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Chapter 4

Are Capital Gains Appropriate Elements of Taxable Income?

While in an economic sense ordinary income and even relatively pure capital gains overlap in considerable degree, the overlapping is by no means always complete. Different concepts of income, moreover, may be valid for different purposes. An individual may readily concede that a $100,000 legacy he received in 1951 increased his wealth by that amount, yet insist that to regard it as a part of his 1951 income would work an injustice on him and be misleading. Similar contentions have been made with respect to capital gains. The practical question faced by the lawmaker is: are the differences in practice between ordinary income and conventional capital gains and losses sufficient to warrant the exclusion of all or most of the latter from taxable income or, at any rate, to justify a special tax treatment for them?

Conflicts of opinion on this question are traceable to differences in the concepts of income we find useful for different purposes, in our attitudes toward different kinds of capital gains, in our tax objectives, and in our estimates of the practical economic effects of different tax treatments. Some of the chief considerations are examined in this and subsequent chapters.

1 DO CAPITAL GAINS REPRESENT LESS TAXPAYING CAPACITY?

As we have observed, capital gains, unlike wages, interests, rents, or ordinary profits, lack a continuing source such as a job, a farm, or a business enterprise. Instead, they arise out of discrete transactions that may occur only a few times in an individual's life. Hence they lack the relative stability and recurring character of ordinary income. For these reasons many believe that a capital gain represents less taxpaying capacity than ordinary income.

For the same reasons capital gains are usually excluded from what we might term the prudent consumption concept of income, a concept widely used to govern an individual's or a family's consump-

tion expenditures. It distinguishes between sporadic and regularly recurring receipts on the ground that only the latter may prudently be spent. Sporadic gains are often followed by sporadic losses. A prudent man conserves much or all of the former to meet the latter. The implication is that he should not have to pay income taxes on receipts he cannot prudently spend.

These considerations obviously possess some merit. We illustrated them in Chapter 1 by comparing the position of a widow whose annual income of $18,000 comes from her ownership of $720,000 par value of 2½ percent Treasury bonds with that of her brother whose $3,000 of ordinary income is augmented in 1951 by a capital gain of $15,000 realized by the sale of a house he had owned 30 years. To tax the brother and sister alike as the recipients of $18,000 incomes in 1951 is to ignore a significant difference in quality between the two incomes. The bondholder will go on receiving her $18,000 a year indefinitely without significant risk, whereas her brother may never again receive an income in excess of $3,000. An income tax that does not distinguish between recurring and nonrecurring types of income might be said to ignore the fact that a man's capacity to pay taxes depends not only upon his income in any single year but upon the average income he has been receiving and to which he may reasonably look forward.

A contrary argument may also be advanced, however, and has often been used to support proposals for relatively heavy taxation of certain windfall receipts. The recipient of an unexpected gain can afford to pay more of it in taxes precisely because it is a windfall. He has not counted upon it for his ordinary expenditures. Since his gain was unsought, or at least was won without a commensurate service on his part, it is a fitting object for especially heavy taxation. The same reasons make it socially safe to impose such taxation, it is contended, for heavy taxes on unsought and unexpected receipts will not discourage effort and enterprise. Some proposals for special taxation of 'unearned increments', such as Henry George's proposal a few generations ago that increases in land values be taxed away, are based in part upon this view. The belief that relatively high rates of profits usually reflect windfall or unearned profits in large degree supplies much of the support for excess profits tax proposals.

But, as we have seen, conventional capital gains function in considerable measure like other profits in providing incentives for business men and investors and in guiding the allocation of our human and material economic resources; and we noted the practical

impossibility of isolating the truly unsought and unearned elements in the total conventional capital gain. These considerations argue strongly against subjecting conventional capital gains to especially heavy taxation on the ground that they represent unearned windfall receipts.

On the other hand, when we examine more closely the prudent consumption concept of income and the related reasons for holding that capital gains represent less taxpaying capacity than ordinary income, we find that these require not so much the complete exclusion from taxable income of all sporadic receipts and losses as some effective provision for averaging them over the incomes of several years. Irregularity is not peculiar to capital gains. Some ordinary kinds of income, notably profits and commissions, are subject to substantial fluctuations, and even wages and salaries are far from stable in many industries. But capital gains and losses display this characteristic in extreme degree. The strong case that exists on equitable grounds for permitting variations in ordinary income to be averaged over a reasonable period to calculate taxable income becomes compelling when applied to capital gains and losses.

Effect of the progressive rate schedule

Not only are capital gains sporadic, but the amount technically realized in a given year may have actually emerged over many years. To impute an irregular or long emerging gain to a single year has serious practical consequences under a progressive scale of income tax rates because it pushes the gain into higher tax brackets than those into which it would fall if it were distributed among several years. A man whose ordinary net income was $10,000 a year in 1940-49 and who realized net capital gains totaling $50,000 in 1949 in securities purchased 10 years previously would be subject to additional income taxes approximating 42 percent of his capital gain if the latter were included in full as a part of his 1949 income whereas the additional taxes would have aggregated only 24 percent of the gain if the latter had been divided equally among the 10 annual tax returns and taxed as ordinary income at the 1949 rates.[1] Analogously, the tax reduction is smaller – barring changes in tax rates – if a long emerging capital loss or any sporadic loss is charged to the single year in which it is realized than if it is distributed over several years.

For administrative reasons primarily, though for other reasons

[1] Assuming taxpayer is married, does not have any dependents besides his wife, and filed a joint return in 1949.

as well, Congress has been reluctant to adopt direct averaging for either capital gains or ordinary income. One objection has been the resistance of taxpayers to having their tax liabilities increased in bad years by reason of their larger incomes in good years. The preferential tax rates applicable to capital gains during most of our income tax history have been an offset to the inequitable results of applying the progressive rate schedule to long emerging and other irregular capital gains, though different income groups have benefited from this offset in varying degree. In recent years Congress has established a partial measure of averaging by permitting net capital losses to be carried forward and applied against the net capital gains of the succeeding 5 years.

2 IS AN INCOME TAX ON CAPITAL GAINS REALLY A TAX ON CAPITAL?

One of the most persistent objections to taxing capital gains as income is the contention that it leads to the destruction of capital and to double taxation. This objection has been made with special force by those who emphasize the value to society of saving and capital accumulation. A rise in the value of a capital asset means merely an increase in the value of the future incomes expected from it, not in currently disposable income. If the rise is taxed, the owner's capital will be reduced, though by only a fraction of the rise in the value of his capital. For analogous reasons, it may be argued that capital losses should be excluded from the calculation of income. Great natural disasters such as earthquakes and floods, for example, produce losses primarily of future income or capital rather than of current income because the impact of the disaster is mainly on future earning power.

However, the tax cannot literally be paid out of the existing real capital of society as a whole, and therefore cannot directly reduce that capital, except in the limited and unusual case in which it absorbs funds needed to maintain the property and allow for its depreciation. The enhanced value of a piece of land, a mine, a building, or some shares of stock will not be cut by the tax, nor will the remaining capital of society be reduced in value in consequence of it. For society as a whole a capital gains tax, like any other tax, can be paid only from current income (with the limited exception already noted), and it can absorb capital only in the sense of reducing the amount of current income that would otherwise be saved.

For example, if the discovery of new ore veins arouses expectations that the future average net income from a given silver mine

will be stepped up from $100,000 to $300,000 a year, and the going rate of return on such investments is 10 percent, the capital value of the mine will tend to rise to $3 million.[2] If the owners sell, they will realize a capital gain of $2 million. But the rise in capital value represents mainly silver still in the ground, most of which will not be available for some years. It represents future incomes. A tax levied on it cannot be paid this year from future income but must be paid from current funds which might otherwise be saved. This is true whether the funds for the tax come from the price paid by the purchasers or, if the latter pay in the form of promissory notes or other securities, from current savings made by or funds borrowed by the sellers.

There is ground for believing that taxes on capital gains tend to absorb potential current savings to a greater degree than taxes on ordinary components of income. Unusual, unexpected, sporadic, and lumped receipts are not often counted on to meet ordinary consumption needs, nor are the consumption standards of the recipients likely to rise promptly to absorb them. Much of such receipts are apt to be treated as additions to capital, not available for consumption. In consequence, taxes on capital gains are more likely to be paid at the expense of savings than taxes on ordinary income.

The view that double taxation results when capital gains are taxed as income, which we examined in another connection in the preceding chapter, applies with equal force to the part of ordinary income that is saved and invested; and the most vigorous proponent of this view so applied it without distinguishing between the two (Ch. 3, note 7). Professor Fisher argued that to tax a man on wealth he acquires but does not consume, whether he obtains it through ordinary savings or through a rise in the value of his property, is to tax him for adding to the accumulated wealth of the nation.[3] Only a tax on consumption spending would approximate a true income tax in this view.[4] Under such a tax, consumption expenditures made from capital would be treated as income.

Saved income resembles capital gains further in that as soon as current savings from ordinary income are invested in durable goods,

[2] Assuming the mine may be regarded, for practical purposes, as having an infinite life and that it cost $1 million.

[3] Not all additions to an individual's wealth add to the wealth of society, however, as is brought out later.

[4] Strictly speaking, expenditures for durable consumption goods would have to be allocated over the life of the goods rather than counted as income of the year in which they were made.

they too become capital values representing future incomes. If a man invests $25,000 of his savings in a store building, he exchanges them for the future incomes expected from this building. If a tax is imposed both on the savings so invested and on the subsequent income he purchased with them, we have the same double taxation. The tax absorbs potential capital equally when it is levied on saved income as on capital gains, for in both cases it is paid from current income that might otherwise be saved. If the government spends the tax revenues for ordinary operating expenses, it might be said to consume potential capital (waiving the question of the availability of idle resources in the economy). If it spends them on capital improvements, it might be said to convert potential private capital into public capital. But the same statements may be made equally about taxes on saved income and on capital gains. In fact, all taxes absorb private income that might otherwise be saved by the taxpayers.

If, as is nowadays customary, we define income as consisting of consumption plus saving (positive or negative), no double taxation takes place when we tax both the saved part of current income and, subsequently, the income derived from the savings. The recipient has a choice of consuming his whole income or saving a part of it in order to increase his future income. With the same concept of income it may be argued that double taxation is similarly absent when realized capital gains are taxed as income. The investor need not reinvest his gains; he can increase his consumption by an equal amount without entrenching upon his capital. If the capital gain is not included in his income when realized, and the recipient consumes it, the gain would not be taxed even once. If he does reinvest the gain, and it is taxed as a part of his income, he is in the same position as one who saved an equal amount out of income from other sources: his reinvested gain is a part of his saved income, and any yield subsequently derived from it would be a part of his income in future years. Logically, the same argument can be extended to unrealized capital gains. These may be regarded as savings from current income which the investor could have chosen to realize and consume, but which he actually chose to reinvest. (Market quotations are not always a reliable measure of the sales value of large blocks of assets, which sometimes cannot be sold at prices per unit as high as those for smaller blocks and sometimes command higher prices.)

A possible distinction between capital gains and saved income is that the latter appears for a time to offer a wide range of choice with

respect to the form the income may take, whereas the former is already embodied in a specialized form. This distinction may be useful for some purposes of national income analysis. A nation engaged in war could conceivably divert all its productive resources for a time to the creation of goods and services for current consumption, and in this way transform all potential savings from ordinary income into consumed income. But, except by selling assets to foreigners, it could not arrange to have all its capital gains take a currently consumable form. The new silver ores mentioned a few pages back will be consumable only in the future. In effect, for society as a whole, capital gains behave like specialized savings that are automatically invested and cannot be converted at will into consumption goods.

But this distinction has only limited application for individuals. By selling the asset embodying a capital gain, a man may convert his gain into any kind of goods. Except for the trouble and expense of selling, his position is not significantly different from that of a man who has saved an equal amount. If the capital gain has just been realized and is in cash, it is indistinguishable from an equal amount of money saved from current income. If the capital gain has not been technically realized by the sale of the asset, it is indistinguishable from an equal amount of ordinary savings invested in such an asset.

For society as a whole, moreover, saving and investing must be virtually simultaneous. An individual may accumulate wealth in the form of money or other claims against other individuals, but society as a whole cannot, for the increase in the claims of some individuals will be canceled by the increase in the obligations of others. Society as a whole can save only by simultaneously investing the savings in specific ways. The savings must take specific forms day by day as they arise because the surplus productive capacity they represent will not 'keep' unless converted into specialized products. A man's labor unused today cannot be added to the labor available tomorrow; it is lost forever.[5] In practice, therefore, the country's savings must be invested in more or less specialized assets just about as soon as they arise if they are not to be dissipated in losses, and these assets, like unrealized capital gains, then derive their value from the future incomes expected from them.

Although a concept of income that identifies it with consump-

[5] Except, of course, to the extent that rest or recreation increases his future productivity.

tion is doubtless valid for some purposes, its application to income taxes appears to have had relatively few proponents among either economists or laymen. Why? Perhaps one reason is that people do not behave as if final consumption is their sole motivation in earning and using their money incomes. Wealth yields power, security, and other satisfactions even when it is not consumed. Another reason is that a reduction of inequalities in the distribution of income has been an objective of tax policy, and in the minds of lawmakers and others this objective has apparently outweighed solicitude for the growth of capital. A more general reason, discussed further below, is that a broader concept of income than the amount used for consumption alone – current accessions to our power to spend for both consumption and investment – has been widely accepted as more useful for most purposes.

Concern over the ill effects of tax policies in dissipating potential private savings has been far less widespread and influential in recent years than formerly. J. M. Keynes and his followers during the Great Depression attacked the assumption once generally made that private savings are always promptly invested and add commensurately to society's wealth. Instead, they asserted that investment outlets are often insufficient to absorb all the would-be savings, so that a portion of the latter remains barren. The attempt to save what is not currently invested actually does damage, moreover, by reducing the aggregate demand for output and, therefore, for labor and other productive factors. Applied to taxation, one moral of these teachings was that when the government absorbs and spends private funds that would otherwise be saved, or creates and spends new funds, the effect is not always or even usually to reduce private real capital accumulation. In times of underemployment of productive capacity and of inadequate investment outlets for savings, it only prevents these would-be savings from going to waste and from reducing output and employment.

The foregoing view obviously rests upon the assumption that the demand for savings is usually deficient, that underutilization of productive capacity is the normal situation. But even if the opposite were usually or temporarily true, and would-be savings could be expected to become fully invested, it might be contended that the resulting additions to the country's capital would not necessarily include some forms deemed essential for public purposes. Given substantially full employment, private spending for capital purposes competes no less actively than private spending for consumption

purposes with the purposes for which the government is raising revenue. Whether a man spends his income on short lived consumption goods, or on factory buildings and machinery, or on consumption goods that last a long time, he is disposing of scarce labor, materials, and other resources that the government is seeking to command by means of its tax revenues. In levying an income tax, the government implicitly seeks to transfer buying power from private hands to its own. Another objective, as noted above, is to reduce inequalities in income and wealth. A concept of taxable income confined to consumption expenditures would appear to be too narrow for these purposes of the income tax. As far as capital gains resemble saved income, therefore, and apart from other considerations noted below, it may be contended that they are properly included in a concept of income designed to serve as a base for the equitable distribution of the costs of government among taxpayers, although various practical considerations may constrain us to give them special treatment and to leave unrealized gains untaxed.

3 SOME CAPITAL GAINS NOT A PART OF SOCIAL INCOME

In the preceding section we implicity assumed that the capital gains and losses of individuals represent also additions to or subtractions from the wealth of society as a whole. The point was made and discussed that such gains and losses represent changes in the value of prospective future incomes rather than in the present disposable income of society, and in this sense constitute changes in capital, not income. New discoveries of natural resources are outstanding examples of private capital gains that are also additions to the wealth of the nation. The man who discovers an oil pool or copper ores may reap a capital gain that represents no less an addition to the country's wealth than an equivalent amount of saved and invested income. Beyond this, a mere redistribution of titles to property through purchase and sale may put capital assets into more active hands or superior uses and so enhance their value.

But many capital gains of individuals do not add anything to either the present or future income of society as a whole. They are gains made by some individuals at the expense of others. For example, the common stockholders of a corporation may obtain large capital gains at the expense of the preferred stockholders as the result of a recapitalization in which arrearages of preferred stock dividends are wiped out and the regular rate of preferred dividends is reduced in exchange for small concessions in cash or stock granted to the holders of preferred stock. The current and prospective net

operating income of the company may be wholly unaffected by the recapitalization, but the relative rights of the two classes of stockholders in the distribution of this income have been altered to the advantage of the common stockholders.[6] Similarly, a marked reduction in federal tax rates on corporate income, by increasing the prospective earnings available for common stockholders, may lead to substantial appreciation in the value of common stocks and substantial realized capital gains without any correlative increase in the wealth or income of the country as a whole. The increase in private incomes is matched by a decline in the government's income. Analogously, a rise in corporate tax rates, other things being equal, will tend to bring capital losses to individual stockholders even though society as a whole many not sustain any corresponding loss (though it may lose indirectly by discouraging subsequent investment in common stocks of new or growing enterprises). Patents, copyrights, and unauthorized monopolies may enable some concerns to charge prices for their products far above costs. Their continuing ability to obtain a high rate of profit will be capitalized by the market, enabling their stockholders to realize large capital gains by selling their holdings. These gains will not represent additions to the wealth of society as a whole, but only the power of one section of the public to exact higher prices from the rest of the public. The increasing scarcity of land in all densely populated areas leads to increases in the rental value of land and, therefore, in its capital value, without necessarily bringing a corresponding net gain to society as a whole.[7]

In all these cases it may be argued that there is no social income corresponding to the capital gains, and that taxes levied upon the gains are therefore not taxes on true income. The individual has obtained an increase in the commodities and services he can command, but at the expense of other individuals, not from a net addition to the total of goods and services. This point, like a somewhat similar one in the preceding section, may be significant for some purposes. In estimating national income with the object of calculating how much might be available for military expenditures in the event of war, for example, it would obviously be absurd to include

[6] On the other hand, the recapitalization may benefit the preferred stockholders as well as the common by facilitating a general improvement in the corporation's affairs. A new and more vigorous management may be attracted and the company's credit position bettered.

[7] Cf. M. A. Copeland, Problems in the Theory of National Income, *Journal of Political Economy,* Feb. 1932, pp. 12-3.

current increases in the scarcity values of urban land because the resulting estimate of national income would be misleading for the purpose for which it is designed.

But is the same concept of income the most appropriate for income tax purposes? In taxing individual incomes Congress does not inquire, in connection with receipts of salaries, commissions, profits, etc., whether corresponding additions have been made to aggregate social income. The gambler's gains, the racketeer's extortions, the monopolist's exactions are all taxable as income. A prevailing view holds that our object in taxing income is to apportion the costs of government among individuals in accordance with their relative capacity to bear them. Income serves as the base for measuring such relative capacity. The income that is appropriate for this purpose, it may be contended, comprises all increases during the year in an individual's economic power except those, such as gifts and inheritances and unrealized gains and losses in property values, that we choose to exclude on special grounds of policy or expediency. A man who obtains a capital gain by shrewd or lucky trading in titles to property may not thereby raise the national income but he surely adds to his own power to command goods and services from others and to contribute to the support of government. Similarly, to the extent that the income tax is designed to reduce inequalities in the distribution of income – and this is a conspicuous effect of the progressive rates at which the tax is levied – the same emphasis upon changes in their relative economic power, including capital gains and losses, would seem to be appropriate.

4 HOW REAL ARE CAPITAL GAINS AND LOSSES DUE TO CHANGES IN INTEREST RATES?

The implication of some of the preceding discussion has been that if, instead of asking 'What is income?' we ask 'What concept of income is most suitable for the income tax?', many, though not all, persons who might deny that capital gains constitute income for various other purposes might conclude that they should be so regarded for the purpose of the income tax. But all capital gains and losses are not alike. Two kinds, in particular, are regarded by many as less indicative of taxpaying capacity than ordinary income: capital gains and losses due to changes in interest rates; and capital gains and losses due to changes in the general price level.

Changes in the rates of interest prevailing in the investment markets may produce capital gains and losses for investors without

altering the interest and dividend payments they receive from their investments. John Smith owns $100,000 principal amount of 4½ percent 50-year railroad bonds which he bought at par in 1929. They have 30 years to run, but Mr. Smith wishes to sell them in order to reinvest the proceeds in bonds with more diversified maturities he deems safer. The average yield to maturity on the current market value of his old bonds and on those he wishes to buy is now 3 percent. If he sells, he will realize a capital gain of nearly $30,000, but he will have to reinvest the entire capital gain along with his original principal if he is to maintain an undiminished income of $4,500 a year for 30 years from his bond portfolio. If a part of his capital gain is taxed away, the remaining proceeds of his bond sales, invested at 3 percent, will not bring him as much interest income as he received before. But if he does not alter his holdings, he will not pay any tax and will maintain his $4,500 income undiminished. Is this kind of capital gain, a gain due solely to a decline in interest rates, properly treated as ordinary income for income tax purposes? Does it reflect increased taxpaying capacity?

A rise in interest rates may create capital losses of a similar debatable character. Suppose Mr. Smith, because he wishes to avoid the tax, decides not to sell his bonds. Suppose, instead, he achieves the diversification he desires by buying with other resources an additional $100,000 of 30-year prime public utility bonds at par to yield an average of 2½ percent. Suppose that 2 years later, interest rates on such bonds rise to 3½ percent. Smith's new bonds consequently decline in market value to about $82,240. Smith's investment adviser may now say to him: "If you sell this second $100,000 worth of bonds at market prices, you will technically realize a loss of more than $18,000. But you can use the proceeds to replace the bonds you sell with an equal amount of other bonds just as good, for many other good bonds are available with the same yields as the bonds you own. By selling your bonds you will be able to use your loss to reduce your taxable income, thereby cutting your income taxes by perhaps $6,000. Since 1942, the law has been that you must take into your income tax account half of the capital gains and losses from assets held more than 6 months and the full amount from those held 6 months or less. Hence your loss would fully offset an equal amount of long term capital gains or half of short term capital gains. If your taxable capital gains this year are not enough to absorb your allowable loss in full, you will be permitted to offset $1,000 of the remainder against your ordinary income this year

and in each of the next 5 years, as well as to offset the rest against taxable capital gains realized in any of the next 5 years. Hence you are pretty sure to make a handsome tax saving by taking this loss. Yet your bond income will not be reduced at all, for you will get just as much interest on the new bonds you buy as you have been getting from those I advise you to sell." The investment counsellor should have added, however, that the shift in holdings will reduce the investor's cost basis, and will therefore create a larger taxable gain or a smaller deductible loss if the new holdings are subsequently sold.

If we confined our attention to relatively uncomplicated cases of this kind, and assumed that the investor intended never to consume any of such capital gains or to alter his consumption outlays by reason of such capital losses, most persons would probably be inclined to exclude this type of gain and loss from taxable income. The increase in Mr. Smith's economic power when his portfolio rises in value from $100,000 to $120,000 will not seem real to them if Mr. Smith continues to receive the same dollar amount of interest as before. Their attitude would be analogous with respect to the losses arising from a rise in interest rates. Such an attitude is likely to be especially strong in countries and among groups where *rentier* incomes are important.

But in practice several complicating considerations arise. Mr. Smith may not always keep his capital gains inviolate. When interest rates fall markedly, he may sell a portion of his bonds at a substantial gain and use some of the gain for consumption purposes. He may have expected the decline in interest rates and sought the accompanying capital gain as a species of profits, more or less as any speculator seeks to profit from a change in prices. He may now believe that interest rates are likely to go up, and he may speculate on this possibility by keeping his funds withdrawn for a time from fixed interest investments. He may invest a part or all of his capital gain and original principal in common stocks with the aim of profiting from an advance in stock prices or of augmenting his annual investment income. If he exercises any of these or other options, his capital gain serves him precisely as would a profit of equal amount on a business transaction. In short, if we think of Mr. Smith's gain as consumable or even as available for new and different types of investment operations we become inclined to modify our initial position that such gains and losses are unreal.

Another and related disturbing consideration is introduced when we compare Mr. Smith's position with that of Mr. Jones, whose sole

income is his salary. When a decline in the interest rate enables Mr. Smith to realize a capital gain of $30,000, has not his economic position improved relative to that of Mr. Jones, whose salary income has been unaffected by the fall in the interest rate? Here, again, the question appears to turn upon whether it is reasonable to emphasize that Mr. Smith is free to consume his capital gain and his original principal. If we emphasize this aspect, the thought stands out that he now has the power to command $30,000 more of the world's goods and services than before, whereas Mr. Jones can command only the same dollar amount as before. If we assume that Mr. Smith will merely reinvest the proceeds of his sales in other similar bonds, we point attention to the fact that his interest income has not increased any more than has Mr. Jones' salary.

Mr. Smith's position has improved also relative to that of an individual who desires to invest for the first time. Both face lower interest rates, but Mr. Smith has an offset in his capital gain.

In principle, capital gains and losses arising from changes in interest rates would not seem to be different from those resulting from changes in other prices. An interest yielding security is simply a contract, a property right. Changes in its value produce the same alterations in the relative position of its owner as against the rest of the community as changes in the prices of other assets. If a lender contracts to supply the services of his funds at 4 percent a year for 10 years, and the market rate falls to 3 percent, his position is not different in principle from that of a firm that makes a transferable contract to deliver 100,000 pounds of copper a year for 10 years at 15 cents a pound just before a drop in the market price to 10 cents a pound. The contracts of both the lender and the copper firm are marketable pieces of property that have appreciated in value.

These conflicting considerations create doubts respecting the perfect justice in all cases of either excluding from or including in taxable income capital gains arising from changes in interest rates. If we attempted to treat these capital gains and losses specially, however, we would encounter difficulties. Were there merely one rate of interest, it might be possible to arrive at a workable measure of changes in it and, possibly, of the resulting capital gains and losses. But in practice many interest rates appear to exist. The pure rate for gilt-edged notes and bonds of some maturities is different from that for other maturities.[8] The supply of loanable and investible

[8] See David Durand, Basic Yields of Corporate Bonds, 1900-1942, and David Durand and Willis J. Winn, Basic Yields of Bonds, 1926-1947 (NBER, *Technical Paper 3* and *6*, 1942 and 1947, respectively).

funds is not perfectly interchangeable among the different maturities. Some investors, notably commercial banks, are constrained by the nature of their business or by governmental authorities to confine many of their purchases to short term securities. Variations in the confidence of these and other investors respecting the economic and political outlook alter their preferences for shorter or longer maturities at different times and bring about changes in the relative rates of interest. Nor are capital funds equally available for all classes of investments. Some funds are earmarked for gilt-edged investments alone. Other funds, in search of higher yields or speculative gains, are attracted to medium or lower grades of bonds and to the various grades of preferred and common stocks. Hence interest rates may move differently in different parts of the capital markets. Other forces, often stronger, are simultaneously affecting the market values of corporate securities, real estate, and other capital assets. To differentiate the part of a capital gain or loss that is attributable to a change in interest rates from the part attributable to all other forces would inevitably involve a large degree of conjecture.

Finally, it is doubtful that Congress and the public would accept the full logical implications of a special tax treatment for capital gains and losses arising from changes in interest rates. Let us suppose, for example, that these gains and losses were to be excluded from taxable income and that the difficulties of measuring them were overcome. An investor who purchased a certain second grade 5 percent 29 year railroad bond at 80, or $800 per $1,000 bond, because he believed its quality would soon improve and entitle it to sell on the same 3 percent yield basis as prime quality bonds, finds, 3 years later, that his judgment was correct. Because of a general rise in interest rates, however, the bond does not go up to $136, which would reflect a 3 percent yield on a 26 year obligation, but only to $116, at which price it is selling on the same 4 percent yield basis as other long term railroad bonds of prime quality. This investor will realize a capital gain of $360 per $1,000 bond when he sells, but if the effect of the rise in interest rates were excluded, his taxable gain would be $560 per bond. Such a discrepancy between the actual and taxable capital gain would be unlikely to be intelligible to the general public. Analogously, if, by reason of a reduction in earnings and dividends, a certain common stock declines in market value from $100 to $50 a share, then rises to $75 by reason of a sharp decline in interest rates, shall the investor who bought the stock at $100 a share and who sells it at $75, realizing a net loss of $25

per share, be credited for tax purposes with a net loss of $50 per share on the ground that this is the true amount of his capital loss when the effects of the decline in interest rates are excluded? Not to exclude the effects of changes in interest rates in such cases but to exclude them in others would obviously be inconsistent and unfair. Yet to depart in this way from measuring gains and losses by actual results in money would be, aside from the question of technical feasibility, extremely likely to create misunderstanding and dissatisfaction.

We are compelled to conclude that the isolation and measurement of capital gains and losses due solely to changes in interest rates does not seem feasible; and that while some reason for doubt exists respecting the perfect justice of either excluding them from or including them in taxable income, we must perforce treat them like other kinds of capital gains and losses.

5 ILLUSORY CAPITAL GAINS AND LOSSES FROM CHANGES IN THE VALUE OF MONEY

Far more questionable than the capital gains and losses due to changes in interest rates are those due to changes in the value of money. Shifts in the general price level create capital gains or losses that are partly or wholly illusory. During 1944-50 many families sold their houses at substantial profits only to find that houses of the same size and character in the same or another city would take the full proceeds; and that even if they spent these proceeds on other goods they would command little more than the goods originally purchasable with a sum equal to the cost of the house at the time of its original purchase. Did they enjoy a real gain, a real increase in economic power? Should such capital gains be included in their taxable income? Does not their nominal gain only or mainly reflect a decline in the purchasing power or value of the dollar?[9]

The same questions may be asked respecting the capital gains realized by business firms and individual investors when prices are rising. For example, a corporation sells one or more of its plants after a substantial rise in the general price level, and with the proceeds buys or constructs other plants, better located or better designed for its purposes. The very rise in prices that created the apparent capital gain on its old plant will inflate the cost of its new acquisition. Similarly, a man who realizes a capital gain during such

[9] If they had owed money on their houses, however, they enjoyed a real gain at the expense of the lenders by paying off the debts with dollars of smaller purchasing power.

a period from an investment in common stocks may not enjoy any net increase in his command over goods and services. If he sells his stocks for double what he paid for them, but the general average of prices of stocks and of goods entering into the cost of living has also doubled, is it fair to tax his apparent capital gain as income?

Analogously, is it reasonable to allow capital losses as deductions from taxable income when the losses merely reflect declines in the general price level rather than real losses in economic power? Various cases of this sort occurred in the early 1930's. For example, if a man purchased an apartment house for $150,000 in 1926, when the net income from it approximated $15,000 a year, and sold it for $100,000 in 1933, when the net income had dropped to $10,000 a year, he realized a capital loss of $50,000. But $100,000 was then sufficient to purchase other apartment houses just as good as the one he had sold, and the $10,000 a year income he could expect from investing his $100,000 in such assets would purchase nearly as many consumer goods and services as the $15,000 income bought in 1926. The general run of other equity investments, notably common stocks, had suffered larger percentage declines in market value than his apartment house.[10] Does his capital loss of $50,000 truly represent a commensurate decline in his economic power? Should it be deductible in calculating his taxable income?

The obvious implication of the foregoing examples is that capital gains and losses that merely reflect changes in the general price level are not 'real' and that injustices are inflicted if they are treated as elements of taxable income. This is doubtless true. But these examples do not tell the whole story. By reason of both different degrees of sensitivity to general price movements and offsetting or accentuating influences in individual cases flowing from ordinary changes in the relative values of assets, all assets do not participate equally in a change in the general price level. When the latter rises 50 percent, some prices double, others triple, still others increase only 25 percent, while some prices do not rise at all, and perhaps a few may actually decline. The common stocks of automobile companies may rise in value both because the dollar amounts of their

[10] Between 1926 and 1933 rent paid by wage earners and lower salaried workers in 34 large cities, as tabulated by the Department of Labor, declined from 150.7 to 100.7 percent of the 1935-39 average. The total decline in the cost of living as measured by the goods purchased by these workers was from 126.4 to 92.4 percent of the 1935-39 average. The Dow-Jones average of industrial stock prices declined from 153.08 in 1926 to 83.73 in 1933 (average of daily closing figures).

earnings, like those of companies in other industries, are mounting, and because the automobile industry is faring relatively better than other industries. In addition, the stocks of some automobile companies may rise more than those of others because the companies are getting a larger share of the total motor car business; and the stocks of some companies may decline because of a shrinkage in their business. Hence the owners of some assets will enjoy very large real gains in their relative economic power after full allowance for the rise in the general price level; some will have smaller gains; others will be able to sell their assets for as much as or more money than before, but not for enough more to compensate for the rise in other prices; while the real losses of those whose assets decline in price will greatly exceed the amount of the decline. One important class of prices in particular will tend to remain unchanged or to decline somewhat: the prices of high grade debt instruments of all kinds, such as gilt-edged bonds, some preferred stocks and lease contracts, insurance policies, and bank deposits. Their loss in real value will not be reflected in a commensurate decline in price because their dollar claims to income and principal are not reduced. Some may decline moderately in price because some investors may press them for sale in an effort to transfer funds into common stocks and other equities whose prices are expected to participate in the general price rise. Individuals and enterprises owing relatively large long term debts, contracted in order to purchase property, will be able to service and retire these debts with a smaller proportion of their output or income, and the debt will constitute a smaller fraction of the total value of the property. Debtors in this way enjoy special real gains at the expense of their creditors when prices rise, in addition to any other real gains that may come to them in the event that the price advances in their assets outdistance the general price rise. In short, a substantial rise in the general price level usually produces large real as well as nominal capital gains and losses. Analogously, a substantial decline in the general price level tends to be accompanied by substantial changes in the relative economic power of individuals.

In recognition of the nominal character of some gains and losses and of the importance of the accompanying real ones the thought naturally occurs that we might measure and eliminate the former by means of price indexes and include only the latter in calculating taxable income. This is possible, though not without difficulty. Disputes over the choice of an index of prices appropriate for this purpose would be heated. At bottom, price indexes are only averages

of what may possibly be highly dissimilar behavior on the part of the prices of different classes of goods and services. On the ground that investors characteristically use the receipts from sales of capital assets to purchase other similar assets, some would argue in favor of an index based wholly on investment assets, or of several such indexes, one for each major class of assets. Others, contending that the ultimate test of the value of the dollar is its ability to command consumption goods, would hold that an index based upon the latter's prices should be applied. Still others would argue for an all inclusive index of all kinds of prices.

To be consistent and fair in excluding from taxable income capital gains and losses that reflect changes solely in the value of the dollar, the law would have to provide not only for substituting, for tax purposes, amounts of gains and losses different from the amounts actually realized in dollars but also for substituting taxable net gains in some circumstances for dollar losses actually experienced, and deductible net losses for some dollar net gains actually experienced. If the price level fell 30 percent, an investor who sold his bonds at a 10 percent loss would properly be required to include a 28 4/7 percent gain in his taxable income. If the price level rose 50 percent, the investor who sold his bonds at the price he paid for them would properly be regarded as having realized a loss of 33⅓ percent, etc. Obviously, unless confined to exceptional circumstances, such tax treatment could be expected to be difficult to administer and highly confusing to the public. Moreover, allowances for imputed losses of the character illustrated, while consistent and fair, would be likely to stimulate an enormous and unnecessary turnover of fixed income securities, for the purpose of technically realizing imputed losses whenever the official index of prices rose significantly. A man whose $100,000 of high grade bonds remained at par while the official price index rose 25 percent would be motivated to sell his portfolio (probably replacing his bonds with other issues of like character immediately) in order to realize an imputed capital loss of $20,000. On the other hand, by not selling, many investors could avoid tax liability on imputed gains due to a fall in prices.

Such difficulties may lead different persons to diametrically opposite conclusions. Some, impressed with the large volume of purely nominal gains and losses, would minimize unfairness by excluding all capital gains and losses from taxable income. Others, impressed with the large volume of real gains and losses occurring at all times, and often accentuated by changes in the general price level, would minimize unfairness and avoid the difficulties of distinguishing one

type of capital gain or loss from another by including all in taxable income.

The latter group will be joined by those who contend that the possibilities of change in the value of the dollar are risks investors must expect to bear and for which they demand and receive compensation; that the tax laws should not be designed to protect investors from such risks; and that protection from the risks of unstable money must rather be sought in our monetary policies and machinery. They further contend that those likely to be hit hardest by the inclusion of fictitious capital gains in taxable income are also likely to be those who, as holders of equities in real estate and common stocks, tend to gain most at the expense of creditors from the depreciation in the value of money. Similarly, in periods of price decline, when the holders of bonds, mortgages, annuities, and other fixed income contracts improve their real economic position relative to others, they tend to benefit less from the tax allowance for nominal capital losses than holders of equities. Hence, it is argued that the practical effects of including these illusory gains and losses in taxable income are roughly equitable.[11] These contentions doubtless possess considerable merit, but they suffer from being applicable in highly unequal degrees to individual cases.

Granting that it is not feasible to isolate spurious from real capital gains and losses with anything like precision, the question remains whether even a crude and limited attempt to make special provision for the former may not produce a net improvement in equity. Occasionally, when the value of a currency depreciates drastically, the resulting fictitious capital gains may be so tremendous as to dictate special provisions for excluding the increase in value between specified dates from income tax, and for allowing depreciation deductions to be based on the new price level. Something of this sort was done in Belgium after World War I, when the gold value of the franc was stabilized at about 3 cents (the prewar value was 19.3 cents).[12] It was done again in both France and Belgium after World War II (see Ch. 10). Even a gradual rise in the price level, if long continued, raises serious questions respecting both the equity and the practical effects of taxing all capital gains in full as ordinary income. In general it can be argued that the preferential tax treatment of capital gains and the limited allowances for capital losses in force in the United States since the 1920's constitute one means,

[11] Simons, *Personal Income Taxation,* pp. 155 ff.

[12] D. M. Van Buuren, *Revenue Revision of 1942,* Hearings, Ways and Means Committee, 77th Cong., 2d Sess., p. 997.

however crude, of recognizing the illusory character of many capital gains and losses.

6 SPECIAL OBSTRUCTIVE EFFECTS OF TAXES ON CAPITAL GAINS

Many persons who are not greatly impressed by the distinctive characteristics of capital gains and losses as reviewed in the foregoing nevertheless favor preferential tax treatment for them on the practical grounds indicated in Chapter 1. They emphasize that an equitable distribution of governmental costs or a reduction of inequalities in the distribution of income are not the sole objectives of tax policy: encouragement to the *creation* of a larger national income and the avoidance of strong deterrents are also major objectives. Taxes on capital gains, at least when applied only to realized gains, impede the mobility of capital and enterprise. A man who is tempted to reduce his ordinary income tax by working less or by keeping a part of his capital idle is restrained by the consideration that he will lose the income at the same time that he escapes the tax on it. He cannot save the hours he does not work this year and use them next year. Hence, to discourage his exertions, the tax must be so high that the additional income left to him after the additional taxes is not worth the extra effort. But a much smaller tax on a capital gain may, if not applicable to unrealized gains, be enough to dissuade a taxpayer from selling property that he would otherwise sell. He does not necessarily lose the gain by postponing the sale and the tax liability. He may feel that the chances are as good that the property will rise further in value as that it will decline, while by not selling, he defers or avoids a tax. Meanwhile, as we have observed, he will enjoy most of the benefits of the rise in the market value of his property even though he does not sell.

When a man is trying to make up his mind whether to sell a property that has appreciated in value, even a moderate tax rate on capital gains, one substantially lower than that on ordinary income, may be decisive. Suppose his taxable income is $50,000 and his capital gain on the sale will be $100,000. If he is like most men he will not be absolutely certain, apart from the question of taxes, that it would be wise to sell. While some of his friends are urging him to take advantage of the high market to make sure of his gain, others are advising him to hold on in the expectation of a further advance in value. The latter perhaps point out that meanwhile the property will continue to give him an income equal to, say, 8 percent of its present market value. The former perhaps

urge the merits of a competing investment. In the absence of personal circumstances exerting a strong contrary influence, the tax considerations loom large. For if the man sells, he will forfeit $25,000 of his gain to the federal government (under 1950 law). If he postpones selling, he retains the use of this $25,000 without cost. He is now getting $2,000 a year, before taxes, from the $25,000 he would pay in capital gains taxes. And if he never sells, his estate, before death taxes, will be $25,000 larger, other things being equal.

The impeding influence upon property transfers of any substantial tax on realized capital gains, when accompanied by the exemption of unrealized gains, is frequently encountered in connection with the rearrangement of property holdings investors desire to make from time to time as they grow older. A man past middle life may no longer be disposed to exploit vigorously his full powers of ownership in a business enterprise or in a piece of vacant or improved real estate, for example. He might prefer, if a tax cost were not involved, to sell his holdings at the market price and invest the proceeds in securities that do not require active management, such as United States government bonds. A familiar additional motive for selling is to reduce the degree in which an estate is concentrated in a single business enterprise or other property, and in this way to give the heirs the protection that comes from a diversification of risks. But these reasonable motives for selling conflict with the desire to avoid the capital gains tax; the consequence is, in many instances, that the sale is postponed until after the owner's death. When the owner is advanced in years or in feeble health, the tax saving offered for delay looms more important because it is more imminent and certain. Under such circumstances, few investment advisers are apt to counsel against delay when the unrealized capital gains are large.

The deterrent influence of the tax may be felt earlier in a man's life also. Men who have accumulated wealth in one or more highly successful ventures early in life, and who would be ready to realize their gains and to transfer their energies and funds to new ventures, are sometimes deterred by the certain immediate loss in their resources and income from the capital gains tax if they sell. As against this certain loss, the profits of a new venture are still conjectural.

In the opinion of some students impediments to transfers of property, though inconvenient and costly to individuals, do not produce seriously unfavorable social consequences. The investments have already been made. Whether they are owned by one person or

another is not of much importance to society. In fact, a reduction in property transfers should be welcomed because of the accompanying reduction in the energies and resources devoted to speculation, and because of the more responsible character of ownership that is stable. H. M. Groves, for example, declared: "We can't be sure that some reduction in the amount of exchange, or the number of exchanges of investments, would be socially bad. It is often observed that this buying of securities for appreciation results in a very fleeting citizenship in American corporations. Stock owners often take very little responsibility and acquire very little information about the companies they own because their ownership is so highly transitory."[13]

Nevertheless, probably few persons would wish to go far in the direction of obstructing transfers of property. Generally speaking, the unimpeded movement of the various kinds of property holdings from those who are less able or willing to carry and manage them to others who value them more is not only in the interest of the individual but in that of society as a whole. It tends to place the ownership of the various types of assets in the hands of those who are disposed to make the best or most vigorous use of them. The tax on realized capital gains, by setting up an impediment to such transfers, may be charged, therefore, with preventing the optimum use of capital assets. Real estate firms in the larger cities occasionally encounter this impediment when they are attempting to assemble several parcels of real estate as a site for a new office building, department store, or apartment house. One or more of the desired sites is found to be owned by individuals who refuse to sell at prices reflecting even generous appraisals because they desire to avoid the resultant tax on their capital gains.[14] In consequence, a substantial improvement in the use to which the property is put may be prevented. Similarly, it may be argued that if there were no capital gains tax the control of various business enterprises would more readily pass from those whose interest in them has flagged by reason of age or competing opportunities to those who would exploit them more fully or wisely. In short, it may be charged that any substantial

[13] *Capital Gains Taxation, Panel Discussion* (Tax Institute, 1946), p. 19.

[14] To justify their conduct they must be convinced, of course, that the property will not depreciate in value significantly before their deaths, and that the sacrifice of income from the potential selling price, after adjustment for the income now received from the property and for both the capital gains tax and ordinary income taxes, will be more than made up by the combination of the saving in the capital gains tax and the possible further appreciation of the property.

tax on capital gains injures society as a whole by tending to keep the control of capital assets in the frail hands of the aged and inactive.

Strictly speaking, the adverse effects of a capital gains tax upon the mobility of property and enterprise do not arise from the tax as such, but from the fact that it is confined to *realized* gains. If an equal tax were annually imposed upon unrealized gains, the motive for retaining appreciated property in order to defer or avoid taxes would be removed. In other words, it may be said that it is the realization criterion for the taxability of capital gains rather than the tax itself that impedes transfers of property. Various proposals to include unrealized appreciation and depreciation in values in taxable income are reviewed in Chapter 11. We have mentioned some formidable objections to doing so (Ch. 2, Sec. 8): an actual market transaction or something approximating it is widely regarded as an essential criterion of the receipt of income; the legal content of income must approximate that of the intelligent layman for the successful administration of a statute requiring the cooperation of millions of individual and corporate taxpayers; an annual appraisal of every taxpayer's assets, including assets with markets so unorganized that any appraisal would be highly conjectural, would involve serious difficulties and a heavy administrative burden; where the assets are not easily divisable, or are saleable in part only at a sacrifice, and the taxpayer lacks adequate other resources, severe inequities would result from sales forced by a tax on unrealized appreciation; etc.

The allowance of realized capital losses as deductions from taxable income has the opposite effect of taxes on realized capital gains; the one stimulates property transfers, the other discourages them. A man who can reduce his income tax by selling an investment that has depreciated in value has a powerful motive to do so if he can find a substitute investment of equal attractiveness. (Theoretically, the new investment may be less attractive up to an amount equal to the value of the prospective saving in income taxes.) In many cases, he can do so without difficulty. He may sell his shares of stock in one steel company and buy shares in another; he may sell one list of high grade public utility and railroad bonds and buy a list of different but similar bonds; he may sell one building and buy another like it; etc. The taxpayer who contemplates rearranging his property holdings in recognition of his changed health or other circumstances has a positive tax saving motive to sell assets on which he can realize a loss.

The various restrictions that have been imposed from time to time in the United States upon the deductibility of capital losses have doubtless weakened this stimulus to property transfers, but they have far from eliminated it. Since 1916 capital losses have been allowed at least up to the amount of capital gains, except for losses from 'wash sales' of securities.[15] Various nontax influences operate, however, to bring about a fuller realization of potential capital losses than of potential capital gains (Ch. 5, Sec. 4). Hence, it would be difficult to contend that the stimulus of the allowance for capital losses completely offsets the brake of taxes on capital gains.

The deterrent effect of capital gains taxes upon transfers of property must be distinguished from their effects upon business initiative and new investment. To the degree that capital gains are truly 'pure', i.e., unexpected, a tax on them can hardly be said to discourage investment. For if a new investment is made without expectation of a capital gain, but solely in response to the prospects of ordinary income, the tax on capital gains does not enter into the investor's decision. To the degree that capital gains are such merely in form but really represent expected, though contingent, compensation for labor services, interest on capital, rent of scarce resources, or risk-taking, taxes on them will probably exert the same restrictive effects upon new investment and business initiative as equal rates of tax upon ordinary income. But in this connection the markedly preferential tax treatment of capital gains as compared with ordinary income in the United States since 1922 is significant. It can be said to have offered a special stimulus to all ventures and investments whose returns could be made to take the form of capital gains rather than ordinary income. Some case studies illustrating this influence were recently published by two members of the staff of Harvard's Graduate School of Business Administration. Summarizing their conclusion concerning the investment policies of the individual investors in the Lithomat Corporation, they declared: "During the first stage (prior to the time when commercial production became feasible) . . . personal income taxes reduced somewhat the *amount* of savings which interested individuals had available for investment in the project but did not significantly affect their *willingness* to invest in it. . . .

[15] That is, if a taxpayer sells securities at a loss but purchases other, substantially identical, securities within 30 days before or after his sale, the loss is not allowed; nor are losses deductible if they occur in connection with exchanges of property between members of a family.

At the second stage (when production was under way but had not yet become profitable) the personal income tax structure actually *increased* the availability of outside capital to Lithomat. The wide disparity between high individual income tax rates, especially on large incomes, and the relatively low rates on capital gains strongly stimulated the interest of venturesome investors in the Lithomat development. . . . This incentive entirely outweighed in importance the fact that capital gains on the Lithomat project, if successful, would have been fully taxable, whereas capital losses might not have been fully deductible if the project had failed.

In many respects the experience of Lithomat . . . is typical of many new developments offering possibilities of large capital gains. For instance, the interest of individuals actively participating in such developments is usually so intense that personal income taxes are not likely to affect seriously their willingness to invest in the project. Similarly, in so far as the participation of outside capital is concerned, the tax incentive provided by the favorable treatment of capital gains is so pronounced that it must have far-reaching effects on the attitude of investors generally."[16]

The objections examined in this chapter to treating capital gains and losses like ordinary income have been found to possess varying elements of merit and to be subject to qualifications of varying seriousness. Competing with these objections for the attention of the intelligent citizen and legislator are the equitable arguments urged by many and presented in Chapter 1 against any special tax treatment for capital gains and losses.

In a controversy so marked by conflicting qualitative considerations, questions of practical expediency are often decisive. How strong is the tendency of taxes on capital gains to impede transfers of property? Do the figures obtained from income tax returns during the last quarter century and more offer any evidence respecting the practical importance of different rates of tax in this respect? And can we get any light from these figures on certain other unfavorable practical effects that are sometimes attributed to the taxation of capital gains? Further, what evidence exists respecting the influence of the different tax treatments of capital losses we have tried? We turn to these questions in the next three chapters.

[16] J. Keith Butters and John Lintner, *Effect of Federal Taxes on Growing Enterprises* (Harvard University Press, 1945), pp. 24-6.