that the full amount of gain accrued in portfolios when annual accrual became effective would be taxed at full progressive rates upon realization.

In view of the difficult problems of valuation involved and the likelihood of valuation errors, the suggestion that if the accrual method be seriously considered, it be combined with averaging of individual incomes, would appear to have some merit. In fact, under averaging, accrued capital gains and losses would perhaps not need to be accounted for annually but only at the end of each averaging period.[59] This raises the question, which will be discussed in the following chapter, whether full inclusion of capital gains as ordinary income when realized under a comprehensive income-averaging system might not be preferable to either annual or periodic inclusion of accruals.

The accrual method would increase the length and the complexity of both personal and corporate income tax returns and require more facilities for checking and auditing in the Bureau of Internal Revenue. A larger number of taxpayers might be involved than those presently reporting realized capital gains and losses, unless the application of the accrual plan were restricted to a relatively small proportion of all capital assets.[60] The administrative and compliance difficulties might be held to outweigh the advantages of the accrual plan in other respects.

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[57] Facing the Tax Problem, 1937, p. 482.

[58] It might be possible to provide some concession for listed securities to prevent their removal from organized exchanges. For example, only 80 percent of the gains could be recognized for tax purposes. Such concessions would, however, raise difficult choice problems for taxpayers and would probably make compliance more, rather than less, difficult.

[59] Unless the period were very long, in which case interest adjustments for the postponed taxes might be preferable to the annual accrual approach. See William Vickrey, Agenda for Progressive Taxation (1947), p. 182, for a discussion of this interest adjustment. Whether or not accrual only at the end of an averaging period could be substituted for annual accrual would also depend on the method of averaging employed.

[60] When only realized gains are taxed individuals do not need to file schedule D unless they have participated in a transaction involving capital assets. Under annual accrual all owners of capital assets would be required to report on them each year.

E. TRANSITION PROBLEMS

Transition from the present basis of capital-gains taxation to the annual accrual basis would raise the difficult problem of how to treat unrealized gain or loss accrued prior to the starting date of the new system. Several different principles might be used for the change over.

One method might be to ignore past accruals of gain or loss and to permit each owner of capital assets to take a new, current basis. This would be simple but also inequitable in that it would distribute windfall tax concessions to holders of substantially appreciated assets while involving hardships to others who had failed for any reason to realize accrued losses.

A second possible method would be to require the taxpayer in the first income year after annual accrual became effective to include all unrealized gain or loss measured from his original basis. This might be considered hard on owners of capital assets containing more than 1 year's appreciation.[61] For example, the first year's tax on urban real estate which had been in a family for several generations might be very heavy.

A third method might be to tax current accruals at current rates and to defer taxing gains which accrued prior to enactment of the accrual system until realization. Antecedent accruals could be taxed either at ordinary rates or under the preferential rates which existed before the accrual system was adopted. This method would allow some taxpayers to postpone sale and to balance the increased tax cost of continued holding (assuming the antecedent accruals are taxed at ordinary rates upon realization) against the possibility of accumulating additional gain.

The second method implies, in effect, a retroactive change in tax rates for investors who do not sell their capital assets prior to the date for change to the accrual system. The third method would also involve a retroactive tax increase, if antecedent accruals were taxed at ordinary rates upon realization.[62] Unless coupled with a system of income averaging, neither method would allow for bunching of antecedent gains and the resulting impact of progressive rates.

F. LEGAL ISSUES RESPECTING ACCRUAL METHOD

Income tax legislation under the sixteenth amendment has consistently assumed that the appropriate time to include the increase in value of an asset in taxable income is generally when the asset is sold or otherwise disposed of. Outstanding among the earlier decisions of the Supreme Court bearing on the concept of taxable income is *Eisner* v. *Macomber*,[63] which held unconstitutional the treatment of stock dividends as income. Under the "realization" principle enunciated by the majority of the Court in its reasoning in the Macomber decision, the accrual method would be plainly unconstitutional. In discussing the concept of income, the Court stated that "enrichment

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[61] If feasible under the effective date of the proposal, many investors might be expected to realize on their investments prior to the change in order to make the gains taxable under the old preferential provisions.

[62] There are, however, many precedents for retroactive tax changes. A recent example is the reduction of individual income taxes applicable to incomes received after January 1, 1948, under the Revenue Act of 1948. The act became law on April 1, 1948. Moreover, any increase in the capital-gains rate is in a very real sense retroactive to the extent that the gains realized after enactment of the change accrued before.

[63] 252 U. S. 189, 40 Sup. Ct. 189 (1920).

through increase in value of capital investment is not income in any proper meaning of the term."

Subsequent decisions have, however, impaired the authority of the Macomber case.[64] The definition which bulked so large in the reasoning of that case is conspicuously absent in the reasoning of later cases, which show an awareness of the need for choice by the Congress in meeting the exigencies of a tax system.[65] The Court's decision in at least one of these later cases [66] applies a concept of income plainly outside the definition of the Macomber decision. While past decisions of the Supreme Court do not, of course, provide conclusive evidence respecting the constitutionality of the accrual method which has never been given the force of law in this country, the Court's recent reasoning apparently does not foreclose an affirmative answer to the question whether the accrual method would be constitutional.

IX. Income Averaging

Three methods of averaging income for tax purposes are of interest in the treatment of capital gains and losses. These three methods may be termed proration, periodic averaging, and cumulative averaging.[67] Proration is the method designed to average a limited group of highly variable or bunched incomes. Periodic and cumulative averaging are broader systems, capable of covering all types of incomes and losses.

Under all three averaging methods, it has generally been contemplated that realized capital gains would be fully included in taxable income and taxed at ordinary income tax rates. For parallelism, realized capital losses would be deductible in full both from capital gains and from ordinary income.

Like the accrual method, averaging may be regarded as making unnecessary such structural features of the current system for taxing capital gains and losses as the holding period, percentage exclusion, the alternative rate, and loss limitations. In addition, most proponents of averaging would treat accrued capital gains and losses on property transferred by gift or at death as realized.

A. DESCRIPTION OF AVERAGING METHODS

1. *Proration*

Under proration, the gain or loss realized from each sale of a capital asset would be spread in equal-size annual increments over the years the asset was held.[68] As previously noted in the historical outline, this method was considered by Congress as an alternative to the optional flat rate or percentage-exclusion types of special treatment. It was rejected in the belief that it would raise difficult administrative and compliance problems.

Another and perhaps administratively more practical form of proration would spread all realized capital gains and losses over a fixed

[64] Rottschaefer, Present Taxable Status of Stock Dividends in Federal Tax Law (28 Minn. L. Rev. 163 (1944)).

[65] See Surrey, Stanley S., The Supreme Court and the Federal Income Tax (35 Ill. L. Rev. 779, 784 (1941)).

[66] *Helvering* v. *Bruun* (309 U. S. 461 (1940)).

[67] This list excludes certain averaging proposals, such as carry-overs of unused exemptions and net operating losses, which are not directly related to the capital gains problem.

[68] Proration is now incorporated in sec. 107 of the Internal Revenue Code, which provides a limited form of averaging for a number of lump-sum items, such as income from personal services rendered over a period of 36 months or more. Under sec. 107, such income may, at the election of the taxpayer, be prorated back over the period during which it was earned, provided that more than 80 percent of the total is received in one taxable year.

arbitrary period of time, such as 5 or 10 years, regardless of the length of time over which the gains or losses had accrued. Under this form of proration, the taxpayer would divide the net realized capital gain or loss in the current year into 5 or 10 equal parts (depending on the length of the averaging period). He would then recompute the tax in each of the preceding 5 or 10 years on the basis of his ordinary net income plus the prorated amount of capital gain or loss at the rates and exemptions applicable in each year. The tax attributable to the capital gain or the tax credit attributable to the capital loss would be determined by the difference between the total taxes actually paid and the new tax liability computed after inclusion of the prorated gains and losses.

The proration technique is usually thought of as involving apportionment of gain or loss backward over time for tax purposes. From an administrative point of view, forward proration might be more practical since it would not require opening prior year tax returns. However, it may be considered more desirable on equity grounds to complete the tax settlement on a given capital gain or loss at the time of realization, when the taxpayer is more likely to have the resources for payment of tax.

An alternative which has been suggested to either forward or backward proration is the following method: Divide the total realized gain or loss by 5 or 10; compute the difference in the current year's tax resulting from the inclusion in taxable income of one-fifth or one-tenth of the gain or loss; and multiply the result by 5 or 10 to obtain the total tax or tax credit.

This method avoids both the problems of opening prior year returns under backward proration, and that of meeting current payments in connection with forward proration. However, it has the disadvantage that the entire tax on gains or tax credit for losses of several years' accrual would be computed on the basis of rates prevailing in the year of realization. This method would, in effect, magnify the importance of current year rates and thus encourage taxpayers to time their realizations in years when the rates would give them the greatest tax advantage.[69]

2. Periodic averaging

Periodic averaging is designed to equalize the taxes of individuals with the same total income, including capital gains and losses, over the averaging period, usually taken arbitrarily to be either 5 or 10 years.[70]

In its most practical form, periodic averaging would retain the present system of annual tax computations and annual tax payment. At the end of the averaging period, the taxpayer would compute the total taxes he would have paid had he received his total income for that period in equal annual installments rather than in fluctuating yearly amounts. If the sum of the annual taxes actually paid exceeded the total recomputed tax liability, the taxpayer would be entitled to a refund or credit against current (or future) tax liability.

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[69] For example, there would be an incentive to realize gains when tax rates are low and when ordinary incomes are low.

[70] Periodic averaging apparently was originally conceived by Henry C. Simons and subsequently endorsed by Harold M. Groves and a number of other tax experts and organizations. See Henry C. Simons, Personal-Income Taxation (1938), pp. 154 and 212; Harold M. Groves, Postwar Taxation and Economic Progress (1946), ch. VIII; Committee for Economic Development, A Postwar Federal Tax Plan for High Employment (1944), p. 30.

To obviate the payment of small tax refunds, most advocates of periodic averaging suggest that refunds be limited to cases where the total of the taxes paid exceeds the total tax recomputed on the basis of average income by some stated percentage (ranging from 1 to 10 percent).[71]

Periodic averaging may be either compulsory or optional. Under the compulsory form of periodic averaging, each taxpayer would be required to recompute his total tax at the close of each averaging period. If this exceeds the total amount actually paid, he would be required to pay the difference.[72]

Under optional periodic averaging, the taxpayer would be permitted to average the income of any 5 or 10 successive years provided the income of any one year is used in only one averaging period. Optional periodic averaging would always operate to the advantage of the taxpayer. He would be allowed to apply for a refund if one were due, but would not be required to make additional payments when the total tax on the average annual income exceeded the total tax paid on the actual annual incomes.

3. *Cumulative averaging*

Cumulative averaging differs from periodic averaging in that it would provide an annual tax adjustment for income fluctuation beginning with the second year instead of only one adjustment at the end of each 5- or 10-year period.

The nature of the annual adjustment may be illustrated as follows: In the first year of the 5- or 10-year averaging period, the taxpayer would pay the tax on the income he actually received in that year. In the second year, he would compute the total 2-year tax liability on the basis of the average income for the 2 years and would pay, or receive a refund for, the difference between this amount and the amount paid the first year. This procedure would be repeated each year, the only additional feature being that the total tax liability would be calculated each year on the basis of a new average income.[73] At the end of the averaging period, the taxpayer's actual net tax payments under cumulative averaging (after refunds) would equal the sum of the annual tax liabilities computed on the assumption that the total income had been received in equal annual installments. Thus, the total tax liability for any given averaging period would be the same under both cumulative and periodic averaging. However, cumulative averaging would, through the process of annual reconciliation, keep the taxpayer current with respect to his tax liability, while periodic averaging would not.

The cumulative plan has been advanced as a compulsory form of averaging, but it could also be operated on an optional basis. If it were made optional, the taxpayer could choose his year of entry into the averaging plan. Once having exercised this option, the taxpayer would presumably not be entitled to revoke it for the duration of the averaging period.

Cumulative averaging might be modified to take account of the interest on the tax postponed by taxpayers who receive most of their

[71] It is also proposed to allow only the excess of the difference in tax over a fixed amount ($10 to $20); or over a fixed amount plus a percentage (say, $20 plus 1 percent of the gross tax). See William Vickrey, Agenda for Progressive Taxation, p. 171.

[72] In general, taxpayers would be entitled to a refund under periodic averaging. Balances would be due to the Government only if tax rates tend to be low in high-income years and high in low-income years.

[73] In the third year, the tax base would be average income for 3 years; in the fourth, for 4 years; and so on.

incomes in the later years of the averaging period. This modification has been proposed for reducing the advantage inherent in postponing the receipt of income, especially where the averaging period is very long.[74]

The operation of the interest modification is illustrated by the following example. Suppose two taxpayers, A and B, start new businesses with the same initial capital investment and earn the same rate of profit on their investments. Suppose further that A realizes the profits from his business in equal annual installments and reinvests the profits left after the payment of tax, while B manages to postpone realization of his profits until the last year of the averaging period. Assuming their incomes from other sources are the same, B's net profit after tax from the investment at the end of the period will exceed A's net profit after tax by the compound interest on the tax which A paid every year. Under the plan to modify cumulative averaging by an interest adjustment, B would be required to pay the total taxes paid by A plus the accumulated compound interest on these taxes.

In most cases, the income of an individual during one averaging period will neither be concentrated in one year nor spread in equal annual installments. To correct for differences in the timing of receipt of income, the plan calls for an interest adjustment to be made along with the cumulative averaging reconciliation at the end of each year. The interest adjustment would be calculated by reference to a pattern of taxes which would be paid annually by a taxpayer who received the same amount of income (including realized capital gains and losses) each year.[75] Thus, at the end of each year of the averaging period, all taxpayers with the same cumulated total income (including compound interest on prior taxes paid) will have made a series of tax payments which would be equivalent when accumulated at compound interest. In practice, the cumulative total tax liability, including compound interest, would be read off a series of annual tax tables which would be arranged in a form similar to that now used in the present surtax table given in the instructions for Form 1040.[76]

B. LENGTH OF THE AVERAGING PERIOD AND TAX LIABILITY

The tax effect that may be attributed to averaging of capital gains and losses will depend on the patterns of individual income tax rates and exemptions and on the size distribution of the ordinary incomes of taxpayers. The nature of these differences may be illustrated by the calculations presented in tables 8 and 9.

Table 8 shows, for various levels of ordinary net income before personal exemptions, the present law effective rates of tax on long-term capital gains received in a single year ranging in size from $5,000 to $50,000. These currently effective rates are compared with the effective rates that would apply if the gain were averaged over 3-, 5-, 10-, or 20-year periods and were taxed as ordinary income. To isolate the tax effect of averaging capital gains over various time periods, the rates and exemptions under the Revenue Act of 1950, for calendar year 1951, were assumed to be applicable throughout, and

[74] This modification was designed by William Vickrey to apply specifically to lifetime averaging. However, it may also be applied to shorter periods. See his Averaging of Income for Tax Purposes, Journal of Political Economy, June 1939, p. 379, and Agenda for Progressive Taxation, pp. 172–195.

[75] It might be noted, however, that the standard pattern could be made to vary with per capita income, cost of living, or other significant variables. See William Vickrey, ibid., pp. 176–178.

[76] Ibid., pp. 172–176.

the taxpayer's ordinary annual net income (i. e., apart from capital gain or loss) was assumed to remain constant.

TABLE 8.—*Effective rate of tax on net long-term capital gains of specified sizes under present law compared with the effective rate of tax on such gains if they were averaged over 3-, 5-, 10-, and 20-year periods and taxed in full at ordinary rates* [1]

MARRIED PERSON—NO DEPENDENTS

Ordinary net income before personal exemptions	Present law tax [2] (percent)	Tax (percent) if averaged over— 3-year period	5-year period	10-year period	20-year period
	$5,000 net long-term capital gain				
$5,000	10.9	21.8	21.6	21.2	20.4
$10,000	13.0	26.0	26.0	26.0	26.0
$15,000	15.2	30.0	30.0	30.0	30.0
$25,000	21.3	42.4	42.0	41.0	39.0
$50,000	25.0	59.0	59.0	59.0	59.0
$100,000	25.0	72.8	72.0	72.0	72.0
$500,000	25.0	91.0	91.0	91.0	91.0
	$10,000 net long-term capital gain				
$5,000	11.3	21.9	21.8	21.6	21.2
$10,000	13.7	26.2	26.0	26.0	26.0
$15,000	16.1	31.4	30.0	30.0	30.0
$25,000	21.7	42.7	42.5	42.0	41.0
$50,000	25.0	59.1	59.0	59.0	59.0
$100,000	25.0	73.0	73.2	72.0	72.0
$500,000	25.0	91.0	91.0	91.0	91.0
	$25,000 net long-term capital gain				
$5,000	13.0	24.0	22.6	21.8	21.7
$10,000	15.5	29.0	27.4	26.0	26.0
$15,000	18.1	34.0	32.2	30.5	30.0
$25,000	23.3	44.0	43.4	42.6	42.2
$50,000	25.0	60.8	60.1	59.0	59.0
$100,000	25.0	74.6	74.3	73.6	72.1
$500,000	25.0	91.0	91.0	91.0	91.0
	$50,000 net long-term capital gain				
$5,000	16.3	28.2	25.0	22.6	21.8
$10,000	18.8	33.3	29.9	27.4	26.0
$15,000	21.2	38.5	34.6	32.2	30.5
$25,000	25.0	48.3	[illegible]	43.4	42.6
$50,000	25.0	61.7	61.0	60.1	59.0
$100,000	25.0	74.8	74.6	74.3	73.6
$500,000	25.0	91.0	91.0	91.0	91.0

[1] Based on rates and exemptions under the Revenue Act of 1950, for calendar year 1951, and assuming that the taxpayers' ordinary annual net incomes before personal exemptions are the same throughout the indicated periods.

[2] Taking into account the 50-percent exclusion and the maximum effective rate limitation on long-term gains.

The figures in table 8 indicate the liberality of present-law treatment of long-term capital gains. The degree of preferential treatment actually accorded long-term capital gains under present law more than compensates for the fact that gains may accrue over periods of time substantially longer than 1 year. The calculations also indicate that, for all but the largest capital gains and at most levels of ordinary income, the length of the time period over which capital gains are averaged appears to make a relatively small difference in the amount of tax on such gains.[77]

[77] Although these conclusions are based on computations which assume that tax rates, exemptions, and the taxpayer's ordinary income remain the same, they are also valid when changes are moderate.

For example, under present law, a married person with no dependents and ordinary annual net income before personal exemptions of $25,000 pays a 21.7 percent tax on a realized long-term capital gain of $10,000 (only 50 percent or $5,000 of which is included in income). If the realized gain were averaged over a period of 5 years and taxed at ordinary rates, the tax would increase to 42.5 percent, or almost double. The tax would be reduced only slightly to 42.0 percent if the gain were averaged over 10 years, and to 41.0 percent if averaged over a period as long as 20 years. In other words, averaging a gain over 5 years instead of 20 years would increase the effective rate of tax on that gain by only 1.5 percentage points, or less than 4 percent.

Lengthening the average period reduces the tax on a realized capital gain only if part of the gain is taxed at higher surtax rates in the shorter period than in the longer period. Averaging, in effect, multiplies the width of each surtax bracket by the number of years in the averaging period. Consequently, with an averaging period of 5 years, a capital gain must exceed five times the difference between the average surtax net income, exclusive of the gain, and the lower limit of the next higher surtax bracket before it is subject to the next higher surtax rate. Since present law surtax brackets are narrowest and rate graduation is steepest in the lower part of the surtax net income scale,[78] important tax differences attributable to relatively short averaging periods would tend to occur at relatively low average ordinary income levels when realized capital gains are large. In such cases, short-period averaging would push the capital gain into higher surtax brackets and the "bunching effect" could be significant.

For example, a married person with no dependents and constant ordinary net income before personal exemption of $5,000 would pay a tax of 21.8 percent on a capital gain of $50,000 if it were averaged over 20 years. If this same gain were averaged over a period of only 5 years, the tax would be increased to 25.0 percent, an increase of 3.2 percentage points, or 15 percent. Further shortening the averaging period to 3 years would increase the tax rate to 28.2 percent or by almost 30 percent.

In contrast, when capital gains are small in relation to ordinary income or when such ordinary income is large, the bunching effect which would occur under the shorter averaging period is less important. Thus, the potential differences in effective rates due to variation in the length of the averaging period may be small at higher income levels, even though capital gains tend to increase as ordinary incomes increase.

The calculations in table 8 indicate that an averaging period of from 3 to 5 years would, in general, be long enough to reduce to tolerable proportions the tax increases which would ordinarily occur under an annual tax from bunching long-term capital gain accruals into the year of realization. Even in the illustrated cases of exceptionally large capital gains, an averaging period of no more than 10 years would be required for equitable results.

Calculations for capital losses somewhat similar to those in table 8 for capital gains are shown in table 9. This table compares the tax

[78] Under the Revenue Act of 1950, the surtax brackets for single persons and married persons filing separate returns are $2,000 wide at the lower end of the surtax scale and increase to a width of $50,000 at the top. For married persons filing joint returns, the surtax brackets are twice as wide because of the effect of income splitting, or $4,000 at the lower end of the surtax scale and $100,000 at the top. Thus, under 5-year averaging, the surtax brackets for married persons filing joint returns would, in effect, begin with a width of $20,000 and end with a width of $500,000. Marginal rates rise by 2 to 5 percentage points in the lower part of the surtax net income scale and by 3 percentage points or less in the upper part. Since the rates are substantially lower at the bottom, the rate of graduation is noticeably greater there than at the top.

credits for long-term capital losses under present law with the tax credit for the same losses if they were averaged over a 3-, 5-, 10-, or 20-year period and deducted in full from ordinary income. It was assumed that the taxpayer has no capital gains which may be used to offset the capital losses or that the indicated amounts of loss are net after the offset against gains.[79]

TABLE 9.—*Effective rate of tax credit for net long-term capital losses of specified sizes under present law compared with the effective rate of tax credit on such losses if they were averaged over 3-, 5-, 10-, and 20-year periods and deducted in full from ordinary income* [1]

MARRIED PERSON—NO DEPENDENTS

Ordinary annual net income before personal exemptions	Present law tax credit [2] (percent)	Tax (percent) credit if averaged over—			
		3-year period	5-year period	10-year period	20-year period
	$5,000 net long-term capital loss—				
$5,000	10.0	20.0	20.0	20.0	20.0
$10,000	12.7	23.9	25.2	26.0	26.0
$15,000	15.0	30.0	30.0	30.0	30.0
$25,000	19.0	38.0	38.0	38.0	38.0
$50,000	29.5	59.0	59.0	59.0	59.0
$100,000	36.0	72.0	72.0	72.0	72.0
$500,000	45.5	91.0	91.0	91.0	91.0
	$10,000 net long-term capital loss				
$5,000	10.0	20.0	20.0	20.0	20.0
$10,000	12.6	23.0	23.6	25.2	26.0
$15,000	15.0	28.2	29.6	30.0	30.0
$25,000	19.0	38.0	38.0	38.0	38.0
$50,000	29.5	59.0	59.0	59.0	59.0
$100,000	36.0	72.0	72.0	72.0	72.0
$500,000	45.5	91.0	91.0	91.0	91.0
	$25,000 net long-term capital loss				
$5,000	4.8	9.1	15.2	20.0	20.0
$10,000	6.0	21.5	22.6	23.3	24.6
$15,000	7.2	25.6	27.4	28.9	30.0
$25,000	9.1	35.6	37.0	38.0	38.0
$50,000	14.2	57.7	59.0	59.0	59.0
$100,000	17.3	72.0	72.0	72.0	72.0
$500,000	21.8	91.0	91.0	91.0	91.0
	$50,000 net long-term capital loss				
$5,000	2.4	4.6	7.6	15.2	20.0
$10,000	3.0	11.3	18.9	22.6	23.3
$15,000	3.6	19.6	25.0	27.4	28.9
$25,000	4.6	31.4	34.6	37.0	38.0
$50,000	7.1	54.8	57.1	58.9	59.0
$100,000	8.6	70.9	72.0	72.0	72.0
$500,000	10.9	91.0	91.0	91.0	91.0

[1] Based on rates and exemptions under the Revenue Act of 1950, for calendar year 1951, and assuming that the taxpayers' ordinary annual incomes before personal exemptions are the same throughout the indicated five periods.

[2] Taking into account the 50-percent exclusion, the maximum $1,000 offset of capital losses against ordinary income and the 5-year carry-over of losses.

[79] In interpreting the calculations in table 9, it should be noted that the tax value of the deduction of losses either under present law or under averaging would depend on the extent to which the taxpayer utilizes the losses to offset short- and long-term capital gains. Under present law, the tax credit for a long-term capital loss which offsets in full a long-term gain ranges from 10 percent (half the first bracket rate of 20 percent) to 25 percent (the maximum effective rate on long-term gains). If a long-term loss is used to offset a short-term gain, the value of the offset ranges from 10 to 45.5 percent (half the top bracket rate of 91 percent). The calculations in table 9 tend to understate the present law tax credit for losses because they show only the tax value of the deduction for capital losses against ordinary income. This understatement is more significant under present law than under averaging, since the present law offset of capital losses against ordinary income is limited to a total of $6,000, after allowing for the 5-year carry-over.

As might be expected, the present law exclusion of 50 percent of long-term capital loss before it is deducted from ordinary income and the $1,000 annual income limitation make a very significant reduction in the tax credit for capital losses. For example, the tax value of the deduction allowed for half of a $10,000 long-term capital loss under present law for a married person filing a joint return with a constant ordinary net income before personal exemptions of $10,000 amounts to 12.6 percent of the loss, after taking account of the 5-year carry-over. If the loss were averaged over a 5-year period and deducted in full, the tax value of the credit for the same loss would be increased to 23.6 percent, or almost doubled.[80]

Table 9 also indicates that the amount of tax credit for capital losses under averaging depends on whether the period is long enough to permit substantially full offset of the loss against ordinary income. For example, a married person filing a joint return with constant ordinary incomes before personal exemptions of $5,000 would receive a tax credit of 20.0 percent for a loss amounting to $10,000, whether it is averaged over a 3-, 5-, 10-, or 20-year period. This tax credit is twice the credit under present law. If this same taxpayer realized a loss of $50,000, the tax credit would be only 4.6 percent of the loss for an averaging period of 3 years, as compared to 7.6 percent for a 5-year averaging period, 15.2 percent for a 10-year averaging period, and 20 percent for a 20-year averaging period.

The very small tax credit for the $50,000 loss under the shorter averaging periods in the foregoing illustration results from the fact that a substantial portion of the loss is wasted. During the 5-year period, for example, the taxpayer received a total of only $19,000 of taxable income (that is $25,000 of net income minus the $6,000 personal exemption allowance for the 5-year period) and, therefore, wasted over 60 percent of the $50,000 loss. Even the 10-year period does not provide full offset for the loss in this case because no tax credit is received for that part of the loss ($12,000) which is wasted because the taxpayer only has a total of $38,000 of taxable net income after allowing for an aggregate of $12,000 of personal exemptions for the 10-year period.

Thus, net capital losses which are large relative to ordinary income provide a special problem that might require either a longer averaging period than might be considered adequate for gains or a supplementary carry-over of unused losses to the next averaging period.

Finally, comparison of tables 8 and 9 indicates that the tax on a given amount of net capital gain under averaging will tend to exceed the tax value of the credit for the same amount of net capital loss. For example, at the $25,000 ordinary net income level, a married person with no dependents would pay a tax of 45.8 percent on a net capital gain of $50,000 under 5-year averaging. But, because of the effect of the graduated rate structure, he would receive a tax credit of only 34.6 percent on a $50,000 net capital loss. As a consequence, if a taxpayer realized a $50,000 net capital gain in one averaging period and a $50,000 net capital loss in the succeeding

[80] It might be noted that permitting or requiring the taxpayer to average a capital loss over a period of years maximizes his tax credit. If he were required to deduct the loss in full against ordinary income in the year of realization before carrying the unused portion back (as under the present system of carry-back for business losses), the capital loss would be offset against income taxable at lower bracket rates. For example, in the above illustration, if the $10,000 capital loss were deducted in full against the taxpayer's $10,000 ordinary income, the tax credit for the loss would amount to only 18.9 percent as against the 23.6 percent computed above under averaging.

period, he would actually pay a net tax of almost 10 percent even though over the 10-year period the capital loss exactly canceled the capital gain.

The assumption of constant rates, exemptions, and ordinary incomes results in an understatement of the difference between the tax on a capital gain and the tax credit for an equal amount of capital loss. Capital gains are generally high when ordinary incomes are high, and capital losses increase both in number and size when ordinary incomes are low. Moreover, if the effective level of individual income tax rates were to increase and decrease along with increases and decreases in the national income, short-period averaging would tend to concentrate net capital gains in high-income, high-rate periods while net capital losses would tend to be concentrated in low-income, low-rate periods. Thus, the basic problems of reducing the effect of progressive rates on capital gains and of preventing the wastage of losses under an annual income tax (whether gains and losses are included on an accrual or realized basis) would not be completely eliminated by averaging. However, these troublesome problems under an annual income tax would be greatly reduced by averaging. They would also tend to become progressively less important as the averaging period is lengthened.

C. EFFECTS OF TAXING REALIZATIONS IN FULL UNDER AVERAGING

Proposals for income averaging require full inclusion of capital gains and losses when realized and the proration of these gains and losses over the averaging period. The realization principle avoids the difficult problems of compliance and administration that are involved in annual valuations of assets. However, the inherent lumpiness of gains and losses would be reduced or eliminated for tax purposes since they would, in effect, be spread evenly over the averaging period.

Proponents of averaging generally recognize that, because of the higher rates effective under their plan, taxpayers might have even greater incentive under averaging than now to realize capital losses and to postpone the realization of capital gains or completely to avoid the capital-gains tax by transferring the gain by gift or at death. For this reason, they recommend that accrued capital gains and losses transferred by gift or at death be treated as realized. This partial accrual accounting of gains and losses would prevent both postponement over more than one life and complete avoidance of the capital-gains tax. This change would, they believe, remove a major inducement for taxpayers to hold capital assets with accrued gains.

Prompt realization of losses and delayed realization of gains during the taxpayer's lifetime would continue to remain profitable under averaging, even if accrued gains and losses transferred by gift or at death were treated as realized. Taxpayers could benefit both by the interest they might earn on the tax credit received for realized losses and by the interest on the postponed tax on unrealized gains. Moreover, realizations would tend to be timed by taxpayers to take greatest advantage of changes in the level or structure of individual income-tax rates.

Proponents of averaging generally believe that these imperfections are not serious enough to warrant abandonment of the realization rule, so long as the possibilities for very long postponement and complete avoidance of the capital-gains tax are removed. Further reduction in the profitability of realizing losses early and postponing the realization of gains would require adjustment of tax liabilities by an interest factor along the lines already described above. That is, taxpayers who received most of their incomes during the early part of an averaging period and who, therefore, paid taxes with funds which might otherwise have been invested would receive a credit for interest on taxes prepaid. Conversely, taxpayers who received most of their income late in the averaging period would be required to pay interest on the tax postponed. This type of interest adjustment would introduce difficult problems of choice for taxpayers and would complicate tax-computation methods, although these complications could be lessened by appropriate tax tables.

The major issue regarding the effects of averaging realized capital gains and losses is whether the substantial increase in the capital-gains tax would "freeze" investors into holding assets with accrued gains.

In the long run, the increased tax on capital appreciation may tend to remove the premium on securities with high-appreciation prospects and to increase the attractiveness of securities with high, stable incomes and low-appreciation prospects. In the short run, the high rates at which capital gains would be taxed under income averaging might deter some portfolio switching on a rising market. At the same time, the fuller offset for realized capital losses against ordinary income under averaging would provide an additional inducement for taxpayers to realize losses quickly, thus making switching on a falling market even more attractive than under present law.

It is sometimes stated that, to the extent tax considerations affect investment decisions, full taxation of capital gains as ordinary income under averaging might raise the highs and reduce the lows of stock market price fluctuations. However, an important consideration to note in this connection is that the smaller turnover of securities on the upswing and the larger turnover on the downswing would affect both the demand and supply sides of the securities markets. If securities were withheld when prices rise, some investment funds would be immobilized and demand might be reduced. If sales of securities were to increase when prices fall, demand might be increased because the liquidity position of sellers would be improved both by the sales proceeds and by the higher and more immediate tax credits for realized losses. The effects already noted of the capital gains tax under averaging on the upswing and on the downswing due to changes in the turn-over of securities would thus tend to be at least partly counteracted in the aggregate by offsetting influences on the demand side.

Even if average prices of securities during cyclical expansions and contractions are not affected, relative prices might be altered. Securities with the highest rates of appreciation will tend to be withheld more than those with little or no appreciation, since the tax cost of switching will increase as the amount of appreciation increases. As a consequence, as average prices increase, securities with high rates of appreciation would tend to become relatively scarcer and their prices higher in relation to others. Similarly, as security prices decrease the supply of securities with the higher rates of depreciation would increase and their prices would tend to fall more than others. Thus, the effects of averaging realized capital gains and losses may be reflected more by a greater dispersion of security prices than by greater over-all cyclical instability in the market.

D. REVENUE CONSIDERATIONS

While averaging may have a significant effect on total revenues, the direct revenue effect attributable to the changes in treatment of capital gains and losses under a broad-based individual income tax will necessarily be small by comparison with that attributable to the averaging of ordinary incomes.[51]

The revenue consequences of averaging ordinary incomes would depend upon the amplitude of fluctuations in income and also on the coverage of the averaging system. If the level of employment and income remained fairly stable and averaging were limited to a relatively few bunched incomes (under proration), the revenue loss would be kept at a minimum. With a general averaging system covering all types and sizes of incomes (under periodic or cumulative averaging), total revenues would be more substantially affected.

Full inclusion of realized capital gains and losses under any of the averaging proposals would tend to increase the yield of the individual income tax during periods of rising prices and to decrease it during periods of falling prices. The net effect on the revenues in the long run would depend on security prices and growth of wealth. With an upward secular trend, revenues would tend to increase provided, however, that capital gains transferred by gift and at death were treated as realized by donors and decedents.

E. COMPLIANCE AND ADMINISTRATION

One of the most important obstacles to the adoption of a general or even a limited form of income averaging is that it would raise difficult problems of compliance and administration.[52] The complications of income averaging result from the fact that tax liabilities in any one year would no longer depend upon incomes, deductions and exemptions of that year. If the averaging adjustment were made periodically every 5 or 10 years, tax computations would involve use of information from five or ten different annual income tax returns and would probably involve several sets of rates and exemptions. Under cumulative averaging, additional computations would be required each year beginning with the second year of the averaging period. However, cumulative averaging would require less extensive record keeping on the part of the taxpayer, since the cumulated amounts of income and taxes paid in prior years of the averaging period could be obtained directly from the last return filed.

Even if averaging were limited to realized capital gains and losses only (that is, under proration), similar problems of compliance would

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[51] More important than the direct revenue consequences of income averaging are its effects on the cyclical sensitivity of the individual income tax. Averaging would, in effect, increase the amount of income subject to tax in the current year during periods of falling income and would reduce it during periods of rising income. Without any changes in rates and exemptions, the yield of the individual income tax under averaging would fall below the present law yield when national income fell and would not rise as high as the present law yield when national income rose. Thus, averaging would tend to improve the counterdeflationary effect and to weaken the counterinflationary effect of the individual income tax. See Richard E. Slitor, The Flexibility of Income Tax Yield Under Averaging, Journal of Political Economy, June 1946, p. 266.

[52] Past experience indicates that the success of a general averaging system depends in large part on such practical considerations. These were among the major considerations which led to the abandonment of general averaging experiments attempted briefly in Wisconsin and Australia. See Report of the Wisconsin Tax Commission, 1934, and Third Report of the Royal Commission on Taxation, 1934, sec. XXXIV.

arise in connection with the computation of tax liabilities of the several million taxpayers, the majority of them with adjusted gross incomes under $5,000,[53] who are likely to realize gains and losses in a 5- or 10-year averaging period.

Although income averaging would increase compliance problems of most taxpayers and the cost of individual income tax administration, it would simplify the computation of tax liabilities with respect to realized capital gains and losses. A major portion of the relatively complicated schedule now required for reporting of capital gains and losses and for the computation of alternative tax would be unnecessary, since the holding period, percentage exclusion, maximum effective rate limitation, and limited income offsets for capital losses would all be eliminated.

Perhaps the most important advantage of income averaging from an administrative and compliance standpoint is that it would substantially reduce the incentive to convert ordinary incomes into capital gains. The recognition of accrued gains as taxable when transferred by gift or at death would be especially important in this connection, since indefinite postponement and complete avoidance of capital gains tax would no longer be possible.[54]

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[53] In 1947, net capital gains or losses were reported on 2.5 million individual income tax returns. Almost two-thirds of these, or about 1.6 million, reported adjusted gross incomes of less than $5,000. (Statistics of Income for 1947, Pt. 1, Preliminary Report, p. 38.) The number of returns with net gains or losses would undoubtedly be substantially larger over a 5- or 10-year period.

[54] It has been argued that a combination of income averaging with "constructive realization" of gains at gift or death would permit outright repeal of a number of troublesome sections of the Internal Revenue Code which are designed to prevent tax postponement or avoidance, such as the provisions with respect to personal holding companies (secs. 500 through 511 and secs. 331 through 340) and the improper accumulation of surplus (sec. 102). See Henry Simons, Federal Tax Reform, Planning and Paying for Full Employment (edited by A. P. Lerner and F. D. Graham), Princeton, 1946, p. 125. However, outright repeal of such provisions would permit, and even encourage, tax postponement during the life of a taxpayer. The gain from tax postponement could be eliminated under income averaging by the type of interest adjustment described above. However, it is doubtful whether the advantage to be gained by adjusting for interest would outweigh the compliance and administrative difficulties involved.

APPENDIXES

Appendix A

Proposals for Revised Income-Tax Treatment of Capital Gains and Losses

This appendix provides an outline of the major proposals that have been advanced during the last few years for modifying the capital gain and loss provisions.[1]

Some of the proposals are included in the comprehensive tax plans sponsored by groups of businessmen during the early postwar period.[2] Others have been offered in the course of recent congressional hearings on revenue revision by representatives of various business groups and trade associations,[3] as well as labor,[4] and professional groups.[5] Also included are recommendations of a special tax advisory committee appointed by the Ways and Means Committee in 1947.[6] The published opinions of a number of individual tax experts are also presented.[7]

In current discussions of basic capital-gains tax revision, the provisions most frequently discussed are the rate of tax, the holding period, the treatment of capital losses, and the treatment of the gain or loss involved in the transfer of capital assets by gift and at death. Proposals regarding the first three of these are presented in this appendix; those regarding transfers by gift and at death are discussed in chapter VII.

A. Rate

Proposals for revision of the rates of capital-gains tax range from complete exclusion of capital gains and losses from the income-tax base (zero rate) to treatment of such gains and losses as ordinary income. Those who recommend eventual elimination of the capital-gains tax generally indicate that they do not expect such a radical change to be made at this time and offer interim recommendations for immediate revision of the tax treatment of capital gains and losses.[8]

It is often conceded that under a progressive tax system, and particularly with the present high level of surtax rates, the treatment of capital gains as ordinary income would be justified only if there were an effective averaging device whereby gains or losses might be spread over several years. Such proposals as have been

[1] It is impractical to cover here all of the numerous postwar tax proposals which have been reviewed in connection with this study. Only the published proposals which appear to be more widely known are included.

[2] For example, the Committee for Economic Development, the Twin Cities Group, and the business committee of the National Planning Association.

[3] For example, the Association of American Railroads, the American Mining Congress, the Chamber of Commerce of the United States, Investment Bankers Association, Machinery and Allied Products Institute, the National Association of Manufacturers, the National Association of State Chambers of Commerce, the New York Board of Trade, and the New York Stock Exchange.

[4] For example, the American Federation of Labor and the Congress of Industrial Organizations.

[5] For example, the American Institute of Accountants, and the Controllers Institute of America.

[6] See Revenue Revision, 1947–48, reports of the Special Tax Study Committee to the Committee on Ways and Means, House of Representatives, November 4, 1947 (Roswell Magill, chairman), H. Doc. 523, 80th Cong., 2d sess.

[7] The chief source for these opinions is Capital Gains Taxation, Tax Institute panel discussion, New York, 1946.

[8] In recommending the eventual elimination of the tax, the chamber of commerce states that such action, along with lower rates of income tax, would mean more transactions and more taxable income and, consequently in the long run, more revenue for the Government and improvement in the general economy (statement of Lawrence A. Tanzer, on behalf of the committee on Federal finance, Chamber of Commerce of the United States, in revenue revision, 1947–48, hearings before the Committee on Ways and Means on proposed revision of the Internal Revenue Code, 80th Cong., 1st sess., pt. 3, pp. 1565-1566).

The New York Board of Trade takes the position that there is a serious question whether from the long-range viewpoint capital gains should be taxed at all or capital losses allowed, but it is felt that this would hardly be the time to make such a radical change if it is decided to make it (statement of M. L. Seidman, taxation committee, New York Board of Trade, Ways and Means Committee hearings, 1947–48, op. cit., pt. 1, p. 71).

The Association of American Railroads also recommends elimination of the tax (postwar tax plan of the Association of American Railroads, prepared by the subcommittee on taxation of the railroad committee for the study of transportation, April 1944).

made for treating capital gains as ordinary income generally make such treatment contingent upon adoption of an averaging system, and in some cases upon reduction of surtax rates as well.[9]

A reduction of the present level of capital gains tax rates is commonly recommended. Business groups which weigh heavily the alleged deterrent effect of the capital gains tax on transactions in capital assets favor such a reduction.

Little discussion is found in the various postwar tax plans either pro or con the present law combination of percentage inclusion and low flat rate. However none of the plans proposes going back to complete reliance upon percentage inclusion for preferential treatment as was the practice during the years 1934 to 1938.

A number of the proposals indicate more concern over the absolute level of the capital gains tax than over the relationship between capital gains rates and rates on ordinary income. In some instances, however, it is suggested that the capital gains tax ought to be reduced proportionately as top surtax rates are reduced.[10] It is also suggested that the maximum effective rate on capital gains be kept in line with the starting rate on individual and corporate income.[11]

One authority expressed the opinion that the present maximum effective rate on capital gains is too low in relation to the ordinary income tax; he would favor changing the relationship of the rates. However, he thought the tax on ordinary income was too high, and he therefore favored leaving the capital gain rate at 25 or perhaps 30 percent, and reducing the rates on ordinary income.[12]

The most frequently proposed rate is 12½ percent—the maximum effective rate in effect from 1922 through 1933. It will be recalled that during those years preferential treatment was extended to long-term capital gains solely by means of the alternative flat rate tax without any provision for percentage inclusion. It is not clear in some of the current proposals whether it is intended to return to the flat rate of 12½ percent and abandon percentage inclusion or whether it is merely intended to reduce the present top effective rate of 25 percent to 12½ percent while retaining percentage inclusion.[13] The latter appears more likely.

Some recommend simply that the present top effective rate of 25 percent on long-term gains be substantially reduced without indicating the specific rate favored.[14] Others recommend a specific low rate, for example, 10 percent.[15]

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[9] The Committee on Economic Development in its 1944 policy statement on taxation recommended that when individual and corporate income tax rates had been substantially reduced and averaging introduced, capital gains should be fully taxable like other income. (C. E. D., op. cit., p. 31). In its 1947 program, however, the Committee took the position that since these conditions had not been met and their achievement seemed some years distant, it is desirable to retain the present preferential treatment of capital gains. (C. E. D. Research and Policy Committee, Taxes and the Budget: A Program for Prosperity in a Free Economy, November 1947, p. 29.)

Harold M. Groves, in his 1944 study, recommended that capital gains and losses be treated as other income if there is adequate averaging for the personal income tax, if full credit is allowed for taxes on undistributed corporate profits, and if personal surtax rates are reduced to reasonable levels. (Production, Jobs and Taxes, 1944.)

The American Federation of Labor recommends that capital gains be fully taxable as other income and capital losses fully deductible provided averaging of income over a 5- or 6-year period is adopted (statement of Arthur A. Elder, consultant, committee on taxation, American Federation of Labor, Ways and Means Committee hearings, 1947-48, op. cit., pt. 3, p. 1130).

The minority report of the special tax study committee to the Ways and Means Committee, submitted by Matthew Woll, November 4, 1947, recommends the treatment of capital gains as other income and the allowance of full deduction of capital losses. Coupled with this proposal is a recommendation that a system of averaging be adopted (op. cit., pp. 61-64).

See, also, Simons, Federal Tax Reform; and Miller, Capital Asset Concept: Critique of Capital Gains Taxation, 59 Yale Law Journal, 837, 1057.

[10] Statement of M. L. Seidman, chairman, Taxation Committee, New York Board of Trade, Ways and Means Committee hearings, 1947-48, op. cit., pt. 1, p. 71.

[11] Statement of James F. Stiles, Jr., Federal Finance Committee, National Association of State Chambers of Commerce, Ways and Means Committee hearings, 1947-48, op. cit., pt. 3, p. 1691.

[12] Enrique Seligman, Tax Institute Panel Discussion, op. cit., p. 94.

[13] The Twin Cities Plan specifically recommends that 50-percent inclusion be retained and included gains be taxed at 25 percent (effective rate of 12½ percent) or as ordinary income, at the option of the taxpayer. (Twin Cities Research Bureau, Postwar Taxes, A Realistic Approach to the Problem of Federal Taxation, June 1944). Others proposing a 12½-percent rate are: the United States Chamber of Commerce (statement of Lawrence A. Tanzer, Ways and Means Committee hearings, 1947-48, op. cit., pt. 3, p. 1566); the Investment Bankers Association (Report of the Federal Taxation Committee, Ways and Means Committee hearings, 1947-48, op. cit., pt. 3, p. 1506); and the American Mining Congress (statement of H. B. Fernald, chairman, Tax Committee, Ways and Means Committee hearings, 1947-48, op. cit., pt. 3, p. 1665).

[14] For example, the National Association of Manufacturers Program for Federal Tax Revision, Ways and Means Committee hearings, 1947-48, op. cit., pt. 3, p. 1473; also the Machinery and Allied Products Institute (statement of George Terborgh, research director, Ways and Means Committee hearings, 1947-48, op. cit., pt. 5, p. 3366).

Mr. Terborgh, in recommending a rate "considerably below the present 25-percent rate," stated that there is more than the usual reason at present for a low rate because of recent price increases and the fact that long-term gains today are in considerable part purely nominal. This special reason, he said, is in addition to the usual reasons, namely that taxation of gains tends to restrict sales of assets and to interfere with the normal process of redistribution among holders.

[15] New York Stock Exchange Report, Economic Progress: Tax Revision and the Capital Markets, October 1947 (prepared by Emil Schram and Franklin P. Cole), p. 25.

A few proposals are found for an increase in the capital gains rate. One group suggests that the 25-percent rate be increased to at least 50 percent.[16] Another report which favors the taxation of capital gains as ordinary income recommends that if that is not done, the capital gains tax rate should be substantially increased.[17]

Some favor retention of the present rate. The Ruml-Sonne postwar tax plan, for example, recommended no change in the rate on the ground that with the present limitation of 25 percent the tax probably does not have an important inhibitive effect on high production and high employment.[18] The Special Tax Study Committee report to the Ways and Means Committee also recommended that the current maximum 25-percent rate be continued.[19]

B. HOLDING PERIOD

Recommendations regarding the holding-period requirements for preferential treatment of capital gains range all the way from complete elimination of the holding-period requirement[20] through retention of the present 6-month requirement[21] to an increase in the period to 1 year[22] or even 2 years.[23]

In some of the discussions the suggestion has been made that several holding periods be provided and the rates be graduated downward according to the length of time the asset had been held. For example, retain the 6-month 25-percent rate provision, but reduce the rate to 20 percent at 9 months, 15 percent at 12 months, 10 percent at 18 months, and so on to no tax after 5 years.[24] Proponents of this plan believe that capital gains arising over a long period of time are of a different character than gains arising in a short period and therefore deserve different treatment. Also, they believe gradual step-downs of rates would result in less interference with transactions since there would be no abrupt cut-off periods. Critics of the plan point out, however, that it is similar to the step-scale plan of percentage inclusion which was in effect from 1934 to 1938. The latter was criticized on the ground that it produced selling resistance which resulted in undesirable security price fluctuations.

C. TREATMENT OF CAPITAL LOSSES

More liberal allowance of capital losses against ordinary income is commonly recommended. Some such proposals are phrased in general language to the effect that deduction of capital losses should be allowed on the same basis that capital gains are taxed without indicating exactly how this should be accomplished.[25] Most proposals, however, relate specifically to more liberal treatment of long-term losses and recommend so-called parallel treatment. Under this principle, the maximum tax benefit from offset of net long-term capital losses against other income would be limited to the maximum rate applicable to net long-term gains.[26]

In most cases, these proposals make no specific reference to short-term losses and it is not clear whether parallel treatment is also recommended for them. An exception is the Twin Cities Plan which recommends that short-term gains and losses be treated as ordinary income and losses. The proposals generally make no reference to loss carry-overs and it is not clear whether the increased allowance

[16] Statement of Stanley Ruttenberg, Assistant Director of Research, CIO, Ways and Means Committee hearings, 1947-48, op. cit., pt. 3, p. 1415.

[17] Minority report, submitted by Matthew Woll to the Special Tax Study Committee to the Committee on Ways and Means, op. cit., p. 64.

[18] Beardsley Ruml and H. Chr. Sonne, Fiscal and Monetary Policy, National Planning Association, Pamphlet No. 35, July 1944, p. 11.

[19] Revenue Revision, 1947-48, op. cit., p. 16.

[20] M. L. Seidman, New York Board of Trade, op. cit., p. 71. Mr. Seidman states that from the point of view of revenue it would seem to be desirable to preserve such a holding period because the 6-month requirement deters owners of property from selling.

[21] United States Chamber of Commerce, op. cit., p. 1566.

[22] Stanley H. Ruttenberg, CIO, op. cit., p. 1415.

[23] Minority Report to the Special Tax Study Committee, op. cit., p. 64.

[24] See the Tax Institute Panel Discussion, op. cit., pp. 91-92, 93.

[25] For example, the recommendation of the National Association of State Chambers of Commerce, Ways and Means Committee hearings, 1947-48, op. cit., pt. 3, p. 1621.

[26] The Special Tax Study Committee to the Ways and Means Committee, for example, which recommends continuance of the current 25-percent maximum rate on capital gains recommends that losses in excess of gains be allowed as a deduction from ordinary income provided that the tax shall not be reduced by more than 25 percent of such losses (committee report, op. cit.). The United States Chamber of Commerce and the Twin Cities Group which recommend reduction of the maximum capital gains rate to 12½ percent propose that the reduction in tax resulting from loss deductions be limited to 12½ percent. Others recommending parallel treatment of long-term losses are: The Controllers Institute of America (Ways and Means Committee hearings, op. cit., pt. 3, p. 1430); and the Machinery and Allied Products Institute (op cit.).

against ordinary income is intended to replace or to supplement the present carry-over.

Little discussion is found with respect to the merits of carry-overs as against more generous allowances against current ordinary income. One authority takes the position that parallel treatment of capital losses has merit from the standpoint of incentives but also has two major weaknesses: (1) gains are bound to be taxed, but losses will not be deductible if the investor has no taxable income, and (2) since the same people do not experience the gains and losses the result of parallel treatment is to accentuate the gains of those who make gains and to accentuate the losses of those who suffer losses. He, therefore, concludes that "long carry-forwards and even long carry-backs of losses are indicated to meet these objections." [27]

Another recommendation for more liberal treatment of long-term capital losses would not limit the tax credit from loss offsets to the rate of tax on gains but would permit such losses to be charged against ordinary income up to the point of reducing income tax liability for the year by one-third or one-half.[28] This suggestion, it may be noted, was included in a list of changes in the tax system which would provide positive inducements to investment.

Others recommend that more liberal treatment of capital losses take the form of an increase in the present $1,000 annual limit of loss that may be offset against ordinary income. The New York Stock Exchange Study, for example, recommends that individuals be permitted to offset their losses against ordinary income to the extent of $5,000 each year.[29] It is said that the present $1,000 limitation, even though combined with a 5-year carry-over, is inadequate in many cases to secure full tax benefit for losses, especially in the case of small taxpayers whose transactions in capital assets are infrequent.

Another variation of the proposals for increasing the allowable capital loss offset against ordinary income is the suggestion that the investor be permitted to offset losses against both capital gains and dividends on common stocks. The basis for this suggestion is that investors in common stock presumably regard both dividends received and appreciation in value as offsets against losses.[30]

Only a few recommendations are found with respect to the treatment of capital losses of corporations. One plan which proposed parallel treatment of long-term capital losses both for corporations and individuals specifically recommended a tax credit limited to 12½ percent which was the maximum rate proposed for capital gains.[31] Another proposal which recommended parallel long-term loss treatment for all taxpayers particularly urged such allowances for corporations and, in addition, recommended that the present carry-over provisions be continued for corporations with respect to the excess of net short-term capital losses over net long-term capital gains.[32]

APPENDIX B

TREATMENT OF CAPITAL GAINS AND LOSSES UNDER THE BRITISH INCOME TAX

Under the British income tax, profits which are considered capital gains and which are called casual profits, are not taxed. No deduction is allowed for capital losses. However, the implications of the statement that the British do not tax capital gains or casual profits are somewhat misleading due to differences between British and American concepts of taxable income in general and capital gain in particular. In general, the British concept of casual profits is narrower than the American concept of capital gains. Therefore, from the American viewpoint the British actually tax as ordinary income some profits which we would consider capital gains. Other profits, which in this country would be taxed as capital gains, are exempt from income tax.

The British concept of taxable income emphasizes its annual or recurrent nature. Profits from occasional trading in securities, from the sale of one's personal residence, or from the sale of an occasional book or article by an author for a lump sum are considered casual rather than recurrent and are not taxed. On the other hand, a frequent trader in securities or real estate might be considered a dealer and his gains taxed as ordinary income. Number or volume of transac-

[27] Lawrence H. Seltzer, Tax Institute Panel Discussion, op. cit., p. 13.

[28] Prof. Sumner Slichter (then chairman of the Research Advisory Committee for Economic Development), What You Should Know About Taxes, Saturday Evening Post, December 23, 1944, p. 23.

[29] Report, op. cit.

[30] Lewis H. Kimmel, Postwar Tax Policy and Business Expansion, Brookings Institution, 1943, p. 37.

[31] Twin Cities Plan, op. cit.

[32] The Controllers Institute of America, Ways and Means Committee Hearings, op. cit., pt. 3, p. 1630.

tions is not, however, an accurate guide. In many cases gains from isolated transactions have been taxed on the ground that they were related to the trade or business of the taxpayer. An author who receives royalty payments rather than a lump sum would be liable for income tax on these payments even though not a professional writer.

British taxpayers report amounts of income derived from different sources under five separate schedules. Thus, rental income is reported on one schedule, wages and salaries on another, and interest on a third. Source payment applies to other types of income than wages, salaries, and dividends under the British system; in other words, their withholding system is more complete than ours. The British income tax schedules are roughly as follows:

Type of income:	Schedule
Rents	A
Farm income	B
Interest on Government securities	C
Profit from trade or business, other interest, dividends	D
Wages and salaries	E

The separate schedules covering different types of income are combined and all computations of tax liability are made by inland revenue representatives rather than by the taxpayer. Assessable or taxable gains, some of which under American practice would be capital gains, are reported under schedule D.

Although the British concept of taxable schedule D income still charges only "annual" or recurrent items, the current interpretation is that gains are taxable regardless of whether or not recurrent provided they are realized in the course of the taxpayer's business or vocation. Those casual gains which are exempt from tax are so exempt less because they are nonrecurrent than because they are unrelated to the trade or business of the taxpayer.

In practice the dividing line between taxable and nontaxable schedule D gains or income is an extremely tenuous one. It does not rest on statutory law but has been developed from customary practice over a century and from a large number of court decisions dealing with specific transactions. The doctrine which has emerged from these decisions is that mere intention to make profits from transactions does not necessarily render these profits taxable provided they are outside the scope of the taxpayer's normal business or occupation. At the same time, many isolated transactions, which by American practice would not be considered related to the taxpayer's usual trade or business, have been ruled taxable.

The distinction between taxable or annual and nontaxable or casual profits has been a frequent source of litigation under the British income tax. That even more cases have not arisen is due chiefly to the fact that, under the British system, the findings of the tax commissioners on questions of fact are, in general, final. The British system allows local tax administrators (inspectors) a considerable degree of discretion in ruling whether particular transactions (which under American practice would give rise to capital gain or loss) are or are not taxable.

In defending tax exemption of casual profits the British reason (*a*) that security speculation is less common in their country than in the United States, (*b*) that their treatment of wasting assets for income tax purposes is stricter than ours and in a sense offsets their leniency toward casual gains, and (*c*) that with their relatively heavier death duties somewhat more of untaxed capital accretion is eventually recovered under their system.

Although the British have consistently adhered to their system of exempting casual profits from income tax, they are by no means satisfied with it, and recognize that it allows a considerable measure of undesirable income tax avoidance. The Royal Commission on the Income Tax, sitting in 1920, condemned the existing distinction between taxable and nontaxable schedule D income and recommended that gains arising from all transactions entered into for profit be made taxable. This recommendation was not followed, however, because it would be administratively impractical to inquire into the intention behind every borderline transaction.

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