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Chapter 7

Effects of the Changing Treatment of Capital Losses and of Short Term Transactions

The character of the allowance for capital losses is in many respects an integral part of the tax treatment of capital gains. Any allowance for capital losses means that the government stands ready to bear a portion of the possible loss of a contemplated transaction, assuming that the loser has other taxable income or capital gains from which all or a portion of the loss may be deducted. The statutory loss allowance, no less than the tax rate on gains, therefore enters into the odds for any investor who can expect sufficient ordinary income or capital gains from which the loss allowance can be deducted. And the character of the loss allowance, like the effective tax rate, may influence the timing of the formal realization of capital gains and losses arising from investments previously made.

1 ALLOWANCES FOR CAPITAL LOSSES HAVE MODERATED THE DETERRENT INFLUENCES OF CAPITAL GAINS TAXES ON INCENTIVES TO MAKE NEW AND LIQUIDATE OLD COMMITMENTS

The preferential tax treatment of capital gains has usually been accompanied by a roughly corresponding or greater limitation upon the allowance for capital losses. Great Britain and other countries that exclude most types of capital gain from taxable income disallow also any deduction from taxable income for capital losses of the same types. In the United States since 1916 capital losses have invariably been allowed in full up to the amount of the capital gains of similar character or holding period, at least.[1] Limitations on deductibility have been confined to net losses, i.e., the excess of losses over gains. In 1918-21, when capital gains were fully taxable as ordinary income, capital losses were allowed in full against income of any kind. When, in 1922-33, the maximum effective tax rate on long term (over 2 years) capital gains was limited to 12½ percent,

[1] Despite the full taxability of capital gains as ordinary income in 1913-17, capital losses were completely disallowed in 1913-15, and were allowed only up to the amount of capital gains in 1916-17.

long term capital losses remained deductible in full at first, but in 1924-33 Congress limited the allowance to a maximum of a tax credit of 12½ percent of the loss, paralleling the preferential tax limit on long term capital gains. Short term capital losses meanwhile, 1922-33, were allowed in full against ordinary income, just as short term gains were fully taxed.[2] When in 1934-49 varying proportions of long term capital gains were exempted from taxation, the same proportions of long term losses were disallowed as deductions; and when in 1938-49 maximum tax rates on capital gains substantially lower than those on ordinary income were reestablished, the tax credits for long term net losses were restricted to similar percentages of the losses. Beyond such parallel treatment, however, the deductibility of *net* capital losses from taxable income has been arbitrarily limited at various times since 1934 to $2,000 or $1,000, or, in the case of *short term* net losses, has at times been eliminated altogether.

Reasons for parallel treatment of gains and losses

One reason for treating capital gains and losses in an at least roughly parallel manner is that the two possess some of the same peculiarities. Both commonly are from assets held longer than 1 year (or may be so defined for purposes of income taxation). If treated as arising solely in the year of realization and subjected to the regular progressive tax rate schedule, a long term capital gain is taxed more heavily, and a long term capital loss yields a smaller tax reduction, other things being equal, than if the gain and loss were divided among the years during which the asset was held. As far as this consideration justifies special tax treatment of capital gains, it justifies a corresponding special treatment of capital losses. Similarly, those who do not regard capital gains as adding commensurately, if at all, to the recipient's 'true' income or to his current taxpaying ability must, for the same reasons, regard capital losses as something less than full subtractions from 'true' income or current taxpaying ability.

Another view that has exerted considerable practical influence upon legislators regards those who report capital gains and losses as constituting a single group whose members both enjoy the gains and suffer the losses. In this view, the members of the group cannot justly ask that their gains be granted preferential tax treatment but

[2] In 1922-23 short term capital losses were not allowed against long term capital gains, though they were deductible in full against other income; and in 1932-33 short term losses on stocks and bonds were allowed only against short term gains from stocks and bonds.

their losses nevertheless be allowed without restriction. Equity demands equal treatment of gains and losses.

In practice the policy of balancing a preferential tax treatment of capital gains with a corresponding limitation upon the deductibility of capital losses has highly unequal effects upon individual investors. Those who lose their capital early are hurt immediately by limited loss allowance but may never benefit from the liberal treatment of gains. And all other investors whose losses exceed their gains can be expected to derive small consolation from the knowledge that the disallowance of part of their losses has been matched by the equal exemption from taxation of the net gains of their more fortunate fellow investors.

Nevertheless, before the investment is made, when the investor is calculating the odds, a parallel tax treatment of capital gains and losses tends to minimize the law's distortion of the odds and to be 'fair' or 'equal', in this sense, to each investor. If only half of any net capital gain or loss is recognized for tax purposes, for example, the risk of a disallowed loss is balanced against an equal chance for a tax-exempt gain.

2 EVEN LIMITED LOSS ALLOWANCE IS OF GREAT VALUE IN REDUCING DETERRENTS TO NEW COMMITMENTS AND TO REALIZATION

Under substantial tax rates the deductibility of capital losses is important in reducing risks even when it is limited to the amount of capital gains reported by the investor in the same year, i.e., even when *net* capital losses are completely disallowed.[8] To an investor who has already realized or can count upon subsequently realizing equal or bigger capital gains during the taxable year, a provision limiting the deductibility of a possible loss to the amount of gains would be of little practical importance. The loss, if realized, would be fully offset against gains otherwise taxable, and so qualify for complete deductibility. Professional short term traders and specula-

[8] In 1934-37, when the statutory or recognized gains and losses were varying fractions of the actual ones, a $2,000 limit on the excess of recognized losses over recognized gains was in force. In 1938-41 net short term losses were completely disallowed against ordinary income but could be carried forward to apply against short term gains of the succeeding year; there was no limit on the allowance for net long term losses. In 1942-50 the excess of recognized losses over recognized gains was deductible from ordinary income up to $1,000 or net income, whichever was smaller, and the balance could be carried forward and deducted unlimitedly against capital gains and up to $1,000 or net income, whichever was smaller, during each of the next 5 years.

tors are commonly in this position with respect to short term commitments, and many other investors are frequently in a similar position with respect to longer term investments, for they can choose when to sell various marketable assets in which they have unrealized profits. If a disallowed net capital loss is otherwise likely, an investor may choose to sell another asset on which he will realize an offsetting gain, thereby, in effect, being permitted to take this gain tax free. He may repurchase the asset the same day yet be considered to have realized his gain. Hence he can receive full allowance for his capital loss without jeopardizing his position in the other investment. The saving of taxes that would otherwise be payable at some time if he took the gain at all during his lifetime would be equivalent to a reduction of the loss on the losing transaction.

Besides encouraging new commitments by reducing risks, an allowance for capital losses encourages *realization* of gains and losses from old commitments. Whenever an investor with unrealized capital gains on other holdings incurs a capital loss he can realize his gains tax free to the extent of the loss allowance. He has, therefore, a motive for converting unrealized into realized gains. And whenever an investor with unrealized capital losses realizes a capital gain he has a motive to realize the former to the extent of his gain in order to avoid future taxes on the latter.

3 LARGE INVESTORS CAN TAKE BETTER ADVANTAGE OF LOSS ALLOWANCES THAN SMALL BUT THE USUAL LIMITATIONS ARE HARDER ON THE LATTER

The large investor is likely to benefit more than the small from the allowance for losses, whether or not the allowance is limited to the amount of capital gains. If the law permits deduction of capital losses from ordinary income, he is likely to have the advantage of a bigger ordinary income against which to offset losses. With unrestricted loss allowance, moreover, he may find it more feasible to reduce his current income taxes to the utmost by formally realizing his capital losses whenever they arise and postponing the realization of gains until his death, when his properties are inherited and become saleable without capital gains taxation.

Severe limitations on the allowance for net capital losses, nevertheless, are likely to be harder on small investors. When no deduction from other income is allowed for net capital losses, for example, the professional speculator and the investor who makes many commitments are favored over the small investor, other things being

equal, because the laws of chance give them more probability of having some gains against which to offset losses. The small investor is more likely than the big to have his capital wiped out early by a succession of initial losses. The presumably wider variety of investments and the larger resources of the big investor give him more flexibility to choose, with an eye to the maximum tax advantage, the time to realize gains and losses. He is more likely to have other holdings that have appreciated in market value, and to be in a better position, therefore, to realize sufficient gains to give his losses full deductibility. In short, limitations on loss allowance paralleling the preferential treatment of capital gains are likely to be especially hard on the small investor.

4 CHIEF AIMS OF SEVERE LIMITATIONS ON LOSS ALLOWANCES IN RECENT YEARS: TO PREVENT EXCESSIVE TAX AVOIDANCE AND TO MAINTAIN REVENUES

Since 1922 Congress has consistently limited the allowance for capital losses more than it has granted preferences to capital gains. The chief motives have been to maintain revenues and to prevent excessive tax avoidance by individuals with big incomes through sales and exchanges deliberately undertaken to reduce taxes. Wide publicity was given in 1930-34 to cases in which wealthy individuals had established large net capital losses by selling securities to their wives, children, or close friends, from whom they repurchased the identical securities after 60 days.[4] Several eminent New York bankers testified before a Senate committee in 1933 that they had been able greatly to reduce or to wipe out their liabilities for income tax in this manner in 1929-30. Sales to controlled family corporations and family trusts also permitted legal recognition of loss even though an underlying continuity of ownership and control persisted. Coming at the same time as public revelations that many well-known financiers had avoided full payment of taxes on their capital gains during the booming 'twenties by using family corporations, trusts, and foreign corporations as vehicles for the receipt of their gains, this testimony aroused widespread resentment against the statutory weaknesses that permitted such tax avoidance.

Opportunities to establish losses by wash sales to relatives, friends, and family corporations were subsequently narrowed by new statutory restrictions. But Congress concluded that even in the absence

[4] Cf. Public Report 1455 (1934), 73d Cong., 2d Sess., Vol. 3, Ch. V, especially citations of testimony in Hearings on Stock Exchange Practices before the Committee on Banking and Currency.

of artificial arrangements large amounts of net capital losses were being realized deliberately to reduce income taxes, without correspondingly reducing the taxpayer's capacity to pay them. Opportunities for taking large capital losses without significantly altering the amount or character of the investor's holdings were abundant and nearly continuous during the long decline in the prices of securities and other capital assets in the 1930's. Suppose, for example, a man had invested $100,000 in a diversified list of stocks and bonds from which he received $4,000 a year in dividends and interest. If, as part of a general decline in the market, the market value of his portfolio shrank one-half, he could sell out, thereby establishing for tax purposes a capital loss of $50,000, and immediately use the proceeds to purchase a similar, though not identical, list of securities, also yielding an income of $4,000 a year. His investment position would be essentially the same, yet he would be able to claim a deduction from taxable income because of his $50,000 capital loss. If he waited 60 days after selling (now 30 days), he would have established his capital loss even if he bought back the identical securities.

The opposite situation, as we noted, has often been cited in support of proposals to exclude capital gains from taxable income. The capital gains of an investor who purchases for $80,000 a portfolio of securities yielding an annual income of $4,000 and, after a rise in the market, sells the portfolio for $100,000 and with these funds buys another but similar list of securities also yielding $4,000 a year, is not, the contention is, a true addition to income. The investor's dividend and interest income remains $4,000 a year, and his holdings of securities, though altered in detail, leave him in an essentially unchanged investment position.

The correspondence in principle between the character of the loss and of the gain in the examples just cited is clear, but Congress preferred to limit the allowance for losses and reduce the taxation of gains instead of excluding both gains and losses from the calculation of taxable income. On the one hand, it did not wish completely to exempt from taxes the large amounts of real as contrasted to nominal capital gains; that is, gains representing a true increase in the wealth or purchasing power of the investor rather than a mere reflection of a general rise in prices. When realized by sale, the increase in the value of a farm from $10,000 to $1 million after oil is discovered on it, and the increase in a stock's value from $40 to $75 a share because of the added earning power resulting from reinvested earnings or expected from new products or contracts, exemplify such real gains. On the other hand, Congress did not wish the

government's revenues to be highly vulnerable to investors' shrewd exploitation of short run price declines and even to longer run declines. Although the initiative is in their hands, many investors find it convenient or necessary from time to time to realize gains that are nominal in some degree, thereby subjecting themselves to taxes on them. But whereas the taxation of gains discourages unnecessary realization of nominal gains, a full or liberal allowance for capital losses encourages the taking of what we have termed nominal losses. In other words, investors are given a tax incentive to minimize their realization of nominal gains but to maximize their realization of nominal losses.

In general, morever, the investor's discretionary control over the timing of the realization of gains and losses, together with the desire to maintain revenues, has probably been the most important factor in influencing Congress to limit the recognition of net losses. It has often permitted the investor to offset ordinary income and real capital gains with nominal losses due to temporary but general price movements in the security markets, and in other ways to whipsaw the government's efforts to tax him. Tax lawyers, accountants, and financial institutions encourage and aid the investor in such endeavors. Toward the close of each calendar year most persons known to possess sizeable security holdings are likely to receive reminders from brokers, banks, attorneys, or accountants that a worth while saving in taxes can be accomplished without risk or essential change in investment position by appropriate shifts of securities with a view to the realization of losses. It is less commonly pointed out that this advantage will be only temporary if the taxpayer subsequently sells the substitute investment. The cost or 'basis' of the latter will be less than that of the original asset by approximately the amount of loss previously reported. Hence the capital gain realized on the new asset will be larger, or the capital loss, smaller, by the same amount.

Even when the allowance for *net* losses is restricted, the investor's discretionary control over timing gives him a decided advantage. To a considerable degree, he can choose to avoid realizing his possible gains when these would be heavily taxed and to establish his losses in years when he would derive the largest tax advantage from them. That is, the investor can often choose to realize losses in years when his capital gains and other income are unusually large or when the treatment of losses, in his opinion, is unusually and only temporarily favorable, and to realize gains in years when his capital losses are large or his other income small or when the tax treatment of gains

is regarded as unusually favorable. The taxpayer does not have any choice, however, with respect to losses from assets that become worthless. Unless they are reported for the year in which the worthlessness first becomes a fact they are not recognized.

While these reasons for limiting allowances for capital losses go far to explain Congressional policy in this regard, they do not necessarily justify it. The policy has doubtless had severely inequitable effects upon many investors whose timing of purchases and sales was not influenced by tax considerations. Further, by weighting the tax-odds against the risk-taker, its general effect is to discourage risky investment. The desire to maintain government revenues is not a sufficient justification for doing so at the expense of losers as against other taxpayers.

Capital losses, short and long term, were allowed in full in 1917-21. The sole limitation on the deductibility of capital losses in 1922-31 was on long term net losses, the maximum allowance for which was limited beginning in 1924 to 12½ percent.[5] This limitation corresponded with the ceiling tax rate of 12½ percent on long term net gains, and was effective only for individuals with substantial incomes. In 1932 and 1933, following large deductions for short term losses suffered in the stock market, Congress eliminated all allowance for net losses from stocks and bonds held 2 years or less, although short term gains from them remained fully taxable as ordinary income. In 1934-37 the law recognized the same proportions of capital losses as of gains, varying with the length of time the asset had been held, but imposed a limit of $2,000 on the amount of statutory net losses that could be deducted from other income. In 1938-41 this limit was removed, but all net losses on assets held 18 months or less were completely disallowed except that they could be carried forward and deducted up to the amount of the short term net gains in the succeeding year. Beginning in 1942 a flat limit on the deductibility of net capital losses in any one year was reimposed, this time at $1,000, but the balance of net losses could be carried forward for the following 5 years and used in each up to the amount of net capital gains plus $1,000.[6]

[5] Except that in 1922-23 net losses on assets held 2 years or less, while allowed in full against other income, were not allowed against long term capital gains.

[6] If the net income was less than $1,000 in the year the net loss was incurred or in any of the succeeding 5 years in which a balance of net loss was carried forward, the deductibility against ordinary income was limited to the amount of net income.

5 STATISTICS REVEAL NO CLOSE RELATION BETWEEN THE CHANGING TAX TREATMENT OF CAPITAL LOSSES AND THE TOTALS REALIZED

Between 1917 and 1946, therefore, there were 5 periods of major differences in the tax treatment of capital losses. The figures for the 5 periods when the various provisions were in effect cannot safely be compared in detail because of variations in tabulating methods and in statutory definitions. For taxpayers with net incomes the annual average of total net capital losses varied moderately, amounting to $661 million in 1917-21, $837 million in 1922-33, $731 million in 1934-37, $911 million in 1938-41, and $705 million in 1942-46 (Table 1). The annual totals of net capital losses varied far more within each period of uniform tax treatment except one than did the averages for the different periods. The range in 1917-21 was from $70 to $1,102 million; in 1922-33, from $213 to $1,815 million; in 1934-37, from $693 to $772 million; in 1938-41, from $642 to $1,424 million; and in 1942-46, from $519 to $1,052 million. These figures indicate that the tax treatment of net capital losses was not the major influence governing their amounts.

On the other hand, when the net capital losses of individuals reporting statutory net deficits are added to the losses of those reporting net incomes, the data, though too meagre for confident inference, suggest that extreme limitations on the allowance for net losses, such as were in force in 1934-37 and since 1942, may operate to reduce loss realization. Figures on deficit returns are not available before 1928. For the years since, the average annual net capital losses of income and deficit returns combined were larger in the two periods in which there was no absolute limit on the allowance, 1928-33 and 1938-41, than in the 2 periods in which the allowance was rigidly limited, 1934-37 and 1942-46 (Table 1). Obscuring the significance of this difference are the severe stock market declines in the 2 periods when there was no ceiling on the allowance for losses.

Substantial net capital losses were nevertheless reported in 1934-37 and 1942-46, when their deductibility from other income was stringently limited, and relatively small amounts were reported in 1917-18 and 1922-23, when they were allowed in full. These facts reflect the coercive force of nontax influences upon the timing of the realization of capital losses. As already noted, investors on the whole are likely to have less choice in timing the realization of their capital losses than of their gains (Ch. 5, Sec. 4). Crises and depressions, such as occurred in 1920-21, 1929-33, and 1937-38, force the technical realization of capital losses upon numerous taxpayers

through threatened and actual bankruptcies, margin calls, and other imperious demands for liquidation; periods of prosperity and boom do not equally coerce taxpayers to convert unrealized into realized gains.

In one major respect, all our revenue acts since 1916 have been similar: capital losses have been fully deductible up to the amount of a taxpayer's capital gains, at least.[7] In consequence, even when the taxpayer could use his discretion about timing a loss, he has had a strong motive to realize it as soon as he had offsetting gains or other income from which it could be deducted. Postponing realization could promise a larger tax advantage only if he was unable to report sufficient offsetting gains or other income or if he expected the statutory allowance for losses to be liberalized or believed the same loss allowance would save him more in taxes in a future year because effective tax rates on his gains and other income might be higher. Of such incentives to postponement, only two were likely to be strong enough to outweigh an immediate saving in taxes: the desire to avoid sacrificing a part of the tax-reducing value of a loss by 'taking' the latter in a year when offsetting gains, together with the allowable deduction from ordinary income, were less than the loss, and the desire to hold an available offset against an as yet unrealized large capital gain.

6 THE LAW TREATED LOSERS LESS LIBERALLY THAN GAINERS IN 1934-46, BUT THE NET RESULTS WERE FAVORABLE FOR UPPER INCOME GROUPS AND UNFAVORABLE FOR LOWER

As previously indicated, even a parallel special treatment of capital gains and losses may produce highly unequal results for different individuals. Taxpayers who realize net capital gains are sure to be taxed on them but those who incur net losses may not receive any allowance for them. Even the same individual may be taxed on his gains but not receive any allowance for his losses. Under the treatment in effect in 1924-31, for example, an investor with no other income who realized a net capital gain of $10,000 in all even-numbered years and a net capital loss of equal amount in all odd-numbered years, paid taxes on the gains of his good years and did not receive a tax reduction for the losses of his bad years. An unlimited power to carry forward the disallowed losses of one year to future years would greatly diminish, though not entirely remove,

[7] Except that short term net losses were at times not deductible from long term gains.

this source of inequality, but an unlimited carry-forward has never been in force.[8] When the law permits only a small fixed amount of capital losses to be deducted from other income, as in 1934-37 and since 1942, an otherwise parallel treatment of capital gains and losses is likely to have even more unequal effects for different individuals and for different classes of investors.

The tax treatment of capital gains and losses during 1934-37 resulted in excluding from tax somewhat more than a third of the net capital gains realized by individuals with net incomes but in disallowing more than three-fourths of their net losses. The excluded net gains amounted to $1.1 billion, the disallowed net losses to almost twice as much (Table 24). While the law required that identical percentages of gain and loss, varying with the number of years the asset had been held, be excluded in calculating the statutory amounts, the $2,000 limitation upon the deductibility of net capital losses imposed a special disadvantage upon those incurring such losses. (This disadvantage applied to *net* losses alone, not to capital losses that were offset by capital gains.)

For the top income groups, the advantage of having portions of their capital gains exempted from income tax strikingly outweighed the disadvantage of having the same portions of their losses disallowed, whereas the reverse was true for the other income groups. Taxpayers with net incomes of $100,000 or more had aggregate net gains about 5.9 times their aggregate net losses, whereas those with smaller incomes had larger aggregate net losses than gains. The exempted net gains of the former were about 3 times their disallowed net losses in 1934-37, whereas the disallowed net losses of the latter were about 2.6 times their exempted net gains (Table 24).

If the more complete figures available for 1936 are representative of the other years, the advantage of the upper income groups was not merely a reflection of the inclusion in this group of individuals with large capital gains. Taxpayers whose net incomes in 1936 from sources other than capital transactions amounted to $100,000 or over, like those with statutory net incomes of that size, had more of their capital gains than losses excluded from the tax base, whereas the opposite was the case for other taxpayers (Table 68).

[8] If the individual never again realized sufficient capital gains or other income from which the accumulated net loss could be deducted, the carry-forward would not benefit him. If the carry-forward were supplemented by a carry-back against the capital gains and other income of preceding years the more equal treatment of complete averaging of income would be approximated.

The $2,000 limit accounted for about a third of aggregate disallowed net losses, and the statutory percentages, for two-thirds, in 1934-37

The statutory percentages accounted for the major part of the total disallowed loss reported on all returns with statutory net incomes in 1934-37: 64 percent in 1934, 70 percent in 1935, 77 percent in 1936, and 50 percent in 1937. In each year a moderate and irregular tendency existed for the $2,000 limit on the deductibility of net losses to be responsible for an increasing proportion of the total disallowed loss as we go up the income scale. In 1934, for example, the application of the percentages accounted for two-thirds of the disallowed loss of taxpayers with net incomes under $5,000, about one-half for taxpayers with net incomes of $100,000 or over except that the proportion for the group $300,000-500,000 was 66.7 percent (Table 25). In 1937 the $2,000 limit accounted for about 41 percent of the disallowed loss of returns with net incomes under $5,000, but was somewhat more important than the percentages in determining disallowed loss for the income groups above $25,000.

In a few instances at high income levels, the application of the percentages operated to *increase* the deductible net loss above the loss actually realized. This could occur with certain combinations of net gain on long term and net loss on short term transactions. For example, a taxpayer who realized a net gain of $1,000 from an asset held more than 10 years and a net loss of $1,500 from an asset held 1 year or less had a statutory net loss of $1,200 by the application of the statutory percentages, as compared with a realized net loss of $500. In 1937 the percentages operated in this way on net balance for all income groups between $100,000 and $500,000 (Table 25).

The $2,000 limit on the deductibility of net capital losses hurt lower and middle income groups chiefly

While prevention of revenue loss and of inequity through tax avoidance by individuals with big incomes was a main reason for the adoption of the $2,000 limit on the allowance for net capital losses, the income tax data do not supply a good measure of the degree to which this objective was achieved. Of the $752 million of net capital losses disallowed in 1934-37 by reason of the $2,000 limit, 35 percent was disallowed taxpayers with net incomes under $5,000, and 76 percent was disallowed taxpayers with net incomes under $25,000 (Table 25). In contrast, only 6 percent of the total was accounted for by taxpayers with net incomes of $100,000 or over.

It would appear, therefore, that the middle and lower income groups were the main victims of the limitation. In the absence of any limit on deductibility, however, members of the top income groups might conceivably have chosen to realize additional losses by selling securities and other capital assets that had fallen in value below their book costs. Despite the statistical results, therefore, the limitation may have realized the objective of reducing opportunities for tax avoidance by those with large incomes. But a much more generous loss allowance, say $25,000, would have been of value primarily to taxpayers with lower incomes.

Even unrestricted deductibility, though it would have offered some major opportunities for tax saving for various individuals with large incomes from ordinary sources, would doubtless have been of most benefit in the aggregate to the middle and lower income groups. Under all the special statutory treatments of net capital losses, the medium and lower income groups have accounted for much the largest part of the aggregate losses reported by individuals with net incomes. Individuals with net incomes under $25,000 accounted for 55 percent of total net capital losses in 1926-33, 82.3 percent in 1934-37, 80.1 percent in 1938-41, and 88.2 percent in 1942-46. On the other hand, those with net incomes in excess of $100,000 accounted for only 18.2 percent in 1926-33, 3.2 percent in 1934-37, 4 percent in 1938-41, and 2.5 percent in 1942-46 (Table 3).

Because of their divergent investment experience, the top income groups continued to enjoy a net advantage, and the others, a net disadvantage, from the tax treatment of capital gains and losses in 1938-41

The allowance for long term net losses was greatly liberalized in 1938 by the removal of the $2,000 limit on their deductibility. On the other hand, net losses on assets held 18 months or less were disallowed completely except that they could be carried over to apply against short term gains of the succeeding year. At the same time, as already noted, a tax credit of 15 percent of net losses on assets held more than 24 months, and of 20 percent on those held 18-24 months, corresponding to the new ceiling rates on net capital gains, had to be substituted for the new allowance of 66⅔ percent of losses from assets held 18-24 months, and 50 percent of those from longer held assets, whenever this would increase the tax.

Because of the changes in the statute and consequent changes in tabulations, the figures for 1938-41 are not closely comparable with those for 1934-37 (Tables 22-4). Among other things, they under-

state the total realized and the disallowed net losses because they do not include net losses from assets held 18 months or less.

Largely reflecting the elimination of the $2,000 ceiling on the deductibility of net losses, the proportion of long term net losses disallowed was approximately the same as that of long term net gains excluded from the tax, about 50 percent for all taxpayers with net incomes. But the aggregate dollar amount of long term net losses disallowed was about 1.5 times the total net gains exempted, because total long term losses exceeded total long term gains by this proportion for all taxpayers with net incomes (Tables 8 and 20).

As in 1934-37, individuals with incomes of $100,000 or over and those with smaller incomes had quite different experiences, in the aggregate. The net gains of the former greatly exceeded their net losses,[9] $921 million vs. $143 million, whereas the net losses of the latter exceeded their net gains, $3,501 million vs. $2,223 million. In consequence, the partial disallowance of net capital losses and the corresponding exemption of equal percentages of net capital gains had the effect of accentuating the good fortune of the former and the misfortune of the latter, as groups. The disallowed long term net losses of taxpayers with net incomes under $100,000 were more than twice their exempted net gains, while the exempted net gains of those with net incomes of $100,000 or more were over 6 times their disallowed long term net losses (Table 24). These figures slightly understate the effective loss disallowance of the upper income groups in 1938-41 because they do not take account of the provision that the tax reduction resulting from a net capital loss could not exceed 15 percent of the loss from assets held longer than 24 months or 20 percent of that from assets held 18-24 months.

Heavy loss realization in 1938-41 does not seem to have been due primarily to removal of $2,000 limit

Net capital losses reported by individuals with net incomes in the 4 years after the removal of the $2,000 limit on loss allowance were substantially heavier than in the preceding 4 years. Their long and short term losses together amounted to $2,925 million in 1934-37, their long term losses alone to $3,494 million in 1938-41, exclusive of $149 million of losses on depreciable property used in the taxpayer's business as well as of short term losses which were completely disallowed.

The year 1941 was noteworthy because the total net capital losses

[9] Exclusive of short term net losses, which were completely disallowed in 1938-41 and therefore not tabulated in *Statistics of Income*.

reported, even though they excluded short term net losses, exceeded those of all years except 1929-33.

The behavior of the stock market, in conjunction with the growing expectation that the United States would enter the war, seems to be the primary explanation for the heavy loss realization of 1938-41. Between the end of 1934 and the end of 1936 stock prices rose markedly, Standard and Poor's index of 90 stocks (monthly average of daily prices) moving from 73.5 in December 1934 to 135.5 in December 1936. A sharp decline followed, the index sinking to 87.5 in December 1937. After small and short-lived recovery movements in 1938 and 1939, the down trend was resumed in 1940. A sharp increase in trading on the New York Stock Exchange accompanied an acceleration of the decline in the months immediately preceding and in the weeks following the Japanese attack on Pearl Harbor on December 7, 1941. The December 1941 index of 69.5 was lower than any monthly average since April 1935.

The removal of the $2,000 limit on loss allowance could be expected to stimulate loss realization but there is no decisive evidence that it was the major influence. The big increase in net losses occurred in 1941, the fourth year following the repeal of the limitation, rather than in 1938, 1939, or 1940 (Chart 7 and Table 1). Approximately 40 percent of the total net losses reported by those with net incomes and 36 percent of the total net losses reported for the 4 years were realized in 1941, while the losses reported for 1938, 1939, and 1940, even after allowing for the exclusion of short term losses, were either smaller or only moderately higher than those of the 3 years immediately preceding.

Nevertheless, a qualification of the foregoing observation is in order. As far as the timing of the realization of losses is in the discretion of the taxpayer, he can be expected not to take them in years when his ordinary income and capital gains are small, such as 1938-40. The removal of the $2,000 limit on loss allowance could be expected to become a stronger stimulus to loss realization after taxpayers' incomes from other sources had recovered, as happened in 1941.

A minor additional stimulus in 1938-41 was a further revision in the treatment of loss by which net losses realized on the sale, exchange, or involuntary conversion of buildings and other depreciable assets used in the taxpayer's trade or business were made fully deductible, whereas in 1934-37 they had been treated like any other capital losses. The rearmament program in 1940 and 1941 stimu-

lated many transfers of such properties in which losses that had long before taken place in the market values of the properties were 'realized'. Of the $3,643 million of net losses realized by individuals with net incomes in 1938-41, $149 million was of this character.

The long term net losses of taxpayers with net incomes of $100,000 or over were about 50 percent larger in 1938-41 than their short and long term net losses together in 1934-37, while the percentage increase in the losses of other taxpayers was less than half as large. The omission from the 1938-41 figures of losses from assets held 18 months or less, which might have increased more for other taxpayers than for those with net incomes of $100,000 or over, impairs, but does not wholly invalidate, the basis for the inference that the removal of the $2,000 limit caused a relatively bigger increase in loss realization by upper than by lower income groups. In any event, the net losses of individuals with incomes of $100,000 and over constituted less than 4 percent of the total net losses of all individuals reporting net incomes in 1938-41.

5 year carryover of net capital losses since 1942 mitigates effect of $1,000 limit on annual deductibility from other income

The maximum allowance of $1,000 in any year for net capital losses, in force since 1942, is the smallest since 1917. But the fact that net capital losses not deducted in one year can be carried forward for the succeeding 5 years and used in full in any of them to offset net capital gains and up to $1,000 of other income removes much of the seeming harshness of the limitation. Indeed, in some respects the new treatment is more generous than any preceding one. Many who suffered large net capital losses in 1929-31 and 1938-41 enjoyed relatively little tax relief from the absence of a ceiling on the deductibility of net capital losses from ordinary income, for their net capital losses greatly exceeded their ordinary income and their unallowed losses could not be carried forward to future years. Under the new treatment taxpayers who sustain heavy capital losses relatively to their ordinary income can expect to obtain a fuller allowance for them because they can carry forward their disallowed losses for 5 years. Taxpayers who die soon after incurring large losses or lose substantially all their capital may suffer heavily from the small immediate allowance for losses yet derive no advantage from the carryforward provision. But for active speculators and investors the long period for which net losses can be carried forward improves their odds by making it more probable that the net capital losses

sustained in any year will eventually be fully offset against the capital gains and ordinary income of other years.

Another respect in which the new treatment is more generous is that short term gains and losses may be used without restriction to offset statutory long term gains and losses, and vice versa, instead of being partly or wholly segregated. Half of realized gains and losses from capital assets held longer than 6 months and the full amounts of shorter term gains and losses are taken into account. The algebraic sum of the statutory amounts constitutes the statutory net capital gain or loss. After up to $1,000 of a statutory net capital loss has been deducted from ordinary income, the balance is carried forward as a short term net loss to the succeeding 5 years. Because $1 of short term capital losses offsets $2 of long term gains, a taxpayer may report a statutory net capital loss even when his transactions actually result in an excess of capital gains.

The new treatment went into force too recently for reliable comprehensive measures of its effects to be reflected in the income tax figures yet available. In 1943-46, $962 million of prior years' net capital loss was carried over on individual income tax returns. The entire amount did not result in current tax reductions mainly because some of it was reported on returns without enough offsetting capital gains. If the present provisions are continued, the aggregate loss carryover is likely in a few years to become very substantial. While it will doubtless operate to reduce tax revenues from capital gains in boom years, it will do so precisely because it will allow taxpayers to offset their gains in such years by losses incurred in the preceding 5 years.

7 EFFECTS OF THE TAX TREATMENT OF SHORT TERM GAINS

During the Congressional committee hearings on the Revenue Revision of 1942 opponents of heavy taxation of capital gains concentrated their attack chiefly upon the tax treatment of short term gains. This was understandable, for gains from assets held 18 months or less were then taxed in full as ordinary income, whereas half the gain from assets held more than 2 years was exempt or, at the option of the taxpayer, the whole was taxed a flat 15 percent, however large his other income.[10]

It was argued that only the lower income groups could afford to 'take' short term gains under the prevailing treatment, and that

[10] Of gains from assets held 18-24 months, a third was excluded from tax or, at the option of the taxpayer, the whole was taxed a flat 20 percent.

short term trading and tax revenues would increase tremendously if Congress would abolish the distinction between short and long term gains, disallow net capital losses completely, and segregate all capital gains from other income and tax them at a low flat rate such as 10 percent.[11] In support of these contentions reference was made to the extremely small volume to which stock market trading had fallen and to the small or negative revenues obtained by the Treasury from the tax treatment of capital gains and losses in recent years: a net revenue loss from this source was estimated to have been experienced in 1940 and 1941 (Table 90). What is the evidence?

The income tax statistics clearly reveal that the progressive increases in tax rates in the 1930's and early '40's were accompanied, in a general way, by a pronounced decline in the relative importance of short term gains at all the main income levels (Table 13). For example, short term gains (capital gains from assets held 2 years or less) averaged 51 percent of the total capital gains of individuals with net incomes of $50,000-100,000 in 1926-29, 41 percent in 1930-33, and slightly under 40 percent in 1934-37. In 1938-41 and in 1942-46, the average proportion fell to 15 and 4 percent, respectively, reflecting, in part, the reduction of the short term period first to 18 months, then to 6 months.

The bare statement of the effective tax rates on short term gains after 1931, particularly for individuals with large incomes, creates a strong presumption that they exercised a restraining influence upon short term trading (Table 87). By 1941 the rates were such that a married man with 2 children paid 48 percent of the next dollar of short term gains if his net income was otherwise $25,000, 59 percent if $50,000, 68 percent if $100,000, and 78 percent if $1 million.

In the face of such rates – they were advanced further in 1942-44 – one might wonder that any material amount of short term gains continued to be realized at all by individuals with sizeable incomes. Yet the Treasury Department, in opposing the contention that high tax rates were responsible for the relatively small importance of short term gains taken by upper income groups, showed that individuals with net incomes over $25,000 accounted for more than twice as large a fraction of the total short term gains as of total net income in each of the 3 years 1938-40.[12]

Outstanding importance of stock market activity

While the rising tax rates doubtless contributed to the declining

[11] *Revenue Revision of 1942,* Hearings, Ways and Means Committee, pp. 910, 922, 928, 983, 1656.

[12] *Ibid.,* p. 1638.

importance of short term capital gains in 1934-46, other forces, notably the movements of the stock market, exerted a strong and perhaps the dominant influence. A large fraction of the total decline took place between 1936 and 1937 when the stock market fell violently but tax rates remained constant (Table 8). In fact, tax rates were not raised for incomes under $50,000 until 1940, and the only advance between 1934 and 1940 for incomes above $50,000 occurred in 1936 when short term gains not only maintained their relative importance but their absolute amount rose to the highest level since 1929. We have already called attention (Ch. 5, Sec. 7, Chart 18, Table 8) to the close relation between fluctuations in stock prices and in short term net capital gains and losses.

The continued contraction in 1938-46 in the relative importance of short term gains at nearly all income levels would appear to be attributable largely to the declining trend of stock prices and the small volume of trading during much of the period and to the reduction of the holding period by changes in the statute, first to 18 months, then to 6 months. From early 1937 until 1943 no recovery that lasted as long as a year or that approached the high prices of 1936 occurred in the average of industrial stock prices. With stock market advances relatively limited in duration and extent, the opportunities for short term capital gains were fewer.[18]

On the other hand, the Treasury's testimony that individuals with net incomes above $25,000 accounted for more than twice as large a fraction of total short term gains as of total net income in 1938-40 does not prove that the high tax rates were not discouraging upper income individuals from short term transactions. The figures cited may be explained in considerable measure by the operations of professional short term traders and speculators, including both those legally designated as dealers and others not so classified. Their transactions account for a considerable proportion of total short term trading in securities. Data made available in recent years by the Securities and Exchange Commission indicate that stock exchange members alone, among such professionals, are commonly responsible for about a fourth of all the shares traded on the New York Stock and Curb Exchanges. Most transactions that stock exchange members conduct for their own account are generally believed to be short term. In addition to members of exchanges, many persons

[18] Short selling during periods of decline can in theory yield gains as large as from buying during periods of advance, but in practice, short selling is undertaken to a much smaller extent, even among professionals and semi-professionals.

devote all or a part of their time to short term speculation and may be properly classified as part- or full-time professionals.

Professional speculators are less likely than casual traders and investors to be deterred from short term commitments by high but nondiscriminatory taxes on their gains. They are practicing a profession or exercising a personal skill, primarily, rather than investing their capital. For this reason their gains are commonly taxed as ordinary income even by countries, such as Great Britain, that exempt similar profits when realized by ordinary investors. Their skill in discounting and otherwise exploiting short term movements in prices constitutes their intellectual capital, so to speak, and can yield them a return only if used. If they diverted their energies to other fields – in which, presumably, they would be less qualified – they would face equally high tax rates. Despite the higher tax costs of short term than of longer term trading, their funds are more profitably employed in numerous very short transactions, such as those characteristic of some floor traders on the New York Stock Exchange who close out each day's commitments before the end of the day's trading.

The deductibility of short term losses from short term gains, even in the absence of more generous allowances for losses, greatly lessens the deterrent influence of high tax rates upon the disposition of professionals to take the risks involved in their operations. Their superior knowledge of the market and the large number of their transactions make it reasonable for them to expect a net balance of gains over losses on their trading as a whole. The high tax rate on the possible gain from any single contemplated transaction is offset in considerable degree by the equally high tax-reducing power of the possible loss, for a loss will be fully deductible from the taxable gains of previous and future transactions within the taxable year. For the professional a 50 percent tax rate, for example, means that the government will not only take half of the possible gain from a contemplated transaction but also stands ready to absorb half the possible loss.[14]

Some short and medium term transactions are adversely affected
The foregoing offsets to the restraining influence of high tax rates upon short term capital transactions apply with much less force to occasional traders and speculators. Those who enter into short term

[14] The practical effects of the tax treatment of capital losses is discussed further in the next chapter.

transactions only infrequently are likely to be more sensitive to high tax rates than professionals for two reasons:

First, they usually lack a backlog of short term gains realized during the taxable year from which a short term loss on a contemplated transaction would be deductible; nor, as previously pointed out, can they be as confident as professionals that they will realize capital gains in future years against which they can offset an excess of losses carried forward from the current year. Short term capital losses have not been deductible from ordinary income to more than an extremely small extent since 1931 (see note 3). Unlike the professional, therefore, they are not likely to be in the position in which the government, by reducing the income taxes otherwise payable on their gains, stands ready to absorb substantially the same fraction of the possible loss on a contemplated transaction as of the possible gain. In consequence, high tax rates may well dissuade the occasional short term trader or speculator from a particular transaction because the prospective gain after taxes does not appear to compensate fully for the risk of capital loss.

Second, such investors, because their skill and information are less specialized for exploiting short term changes, are likely to be more attracted than professionals by the possibilities of reducing their taxes by delaying liquidation if the statute discriminates substantially in favor of longer term gains.

Large capital gains arise from short and medium term promotion efforts, such as the assembling of the constituent members of a merger, of adjoining parcels of real estate that are saleable at a higher figure under common than under separate ownership, and the organization of new enterprises with the deliberate intention of seeking buyers for them as soon as they are well launched. Sometimes the men who launch such ventures have little choice when to 'take' their gains; at other times they have considerable flexibility. If delay in selling significantly enhances the risks, as when large sums must be tied up and the outcome is sensitive to changes in business conditions, or when options to purchase the needed properties can be had only for short periods and the promoters lack the resources to take up the options unless they can sell the properties simultaneously, the possibility of reducing taxes by delaying liquidation will be of little influence. In such situations high tax rates on short term gains will doubtless prevent some transactions that would take place under lower rates, because the prospective gain after taxes does not seem to compensate fully for the risk of loss. But if a moderate delay

in completing the transaction will not increase risk or expense much, a significant difference between the rates applicable to shorter and longer term gains will give investors a strong motive to postpone realization.

In the Revenue Acts of 1942-49 Congress was more responsive to these considerations than it had ever been before. In extending the preferential tax treatment of capital gains to those from assets held less than a year, Congress departed from one of the most widely accepted equitable grounds for differentiating between capital gains and ordinary income: the ground that under a steeply graduated system of tax rates it is unfair to tax a capital gain arising over several years as the income of the single year in which it is realized. The reduction to 6 months doubtless diminished the artificial incentive that had operated under previous Acts to delay some sales a year or more and to inhibit some purchases. Nevertheless the new provision encouraged many who had formerly been resigned to the ordinary tax rates on their short term gains to face the merely moderate delay now required in the technical consummation of such transactions to make their gains eligible for the large concession in tax rates.

The short period of required holding also stimulated the use of various artificial expedients for extending legal ownership of an asset beyond the 6 months even though the substantial equivalent of a sale had been made. For example, a man who wanted to sell 1,000 shares of United States Steel Corporation common stock at $70 a share after buying them only a month before at $65 a share, and yet to treat his $5,000 profit as a long term capital gain, would retain his own shares, for the time being, and sell another 1,000 shares he did not own, directing his broker to borrow the latter from some holder and deliver them to the purchaser. When the 6 months holding period had elapsed, he would close out his short position by delivering his original shares. A provision designed to close the short sale loophole was included in the Revenue Act of 1950. In real estate substantially similar results can be achieved, though with more risk. A seller postpones actual sale but gives an option, for which he exacts a heavy advance payment, exercisable on the day following the expiration of his 6 month ownership. Also used with the same effect is the device of entering into a sales contract but fixing the date for the actual transfer of title beyond the 6 month period.[15] When the required holding period for a long term capital gain was 1 or 2 years, such expedients were riskier and less attractive.

[15] J. K. Lasser, *Your Income Tax, 1948*, p. 118.