

THE QUESTION OF TAXING CAPITAL GAINS

II. THE CASE AGAINST TAXATION

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In presenting the case against the taxation of capital gains I need withhold no reservations as to personal views or opinions, because I thoroughly believe that transactions in capital assets should generally be immune from the imposition of the income tax. That which flows from capital, like interest, rent and other items of income, is as separate and distinct from the capital which produces it as gathered fruit is separate from the tree that bore it. While income may be transformed by accumulation into capital, like fruit, the seed of which produces another tree, the growth itself of neither capital nor the tree is income.

In the absence of explicit provision for the treatment of capital gains and losses in our earlier revenue acts under the Sixteenth Amendment,¹ the Commissioner of Internal Revenue held capital gains to be taxable as income, and, upon appeal, the United States district courts, in a number of cases, reversed him. Ultimately the United States Supreme Court reversed the lower courts, holding that such gains were taxable as income.²

In view of this conflict in the judicial opinions, it seems appropriate to review very briefly the taxation of capital transactions in the leading foreign countries in which income has been subjected to tax. Economic definitions are of little help in a consideration of capital gains as a subject of taxation; the law merely defines such gains, of necessity more or less arbitrarily, according to the extent to which they are taxable.

Taxation of Capital Gains in Foreign Countries

In England capital gains and losses are not generally taken into account in computing taxable income. Except where the taxpayer is in the business of buying and

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¹ The 1916 and 1917 Acts were open to the construction that they taxed gains from sales of property only when realized in the business of buying and selling for profit.

² *Merchants' Loan & Trust Co. v. Smietanka*, 255 U. S. 509 (1921); *Eldorado Coal Co. v. Mager*, *id.* 522 (1921); *Goodrich v. Edwards*, *id.* 527 (1921); *Walsh v. Brewster*, *id.* 536 (1921). Justice Holmes and Brandeis, "because of prior decisions of the court," concurred in the judgments only.

selling securities as a dealer, when the securities represent stock in trade, gain realized from occasional sales is not regarded as taxable income.

"The British do not consider income to arise in the case of gains arising from the sale of capital assets, unless the taxpayer makes transactions in such assets his trade or business. Inasmuch as they do not tax capital gains, they do not allow capital losses to be deducted from income."³ The Canadian income tax, being patterned after the British system, does not impose a tax upon capital gains and, likewise, makes no allowance for capital losses.

The French personal income tax bears much resemblance to that employed in England. Capital gains are not taxable in France unless the taxpayer is regarded as being engaged wholly or partly in the business of buying and selling securities. Occasional transactions, however, are not deemed to constitute the conduct of a business. Capital losses, on the other hand, are not deductible in computing taxable income.

Taxation Under Early United States Excise Taxes

In 1872, under one of the earliest taxes imposed on income in the United States, enacted shortly after the Civil War, the question arose before the United States Supreme Court, in *Gray v. Darlington*,⁴ as to the taxability of realized accretions of capital. The statute⁵ then before the Court, in point of defining taxable income, was even broader in its language than any of the earlier revenue bills enacted after the Sixteenth Amendment. In part the applicable statute read as follows:

There shall be levied, collected and paid annually upon the gains, profits, and income of every person, . . . whether derived from *any kind of property*, rents, interest, dividends or salaries, or from any profession, trade, employment, or vocation, . . . or *from any other source whatever*, . . . a tax of five per centum on the amount so derived over one thousand dollars. (Italics supplied.)

The opinion of the Court, written by Mr. Justice Field (from which there were three dissents), held that increment in value of personal property occurring during a period of years does not constitute gains, profits or income of any particular year, even though the entire amount of the increase in value be at one time converted into money by a sale of the property. The majority opinion, in part, reads as follows:⁶

The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. *It constitutes and can be treated* merely as increases of capital. (Italics supplied.)

Corporate Excise Tax of 1909

On August 9, 1909, a federal excise tax was enacted, measured by "the entire net income" of corporations; this tax remained in effect until the enactment of the Revenue Act of 1913, the first revenue act passed by Congress after the Sixteenth

³ MAGILL, PARKER, AND KING, A SUMMARY OF THE BRITISH TAX SYSTEM (1934) 20.

⁴ 15 Wall. 63 (U. S. 1872).

⁵ Act of March 2, 1867.

⁶ *Gray v. Darlington*, 15 Wall. 63, 66 (U. S. 1872). In a footnote to the *Gray* case in 15 Wallace, there is a reference to an unreported decision, *Bennett v. Baker*, rendered by Mr. Justice Grier in the Third Circuit, holding under an earlier statute that capital gains did not constitute taxable income.

Amendment. This excise tax was imposed with respect to "carrying on or doing business" by corporations "organized for profit and having a capital stock represented by shares," at the rate of 1% "upon the entire net income over and above \$5,000, received . . . from all sources" during the taxable year.

The Commissioner of Internal Revenue ruled under the excise tax that capital gains were taxable as income. In a suit to recover a tax paid under protest, a United States district court gave judgment for the corporation,⁷ holding that capital gains are not taxable, and was sustained by the Circuit Court of Appeals.⁸ In the final appeal the Supreme Court reversed the lower courts and sustained the government.⁹

It must be borne in mind that here there was under consideration an *excise tax* imposed upon income of *corporations only* for the privilege of doing business. The taxation of income, as such, by the federal government had been held unconstitutional under the Income Tax Law of 1894.¹⁰ Obviously the excise tax was not required to withstand the same tests which had been applied in the *Pollock* decision. Excise taxes may be imposed upon any privilege if there is a sufficiently definite measure, like sales, receipts or capital stock. The tax could even have been measured by the proceeds of sales of capital assets.

Moreover, when the final decision in this case was written (May, 1918), the income tax had already been in effect for five years by authority of the Sixteenth Amendment. The United States was at war; the need for large revenues was being experienced; high tax rates were then being imposed and higher rates were in prospect. If unfavorable to the government, the Court's decision under the excise tax might have proved a troublesome hurdle when the same question arose under the income tax. While these observations are being made in retrospect, they seem permissible in view of the *Darlington* decision and the position previously taken by the courts of foreign countries employing the income tax.

In its decision the Supreme Court was mindful of the fact that the taxing act was an excise imposed upon profits derived from sales and for the privilege of doing business as corporations. The Court said:¹¹

Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received "from all sources."

But the term "selling for profit," in connection with the regular conduct of business, has particular reference to the sale of goods or commodities in which the corporation regularly deals and from which it derives its ordinary income. It can hardly be said that the sale of capital assets is one of the ordinary functions of business whether or not corporate in form of organization. While the sale of capital assets is an essential function of business enterprise, such sales are certainly not made

⁷ *Mitchell Brothers Co. v. Doyle*, 225 Fed. 437 (W. D. Mich. 1915).

⁸ *Doyle v. Mitchell Brothers Co.*, 235 Fed. 686 (C. C. A. 6th, 1916).

⁹ *Doyle v. Mitchell Brothers Co.*, 247 U. S. 179 (1918).

¹⁰ *Pollock v. Farmers Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601 (1895).

¹¹ 247 U. S. at 183.

in the regular daily course of "doing business." Capital assets imply permanency of investment; they are related to capital of the corporation in which change ordinarily results from annual profit or loss from trading or from other recurring business operations.

Capital Gains Under the Sixteenth Amendment

When the question arose under the income tax law the Supreme Court was hard pressed for convincing argument in their attempt to maintain the position taken under the excise tax. The Court felt that, inasmuch as the Sixteenth Amendment had been adopted for the purpose of making the tax upon income possible, the raising of revenue thereby was paramount and must not be relinquished in any regard. No matter how persuasive the argument of counsel, the gathering of revenue was obviously deemed of prime importance. To this effect the Court said:¹²

The interesting and ingenious argument, which is earnestly pressed upon us, that this distinction is so fundamental and obvious that it must be assumed to be part of the "general understanding" of the meaning of the word "income," fails to convince us that a construction should be adopted which would, in a large measure, defeat the purpose of the Amendment.

The Court insisted that the word "income" must be given the same meaning as it had been given under the corporate excise tax. Thus, the Court would recognize only the popular conception of profit—the excess of proceeds of sale over the cost. Said the Court:¹³

In determining the definition of the word "income" thus arrived at, this court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what is believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.

The Court obviously refused to give consideration to any meaning of the word "income" other than that previously adopted in respect to capital gains under the Corporation Excise Tax Law of 1909.

Changes from 1921 to 1934

Until the close of 1921, capital gains, like other income, were subject to both normal and surtax rates, and losses were deductible in full, except for 1916, when net capital losses were allowed only to the extent of gains from similar sources. In 1921 the Ways and Means Committee of the House recognized that "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 . . . taxed as a lump sum in the year in which the profit is realized"; that many such sales were "blocked" by the capital gains tax.¹⁴ In order to remove the "fear of a prohibitive tax" on capital

¹² *Merchants' Loan & Trust Co. v. Smietanka*, 255 U. S. 509, 521 (1921).

¹³ *Id.* at 519.

¹⁴ *Report of House Ways and Means Committee on Revenue Bill, 1921*, H. R. REP. 350, 67th Cong. 1st Sess. (Aug. 16, 1921), pt. I.

gains a maximum rate of 15% was proposed, the deduction of losses to be limited to the same rate.

Later the Senate Finance Committee also recognized the retarding effect of the tax on capital gains and suggested taking "an intermediate position between the extreme views embodied, respectively, in the present American and British laws," noting that "in Great Britain capital gain or loss is ignored or eliminated in computing the net income."¹⁵ As finally agreed upon the 1921 Act provided for a tax upon net capital gain from the sale of property held for a period of over two years at the maximum rate of 12½%. Capital net losses were deductible in full from ordinary income.

The 1924 Act retained the same formula in respect to capital net gains except that it limited the deductibility of net losses to the rate of tax, 12½%. No material change was thereafter made in these provisions until 1932 when, because of shrinkage in the revenues due to the depression, losses sustained from the sale of stocks and bonds held for two years or less were allowed only to the extent of gains arising from similar transactions. Net losses in excess of such gains could be carried forward, under the 1932 Act, and deducted from short-term gains of the next year. However, the latter provision was rescinded in 1933 by the enactment of the National Industrial Recovery Act so that this provision never became operative.

By the close of 1933 the Congress realized that the capital gains tax had had a very unsettling effect upon the revenues. In December, 1933, Samuel B. Hill, Chairman of the Subcommittee on Tax Revision, in a report to Ways and Means Committee of the House,¹⁶ called attention to some of the defects of this tax, stating that it produced an unstable revenue, that is to say, large receipts in prosperous years and low receipts in depression years. In this connection the Sub-committee, reporting upon their examination of the British system, stated as follows:¹⁷

The stability of the British revenue over the last eleven years is in marked contrast to the instability of our own. In that period the maximum British revenue was only thirty-five per cent above the minimum, while in our own case the percentage of variation was two hundred and eighty per cent.

Comparing the British and American revenues, Mr. Parker stated:¹⁸

While this stability of the English revenue is not entirely due to their treatment of capital gains and losses, it is a very important factor in producing this condition. It is easy to show that much of the instability of the federal income tax revenue is due to our system of taxing these gains and losses.

Further Changes After 1933

Seeking further to augment the revenues from capital gains an entirely new method of taxing such transactions was adopted in 1934. The flat maximum rate of 12½% and the two-year limitation were abolished. Such gains were taken into account, except as to corporations, only to the extent of prescribed percentages of the

¹⁵ *Report of Senate Finance Committee on Revenue Bill, 1921*, 67th Cong. 1st Sess. (Sept. 26, 1921).

¹⁶ *Report of Subcommittee on Prevention of Tax Avoidance, of the House Ways and Means Committee*, 73d Cong., 2d Sess. (1933).

¹⁷ *Id.* at 6.

¹⁸ *Id.* (Exhibit C) at 32.

gains and these were subject to the normal tax and the surtax according to the length of time the property was held. A gain on a capital asset held for not more than one year was wholly taxable—at 100%; if property was held for over one year but not more than two years, 80% of the gain was taxable; from two to five years, 60%; from five to ten years, 40%; if held over ten years, 30%. Capital net losses, however, were deductible only to the extent of capital gains plus \$2,000. The same method was retained in the Revenue Acts of 1935 and 1936.

By the early part of 1938 protests in respect to the severity of taxes imposed on capital gains were being heard by members of the Congress. The high rates of surtax were limiting the number of capital transactions to such an extent that assets were becoming more and more frozen. The House Ways and Means Committee determined that the law must be changed in order to encourage taxpayers to take their gains and also to influence them to assume their losses. Various plans were suggested and rejected.

The plan finally adopted in the 1938 Act differentiated between short-term and long-term gains and losses. A short-term gain or loss is defined as one which occurs on the sale or exchange of a capital asset held for not more than 18 months. Such gains are fully taxable. Such losses, however, may be carried forward into the succeeding taxable year and applied against short-term capital gains of that year. The amount so carried over is limited to the amount of the current taxable year's net income. Long-term capital gains and losses consist of two groups: those resulting from the sale or exchange of capital assets held for more than 18 months and not more than 24 months are taxable to the extent of 66 $\frac{2}{3}$ % thereof; gains from property held for more than 24 months are taxable at 50%. However, the tax on gains in the first group is limited to a maximum of 20% of the gain, and, in the second, to a maximum of 15% of the gain.

Long-Term Capital Gains

Capital gains from long-term transactions, when analyzed, are frequently not real income at all; and they result in no real benefit to the taxpayer. As stated in the report of the Joint Committee of Congress, already mentioned, "in many instances, the capital gains tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of on a real increase in value."¹⁹ Discussing the subject before the Institute of Public Affairs at the University of Virginia, in response to a question from the audience, Mr. Parker said:²⁰

Now, as to this increment, it may be not a real increment at all; as has already been pointed out. For instance, suppose you bought a house in 1913 for \$5,000 and at that time the purchasing power of the dollar was considerably higher than now. And supposing that in 1928 you had to go to another part of the country and you sold the house for \$15,000. You would have a profit of \$10,000. And when you got your new place of residence you found that it would cost you \$15,000 to buy for yourself a house just like the one you sold; in other words, no better. That can easily happen. So the tax on the capital gain may not be a real increment at all.

¹⁹ *Id.* at 5.

²⁰ INSTITUTE OF PUBLIC AFFAIRS, PROCEEDINGS, 1936, p. 335.

This off-hand statement by Mr. Parker illustrates the fact that capital gains resulting from monetary changes affecting the general price level are not real gains in economic wealth, and that taxes imposed on "gains," so computed, are levies upon capital and not upon income.

The Difficulties in Valuation

The economic effects of the capital gains tax have been such unquestionably as to weaken the whole income tax structure. When it is necessary to employ forced reasoning in order to justify the imposition of an income levy, the harm that results is not confined merely to the particular subject of tax involved; indeed the entire system of taxation is affected.

In the first decade of the income tax—after the adoption of the Sixteenth Amendment—the courts recognized, to a much greater extent than thereafter, the doctrine of "realization of income." Until the 1921 Revenue Act was adopted, capital transactions were generally subjected to the same rates of tax as ordinary income. Prior to that act, however, increments were rarely taxed unless the taxpayer actually realized in money on the property received through such transactions.

A large proportion of capital transactions consists of exchanges of property and "to boot" transactions. While the draftsmen of federal income tax statutes and the courts have developed the law with respect to definitions of the terms "market value" and "fair market value," they have made little progress with respect to what should determine "value" generally. Writing on "realistic valuation," Randolph E. Paul says:²¹

Valuation is neither crystal gazing nor geometry, but a serious hard business with economic and social implications of vast significance. The complexities of the task, if it be done in the right way, are almost past belief. The law of valuation cannot be put into a strait-jacket; it involves, as do few tasks in the law, a delicately poised judgment which will reduce to their proper place a host of cross influences and deflecting forces. Principles of valuation, like other principles in the law, are "complex bundles," and no theory may be wholly trusted, for it may be out of touch with reality. A conventional attitude is as dangerous as a radical approach. A thousand shades of contradiction must be carried in the mind at one time. One must look in many directions at the same time. One must avoid a microscopic attitude, yet a host of details must be balanced in the most accurate scales:

One school of thought has suggested the principle of requiring taxpayers to evaluate their assets annually with a view to taxing the capital accretion thus disclosed. Commenting thereon Roswell Magill has said:²² "Experience indicates that valuations are provocative of endless difficulty and litigation, and must be avoided so far as possible." Judge Learned Hand has observed that the practice of taxing accretions annually "would have been rational" but "awkward in administration."²³

The problem of taxing to the lessor improvements by the lessee on leased premises illustrates how far the Supreme Court has gone in taxing economic gains. In the

²¹ PAUL, *STUDIES IN FEDERAL TAXATION* (1937) 228. ²² MAGILL, *TAXABLE INCOME* (1936) 20.

²³ *Hewitt Realty Co. v. Comm'r of Internal Revenue*, 76 F. (2d) 880, 884 (C. C. A. 2d, 1935).

most recent case, *Helvering v. Bruun*,²⁴ involving an almost similar situation, the Supreme Court, reversing the District Court and the Circuit Court of Appeals, held that a lessor realizes gain from the acquirement of a building erected by the lessee on leased premises, upon default of the lessee, in the year of repossession. Here, however, the parties to the action had stipulated as to a "fair market value" of the building. But in 1919 the Court denied certiorari in a case wherein the Circuit Court had held a Treasury regulation invalid because "the gain, if taxable at all, must be taxed as of the year when the improvements were completed."²⁵ In 1938 the Supreme Court, reversing the Court of Claims, held on a similar issue that the amount allowed to lessee as depreciation on the building was not rental to the lessor, "and that, in the circumstances disclosed, any enhancement in the value of the realty in the tax year was not income realized by the lessor within the Revenue Act."²⁶

These cases illustrate how difficult it is to rule consistently upon questions involving transactions in capital assets, not to mention the doing of justice to the taxpayer. Moreover, the law is not yet settled. One might conclude that, on the facts in *Helvering v. Bruun*, the lessor would not be taxed unless the taxpayer stipulates as to the value of the building. On the other hand, the "fair market value" may be established by the government by expert testimony. The principle of law having been laid down, the government will no doubt be prepared in the future when a similar issue arises to "prove" value if no stipulation has been entered into.

In these circumstances, must the lessor cause the building to be demolished by the lessee in order that he may escape the tax? This may be too late after the lease has expired or the lessee has defaulted. Under present law, the value of the building would be taxable as a capital gain. If the lessor razes the building within 18 months he sustains a short-term capital loss which could not be offset against a long-term gain. If the lessor is taxed, he receives no income from which to pay the tax. If the building is of special construction, it is probably not rentable.

On the ground of equity, one is forced to the conclusion that these and other difficulties will ultimately lead to exemption of such transactions from the capital gains tax and it is not inconceivable that, in the evolution of the income tax, exemptions will in effect nullify the capital gains tax.

Exceptions to the General Rule

Ever since the inception of the income tax the taxation of capital accretions has been recognized as calling for special legislative treatment. Those favoring the tax have called attention to the difficulties experienced under the English system in determining whether gains are derived from a taxpayer's vocation or avocation; and to the possibility that tax-free capital transactions may become a real threat to the revenues—if investors should adopt the practice of investing for appreciation rather than for income. These are problems which must be dealt with; whether or not capital gains are subjected to tax and whatever plans be adopted to meet the situations must, of necessity, be more or less arbitrary.

²⁴ *Helvering v. Bruun*, 60 Sup. Ct. 631 (1940).

²⁵ *Miller v. Gearin*, 258 Fed. 225 (C. C. A. 9th, 1919) cert. denied, 250 U. S. 667 (1919).

²⁶ *Blatt Co. v. U. S.*, 305 U. S. 267 (1938).

One of the indications of inherent weakness in the system of taxing capital transactions is the number of exceptions to the general rule. For example, purchases and sales of a corporation's own capital stock, except where it is dealt in for profit upon an exchange are not taxable; tax-free consolidations and mergers by provision of statutes, a subject on which volumes of court decisions have been written; purchases of a corporation's own bonds on which the law is still uncertain by reason of fine distinctions; sale of property used in a trade or business where the property is of a character which is subject to the allowance of depreciation; gain or loss is not recognized in an exchange of property held for productive use, for other similar property and for the same use; reinvestments in like facilities as in the case of condemnation of property are tax-free.

Such exceptions are being made as and when the courts and the Congress recognize the inadvisability or impracticability of imposing the income tax on capital transactions. Of all the inconsistencies growing out of the taxation of capital assets, however, one of the worst examples is probably the taxation of a gain on the sale of one's own residential property and the disallowance of loss on the sale of such property.

Instability of Capital Gains as a Tax Base

As a practical matter, and viewing the taxation of capital gains in its broadest aspects, one cannot escape the conviction that this form of taxation is unstable and irrational. According to one theory of security market fluctuations a business cycle is one in which "bull" markets are counterbalanced in volume by "bear" markets.²⁷ If capital transactions in securities were taxed on a uniform basis from year to year, and losses were fully allowed, or allowed to the extent of the tax, it would appear that the revenue received by the Treasury in market upswings would be approximately offset by losses of revenue in depressions. On this theory it would seem that to the extent that there is income from ordinary sources during the depression periods in sufficient amounts to permit of offsetting losses for tax purposes, the shrinkage in revenue by reason of capital losses would approximately counterbalance the revenue received during inflationary periods—except in so far as the normal average during the business cycle might have advanced and be represented by a permanently higher level of value. Thus, if no limitations were placed upon the deductibility of losses it would appear that over periods of business cycles the government would receive little, if any, benefit from the imposition of the capital gains tax.

Data published by the Bureau of Internal Revenue, in *Statistics of Income*, reveal the instability of capital gains as a tax base and indicate the disastrous effect that the violent declines had upon the revenues in the depression years and until 1934, when the deduction of losses was limited to offset against gains plus \$2,000.

Our experience during the depression years proved that the capital gains tax could only be made productive of revenue by depriving the taxpayer of the right to deduct capital losses. A tax which is desirable to the Treasury only when it is unjust to the taxpayer is unsound in principle.

²⁷ The Treasury Department has estimated that 85% of capital gain and loss transactions consist of securities.