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# Chapter 2

## Origins of the Special Legal Status of Capital Gains

### 1 THE HARVEST TRADITION OF INCOME

The concept of income that has come down to us from the past took its character from agriculture as practiced in the Temperate Zone. In a predominantly agricultural economy, income appears to be a physical fact and to consist of the annual harvest or its worth in money. Capital too appears to be a physical fact: it is the land, predominantly.

The formal concepts of income evolved by economists during the eighteenth and most of the nineteenth centuries, though generalized in form, were based squarely upon the nature of agricultural income.[1] Income arises from purposeful economic activity, such as farming, and recurs fairly regularly with the lapse of time, e.g., with the passage of the seasons. It arises from a fixed and continuing source, such as a farm or landed estate. Like the annual harvest, it is given off by or separated from this fixed source and becomes available for independent disposition or consumption without depleting the source. Strongest of all these traditional earmarks of income is the tendency to recur at more or less regular intervals.

Casual, sporadic, and unexpected gains, whether from the sale of land, other property not ordinarily dealt in by the recipient, gifts, or otherwise derived, did not fit into this concept of income. They appeared to be the result of good luck, not the usual product of purposeful activity. Lacking a continuing source, such as a farm or business enterprise, they arose from discrete events. Hence they could not reliably be expected to recur at regular intervals. A prudent man, the conclusion was, will therefore regard them differently from ordinary income. He will treat them as additions to his capital, not available for ordinary consumption. Capital gains in this view included all unexpected receipts.

[1] See P. H. Wueller, Concepts of Taxable Income, a series of four articles in the *Political Science Quarterly,* March, June, September, and December 1938.

## 2 EARLY JUDICIAL CONCEPT OF INCOME DESIGNED FOR ENTAILED AND TRUST ESTATES

The need for a legal concept of income first arose in connection with the common practice of landowners in England and on the Continent of entailing their estates; that is, of limiting the inheritance of an estate to a specified line of heirs so that the estate could not be sold by any one of them or bequeathed at his pleasure. In effect, each succeeding heir was entitled only to the income from the estate during his lifetime, not to any part of the principal. The courts had to distinguish between income and principal in the sense of what could be rightfully consumed by the life-tenant as against what belonged to the *corpus* or body of the estate.

The resulting legal concepts of capital and income were evolved at a time when landed property comprised the bulk of all durable property. The courts adopted the view that a man's capital or estate, usually a farm or group of farms, was a physical entity, and the income from it, its separable fruit or harvest. Increases in the capital value of an entailed estate could not be regarded as income of the life-tenant. What had been left to him was a life-interest in specific pieces of physical property, not in a given capital value. He did not have a right to sell any part of the estate and therefore could not 'realize' a gain in value if it occurred. Hence there was no useful sense in which appreciation in the value of the estate could be considered income. For similar reasons, declines in value did not reduce the income allotted to the life-tenant.

Where property was not entailed or transferred in trust, the question whether a rise or fall in value, realized or unrealized, should be regarded as an element of income was of small practical importance because of the general immobility of ownership and the absence of income taxes.

Since the estates of the propertied classes in postfeudal Europe were commonly entailed, a man's wealth was better measured by his income than by the capital value of the property from which he drew it. And the kind of income that was significant for this purpose was the income that could be reasonably expected, the more or less recurring income, not unforeseen, sporadic gains. Hence in England and in Europe generally it became traditional to measure a man's economic position by the amount of his recurring annual income, not by the principal amount of his estate. 'Smith is worth £5,000 a year' illustrates the type of measure of wealth that persists in England to this day.

### 3 THE PHYSICAL CONCEPT OF INVESTMENT APPLIED TO SECURITIES

When securities and saleable real estate came to constitute large parts of trust estates, the courts had to choose between assigning to the life-tenant as income or to the remainderman as principal the profits realized on sales of assets. Had it been common to think of capital or principal as a pecuniary quantity, the estate to be safeguarded might have been conceived as consisting of a given capital value, with all additions being viewed as income available for consumption. Even unrealized changes in the market value of the items comprising the estate might conceivably have been taken into account in arriving at the income available for the holder of a life-interest.

But this, we have seen, was not the case. The dominant position long held by landed property had fostered the concept of capital as a physical thing. As against the fairly elaborate accounting practices needed to administer a pecuniary or quantitative concept of capital, most owners of property until a century or so ago kept only primitive and scanty financial accounts. Although government bonds and some other securities were bought and sold to a limited extent through stockbrokers long before the organization of the London Stock Exchange in 1773, they were only a tiny and unrepresentative fraction of accumulated private wealth. For most capital assets, primarily landed properties, ready markets did not exist and sales were infrequent.

In these circumstances it is not surprising that, instead of regarding securities as quantities of pecuniary value, measured by cost or market price, the courts applied the same physical concept of capital or principal that they had long applied in the administration of landed estates.[2] A government bond in which the purchaser had invested £1,000 was regarded as a *res*, a thing. The capital investment was not the quantity of money that had been paid for the bond or its market value, but the bond itself. Hence a rise or fall in the value of the bond did not change the investment and was not an element of income. If gains were realized on the sale, they were regarded as nonincome 'accretions to capital' in much the same way as an accretion was said to take place to a piece of land when, in the course of time, a water boundary receded. Since the capital investment was regarded as a thing, not a pecuniary quantity, the

[2] See Nathan Isaacs, Principal – Quantum or *Res*, 46 *Harvard Law Review*, 776 ff. (1933); Roswell Magill, *Taxable Income* (Ronald Press, rev. ed. 1945), p. 29, 40-2.

'maintenance of capital' did not require the maintenance of its value. The entire receipts from interest payments constituted income even if the value of the bond fell below its cost and it was sold at a loss. The retention of the *res* concept of capital in the administration of various trust estates, despite a clear recognition of its alternative, was emphasized by an American court in 1927 (*Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 1043, 298 S. W. 91, 97): "What is the principal or corpus of the estate in cases of this kind? Is it the corporate stock, itself, or its *value* at a given time? Undoubtedly the former. If the trust estate were land, the fact would be clear."

By dint of long usage the concept of a capital investment as a *res* or thing and the correlative view that a rise or fall in its value, realized or unrealized, is not relevant for determining income became thoroughly embedded in the law and traditions of England and various other countries. When the use of incomes as a base for taxes was gradually introduced into Great Britain and Europe, mainly during the 19th century, taxable income was commonly limited to the yields from specific continuing sources. The early European income taxes were not levied upon the total incomes of *persons,* but upon the net yields of various *sources* of income, the rates often varying with the source. Net yield taxes of this type, though now usually supplemented by general personal income taxes, are still levied in most European countries.

When Great Britain inaugurated income taxation in 1798 and when she adopted her present income tax system in 1842, the *form* of the tax was that of a levy on the yields from stated sources, but the effect was that of a *personal* income tax because the same rates were applied to incomes from all sources and because nearly all kinds of income were covered. Consistent with the *res* concept of an investment, though doubtless for other reasons as well, capital gains were excluded. By long tradition capital gains were not regarded as ordinary income, and the British early adopted, and still retain, the principle that taxable income is to be determined by the practices of the business community when these do not conflict with express provisions of the law.[3]

Before World War I British practice also excluded from income tax the profits from isolated or infrequent transactions. This exclusion was in keeping with the agricultural tradition that confined the concept of income to regularly recurring receipts. It appeared to be in keeping, too, with the wording of the law, which applied to

[3] See George O. May, *Financial Accounting* (Macmillan, 1943), Ch. IV.

'annual' income. The British Revenue Act does not expressly define income as such and does not cover all forms of income. It applies only to the types described in 5 'schedules.' Schedules A, B, C, and E deal with income from specified sources, such as the rental value of lands and buildings, and interest on government bonds. Schedule D applies to "the annual profits or gains arising . . . from any kind of property whatever . . . from any trade, profession, employment or vocation," to interest annuities, "and other annual profits or gains not charged under Schedule A, B, C, or E, and not specially exempted from tax. . . ." The word 'annual' had long been interpreted to exclude occasional isolated profits. Opportunities to make sporadic, nonrecurring gains were exceptionally abundant during and immediately after World War I, and much indignation was aroused by the fact that such profits were escaping taxation.[4] The Royal Commission on the Income Tax (Par. 91) was "of the opinion that any profit made on a transaction recognizable as a business transaction, i.e., a transaction in which the subject matter was acquired with a view to profit-seeking, should be brought within the scope of the income tax, and should not be treated as an accretion of capital simply because the transaction lies outside the range of the taxpayer's ordinary business, or because the opportunities of making such profits are not likely, in the nature of things, to occur regularly at short intervals."

But the Commission distinguished such profits from those realized by "ordinary changes of investments" (Par. 90): "Profits that arise from ordinary changes of investments should normally remain outside the scope of the tax but they should nevertheless be charged if and when they constitute a regular source of profit."

The Commission's recommendations were not formally embodied in law. Instead, the Board of Inland Revenue made a vigorous and successful effort to reach the profits from single ventures of an obviously trading nature and those from a series of transactions, each of which separately would not have constituted the carrying on of a trade.[5]

## 4 AMERICAN CONDITIONS DIFFERED

While the economy of the United States was predominantly agricultural in its early years, realized capital gains quickly took on a more

[4] See George O. May, The British Treatment of Capital Gains, *Journal of Accountancy,* June 1942.

[5] *Ibid.*

conspicuous role than they had abroad. Land was so plentiful and cheap that its ownership did not carry the social prestige it did abroad. The strong desire to keep the descent of land ownership along family lines, so conspicuous in Europe, was relatively weak here. The purchase and sale of land and the accumulation of private fortunes through the profits from such transactions became common early in our history. On the other hand, long established and stable incomes from land rents and bond interest were rare. Later, the quick succession of economic changes created by the rapid growth of population and the discovery and exploitation of natural resources produced frequent large increases in the market values of countless business enterprises and pieces of real estate. By reason of a high degree of mobility of business men and their capital, a considerable part of such value increases was converted into realized gains.

In many transactions gains from sales of capital assets constituted the major type of profit contemplated. With little regard for the niceties of accrual accounting, profits were commonly sought and calculated on the basis of specific transactions. Opportunities for capital gains were in fact recurring. It became not uncommon for some business men to meet a part or even all of their consumption requirements from capital gains. In some sections of the country farmers acquired the reputation of buying their farms with one eye on the income to be obtained from farming and the other on the trend of land values.

In this environment capital gains became scarcely distinguishable from ordinary business profits for many business men and a familiar source of private wealth. At the same time, unlike the situation in England, the value of a man's principal or capital, rather than the income he derived from it, was generally adopted as the measure of his wealth. For these reasons the sharp distinction between ordinary income and capital gains that still prevails in England never obtained as strong a hold in the United States.

### 5 AMERICAN JURISPRUDENCE INHERITED THE BRITISH CONCEPTS BUT WAS GOVERNED BY DIFFERENT STATUTES

American jurisprudence inherited from the British common law the tendency to regard a capital investment as a thing, rather than as a quantity of pecuniary value equal to the original cost or market value. But when Congress expressly included the gains from capital assets in taxable income, the Supreme Court did not find this unconstitutional. The Court did, however, establish the requirement that, to be taxable as income, the gains must be 'realized.' And in ruling on the earmarks of realization, it has tended to apply the *res* as against the value concept of capital investment.

The Revenue Act of 1862, the first tax measure of the Civil War period to become effective, introduced an income tax "upon the annual gains, profits, or income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any other source whatever, except as hereinafter mentioned, if such annual gains, profits, or income exceed the sum of six hundred dollars. . . ."[6] Neither the Act nor the regulations referred specifically to capital gains and losses, though the language of the form for reporting the tax appeared to be broad enough to include them.[7] That profits on sales of real estate were taxable is known from the objections raised in Congress during the discussion of the Revenue Act of 1864 to a ruling of the Commissioner of Internal Revenue that profits from real estate were income in the year of sale even though they had accrued over a long period.[8] The 1864 Act altered this treatment by providing that gains and losses from sales of real estate should be taken into account in determining taxable income only when realized from property that had been acquired within the preceding year, but expressly included in "the annual gains, profits, or income" to be taxed "all income or gains derived from the purchase and sale of stocks or other property, real or personal. . . ."[9] In 1867 the law was amended (14 *Stat. L.* 471-87) by dropping the word 'annual' from the general definition of "the gains, profits or income" to be taxed; by omitting the clause quoted in the preceding sentence under which gains from the purchase and sale of stocks or other property were specifically included; and by including gains from real estate acquired during the preceding two years.

[6] The first act passed, that of 1861, never went into effect. Revenue Act ot 1862, Sec. 89, Public No. 97, 37th Cong., 2d Sess., Ch. 119, 12 statutes.

[7] For a copy of the income tax regulations and an outline of the form for reporting, see C. F. Estee, *The Excise Tax Law* (Fitch, Estee, and Co., New York, 1863).

[8] J. S. Seidman, *Legislative History of the Federal Income Tax Laws, 1861-1938* (Prentice-Hall, 1938), p. 1028, cites to this effect the *Congressional Globe,* 38th Cong., 1st Sess., p. 2516.

[9] 13 *Stat. L.* 223.

In a famous case interpreting the Civil War Income Tax Act of 1867 – *Gray v. Darlington,* decided in 1872 (15 Wall. 63) – the Supreme Court declared that profits of $20,000 realized by an investor in 1869 on the sale of United States government bonds he had owned for four years were not taxable as income.

"The statute looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income. Its general language is 'that there shall be levied, collected, and paid *annually* upon the gains, profits, and income of every person. . . .' This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. There are exceptions, as already intimated, to the general rule of assessment thus prescribed. One of these general exceptions is expressed in the statute and relates to profits upon sales of real property, requiring, in the estimation of gains, the profits of such sales to be included where the property has been purchased, not only within the preceding year, but within the two preceding years. . . . Except, however, in these and similar cases, and in cases of sales of real property, the statute only applies to such gains, profits, and income as are strictly acquisitions made during the year preceding that in which the assessment is levied and collected.

The mere fact that the 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 increase of capital.

The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the statute."

Although some of the language of the opinion, particularly in the second of the three paragraphs reproduced above, reflects the traditional British distinction between income and an accretion to capital, the actual decision appears to have been based squarely upon the wording of the statute.[10] Except for gains from real estate acquired within 2 years, the statute was interpreted to apply only to annual or recurring gains. It is noteworthy that the Court did not condemn the inclusion of the specified real estate gains in taxable income.

The Revenue Act of 1870 (16 *Stat. L.,* 256-62), nearly identical with that of 1867 in its definition of income, was the last of the Civil War income tax laws. After it expired in 1873, Congress did not reimpose an income tax until 1894, when it enacted a measure (28 *Stat. L.,* 553-69) under which taxable income was defined, in part, as in the 1867 Act, as "the gains, profits, and income . . . whether said gains, profits, or income be derived from any kind of property, rents, interest, dividends, or salaries . . . or from any source whatever." Gains from the sale of real estate acquired within 2 years and the money value of gifts and inheritances were specifically included. But the Supreme Court, by a five to four decision in *Pollock v. Farmers' Loan and Trust Company,* held the Act unconstitutional on the ground that the tax was a direct tax which could be valid only if apportioned among the states in proportion to population.[11]

Fourteen years later Congress accommodated itself to this decision, as far as a tax on corporation incomes was concerned, by enacting the Corporation Excise Tax Act of 1909 (36 *Stat. L.,* 13-8) under which the tax was nominally imposed for the privilege of doing business in corporate form, but the amount of the tax was measured by 1 percent of the net income in excess of $5,000. This law was found constitutional.[12] In a leading decision interpreting it, the Supreme Court enunciated a definition of taxable income that it subsequently repeated many times: "Income may be defined as the gain derived from capital, from labor, or from both combined."[13]

In three other decisions under the 1909 Act, all handed down

[10] Magill, *op. cit.,* pp. 103-4.

[11] 157 U. S. 429, 15 Sup. Ct. 673 (1895); on rehearing 158 U. S. 601, 15 Sup. Ct. 912 (1895).

[12] *Flint v. Stone-Tracy Company,* 220 U. S. 107, 31 Sup. Ct. 342 (1911).

[13] *Stratton's Independence, Ltd. v. Howbert,* 231 U. S. 399, 34 Sup. Ct. 136 (1913).

on the same day in 1918, the Supreme Court upheld the inclusion in taxable income of realized gains derived from the appreciation of property values. In *Doyle v. Mitchell Brothers Company,* in which a lumber dealer contended that the proceeds of its sales largely represented a rise in the value of its capital assets, not a taxable gain, the Court said:[14]

"The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the act. 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'.

. . . In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

In *Hays v. Gauley Mountain Coal Company,* the defendant company had realized a gain of $210,000 in 1911 on the sale of stock in another company acquired nine years before.[15] The Court held that the excess of the sales price over the value on December 31, 1908, constituted a taxable profit, and a decision to the same effect was rendered in *U. S. v. Cleveland, C., C. & St. L. Ry. Co.*[16]

## 6 STATUTORY PROVISION FOR TAXING REALIZED CAPITAL GAINS AS INCOME UNDER THE 16TH AMENDMENT SQUARELY UPHELD

The 16th Amendment to the Constitution was ratified on February 25, 1913. The present-day series of income tax laws begins with the first Act passed under it, that approved on October 3, 1913, effective as of March 1, 1913 (38 *Stat.* 166). Net income was defined in the following paragraph, the substance of which has been repeated in the subsequent Acts:

"That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation, or personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property whether real or personal, growing out

[14] 247 U. S. 179, 38 Sup. Ct. 467 (1918).
[15] 247 U. S. 189, 38 Sup. Ct. 470 (1918).
[16] 247 U. S. 195, 38 Sup. Ct. 472 (1918).

of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits, and income derived from any source whatever."

In a series of notable decisions in 1920 and 1921 the Supreme Court crystallized its interpretation that the word 'income' includes capital gains. In *Eisner v. Macomber,* Justice Pitney, speaking for the majority, declared:[17]

"For the present purpose, we require only a clear definition of the term 'income' as used in common speech, in order to determine its meaning in the Amendment; . . . after examining the dictionaries in common use . . . we find little to add to the succinct definition adopted in two cases arising under the Corporation Act of 1909. 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets."

In the *Merchant's Loan and Trust Company v. Smietanka* the Court held that the word 'income' in the 16th Amendment included a gain from a single isolated sale as well as profits from sales by one engaged in buying and selling as a business.[18] The Court said:

"It is sufficient to say of this contention, that no such distinction was recognized in the Civil War Income Tax Act of 1867, c. 169, 14 Stat. 471, 478, or in the Act of 1894, c. 349, 28 Stat. 509, 553, declared unconstitutional on an unrelated ground; that it was not recognized in determining income under the Excise Tax Act of 1909, as the cases cited, *supra,* show; that it is not to be found, in terms, in any of the income tax provisions of the Internal Revenue Acts of 1913, 1916, 1917, or 1919; that the definition of the word 'income' as used in the Sixteenth Amendment, which has been developed by this Court, does not recognize any such distinction; that in departmental practice, for now seven years, such a rule has not been applied; and that there is no essential difference in the nature of the transaction or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction or one of many. 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 a part of the 'general understanding' of the meaning of the word 'income' fails to convince us

[17] 252 U. S. 189, 40 Sup. Ct. 189 (1920).

[18] 255 U. S. 509, 41 Sup. Ct. 386 (1921).

that a construction should be adopted which would, in a large measure, defeat the purpose of the Amendment.

. . . 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 it 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 British income tax decisions are interpretations of statutes so wholly different in their wording from the acts of Congress which we are considering that they are quite without value in arriving at the construction of the laws here involved."

### 7 ACCRUED BUT UNREALIZED CAPITAL GAINS AND LOSSES EXCLUDED FROM DETERMINATION OF TAXABLE INCOME

On the question whether an unrealized appreciation in the value of an asset may be taxed as income the Supreme Court has consistently ruled in the negative. In *Towne v. Eisner* a unanimous court declared that Congress had not intended, when it passed the Revenue Act of 1913, to tax stock dividends as income.[19] The 1916 Act specifically included the cash value of stock dividends in taxable income. When the Standard Oil Company of California distributed a 50 percent stock dividend in 1916, charging the dividend against its accumulated surplus account, one stockholder paid under protest a personal income tax on the part of the value of the dividend that represented corporate profits accumulated after March 1, 1913, and sued to recover the amount on the ground that the stock dividend was not income. In a famous five to four decision in *Eisner v. Macomber* (see note 17), the Supreme Court held on constitutional grounds that income, to be taxable, must be realized, and that a stock dividend is not a realization. The Court declared: "Neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder.

We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is

[19] 245 U. S. 418, 38 Sup. Ct. 158 (1918).

the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

. . . without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

. . . Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term."

The Court made liberal use of italics to emphasize that to constitute income the gain must be separated from the capital:

"Here we have the essential matter: *not* a gain accruing to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in,* being *derived,* that is, received or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; – *that* is income derived from property."

As Professor Magill has pointed out, the decision does not explain the Court's reasons for holding why a mere growth in the value of an investment cannot be regarded as income; why a gain, to be income, must be severed from capital (*op. cit.,* p. 18). Professor T. R. Powell, in an often-quoted comment upon this decision, declared:

"Nothing in the nature of things makes separation from capital one of the requisites of income from capital. From a practical commonsense point of view, there is something strange in the idea that a man may indefinitely grow richer without being subject to an income tax."[20]

In accordance with the Court's decision, Congress expressly provided in the Revenue Act of 1921 and in subsequent revenue acts until 1936 that "a stock dividend shall not be subject to tax". The Treasury interpreted this to mean that a corporation might issue any class of its own stock as a dividend to its stockholders without subjecting the latter to income tax on it.[21] The common stockholders might receive a tax-free dividend of 6 percent preferred

[20] Income from Corporate Dividends (1922), 35 *Harvard Law Review,* 363, 376.

[21] Articles 115-8, Treas. *Reg.* 86 (1934).

stock, for example. But in 1936, in *Koshland v. Helvering* (298 U. S. 441, 56 Sup. Ct. 767), the Supreme Court declared: "where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented, he receives income," and "the latter type of dividend is taxable under the Sixteenth Amendment". Congress promptly removed the blanket statutory exemption it had apparently granted to stock dividends since the Macomber decision of 1920, and replaced it with one reading:

"A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

The Treasury Department soon brought a case before the Supreme Court in which the issues decided in *Eisner v. Macomber* might be reconsidered.[22] The Court, however, on the ground that Congress had not intended to tax the stock dividends in question, refused to reconsider the Macomber decision. A minority of the Court, nevertheless, was ready to do so. Speaking for the minority of three justices, Mr. Justice Douglas declared (pp. 409-11):

"The wealth of stockholders normally increases as a result of the earnings of the corporation in which they hold shares. I see no reason why Congress could not treat that increase in wealth as 'income' to them. . . . The notion that there can be no 'income' to the shareholders in such a case within the meaning of the Sixteenth Amendment unless the gain is 'severed from' capital and made available to the recipient for his 'separate use, benefit and disposal' . . . will not stand analysis. . . . The narrow question here is whether Congress has the power to make the receipt of a stock dividend based on earnings an occasion for recognizing that accrual of wealth for income tax purposes."

## 8 RATIONALE OF THE REALIZATION DOCTRINE

The Supreme Court's insistence that a capital gain must be realized in order to be taxable as income is consistent with the traditional judicial view that a taxpayer's capital investment consists of the thing, the *res,* rather than its value, the land or factory building or share of stock or bond, not its money cost or its market price. As long as the gain is embodied in the same investment entity, the taxpayer is said not to have anything more than he had before.

[22] *Helvering v. Griffiths,* 318 U. S. 371, 63 Sup. Ct. 636 (1943)

When it is separated from this entity or when the investment is sold, the gain constitutes taxable income. In holding that realized capital gains are income, however, the Supreme Court has applied the *res* concept in less extreme form than the British. The latter have continued to regard realized, like unrealized gains, as mere 'accretions to capital': what the seller receives is only the money value of the investment entity he possessed before; the entire proceeds of the sale merely replaces the capital investment he gives up.

As we have observed, the *res* concept was convenient in an agricultural economy with only rudimentary accounting practices. Under present conditions it is much less so. A landed estate could once be presumed to last forever. But much of present-day capital equipment has a relatively short life. To determine net income now requires pecuniary appraisals of the amounts of capital value used up through the depreciation and obsolescence of assets, even when the latter retain the same physical dimensions as before. Stocks and bonds now form a major part of private property, and these are passed frequently from hand to hand by transient owners, quite unlike the landed estates of postfeudal England. Their market value is often their most significant aspect for the investor. A rise in their value gives him the same addition to his command over economic goods and services as an equal addition to his savings from other sources; a fall, the same decrease.

For these reasons, outside the courts, the physical aspects of capital and income have receded into the background and the pecuniary or value aspects have assumed predominance. A man's capital today tends to be regarded as a quantity of pecuniary value that may be shifted from one investment to another. And because the investment is viewed as a quantity of value, not as a thing or series of things, the ancient judicial distinction between income and an 'accretion to capital' now sounds archaic to laymen and is not always intelligible to them. The *res* concept of capital gives rise to such anomalies in England as the nonallowance of depreciation in the determination of taxable income from buildings other than factories, and the nonrecognition of deductions for depletion. In the modified form in which the concept has been applied in the United States such anomalies are greatly reduced. But the requirement that gains must be 'realized' to be taxable frequently produces highly unequal tax treatment as between individuals who realize and those who do not realize their gains. For example, a man whose $5,000 investment in an industrial enterprise becomes worth $5 million during his lifetime may leave his fortune to his children without ever paying an income tax on the amount of the increase by merely not selling the stock or trading it in a taxable exchange. (Of course he will have been subject to income tax on any cash dividends and certain stock dividends he may have received.)

In accordance with the value concept of a capital investment, some economists contend that income in the sense of a man's capacity to contribute to the support of government properly includes both the amount of his consumption expenditures and all net additions to the value of his property during a given period. R. M. Haig's definition, "Income is the money value of the net accretion to one's economic power between two points of time" is of this character.[23] So is Henry Simons' view: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question."[24] Georg Schanz proposed a similar view in Germany in 1896.[25]

Nevertheless, no one can contend that the popular conception of income includes unrealized or 'paper' profits and losses. The income tax statute depends for its successful administration upon the co-operation of millions of individual and corporate taxpayers, each of whom is responsible for making out his tax return. The legal concept of income should therefore approximate that of the intelligent layman. Even if the popular conception were altered through education and experience to include unrealized gains and losses, the difficulties of administering a concept of income that required an appraisal of every taxpayer's assets each year would be forbidding. The liquidation of capital assets is often costly, and the market value of a small amount of a given asset, say 100 shares of X Company common stock, is sometimes not a reliable measure of the price that could be obtained if a much larger amount had to be sold. For these and other reasons, the valuations would in many cases have to be conjectural and therefore subject to dispute; and the accounting and auditing requirements of both taxpayers and tax enforcement officials would be multiplied.

[23] The Concept of Income, *The Federal Income Tax* (Columbia University Press, 1926), Ch. 1.

[24] *Personal Income Taxation* (University of Chicago Press, 1938), p. 50.

[25] Der Einkommenbegriff und die Einkommensteuergesetze, *Finanz Archiv*, XIII (1896), 23.

Nor is the popular conception without merit. Changes in the market values of capital assets are often transitory. To take account of all changes might entail much burdensome bookkeeping with little net result. Even when a rise in value appears to be more lasting, the taxpayer who does not sell might be gravely inconvenienced or injured if he had to pay a tax on his imputed gain under the income tax in the year in which it arises. To sell a portion of his asset to raise funds to pay the tax might be impractical or unduly costly. In short, we might wholly agree with the general validity of the position taken by Haig, Simons, Schanz, and some others, but still hold that the appropriate and convenient time to take account of changes in the value of a man's property is when he realizes the gains or losses.

What constitutes 'realization', however, is a critical question. If only sales for cash were deemed to occasion realization for tax purposes, the door would be opened wide for avoiding taxes on capital gains. Since many if not most sellers of capital assets sooner or later reinvest rather than consume the proceeds, they could contrive, possibly with the aid of third parties, to have their sales take the form of exchanges of some types of capital assets for others. A man might exchange a parcel of real estate for marketable securities having a value several times the cost of the real estate to him, without technically realizing a gain. If an investor wanted to take his profits in General Motors common stock and to shift his funds to Bethlehem Steel common, he might have a broker arrange an exchange, instead of a sale and purchase, and so avoid realizing a taxable gain. Or a corporation might distribute its accumulated profits as dividends consisting of marketable shares of preferred and common stocks in subsidiary or affiliated or even unrelated corporations, without making its stockholders liable to income taxes on the distributions.

But the Supreme Court, by a broad construction of 'realization', removed most of these possibilities of avoiding income taxes on capital gains. In *Peabody v. Eisner* it held that the gain need not be realized in money but might occur in connection with the receipt of property having an exchangeable value.[26] Exchanges of property, no less than sales, may give rise to taxable gains. The Court's rulings in 1920, that the receipt of a stock dividend in the Macomber case did not constitute taxable income to the stockholder even though the dividend represented accumulated profits, has been of

[26] 247 U. S. 347, 38 Sup. Ct. 546 (1918).

much narrower application than was at first supposed. In a series of leading cases concerning new securities received by stockholders in connection with corporate reorganizations, decided between 1921 and 1925,[27] it held that the stockholders realized taxable income when they received securities differing in kind or extent from their previous holdings.[28] When a gain previously accrued was realized by being separated from the investment, it was held to be taxable income even if the value of the investment declined by an amount corresponding to the gain. This was the situation of the stockholders of the Prairie Oil and Gas Company who were held to be liable for income tax on the value of the stock they received in a new pipeline company the parent company created to separate its pipeline business from its oil and gas operations.[29] In short, the realization doctrine has often functioned in practice not so much to deny that unrealized gains are truly gains as to determine the appropriate time or occasion for taking account of them for tax purposes. The chief exceptions are that transfers of property at death or by *inter vivos* gifts are not regarded as occasioning realization of capital gains or losses.

### 9 CORPORATE REORGANIZATIONS AND THE REALIZATION DOCTRINE

Even the realization doctrine, as applied by the Court, led to the creation of income tax liabilities sooner, in many instances, than Congress deemed wise or appropriate. These instances occurred mainly in connection with corporate mergers, consolidations, recapitalizations, and reorganizations. The stock- and bondholders of corporations participating in such readjustments commonly received new securities in exchange for their old ones. Before the Revenue Act of 1921 such exchanges were in some cases held to be the equivalent of sales, requiring the participants to report as a realized gain or loss any difference in value between the securities received and the cost or other basis of the securities surrendered.

Two objections were forcefully voiced against recognizing gain or loss for tax purposes on exchanges of this character. First, many

[27] *U. S. v. Phellis,* 257 U. S. 156, 42 Sup. Ct. 63 (1921); *Rockefeller v. U. S.,* 257 U. S. 176, 42 Sup. Ct. 68 (1921); *Cullinan v. Walker,* 262 U. S. 134, 43 Sup. Ct. 495 (1923); *Weiss v. Stearn,* 265 U. S. 242, 44 Sup. Ct. 490 (1924); and *Marr v. U. S.,* 268 U. S. 536, 45 Sup. Ct. 575 (1925). See Magill, *op. cit.,* for a brief account of these cases.

[28] James Parker Hall, Exchange of Securities in Corporate Reorganization as Income, 20 *Illinois Law Review* 601 (1926).

[29] *Rockefeller v. U. S.,* 257 U. S. 176, 42 Sup. Ct. 68 (1921).

corporate readjustments that involve the issuance of new securities for old do not interrupt the continuity of the taxpayer's investment or alter its essential character. The investor does not receive any money; the new securities merely replace the old ones. To require him to pay a tax on the paper profit imputed in such a transaction may force him to sell a portion of the securities and to make the sale at an unfavorable time as well. He is in essentially the same position as an investor with an unrealized gain.

Second, when all or many such exchanges are treated as occasioning a realization of gain or loss, corporate officials and securities owners hesitate to make various normal and useful readjustments in capital structures and intercorporate relations for fear of incurring immediate tax liabilities. During the Congressional hearings on the Revenue Act of 1921 it was contended that many corporate reorganizations the depression of 1920-21 had made desirable were being impeded by this fear.[80]

In response to these considerations, Congress specified in the Revenue Act of 1921 that no gain or loss shall be recognized in connection with certain classes of exchanges even if the property received in exchange has a realizable market value. The aim was not permanently to exclude these gains and losses from the income tax but to postpone recognition until a more appropriate occasion, i.e., sale. Wide openings for tax avoidance through the so-called reorganization provisions were soon discovered, however. Successive attempts to close the loopholes were made in the Revenue Acts of 1923, 1924, 1926, 1928, 1932, 1934 and, in minor ways, since. Under present law, which in the main embodies the elaborately contrived revisions enacted in 1934, 6 kinds of reorganization are defined in connection with which exchanges of property may take place without the recognition of gain or loss:

1) A statutory merger or consolidation by which one corporation absorbs another, or two or more corporations unite to form a new one.

2) The acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 percent of the voting stock and at least 80 percent of all other classes of stock of another corporation.

3) The acquisition by one corporation, in exchange solely for all

[80] See *Hearings on Revenue Revision,* Ways and Means Committee, 66th Cong., 3d Sess.; *Report of the Ways and Means Committee,* 67th Cong., 1st Sess. (House Report 350); Seidman, *op. cit.,* p. 790.

or a part of its voting stock, of substantially all the properties of another corporation.

4) A transfer by a corporation of all or a part of its assets to another corporation if, immediately after the transfer, the transferor or its shareholders or both are in control of the corporation to which the assets are transferred.

5) A recapitalization.

6) A mere change in identity, form, or place of organization.

In addition, the *Internal Revenue Code,* Section 112 (b) (5) specifies: "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of stock or securities received by each is substantially in proportion to his interest in the property prior to the exchange. . . ." (Control is defined as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock.)

In seeking to confine the taxpayer's advantage from the nonrecognition provisions to postponement of, rather than exemption from, tax liability, Section 113 (a) (6), requires him to measure the gain on any subsequent sale of the property he receives by a basis determined by the original cost of the property given for it, minus any money received and plus any gain recognized. When a corporation issues its own stock as a consideration for property, the basis of the property acquired is the cost to the transferor, increased by the amount of any gain or decreased by the amount of any loss recognized by the latter in the transfer (Sec. 113 (a) (7) ). In these ways, the law endeavors to take account eventually of the appreciation or depreciation occurring up to the time a piece of property is transferred in a tax-free exchange.

Specific as the reorganization provisions appear to have become, they still leave considerable room for judicial interpretation. The question of the distinction between an outright sale and a reorganization has arisen repeatedly. In *Pinellas Ice and Coal Storage Company v. Commissioner,* 287 U. S. 469 (1933), the assets of two companies were transferred to another company for cash and short term notes. The Court held that this was not a reorganization, observing that to rule otherwise "would make evasion of taxation very easy". In a series of decisions the Court appears to have arrived at the broad rule that, as respects the consideration received in what purports to be a tax-free reorganization rather than a sale, "common and preferred stock in sufficient proportion passes the test, while bonds do not".[31] The Court has indicated that a continuity of proprietary interest in the reorganized company must be maintained by the shareholders in the predecessor company.[32] It has excluded various tax-avoidance schemes by requiring that the exchange of assets by one corporation with another in a tax-free reorganization must have a business purpose, not merely the purpose of avoiding taxes.[33] It has held that the earnings of the predecessor companies participating in a tax-free reorganization are the earnings of the successor too, and therefore constitute taxable dividends when distributed to the shareholders. It thus prevented the use of reorganizations for the purpose of effecting tax-free distributions of accumulated corporate earnings. In all these respects it has generally insisted that the spirit as well as the letter of the law be observed. To be tax-free the exchanges must be "required by business exigencies" and must "effect only a readjustment of continuing interest in property under modified corporate forms".[34] The consequence has been to narrow the opportunities for tax-avoidance. Taking its language in part from the decisions of the Court, Congress amended the Internal Revenue Code in 1943 (Sec. 129) to provide that persons who obtained control of a corporation on or after October 8, 1940 and corporations that acquired the property of others the basis of which is also transferred, for the principal purpose of evading or avoiding income or excess profit taxes, are denied the deductions, credits, or other allowances requisite to attaining that end.

### 10 CONGRESS POSSESSES WIDE LATITUDE IN THE TAX TREATMENT OF CAPITAL GAINS AND LOSSES

In the light of these judicial decisions, Congress possesses wide constitutional powers respecting the tax treatment of capital gains and losses. It may tax realized capital gains in full as ordinary income, as it did under the income tax laws of 1913 through 1920. It may subject them to lower rates of tax or exempt varying proportions,

[31] Randolph E. Paul, *Studies in Federal Taxation,* 3d Series (Harvard University Press, 1940), p. 104.

[32] *Ibid.,* pp. 104-21, and Magill, *op. cit.,* pp. 153-62.

[33] *Gregory v. Helvering,* 293 U. S. 465 (1935); and *Lea v. Commissioner,* 96 F (2nd) 55 (1938).

[34] Treas. *Reg.* 103, Sec. 19, 112 (g)-1.

as it has done in one fashion or another at different times since 1921. There is no reason to believe that it lacks the power to exempt them altogether from ordinary income taxes. Its power to allow or to disallow deductions for losses to any extent it deems desirable is beyond dispute. Only the power to tax unrealized gains has been denied by the Supreme Court. Even here, there is a strong possibility that the Court might uphold at least the optional inventorying of securities and other capital assets on the basis of market value, if Congress saw fit to extend this privilege. Dealers in securities are at present permitted to inventory their holdings on the basis of market value if they choose. (Ordinary business concerns are usually required to account for their inventories on the basis of cost, or the lower of cost or market value, or on a 'last-in first-out' basis.[35]) If the law so permitted, the investor who elected to inventory his securities on a market value basis would, in effect, acquire the right to deductions for unrealized capital losses in exchange for agreeing to subject his unrealized profits to taxation. In the opinion of Professor Magill, the decision of the Supreme Court in *Helvering v. Independent Life Insurance Company* indicates that an optional provision of this kind would be valid.[36]

That the Court would uphold the *compulsory* inventorying of capital assets on a market value basis as a part of a general method of accounting and reporting for income tax purposes is doubtful, though not inconceivable. Although the issue is by no means clear, Professor Magill has pointed to several recent decisions indicating that such a plan might be upheld.[37] Whether Congress could constitutionally treat as income unrealized capital gains embodied in property transferred by *inter vivos* gift or at death is a major unsettled question.

Within these relatively moderate constitutional barriers Congressional policy is free to respond, in framing the tax treatment of capital gains and losses, to considerations of equity, economic effects, and administrative convenience. In beginning our discussion of these considerations, we turn first to the economic nature and sources of capital gains and losses.

[35] *Ibid., Reg.* 111, Sec. 29.22, (c)-5 and (c)-2; Sec. 22 (d).

[36] 292 U. S. 371, 54 Sup. Ct. 758 (1934); Magill, *op. cit.*, p. 121.

[37] *Op. cit.*, pp. 119-20. Magill cites *Helvering v. Bruun*, 309 U. S. 461, 60 Sup. Ct. 631 (1940); *Helvering v. Midland Mutual Life Insurance Company*, 300 U. S. 216, 57 Sup. Ct. 423 (1937).