THE QUESTION OF TAXING CAPITAL GAINS

I. THE CASE FOR TAXATION[1]

ARTHUR H. KENT*

The issue as to the proper method of taxation of capital gains and losses which includes the question whether such gains and losses should be subject to the income tax at all, has been and will probably continue to be a perennial bone of controversy. The issues involved are not partisan nor, strictly speaking, even political in character. But they have given rise to deep and, at times, bitter differences of opinion, transcending party lines. The controversy is not new, although it has blazed hotly in recent years. It goes back almost to the beginning of federal taxation of incomes under the authority of the Sixteenth Amendment, and so far antedates in point of time the New Deal and New Deal fiscal policies.

Nor has the controversy been peculiarly an American one. This same set of problems has arisen in other countries in which an income tax is an important part of the revenue system. Differences of view similar to those which are evident in the United States exist among students of fiscal problems and policies in these other countries. While their solutions have differed in some important respects from our own, it does not appear that they have worked materially better or have given more general satisfaction. The fact is that the conflicts of interest and of philosophical outlook which are involved are probably too deep-seated to warrant optimism that a solution will ever be found which will satisfy all the important groups and interests affected.

The reason for the universality of these problems is not far to seek. It inheres in the necessity of defining the base to which an income tax is to apply. At the very threshold fundamental differences between schools of economic thought with respect to the concept of income itself are encountered. At least two basic and self-consistent concepts of taxable income have won respectable followings: For convenience these may be labeled the "dispositive" or "expenditure" concept and the "accrual" concept. Neither concept, of course, furnishes an exact measure of true economic income

* A.B., 1917, Univ. of Southern California; J. D., 1925, Stanford University. Member of the California Bar, San Francisco. Formerly Assistant General Counsel, Treasury Department, 1936-1938; Assistant Chief Counsel and later Acting Chief Counsel, Bureau of Internal Revenue, 1934-1936. Professor of Law, University of Chicago, 1927-1934. Contributor to legal periodicals.

[1] The present article is to a large extent a restatement of views presented by the author in a paper published in *The Tax Magazine* for July, 1938, at p. 389. Some passages are virtually identical.

which includes too many intangible and impalpable psychical elements to be practical of use as a tax base.[2] Any attempt to analyze and compare in detail these two general conceptions would be out of place here. Suffice it to say that the "expenditure" concept largely eliminates savings from the tax base. Under it capital gains are not income except to the extent they are spent during the taxable year, but the same is true, for that matter, of wages, interest, dividends, and other sources of gain. Capital losses are of no significance except to the extent they may actually operate to restrict spending in future years. Moreover, the familiar distinctions between income and return of capital are of no relevance under the "expenditure" concept, since it is the fact of spending, not the source of that which is spent, which determines taxability. Consequently, if the "expenditure" concept should ever be adopted, the capital gain and loss problem would disappear.[3]

But there is small chance of any such radical change occurring in the foreseeable future. Whatever its asserted advantages, the man in the street is unlikely to regard as equitable or just, and therefore to accept, a fiscal system under which a wealthy person of miserly disposition, whose fortune is increasing at a rapid rate year after year, may pay less tax than an individual who is spending most of his salary, his principal resource, to support his family. In any event, virtually every country with an income tax has chosen to construct its tax base upon some form of the accrual concept. From the beginning of the income tax the American people have regarded it as equitable to apportion the tax burden among individuals according to what each has been able to accumulate during the taxable year as well as the amount of his spending. Except to the extent that favored treatment has from time to time been extended to capital gains[4] the definition of the personal income tax base has taken a relatively neutral position as between saving and spending. It is true that the personal exemptions and the credit for dependents are based upon the policy of exempting from taxation moderate amounts ordinarily required for necessary forms of consumption and service. To that extent the law may be said in a practical sense to favor expenditure. With this qualification, the tax base may be said roughly to represent the amount of increase, if any, in net worth during the taxable year plus the pecuniary value of personal and family consumption during such period.[5]

[2] Perhaps the ablest and most articulate of American proponents of the "expenditure" concept has been Dr. Irving Fisher.

[3] So, too, the problem of the taxation of corporations, including the treatment of undistributed profits. See *Preliminary Report of the Committee of the National Tax Association on Federal Taxation of Corporations* (1938) 17 *et seq.*

[4] While no statistical evidence has been found, it seems reasonable to suppose that a somewhat higher percentage of capital gains of individuals is saved in some form than is the case with other important sources of taxable income, such as wages and salaries, interest, rents, or even corporate dividends. In the case of trusts, capital gains are very likely to be saved for legal reasons, since state laws usually require, unless the trust instrument stipulates to the contrary, that capital gains shall not be distributed but shall be added to corpus.

[5] SIMONS, PERSONAL INCOME TAXATION (1938) 61, 62. "Accretion to net worth" must be interpreted, in view of judicial interpretation of the Sixteenth Amendment by the United States Supreme Court, to include only *realized* accretions, and not mere paper accruals representing unrealized appreciation in the fair market value of assets. Even with this important limitation, the statement in the text is at best only a crude approximation of the realities in individual cases, since it takes no account, *inter alia*, of the

Many—probably a majority—of those who advocate either the exclusion of so-called capital gains and losses from the income tax base or a special and favored tax treatment of capital gains, accept in general the "accrual" concept of income and would not favor a thoroughgoing shift to the value of spending or consumption as a tax base. But for various reasons, chiefly supposed adverse economic repercussions and effects, they insist that capital gains should not be taxed as ordinary income. They are not agreed upon any particular method of taxation, but fall into three general groups: (1) those who point to the British system as a model and favor the complete exclusion of so-called casual or non-business capital gains from the income tax base;[6] (2) those who believe that capital gains and losses should be completely segregated into a separate basket or schedule and taxed either at a flat rate or under graduated rates much more moderate than the rates applicable to "ordinary" income;[7] (3) the group which has had the greatest influence on legislative policy, consisting of those who believe the capital gains represent to some extent tax-paying ability and should pay some tax, but who believe that it is wise policy for economic reasons to restrict the maximum effective rate of tax on capital gains to a moderate percentage, such as 12½%.[8]

Before attempting to weigh on their merits the arguments *pro* and *con* for the various points of view, it would be well to summarize briefly the evolution of federal tax policy with respect to capital gains and losses in its vacillations and permutations throughout the long series of revenue acts.[9] It may be noted also in passing that a great majority of the states which have a tax on net income regard capital gains as ordinary income, probably for the reason that the relative lowness of the state rates has saved state legislatures from the pressure of those groups which have been successful in influencing Congress to eliminate the application of the higher surtax brackets to capital net gains.[10]

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various forms of tax-exempt income nor important sources of enrichment, such as legacies, gifts, and other gratuitous receipts, the constitutional status of which has never been adjudicated under the Sixteenth Amendment because of the settled legislative policy to exclude them from statutory gross income.

[6] A leading proponent of this point of view is Mr. Morris Tremaine. See Tremaine *The Capital Gains Tax* (1937) 15 TAX MAGAZINE 517.

[7] The clearest and most persuasive presentation of the case for segregation is found in an article by L. H. Parker, *Capital Gains and Losses* (1936) 14 TAX MAGAZINE 605.

[8] For an exposition of this point of view, see Alvord, *Capital Gains and Undistributed Profits Taxes* (1938) 16 TAX MAGAZINE 145.

[9] This summary takes account only of the personal income tax. As regards corporations, they were taxed in full on their capital gains until 1932 and allowed to deduct all their capital losses. In 1932 and 1933 the limitation with respect to losses on stocks and bonds applied. From 1932 to 1939, corporate capital gains were taxed in full, but from 1934 to 1939, deduction of corporate capital net losses was limited to $2,000. Under the Revenue Act of 1939, amending the Internal Revenue Code, capital gains are taxed in full. In the case of corporations other than foreign personal holding companies and personal holding companies, short-term capital losses are allowed as a deduction only to the extent of short-term capital gains, with a one-year carry-over allowed for a net short-term capital loss, while a full deduction is wisely allowed for long-term capital losses. However, a net long-term capital net loss is not allowed to be included in computing the amount of the net operating loss carry-over happily restored to the income tax law by §211 of the Revenue Act of 1939, INT. REV. CODE, §122.

[10] For an illuminating summary of the status of taxation of capital gains in the states, prepared as of 1938, see Table II in *Report of Committee on Taxation of Capital Gains*, NAT. TAX ASS'N, PROCEEDINGS, 1938, p. 806, at pp. 815, 816.

It should be observed at the outset that the statutory definition of capital gains and losses has been quite uniform and stable throughout the years. In general, a capital gain or loss has been defined as the difference between the realized selling price and the cost of any asset[11] except stock in trade and, since the 1938 Act, property of a kind subject to the statutory allowance for depreciation. Beginning with the Revenue Act of 1938 certain losses formerly regarded as ordinary, *viz.*, losses sustained in the taxable year on account of stock becoming worthless and certain categories of bad debts (corporate bonds, notes, etc.) ascertained to have become worthless during the taxable year and charged off, have been included in the category of capital losses. Also in certain years the definition of capital asset has excluded assets held for less than a specified minimum period, so that gains from the sale or exchange thereof would constitute ordinary income, while losses therefrom were subjected to more or less arbitrary limitations as regards deductibility.[12]

From 1913 to 1921 capital gains were taxed as ordinary income, while prior to 1918 no deduction of capital losses was provided. From 1918 to 1921 capital losses were deductible in full. Until the sharp increase in income tax rates which came with the war, the capital gains controversy was relatively quiescent despite the manifest unfairness of the early acts in allowing no deduction for capital losses. After the conclusion of the war, as the result of a furious struggle in Congress during the consideration of the 1921 Act, that body was finally persuaded that the very high rates of tax then in effect were obstructing the proper functioning of the capital markets and the orderly marketing of capital assets. It was therefore provided in the 1921 Act that the rate of tax on gains realized on capital assets held more than two years should not exceed a maximum of 12½%, while gains realized on assets held less than two years should be taxed as ordinary income, presumably because such gains were thought to be chiefly the result of speculative as distinguished from investment transactions. The foregoing method of taxing capital gains, characterized by a *ceiling* of 12½%, remained in effect unchanged until the enactment of the Revenue Act of 1934, but the treatment of losses underwent several changes during this period. Under the 1921 Act such losses were deductible in full, except if realized on assets held less than two years. The 1924 Act made capital losses deductible in full, except that, if realized on assets held over two years, they were limited in their effect on the tax to 12½% of the loss. Thus there was created a correlation between the treatment of gains and losses and a superficial symmetry in the statute, but this limitation on losses was defensible only from the point of view of the revenue in order to offset, at least in part, the concessions made with respect to gains, since the taxpayers benefited by the generous treatment of gains were not necessarily the same as those disadvantaged by the limitation on losses.

Save for certain additional limitations on losses on stocks and bonds held for less

[11] In certain cases, such as that of an asset owned on March 1, 1913, the basis may be other than actual cost.

[12] For a graphic table showing this legislative history for the years up to and including 1938, see *Report of Committee on Taxation of Capital Gains, supra* note 10, Table I, at p. 814.

than two years,[13] introduced by the Revenue Act of 1932, the above scheme remained in effect for ten years, or until the enactment of the Revenue Act of 1934, when an entirely new method of dealing with capital gains and losses made its appearance. Its principal features, other than certain unfortunate limitations with respect to the deduction of capital losses which were the natural result of the critical need for revenue and other conditions then existing, were two: (1) it ameliorated the anti-progressive character of the earlier law by measurably reducing the advantages enjoyed by individuals in the higher surtax brackets; (2) it brought the portion of the capital gain taken into account into net income, where it was then taxed under the same normal and surtax rates applicable to other forms of income. The percentage of gain or loss taken into account varied according to the length of time the assets had been held, running from a maximum of 100% per cent on assets held for not more than one year, by rather sharp drops, to a minimum of 30% with respect to assets held for more than ten years. Deduction of capital losses was limited to the amount of the capital gains for the taxable year, plus not to exceed $2,000. These percentage brackets were the product of an earnest effort to adjust the tax burden in the year of realization roughly to what it would have been if taxes had been paid each year on the amount of the appreciation accruing in that year, assuming the appreciation had taken place at a uniform rate throughout each year of the holding period.

The 1934 scheme lasted for only four years and went into the discard almost completely when the capital gain and loss provisions again underwent radical surgery in the Revenue Act of 1938. What was thought in 1934 to be the best feature of the new method then adopted, *viz.*, the device of the percentage brackets to offset the inequities of the realization doctrine in the case of casual and intermittent gains, proved, ironically enough, its chief weakness in 1938 because of its alleged effect in influencing artificially the holding and/or sale of securities. The 1938 scheme, with certain additional admirable changes affecting only capital losses of corporations in the Revenue Act of 1939, is still operative. In its main outlines, it closely resembles the plan which was in effect for ten years or more prior to 1934 and which was discarded as unsatisfactory by the Congress in that year.

Under this scheme, on the gain side, 100% of the gain is taxed as ordinary income if the asset is held for less than 18 months. But with respect to assets held for between 18 and 24 months, only 66⅔% of the gain can be taken into account, and the maximum tax cannot exceed 20% of the total gain in such category, while in respect of assets held for over 24 months, only 50% of the gain is taken into account and the maximum tax cannot exceed 15% of such total gain.[14] This maximum rate of tax on long-term capital net gains, 15 to 20% according to the holding period, is to be contrasted to a possible maximum rate (normal and surtax) of 79% on other or ordinary income under the present law, whereas during the greater part of the decade prior to 1934 the then maximum rate of 12½% on long-term capital gains

[13] See Revenue Act of 1932, §22(r).

[14] See INT. REV. CODE, §117(c)(1).

contrasted with a maximum rate (normal and surtax) of but 25%. The 1938 Act also liberalized greatly the treatment of losses. Short-term losses are deductible only against short-term gains, but a carry-over of one year of short-term net losses is provided. With respect to long-term losses the same percentages are taken into account as in the case of gains, except that the effect on the tax which the allowance of such percentages may produce is the minimum rather than maximum.[15] That is, the allowance of a long-term capital net loss cannot operate to reduce the tax otherwise payable by more than 20% of the full loss, in the case of an asset held from 18 to 24 months, or 15% of the full loss if held for over 24 months.

What are the principal arguments advanced in opposition to the inclusion of capital gains in taxable net income and/or in support of the 1938 revision? The first of them is that capital gain is not income at all and hence is not properly includable in an income tax schedule. This argument is hardly of sufficient importance or merit to warrant extended rebuttal. It usually assumes as its major premise, whether articulate or inarticulate, a definition or concept of income from which capital gain has been conveniently excluded. It flies in the face of numerous decisions by the United States Supreme Court defining the income upon which the Sixteenth Amendment authorized Congress to levy an unapportioned tax as including gain from the sale or exchange of capital assets. It is submitted that this interpretation reflects credit upon the wisdom and good sense of the Court. Capital gains are income because the layman thinks they are, whether such gains result from transactions motivated primarily by speculative or investment considerations. Such gains do not seem to differ in any essential respect from gains derived from other forms of economic activity, when viewed from the point of view of ability to pay, the most common ground of rationalization of graduated personal income taxes. It does not alter these fundamental realities merely to call capital gains "accretions to capital" or the like. As a matter of fact, it now appears that the Sixteenth Amendment was not necessary to enable an unapportioned tax to be levied upon gains realized upon the sale of assets,[16] although, by virtue of *Pollock v. Farmers' Loan and Trust Company*,[17] the Amendment was necessary to enable such a tax to be laid upon interest, rent or dividends resulting from the ownership of such assets.

Another and much more weighty argument is that the taxation of capital gains is inequitable because the appreciation in value of an asset realized by a sale or exchange is often fictitious. Passing over the difficulties inherent in the concept of realization—difficulties overshadowed, however, by those which would arise were that concept to be wholly abandoned—it is true that appreciation in value may be due to the action and interaction of a host of very dissimilar factors. Among these may be mentioned changes in the purchasing price of the dollar, reflected in fluctuations in the price levels of commodities; changes in the gold value of the monetary unit resulting from devaluation or other measures of national fiscal policy; accretions due in whole or in part to the passage of time, such as growth of crops or the de-

[15] See *id.* §117(c)(2).

[16] Willcutts v. Bunn, 282 U. S. 216 (1931).

[17] 157 U. S. 429 (1895); 158 U. S. 601 (1895).

velopment of new processes; accumulation of corporate earnings, reflected in the higher market value of corporate securities; changes in the relative value of property due to factors beyond the owner's control, which are reflected either in partial obsolescence or unearned increment; and discounting of anticipated increase in earnings. It is apparent that the significance of appreciation in value, from the point of view of ability to pay, varies widely according to which of these factors such appreciation is attributable.[18]

But it can scarcely be denied that gains which result from appreciation for which factors other than changes in the purchasing power or gold content of the dollar are responsible are real gains and afford a true measure of ability to pay. It is to be regretted that practical considerations seem to exclude allowance for monetary fluctuations in the computation of capital gains and losses.[19] But the overwhelming difficulties in practical administration which would flow from any thorough-going attempt to allow for monetary fluctuations in the computation of taxable net income are too obvious to require elaboration here.[20] While monetary instability and the resulting fluctuation of price levels undoubtedly interfere with the equitable operation of highly graduated surtaxes on annual incomes, these are problems which must be solved, if at all, on their own ground and not by tinkering with the tax laws.

Furthermore, it is incontestable that a rigid system of computing net income and net losses on an annual basis works as serious inequity and hardship in many other situations as in the case of irregular or fortuitous capital gains and losses. Instances of this not uncommon situation are the professional man reporting on the cash basis and receiving in one year a very large fee for winning a case on which he has worked for several years, or the author or composer who receives large royalties for a year or so from a best seller, or other cases where incomes are temporarily inflated through the receipt of rewards for services having greater or less social value. Surely such cases weigh at least as heavily in the scales of equity as those of individuals who derive a large gain through the employment of capital in a fortunate investment or speculation. It would seem wiser policy to seek mitigation of such inequities generally by perfecting devices for averaging fluctuating incomes over a period,[21] thus levelling off the hills and valleys, than to single out a particular form of income or gain, and, without regard to its real or fictitious character, to subject it to a highly preferential rate.

The fiscal policies of other countries, principally Great Britain, France, and Ger-

[18] For a brilliant analysis of capital gains, going to the heart of this matter, see SIMONS, *op. cit. supra* note 5, at 150-151.

[19] That courts will not assume the responsibility of attempting to correct such inequalities is demonstrated by the recent case of Bates v. United States, 108 F. (2d) 407 (C. C. A. 7th, 1939), *cert. den.* 60 Sup. Ct. 591 (1940), where the court held that no effect could be given to the statutory change in the gold content of the dollar in computing the taxable profit on a sale in 1935 of securities purchased prior to devaluation during 1931 to 1933.

[20] For a good discussion of these difficulties, see SIMONS, *op. cit. supra* note 5, at 155 *et seq.*

[21] Congress made a cautious but nevertheless interesting experiment in the 1939 Act in providing in certain cases for what is in effect an averaging over a period of earned income received in one year for services or work extending over a period of at least five calendar years. See Revenue Act of 1939, §220, inserting §107 in the Internal Revenue Code.

many, are often pointed to as evidence of the unwisdom of Congress in subjecting capital gains to an income tax burden. No doubt we can learn from the experience of other countries. But persons advancing this argument seldom, if ever, recognize that there is no more agreement as to fundamental principles in these countries than in our own, and that they seem to be no more happy in their solutions of the problem than ourselves. Yet a casual listener to much of the discussion of this problem among some Americans might well be pardoned for thinking that the British had achieved Utopia because in that country *casual* capital gains are, like accretions to capital, excluded from the tax base.

A good corrective to so superficial a view is provided by Dr. R. M. Haig's clear and dispassionate critical examination of the systems of these three countries.[22] Summarizing the English situation, Dr. Haig writes:

> It has been shown: (1) that the exemption of capital gains in England is far narrower than it is commonly conceived to be; (2) that the partial exemption of capital gains under their law involves drawing an arbitrary line between taxable and exempt transactions, with uncertain and inequitable results as between individuals in substantially similar circumstances; (3) that the British themselves are far from satisfied with their formula, a Royal Commission having gone so far as to declare that "it cannot be justified"; (4) that the formula places a premium on the transformation of taxable income into exempt capital gains, a premium sufficiently substantial to give rise to tax avoidance and loss of revenue in spite of England's superior administration and her high degree of taxpayer cooperation; and (5) that the devices for tax avoidance cause investors to buy and sell securities at "unnatural times," with consequences for the market that may be expected to be accentuated under American conditions.

Dr. Haig's observations make it unnecessary to point out the disastrous possibilities involved in the incorporation into our law of exemptions of capital gains coextensive with those of the British law, when American psychology and conditions are taken into account. The basic structure of the French law is very similar to the British, but lax French administration appears to have made even the tax on speculative profits a dead letter there, while the exclusion of so-called investment gains and the inclusion of so-called speculative profits in the tax base in Germany have worked apparently only because of perfectly artificial and arbitrary, if simple, statutory rules for determining which gains are includable as speculative profits. It is accordingly quite arguable, so far as tax treatment of capital gains and losses is concerned, that the evolution of American law, however uncertain and vacillating it has been, has manifested a sounder trend than the comparable development of the statutory law in these other countries.

It is commonly asserted that the revenue would suffer no net loss and perhaps even a gain over the full period of an economic cycle, if a policy were adopted of complete exemption of capital gains, other than those realized in the form of business profits and, perhaps, those arising from speculative transactions (in practice, this would necessarily mean gains from assets held for a relatively short period). How-

[22] *Taxation of Capital Gains*, a series of articles appearing in the *Wall Street Journal* in issues between March 23 and April 13, 1937.

ever this may be,[23] it does not follow that such an exemption would represent sound policy. Important as revenue productivity is and must be, such productivity cannot safely be made the sole or conclusive criterion of the relative merit of alternative schemes. No one would seriously suggest eliminating all the deductions and credits allowed under the present law, merely because such action would undoubtedly balance the federal budget, at least for a year. The prime justification for, and the chief point of superiority of, a graduated personal income tax is that it, more than any other tax save perhaps graduated estate and inheritance taxes, achieves an allocation of the tax burden among individuals upon a progressive basis and in rough accordance with ability to pay. The entire or partial exclusion from the tax base of a particular category of real gains and losses inevitably creates a serious interference with its operation in this respect, and thereby tends to impair the superiority of the tax and destroy its chief *raison d'etre*.

Another weighty fact which it is not wise to ignore is that preferential treatment of capital gains, as compared with earned income, business profits, and periodic investment income, tends to aggravate certain refractory problems of tax avoidance, and creates incentive to resort to new forms of avoidance. It thereby endangers the integrity of the income tax as a whole. The Treasury statistics show that, on the average, 85% of the capital gains reported in income returns is derived from sale and exchange of stock and securities. It seems safe to assume that much the larger part of this 85% is referable to equity securities. While other factors play a material part, this appreciation in the value of corporate equities is in substantial measure the result of accumulation of corporate earnings. Such retention of corporate profits swells corporate surplus and enhances the value of the assets underlying the securities. It requires no high degree of wisdom to see that, the greater the tax preference which capital gains enjoy, the larger the incentive to retention of corporate earnings becomes.

A system of income taxation which included in the tax base gains from whatever source derived, without discrimination on the basis of source, would remove the principal tax incentives for accumulation of corporate earnings in surplus. With the maximum tax liability upon capital gains under the existing law hardly a fifth of the maximum tax upon corporate earnings distributed as dividends, it is difficult to believe that corporate shareholders will not prefer, as time goes on, to realize their profits on corporate investment, so far as practicable, through the sale or exchange of his shares at a profit created by the retention of corporate earnings rather than through the receipt of dividends out of such earnings. Since the abandonment of the undistributed profits tax in the Revenue Act of 1939, Section 102[24] remains as the only statutory sanction to discourage this practice, except for the special pro-

[23] The statistics of revenue do not bear out this contention, but no conclusive answer appears to be possible upon the basis of facts now precisely ascertainable. Much would depend, no doubt, upon the generosity or niggardliness of the allowances for losses.

[24] Internal Revenue Code, §102, imposes a substantial surtax upon the undistributed net incomes of corporations formed or availed of to evade surtaxes upon their shareholders by permitting earnings to accumulate beyond the reasonable needs of the business.

visions applicable only to the limited class of corporations constituting personal holding companies or foreign personal holding companies. It remains to be seen whether this section, the application of which depends on motive, will prove equal to the great demands now put upon it. Fortunately the great majority of corporations at present seem to be following the wise course of determining their dividend policies without regard to tax considerations.

Methods of segregating capital gains and losses into a separate schedule, whether such segregation be complete as Mr. Parker has suggested or partial, as under the existing revenue laws, seem to assume that a line of demarcation between capital gain and other income can be drawn with a high degree of precision. Unfortunately, such an assumption is far from corresponding with fact. We cannot talk about capital gain and ordinary income as if we are dealing with tight and mutually exclusive categories, for there happens to be a disturbing variety of devices for transmuting what would otherwise be ordinary income into capital gain. Foremost among these are the various uses to which the corporate entity may be put, such as the accumulation of earnings and profits in a corporation, followed at a time convenient to the shareholders by complete liquidation. A few others which may be mentioned are the sale of stocks before dividend date *cum dividend* and their subsequent repurchase *ex dividend,* a practice which became so prevalent in England as to force action by Parliament, action which has proved of doubtful efficacy; issue or purchase of bonds carrying a low rate of interest but selling at a discount, followed by sale thereof at or close to par just prior to maturity; and even issue of bonds, at a heavy discount, carrying a nominal rate of interest or no interest.

With surtax rates on other income running up to the present maximum of 75%, it is quite apparent that the preference in favor of capital gains under the existing law is such as to create a great incentive for tax avoidance through such transmutations of ordinary income into capital gain. How much greater would such incentive be were capital gains to be completely exempted from taxation. Undoubtedly Congress would be confronted in due course with problems of tax avoidance even more refractory to legislative solution than the foreign personal holding company and other devices which resulted in Supplement P and other complicated provisions of the Revenue Act of 1937.

It is urged that even the partial inclusion of capital gains and losses in the tax base necessitates many complexities in the income tax law, such as the provisions relating to non-recognition of gain or loss and to basis. This argument overlooks at least two important facts. The first of these is that many basis provisions would still be necessary to provide yardsticks for measuring allowances for depreciation, obsolescence and depletion; the other that many new provisions, probably more complicated and technical than those eliminated, would soon be found necessary in order to sterilize the many new devices of tax avoidance, samples of which are given above, which American ingenuity would evolve.

It is sometimes urged, with a degree of truth, that severe practical hardship may

often result from taxing capital gain, because such gain may be realized in contemplation of law in cases where, by reason of the form in which such gain accrues, the result of realization is to saddle the taxpayer with a tax liability although he has received nothing but assets which may be frozen or semi-frozen with which to pay; also that he may be compelled to pay a tax although he has done no more than to alter the form of his investment, the value remaining unchanged.[25] Such objections, to the extent they possess merit, do not present real issues of principle. Congress has not been niggardly in extending statutory relief in such cases through the familiar devices of non-recognition of gain or loss and substitution of basis. There are, of course, limits beyond which this principle of non-recognition cannot safely be carried, even where gain is realized in a form other than money or a highly liquid security.[26]

There still remains to be considered the argument for highly preferential tax treatment of capital gains, or even their complete exemption, which has been most plausibly and forcefully advanced. It is the argument which has undoubtedly carried the greatest popular appeal, both in and out of Congress. The substance of this argument is that the economic effects of capital gains taxation are peculiarly bad, in that the impact of high surtax rates upon capital gains freezes the capital market, and impedes or prevents the investment of capital in new enterprises where risk is involved, thereby hampering industrial expansion and fostering unemployment. It is furthermore said that a capital gains tax creates artificial and unhealthy conditions in the securities markets by interference with the free transfer of securities, thereby aggravating both inflationary booms and deflationary collapses. Several writers have gone so far as to assert that the capital gains tax is a prime or even principal cause of cyclical booms and depressions.[27]

These assertions are made in face of the fact that stock market panics and business booms and depressions antedated the ratification of the Sixteenth Amendment. Moreover, it is a familiar fact that a decade in which the maximum rate of tax on capital gains was 12½%, scarcely an oppressive or paralyzing tax burden, nevertheless culminated in the most catastrophic stock market collapse and the beginning of the most devastating economic debacle in our national history. It is one of the ironic facts of history that, although this 12½% rate was often denounced as an intolerable burden on capital and the capital markets during the 1920's, its approximate restoration was hailed as one of the best guarantees of recovery during

[25] Such hardship at its worst can scarcely exceed that which may flow from the recent decision of the Supreme Court in Helvering v. Bruun, 60 Sup. Ct. 631 (1940), reversing 105 F. (2d) 442 (C. C. A. 8th). In this case the Court finally ended a twenty-year period of confusion and uncertainty by holding that, in cases where a lessee makes improvements upon the leasehold, the lessor derives income—apparently ordinary income—in the year of termination of the lease, to the extent of the fair value of the improvements in such year. The decision seems sound in principle. Yet it is apparent that a lessor, whose other resources are limited, may be hard put to it to pay the tax where the value of the improvements, such as an office building, is very large.

[26] An instance is the short-lived provision of the Revenue Act of 1921, §202(c), allowing exchange of stock or securities without recognition of gain even though such exchange was not pursuant to a tax-free reorganization. Congress quickly realized the too great liberality of this provision.

[27] Tremaine, *The Capital Gains Tax* (1937) 15 TAX MAGAZINE, 517; Fisher, *A Practical Schedule for an Income Tax* (1937) 15 *id.* 379.

the successful drive for revision of the capital gains tax in 1938. It is unnecessary to point out that the 12½% maximum rate gave no relief whatever with respect to capital gains realized by taxpayers in the lower tax brackets.

The most cogent answer to the charge that the capital gains tax is a major cause of booms and depressions is given in the Report of the Committee on Taxation of Capital Gains of the National Tax Association in 1938.[28] It is there well said:

> Mr. Tremaine overlooks the fact that in boom times it is primarily the speculator who is realizing capital gains. In the hands of speculators these gains can only aggravate market conditions, since they will almost certainly be used further to inflate the security market. Even "unwise" investments by government would be preferable to this course for the money would be retired from the security markets and placed where it would help to improve the general price structure.

What has been said above, however, does not meet the criticism levelled at the tax treatment of capital gains under the Revenue Act of 1934 on the ground that its effect was to discourage wealthy individuals from embarking their capital upon new enterprises. It is undoubtedly true that large scale ventures into new fields cannot commonly look to public financing to provide their capital requirements, and that the great majority of such ventures require one or more men of large means who are willing to take the risks which are involved. What has been termed the "enterprise capital" provided by such individuals unquestionably performs a highly useful and even essential economic and social service. Such individuals are the very ones best fitted to assume the risks new enterprises necessarily involve. But it is contended that the prospect that much of the gains, if the enterprise proves successful, will go to the tax collector, while the losses, if the venture fails, will be allowed only in part as a deduction against taxable income, removes most of the incentive for such enterprise capital.

This contention, so far as the gains aspect is concerned, ignored one vital fact with respect to the rate structure of the 1934 Act.[29] That rate structure really offered to wealthy individuals a very strong inducement to make their new investments precisely in such manner as would cause their returns to take the form of capital gains. Under that act, if an asset had been held for over ten years, the maximum effective rate on the actual gain from its sale would be only 23.7%, as compared with

[28] *Report of Committee on Taxation of Capital Gains, supra* note 8, at 809. The author finds himself in general agreement with the content and conclusions of this report and agrees that a fair and adequate solution must ultimately be found in some not too complex device of averaging operating over at least a five-year period.

[29] Space does not permit consideration of policy in the matter of taxation of capital gains in the light of facts developed in the hearings of the Temporary National Economic Committee with respect to present conditions of supply and demand in the enterprise capital market. That the findings of this investigation may have a profound bearing upon future national policy in the tax field, as well as other fields, is obvious.

It may also be suggested that the elimination of future issuance of tax-exempt securities might have a more profound and lasting ultimate effect in unfreezing enterprise capital than a return to anti-progressive principles of personal taxation can ever do.

The developments in the capital market since the Revenue Act of 1938 can scarcely be said to lend support to those who asserted prior to its enactment that the capital gains and losses provisions of the 1934 Act were the principal obstacle to the revival of large-scale capital investment.

a top rate of 79% on other income; while if held for over five years the comparable rate would be 31.6% against 79%. Even so the discrimination as between taxpayers in the low and high surtax brackets was much less invidious under the 1934 Act than under prior laws.

The following examples will show concretely the extent of this tax inducement in the 1934 Act: Assume an individual with other surtax income of $200,000 who has $1,000,000 to invest. Under the rates prescribed by the 1936 Act, if he can find an investment which, over a period of ten years, will return him a capital gain averaging only 5% per annum, compounded annually, he would discover upon calculation that his net return, after taxes, would be equivalent to 12.8% annual yield on an ordinary income-producing investment. He would find that over a period of five years he would need to obtain an annual yield of 11.5% from an ordinary income-producing investment to equal the net return, after taxes, that he might obtain through a capital gain averaging only 5% per annum. Even on an investment for only one year (one day should be added to each of these periods), a 5% capital gain would give him just as large a return after taxes as a 7.1% yield in interest, dividends, rents or royalties.

Similarly, a capital gain averaging 10% per annum, compounded annually, would give him the equivalent, after taxes, of annual yields of fully taxable income of 27.7%, 24.6% and 14.5% respectively, according as he held the capital gain investment for just over ten, five or one years. He would need a capital gain averaging only 1.5% per annum, compounded annually, over a period of ten years, to obtain the same net income, after taxes, that he would derive from a 3½% bond; and even over a period of only one year and a day, a capital gain of 2½% would equal his net yield after taxes from a 3½% bond, etc.

It is quite possible, however, that the limitations on losses which the 1934 Act contained operated as a marked deterrent to new and hazardous investment. But these defects could have been easily ameliorated or removed without abandoning the worth-while features of that act and returning to an essentially unprogressive system, so far as the treatment of gains is concerned. The liberalization in the allowance for capital net losses in the Revenue Act of 1938[30] and the provisions which ameliorate the discrimination in the treatment of the capital gains of taxpayers whose net incomes fall into the lower surtax brackets are sound and admirable. These features may well be preserved and extended. The restoration of fair and logical treatment of the capital losses of partnerships by the 1938 Act is another praiseworthy feature.[31]

In conclusion, it is submitted that we should apply our best intelligence to finding

[30] It is argued by some that there is nothing unfair or arbitrary in the provisions of the 1934 Act narrowly limiting the deduction of capital net losses from ordinary income. It is said that such losses do not presently diminish ability to pay, whatever their effect in future years may be. This may be true, but it does not shake the writer's conviction that it is bad policy in the long run to tax capital gains in the same manner as other income and at the same time arbitrarily limit deduction of capital losses. The majority of taxpayers regard such a tax policy as inconsistent and unjust. Moreover, such loss limitations may well hinder the financing of new and hazardous enterprises.

[31] INT. REV. CODE, §182, 183.

a fiscal system which will at the same time maintain sound principles of progressive taxation of income without discrimination on account of source and reduce to a minimum the inequities which inhere in the doctrines of realization and the computation of income on an annual basis. Such a solution will probably involve more liberal treatment of losses and the averaging of income over a longer period than we have ever attempted. Equity having been achieved in these respects, capital gains should be included in the income base and taxed at progressive rates without preference. How high such rates should be graduated presents controversial issues of policy outside the field of the present discussion. But the question may well be asked, if it be true that the rates of tax are now graduated so high that their non-discriminatory application to capital gains would be a major cause of depression and unemployment and would be a menace to the perpetuation of a system of free enterprise, why the application of the same rates to wages and salaries, business profits, interest, dividends, and other fruits of economic activity should have less dangerous or detrimental results?