Chapter 6
EFFECTS OF THE CHANGING TAX TREATMENT OF CAPITAL GAINS UPON INVESTORS' BEHAVIOR

The most persistent and influential objection offered in Congress to any except very low taxes upon capital gains is that they obstruct and distort investment transactions. It is contended that:

1) They induce business men and investors to postpone many potential selling transactions for varying periods or indefinitely. The mobility of capital and enterprise is thereby impaired.

2) They seriously weaken the incentives to make risky though socially desirable investments: enterprise capital, the kind that is willing to forego a relatively safe and regular income in return for a chance for big gains, is deterred by the prospect that the tax collector will reduce the gains to moderate proportions if they are realized at all, and that he will make only niggardly concessions if losses are incurred.

3) They accentuate stock market booms and collapses by discouraging the liquidation of over-priced securities: such liquidation might check or moderate an unhealthy rise. If it does not take place, both the rise and the subsequent decline are accentuated.

4) They so cut down the volume of transactions that tax revenues are less than they would be were the rates lower.

Do the figures compiled from income tax returns provide clear-cut evidence respecting the validity and force of these contentions? And what light do they throw on the effects of specific changes in tax treatment? In examining these figures we must remember that they tell us directly, and inadequately, only what individuals did, not why they did it. Nor can the latter always be inferred. A whole complex of forces operates upon the motives and actions of investors. The tax treatment of capital gains and losses is only one of these, and its influence is usually inextricably interwoven with that of the others. In drawing inferences from the figures reviewed in this chapter a high degree of caution is therefore necessary.
Although in 1917-21 effective tax rates on long term capital gains were the highest in our history, large net gains were realized.

From 1913 through 1921 capital gains, both long and short term, were subject in full to the ordinary income tax rates. These rates were very low at first. In 1913-15 the maximum surtax rate was only 6 percent, and in 1916 only 13 percent. But tax rates were sharply raised during the war years 1917-18, and were lowered only slightly in 1919-21. In 1918 the effective rate on an additional dollar of capital gains for a married individual with 2 dependents was 77 percent if his statutory net income would otherwise be $1 million; 64 percent, if $100,000; 36 percent, if $50,000; 23 percent, if $25,000; 16 percent, if $10,000; and 7 percent, if $5,000. For long term gains these rates were the highest in our history until 1942, when they were exceeded for income levels below about $30,000 but not for those above (Chart 24 and Table 87).

Although capital gains were fully taxable, capital losses were not at first fully deductible. In 1913-15 they were not deductible at all,
and in 1916-17 they were deductible only up to the amount of capital gains realized by the taxpayer. But in 1918-21 they were deductible against income of any kind.

The amounts of net capital gains and losses reported by individuals with net incomes under the 1917-21 tax treatment varied widely in the different years. Despite full taxability at the high regular income tax rates then in force, net capital gains in 1919 and again in 1920, doubtless reflecting the postwar boom, were among the 15 largest in 1917-46 (Table 1). Net gains reported for 1917, 1918, and 1921, on the other hand, were among the 5 lowest in the 30 years. Net capital losses were similarly irregular. The amounts in 1920 and 1921 were among the 9 largest in the 30 years, reflecting the crisis and depression of 1920-21, but in 1918, when net losses were just as fully deductible, the amount was among the 4 lowest.

In the uppermost income groups, however, there is evidence that the high tax rates discouraged the realization of capital gains. First, capital gains constituted a strikingly smaller proportion of incomes of $100,000 or more in 1917-21 than in any subsequent year (Table 5). Further, in 1917-21 they were only about the same proportion of the largest incomes as of all incomes, whereas in the other years they consistently accounted for a conspicuously bigger fraction of very large incomes than of smaller. Finally, in 1922, the first year in which a 12½ percent maximum tax was set on net long term capital gains, the aggregate amount realized by those with net incomes of $100,000 or more jumped very much more than the total realized by those in the other income groups. The rise in the former was about 2,400 percent; in the latter, 70 percent; and the contribution of capital gains to net income rose from less than 2 to about 25 percent for the former, but only from 2 to less than 4 percent for the latter (Tables 2 and 41).¹

¹ The comparisons between different years are not perfectly accurate because changes in the law and in tabulation practices affected the figures in some degree. But little of the pronounced contrasts cited here can be attributed to such changes.
an upper limit of 12½ percent upon tax rates applicable to net capital gains from assets held more than 2 years. This ceiling remained in force until the end of 1933. During this period anyone whose long term gains would be subject to a higher rate if treated as ordinary income was permitted to pay a flat tax of 12½ percent on them in lieu of including them in his ordinary income tax computation. Those with net incomes of less than an amount that varied between about $16,000 and $32,000 in different years continued to be taxed at ordinary income tax rates on their long term net gains, and all taxpayers were so liable on gains from assets held 2 years or less.

Although the upper income groups alone benefited from the 12½ percent ceiling rate on long term capital gains, all taxpayers with capital gains benefited from the successive reductions in normal and surtax rates during the 'twenties. For the upper income groups these reductions lowered the effective rates on short term capital gains, and for other taxpayers, on both short and long term. For a married individual with two dependents and a statutory net income of $1 million, the effective rate on an additional dollar of short term capital gains was reduced from 73 percent in 1921 to 25 percent by 1925; if the statutory net income was $100,000, the reduction was from 60 to 25 percent; if the statutory net income was $50,000, from 32 to 18 percent; if the statutory net income was $25,000, from 19 to 12 percent. The rate for both short and long term gains was cut for those with smaller incomes: from 12 to 4 percent if the statutory net income was $10,000, and from 5 to 1.5 percent, if $5,000 (Chart 25 and Table 87).

Several years after the adoption of the 12½ percent ceiling rate on long term capital gains and after several successive reductions in normal and surtaxes, an unprecedented stock market boom developed in the United States, and the totals of net capital gains realized and of tax revenues from them rose to new heights. After a moderate rise from 94 in 1923 to 114 in 1924, the Dow Jones index of industrial stock prices jumped to 154 in 1925 (December average). The slight recession in 1926, to 149, merely interrupted the vigorous rise which brought the December 1927 average to 197.99 and the 1928 average to 281. Though the index fell to 247 in December 1929, the average for the year was 311. The movement of Standard

\[ \text{For 1922 and 1923, but not for the subsequent years, the law provided that the total tax, including the tax on capital gains, of an individual electing the flat tax of 12½ percent in lieu of the normal and surtax rates, had to be at least 12½ percent of his total net income.} \]
and Poor's more comprehensive index of the prices of 90 industrial, railroad, and public utility company stocks, based upon 1926 prices was roughly similar. The December average in 1923 was 67.6; in 1924, 82.4; in 1925, 101.2; in 1926, 107.1; in 1927, 138.7; in 1928, 183.8; in 1929, 170.0; and the average for 1929 as a whole, 206.6. Considerable speculation in urban and suburban real estate and a large volume of speculative construction of houses, apartment and office buildings, and hotels accompanied the stock market boom.

From roughly $1,200 million in 1923 total net capital gains reported by taxpayers with net incomes, including both short and long term, rose to $1,500 million in 1924 and to $2,900 million in 1925 (Table 1). After a slight recession to $2,400 million in 1926 and a recovery to $2,900 million in 1927 they jumped to $4,800 million in 1928 and sagged a trifle to $4,700 million in 1929. In 1930 the total was again less than $1,200 million; in 1931 it was less than $500 million, or about half the amount reported under the
very much higher tax rates of 1919 and 1920; in 1932 it was the lowest in the 30 years, $163 million; and in 1933, $553 million (Table 1).

The Treasury Department has estimated that its net revenues from capital gains and losses aggregated $1.5 billion in 1926-29, or 41 percent of the total income tax liability of all individuals and taxable fiduciaries. This proportion was not approached in any other period for which figures are available (Table 90). In contrast, the Treasury has estimated that its net revenues in the next four years would have been some $168 million higher had capital gains and losses been excluded by statute from the determination of taxable income.

Did the tax treatment of capital gains and losses in the 'twenties contribute materially to the unprecedented amounts of net gains and of tax revenues from them?

3 MOST CAPITAL GAINS REPORTED IN 1922-33 WERE SUBJECT TO ORDINARY INCOME TAX RATES, WHICH REACHED THE LOWEST LEVELS SINCE 1917

We may note, first, that the greater part of capital gains reported in 1922-33 did not benefit from the 12 1/2 percent ceiling rate because they were realized by taxpayers whose incomes from other sources were not large enough to subject them to a tax rate of more than 12 1/2 percent if reported as ordinary income, or by upper income individuals who had held the assets 2 years or less. In 1922-33 approximately 98 percent of the aggregate net capital gains of taxpayers with net incomes under $50,000 was reported as ordinary income; slightly more than half of the net gains of those with net incomes between $50,000 and $100,000; and 62 percent of the aggregate net gains of all income groups (Table 13). In only one of the 12 years, 1929, did as much as half of the aggregate net gains of all income groups benefit from the 12 1/2 percent ceiling rate (Table 13). In short, for the taxpayers who were responsible for about three-fifths of the total capital gains reported, the tax rates that counted in 1922-33 were those on ordinary income, not the special 12 1/2 percent ceiling rate on capital gains.

Ordinary income tax rates were lower in 1925-31 than at any other time since 1917 (Chart 25 and Table 87). Consequently, the tax rates on short term capital gains were at their lowest. Those on long term gains were in no case higher than those on short term; moreover, they were specifically limited to a maximum of 12 1/2 percent.

In other words, the price, in taxes, of realizing net capital gains during the boom years of realization was the lowest in the history of our income tax except for 1913-16.

The tax provisions ruling in 1925-31 were especially favorable to short term capital transactions. Not only were short term net gains taxed at substantially lower rates than before or after, but short term net losses were fully deductible against income of any kind. For individuals with net incomes above a figure that varied between $16,000 and $32,000 in different years, the ceiling rate of 12½ percent on long term net capital gains was more favorable than the effective rates on short term gains, but this advantage was partly offset after 1923 by a corresponding limit of 12½ percent of the loss on the deductibility of long term net losses. In addition to making the ‘tax cost’ of realizing short term gains much lower than before or after, the tax provisions gave individuals with substantial incomes a special incentive to ‘take’ their losses while these were still short term, and to defer the realization of capital gains until the assets had been held more than 2 years.

4 NONTAX FACTORS WERE OF TRANSCENDENT IMPORTANCE IN THE BOOM OF THE ’TWENTIES

The outstandingly favorable tax laws offer such a tangible and readily intelligible explanation that the temptation is great to ascribe to them the major role in the capital gains boom of the ’twenties. But income tax figures and collateral data indicate that they accounted for only a part, and perhaps a small part, of the behavior of investors and speculators. We know that the boom did not begin as soon as tax rates were reduced, and that the favorable tax treatment did not prevent a drastic decline in capital gains in 1930-33.

Many factors contributed during the ’twenties to raise the prices of capital assets and to swell the volume of capital transactions and of realized capital gains. The period was one of enormous business expansion. The Federal Reserve Board index of industrial production rose from 67 in 1921 to 119 in 1929, or 78 percent. Bank deposits rose $18 billion, or about 50 percent. The underlying business situation received powerful support from such forces as house construction expenditures aggregating $34 billion (as against $8 billion in 1930-38); public utility and railroad construction of $20 billion (as against $11 billion in 1930-38); commercial and miscellaneous building of $20 billion (as against $13 billion in 1930-38); consumer credit expansion of $6 billion (as against a contraction of
$1 billion in 1930-38); and American loans to foreigners of $5 billion (as against $2 billion in 1930-38).¹

The period was also one of rising corporate profits, numerous corporate mergers, and of generally declining interest rates. All three influences operated to raise the market values of capital assets: the first by increasing the income obtainable from corporate securities; the second by promising both a reduction in risks and an increase in income; and the third by giving each dollar of income a higher capital value. Corporate net income reported for income tax purposes rose from $4.3 billion in 1921 to $9.6 billion in 1925, $10.6 billion in 1928, and $11.7 billion in 1929. Moody's average of Aaa corporate bond yields was 5.97 percent in 1921, 4.88 percent in 1925, 4.55 percent in 1928, and 4.73 percent in 1929. And on top of the increases in value due directly to these influences, further increases occurred as speculators attempted to discount the continuation of the favorable trends. The middle 'twenties saw a widespread wave of speculation in urban real estate; the later 'twenties, unparalleled speculation in the stock market.

Unprecedented activity by speculative pools gave an extraordinary stimulus to stock speculation in the second half of the 'twenties. Unhampered by the restrictions imposed by the Securities and Exchange Commission legislation of 1933-34 many such pools were formed and conducted with the aid of corporate managements and of large holders of the stocks involved. Operating on a big scale, they provided organized leadership and attracted large followings. The market value of sponsored stocks not uncommonly rose 50 to 100 percent in a few months. New issues of securities, often of holding companies in the electric light and power industry, were frequently made the vehicles for spectacular speculative operations led by the sponsoring investment bankers. Many members of the upper income groups whose capital gains were usually derived from long term investments became participants in short term speculative operations through their relations with pool leaders and investment bankers.

Other influences also contributed to the rise. Attracted by the price behavior and the prospects of American securities, foreigners bought substantial amounts. More foreign funds supported the rise in American stocks by being lent in the call money market. Bank credit for stock speculation was abundant and margin requirements

¹Lauchlin Currie, testimony before the Temporary National Economic Committee, Hearings, IX, 4010-11.
low, for besides foreign funds, the call loan market benefited from large amounts of the new capital raised through stock issues by domestic corporations and temporarily placed in the call market through New York banks.

And active throughout as both cause and effect in the tremendous rise of capital values during the middle and late 'twenties was the pervading speculative temper of the time.

That these nontax factors were at work does not prove that the low level of taxes on capital gains was of no influence in determining the amounts realized during the 'twenties; even the speculative temper doubtless owed something to the low taxes. The favorable tax situation may reasonably be supposed to have made some speculative and investment operations attractive that would not have been undertaken in the face of higher tax rates, and to have encouraged more realization than would otherwise have occurred. The favorable tax rates were doubtless most influential in the uppermost income groups. Those who had large incomes from other sources and those whose potential capital gains, if realized, were alone of sufficient size to place them in the topmost income groups would naturally be expected to be most sensitive to the character of the tax treatment of their capital gains. In 1922-29 capital gains contributed 62 percent of net income for individuals with net incomes of $1 million or more, 51 percent for those with net incomes of $500,000-1,000,000, 46 percent for those with net incomes of $300,000-500,000, 34 percent for those with net incomes of $100,000-300,000, and 11 percent for all income groups (Tables 2 and 41). While these figures reflect other and more fundamental forces as well as taxation, they show that the tax treatment in the 'twenties was sufficiently favorable to the upper income groups to be accompanied by the realization of gains on an enormous scale by members of these groups.

The low tax cost of short term gains at all income levels and the full deductibility of short term losses probably encouraged more short term trading than would otherwise have taken place. Other conditions also were peculiarly favorable to short term speculation, as we have seen, and, even in the face of materially higher taxes, these might well have produced a very large proportion of the speculative activity that actually occurred. Very much higher tax rates on both short and long term gains did not prevent net capital gains of a billion dollars a year in 1919 and 1920, when other conditions were favorable.

Despite the tax inducement to those with large incomes to con-
vert their unrealized short term losses into realized ones as offsets against their taxable income, the figures do not indicate that this expedient was resorted to extensively—presumably for the very good reason that the trend of the market until 1929 was largely upward, making net gains more common than net losses. From 1926 through 1929 individuals with net incomes of $50,000 or over reported aggregate long term net capital gains of $6.1 billion and aggregate short term net gains of $2.5 billion (Table 9). In contrast, their aggregate short term net losses, while nearly 3 times their long term net losses, were only $.4 billion, more than two-thirds of which was sustained in 1929, the year of the stock market crash (Table 9). Since the general run of long-held capital assets had appreciated markedly in value during the boom, short-held assets would naturally be expected to constitute the chief source of capital losses even if short and long term losses had been equally deductible for the income tax.

Nontax influences for the rising proportion of long term gains in total gains as we ascend the income scale may be reflected in the figures for 1925-31. The effective rate on additional short term gains, as on long, was exactly the same for all incomes of $100,000 or over. Hence, beginning at this income level those with bigger incomes had no more incentive, as far as the rate was concerned, to prefer long to short term gains than those with smaller incomes. Nevertheless, long term gains constituted a progressively larger proportion of the total in this period as in others as we go from incomes of $100,000-300,000 to $300,000-500,000, to $500,000-$1 million, and to $1 million or more (Table 13).

To the extent that those with bigger incomes tended to realize bigger average gains than those with smaller, however, the same tax rate would subject them to a larger absolute tax and might therefore deter them more than those with smaller incomes from realizing their potential gains: the same tax rate, 24 percent, on a short term capital gain and 12½ percent on a long, would take twice as many dollars out of a $200,000 gain as out of a $100,000.

5 Did the 12½ percent rate on long term gains of the upper income groups obstruct the liquidation of securities in the 1928-29 boom?

Curiously enough, the maximum rate of 12½ percent, inaugurated in 1922 as a stimulus to transfers of capital assets, was widely

6 Since the tabulated figures are those of net gains and losses reported, they do not show losses that were less than the gains realized by a taxpayer.
charged in 1928 and 1929 with obstructing the liquidation of securities, and with thereby creating an artificial scarcity of stocks and artificially high stock prices. No doubt the rate seemed higher after 1925 than it had in 1921 because the rates on ordinary income had been so drastically reduced meanwhile: for a married individual with two dependents the maximum effective rate on an additional dollar of income had been cut from 73 percent in 1921 and 58 percent in 1922 to 25 percent by 1925. The ceiling tax rate for capital gains was therefore less of a ‘bargain’ rate after 1924 than it had been before. Nevertheless, it was only half the rate on additional ordinary income for individuals with net incomes of $100,000 or more (Table 87).

But for the many investors who lacked strong opinions respecting the probable trend of prices for one or more of their assets, even a moderate tax on capital gains could doubtless deter liquidation. Such an investor had to consider that if he sold, he not only gave up the chance of benefiting from a possible rise in the value of the asset but faced a certain loss of capital resources and earning power through paying the tax. If he contemplated shifting his funds to what seemed a more attractive investment, the tax on his accrued gains would rationally deter him unless the contemplated new commitment seemed sufficiently more attractive than the old to offset the certain loss of capital funds entailed by the transfer. To these influences must be added the consideration that although the 12½ percent ceiling rate on capital gains was only half the rate on ordinary income, it represented a considerable sum of money when gains were large. And this rate had to be compared not only with the rate on ordinary income but also with the zero rate open to those who kept their property until death or gave it to relatives and others who did not sell it.

Against the contention that the 12½ percent rate prevented a substantial amount of liquidation is the unprecedented volume of stock market sales in the boom years. Between January 1925 and July 1929 the average number of shares listed on the New York Stock Exchange more than doubled; yet the average number of shares sold monthly increased from 7.9 percent of the total in January 1926 to 8.7 and 14.2 percent respectively in January 1928 and 1929. Such a volume of sales might be reconciled with a small volume of real liquidation if the sales represented primarily an enor-

* Based upon tables in the monthly issues of the New York Stock Exchange Bulletin.
mous turnover in a small fraction of the securities outstanding. But
the evidence indicates that a very considerable diffusion of stock
ownership took place. Berle and Means estimate that the number
of stockholders in three of the largest American corporations, the
American Telephone and Telegraph Company, the Pennsylvania
Railroad, and the United States Steel Corporation, increased 237,
47, and 26 percent, respectively, between 1920 and 1929. In a
series of estimates of the number of stockholders of American
corporations, excluding duplicate names, the midpoint of the esti-
mates in 1927 is 5.5 million; in 1929, 8 million — an increase of 45
percent. Total net gains realized by individuals with net incomes
through the sale of securities and other capital assets during the 3
years 1927-29 exceeded the aggregate reported during the preceding
decade.

Finally, the point needs emphasis that even if a lower rate or the
complete tax exemption of long term capital gains might have led
to substantially larger sales of stocks by certain individuals, these
additional sales would not have exerted a moderating influence upon
the general level of prices in the stock market unless the sellers had
refrained from investing the proceeds in other stocks. Only if, in their
judgment, the general outlook had become clouded or adverse would
we expect a large number of sellers to liquidate particular securities
without reinvesting in others. But if they thought the outlook had
indeed become clouded or worse, the 12½ percent maximum rate
on capital gains would not, rationally, act as a serious deterrent to
selling. Since the tax applied to their net gains alone, not to the gross
sales price, an expected decline of substantially less than 12½ per-
cent in the market value of their stocks would more than justify the
‘tax cost’ of selling in the case of stockholders who were actually
considering liquidation.

6 STRONG EVIDENCE THAT THE UNUSUALLY HIGH TAX RATES ON
MEDIUM TERM GAINS OF UPPER BRACKET INCOMES AND THE
LARGE DISCOUNTS OFFERED FOR CONTINUED HOLDING IN 1934-37
POSTPONED LIQUIDATION

The preferential tax treatment of capital gains took a new form in
1934. The flat 12½ percent ceiling rate on long term gains and
losses, which had been effective for the upper income groups alone,
was eliminated. Instead, for all taxpayers 70 percent of the capital

\* The Modern Corporation and Private Property (Macmillan, 1933), p. 56.
\* N. R. Danielian, The Securities Markets (Twentieth Century Fund, 1935),
p. 50.
gains realized on assets held longer than 10 years was excluded from taxable income; 60 percent, if the assets had been held 5-10 years; 40 percent, if held 2-5 years; and 20 percent, if held 1-2 years. The remainder of the gains on assets held longer than 1 year, and the entire amount in the case of assets held 1 year or less, were made subject to the full scale of normal and surtax rates applicable to ordinary income. The same proportions of capital losses, similarly varying with the number of years the assets had been held, were excluded in calculating taxable income, except that a maximum of $2,000 net capital losses so computed was allowed as a deduction from ordinary income.

This new treatment caused the effective tax rates on capital gains to vary with the size of income throughout the income tax scale and with statutory changes in the exemptions, credits, and rates applicable to ordinary income. In general, the new treatment lowered the effective tax rates on the capital gains of individuals with small or moderately large incomes, but raised them on those with upper bracket incomes. The dividing line varied with the holding period. All income groups benefited from the treatment accorded gains from assets held 1-2 years because such gains had previously been taxed as ordinary income. On gains from assets held 2-5 years, the effective rates were raised for taxpayers whose surtax incomes, exclusive of the contemplated gains, exceeded about $22,000, and lowered for others; if the assets had been held 5-10 years, the dividing line was about $50,000; and if longer than 10 years, about $68,000.

The increases were especially sharp on gains from assets held 2-5 years realized by taxpayers with incomes approaching or exceeding $100,000, because the exclusion of 40 percent of the gain from taxation still left the effective rates in this part of the income scale far above the previous 12½ percent maximum. A taxpayer whose surtax net income from other sources was $50,000 in 1934 and who contemplated realizing a capital gain of $100,000 from an asset held 2-5 years faced a tax of $27,900, or 27.9 percent on his capital gain. If his surtax net income from other sources was $100,000, he faced an effective tax rate of 33.7 percent on his gain. (An upward adjustment in the surtax schedule raised these rates somewhat in 1936-37.) For all except the top income groups, the exclusion from taxable income of 60 and 70 percent of the gains from longer holding periods was enough to bring the effective rates either below or only moderately above those previously prevailing. If the $100,000 capital gain contemplated by the taxpayer in the last
example was from an asset held more than 10 years instead of 2-5 years, the tax on the gain would be 16.8 instead of 33.7 percent.

The substantial tax cost of realizing a medium term capital gain when the addition to the taxpayer's ordinary income would put him in an upper income group can well be supposed to have dissuaded many persons from realizing such gains during this period. Accentuating the deterrent influence of the high tax rates were the direct incentives for postponement provided in the law. Prior to 1934-37 two years and a day was the only period of holding required to qualify a capital gain for the most preferential tax treatment. In 1934-37, however, the law offered the equivalent of a series of successively larger discounts from the tax rates on ordinary income for postponing realization of gains. In effect, those from assets held more than 10 years were given a discount of 70 percent and those from shorter periods of holding, discounts of 60, 40, or 20 percent, according as the asset had been held 5-10, 2-5, or 1-2 years, respectively.

Although these discounts were uniform for all income levels, their value was small at the lower levels because the ordinary income tax rates were low; and their value rose with income because of the progression of income tax rates. If a man with $5,000 income kept his asset more than 10 years instead of 1 year or less, he would reduce the effective tax rate on the first dollar of his gain only from 4 to 1.2 percent; but for a man with $100,000 income, the rate would be reduced from 54 to 16.2 percent, and for one with $1 million income, from 62 to 18.6 percent. The stepdowns in the rates in the intervening periods were similarly progressive. The effective tax rate on the first dollar of capital gains was reduced by the following percentage points for the indicated amounts of income for holding an asset over 1 year, over 2 years, over 5 years, and over 10 years, respectively: for an income of $1 million, 12.4, 24.8, 37.2, and 43.4; for $100,000, 10.8, 21.6, 32.4, and 37.8; for $50,000, 6.2, 12.4, 18.6, and 21.7; for $25,000, 3.8, 7.6, 11.4, and 13.3; for $10,000, 1.8, 3.6, 5.4, and 6.3; for $5,000, 0.8, 1.6, 2.4, and 2.8.

The combined effect of the foregoing influences upon individuals with large incomes from ordinary sources or large amounts of medium term capital gains was a powerful inducement to defer realization for a longer period than under the two-year rule of 1921-33. And adding to this inducement was the hope that Congress might

* In 1934-35. The rates were somewhat higher and the margins slightly different in 1936-37; see Table 87.
be persuaded soon to reduce the effective rates on capital gains by reimposing a low ceiling rate or other means.

The operations and fortunes of investors are ordinarily the joint products of so many conflicting influences that clear evidence of the effects of tax factors upon their conduct cannot always be found in *Statistics of Income*. In the present instance, as in a few others, however, such evidence appears to exist. When a maximum tax of 15 percent on gains from assets held more than 2 years was substituted in 1938 for the rates prevailing in the preceding 4 years, the aggregate net capital gains of individuals with incomes of $100,000 or over jumped 144 percent — from $135 million in 1937 to $328 million in 1938 — even though the net gains of all other income groups fell $192 million, or 28 percent (Table 2).  

The inference is reasonable that many selling transactions previously held up by the substantial tax rates imposed on the gains of upper bracket individuals were rushed through in 1938 when a ceiling rate of 15 percent was substituted. This inference is supported by the behavior of net capital gains in the following year, when the amount reported by individuals with net incomes of $100,000 or over fell off nearly two-thirds, while the total reported by all other taxpayers increased somewhat.

The effect of the flat ceiling rate of 15 percent on gains from assets held more than 2 years and of the 20 percent maximum rate on gains from assets held 18-24 months does not appear to have been limited to 1938. During the 4 years 1938-41 as a whole, the net gains of individuals with incomes of $100,000 and more increased $371 million, or about 67 percent, over those of 1934-37, in the face of a decline of $467 million, or about 17 percent, in the net gains reported by all other income groups (Table 2). Most of this increase

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10 The figures here cited only approximate the absolute and relative amounts involved because changes in the statutes and tabulations caused the classifications for 1938-41 to differ in certain respects from those for 1934-37. A less complete offsetting of losses against gains caused total net capital gains in 1938-41 to be somewhat overstated as compared with those in 1934-37, and the statutory net incomes included different percentages of capital gains and losses (see the statistical notes in Appendix One). But the movements here noted are so pronounced and of such character that their significance is not vitiated by these differences.

11 The 15 percent maximum rate applied to gains from assets held more than 2 years; the ceiling was 20 percent on gains from assets held 18-24 months.

12 A special Defense Tax of 10 percent of the total income tax liability as otherwise determined, imposed in 1940, raised the effective ceiling rates on capital gains 10 percent.
was accounted for by taxpayers with net incomes of $300,000 and over, whose aggregate net gains in 1938-41 were more than twice as large as in the preceding 4 years.

Several factors appear to account for the divergence between the experience of the uppermost income groups and that of other taxpayers in 1938-41 as compared with 1934-37. The conditions of 1938-41 were unfavorable for increases in capital values. The business recession, which had become marked in the latter part of 1937, deepened in 1938; and the shadow of World War II created grave uncertainties for investors well before its actual outbreak in September 1939. Partly because of military orders from abroad and from our own rearmament program, industrial production expanded sharply in 1940 and 1941, but capital values as measured by stock prices did not respond. In fact, the stock market was depressed throughout most of the 4 years. The December average of Standard and Poor’s index of 90 stocks, which had been 135.5 in 1936 and 87.5 in 1937, was 100.7 in 1938; 98.2 in 1939; 83.7 in 1940; and 69.5 in 1941. Tax factors apart, a lower level of aggregate capital gains in 1938-41 than in 1934-37 was to be expected from the behavior of the stock market.

It seems reasonable to attribute the divergence of actual results from this expectation in the case of the uppermost income groups to the change in tax treatment, which encouraged the realization of accumulated capital gains previously dammed up by unfavorable tax treatment. On the other hand, because of the lower tax rates to which they had been subject, those who could realize capital gains in 1934-37 without moving their total taxable incomes close to or above the $100,000 level had been offered a much smaller incentive to postpone realization than those with larger incomes. In consequence, a relatively smaller amount of dammed-up realization was presumably released in these income groups by the tax treatment inaugurated in 1938.

Individuals with net incomes of less than $100,000 nevertheless continued to account for the greater part of aggregate net capital gains. Although their share fell from about 83 percent in 1934-37 to about 71 percent in 1938-41, it continued to dominate the totals (Table 3). Hence superficial inspection of the figures would show that the more favorable tax treatment of capital gains was accompanied by a reduction in the total realized. In reality, however, the income groups most affected by the changed treatment responded to it quite sharply in the face of adverse business conditions, while
the other income groups, dominating the aggregate, did not respond, because the change for them was relatively small and was overshadowed by the other conditions affecting capital values.

Finally, the movement of some individuals into higher income groups through large-scale realization of capital gains doubtless contributed in some degree to the divergent changes in the amounts realized. Since the classification by incomes is based upon incomes including the statutory proportions of capital gains taxable as income, a taxpayer's decision to realize or postpone realizing any substantial amount in a particular year may be the primary influence in determining the income group in which he is counted in the published statistics for that year. The big increase in the capital gains reported by the uppermost income groups in 1938-41 was swelled by the gains of some taxpayers who reached a high income level in this period solely or primarily because they realized previously deferred capital gains. If, for example, a man with a surtax net income of $50,000 from ordinary sources in any of the years 1934-37 postponed realizing a capital gain of $300,000 on an asset held 2-5 years in order to avoid the substantial tax rates in force, then realized the gain in 1938, he would be in the $50,000 income group in 1934-37 and in the $200,000 income group in 1938 ($50,000 of ordinary income and 50 percent of the $300,000 capital gain).

7 SHARP ADVANCE IN TAX RATES SINCE 1942 ACCOMPANIED BY SUBSTANTIAL INCREASES IN REALIZED CAPITAL GAINS

The large expenditures for rearmament preceding our entrance into World War II led to sharp increases in income tax rates, and even sharper advances were made in the Revenue Act of 1942, following the United States declaration of war. Between 1939 and 1942 the exemption for a head of a family was reduced from $2,500 to $1,200 and that for a single individual from $1,000 to $500. The normal tax rate was raised from 4 to 6 percent, the initial surtax rate from 4 to 13 percent, the exemption from surtax of the first $4,000 of surtax net income was eliminated, other surtax rates were substantially advanced, and a new maximum surtax rate of 82 percent was made applicable to surtax net incomes over $200,000 instead of over $5 million. The combined effect of these changes is indicated by the rise in the effective tax rate on an additional dollar of income at various income levels. For a $5,000 a year married man with 2 children, the effective rate on an additional dollar of ordinary income rose from 4 to 22 percent; for one with $10,000 income, from 9 to
34 percent; $25,000, 19 to 58 percent; $50,000, 31 to 69 percent; $100,000, 59 to 83 percent; $1 million, 76 to 88 percent (Chart 25 and Table 87). For 1943 these rates were increased by the imposition of a special 5 percent Victory Tax with lower exemptions, credits, and deductions than usual, and were further increased in 1944 by several percentage points in most income brackets.

Because the maximum tax rates on capital gains remained unchanged in 1940, except for the Defense Tax cited in note 12, and 1941 in the face of the higher levies on ordinary income, the disparity of tax treatment for individuals with large incomes became wider than ever (Table 88). But the Revenue Act of 1942 imposed heavier taxes on capital gains and reduced the allowances for capital losses. The maximum effective rate on a long term capital gain, which had been 20 percent if the asset had been held 18-24 months, and 15 percent if held longer, was raised to 25 percent on all long term capital gains. In 1938-39 persons with surtax net incomes smaller than about $44,000 had been subject to rates lower than the 20 and 15 percent ceilings on long term gains; now, only those with surtax net incomes less than $18,000 were subject to effective tax rates on such gains lower than 25 percent. The special treatment of long term capital gains was achieved in substantially the same manner as previously: only half of such gains was included in taxable income, and the taxed half could be reported on a separate schedule subject to a flat 50 percent tax rate if inclusion in ordinary income would result in a rate higher than 50 percent.

For the previous unlimited deductibility of the statutory amounts of net long term capital losses from ordinary income there was substituted a maximum allowance of $1,000 in any one year, but the taxpayer was given the privilege of carrying forward the remainder of a net capital loss for 5 years, applying it to offset capital gains during this period to the full amount of the carry-over and to offset ordinary income up to $1,000 in each year.

These steps in the direction of more stringency were partly offset by a major concession respecting the holding period necessary to qualify a gain for preferential treatment. In response to strong representations that the realization of many bona fide capital gains is obstructed when a long holding period is required, Congress reduced this period to the shortest ever required, 6 months. A concession was made with respect to short term losses also. Previously these could be offset only against short term gains. Now they were combined with long term losses and could be used to offset short or long term gains,
and to reduce other taxable income up to $1,000; and, as indicated above, the balance of any combined short and long term net loss could be carried forward for 5 years. Because only half of long term gains but the full amount of short term losses were taken into account, each dollar of short term loss offset the tax liability on $2 of long term gains.

Despite these concessions, the 1942 changes in tax treatment brought the effective tax rates on capital gains to the highest levels since 1921, with the exception, previously discussed, of a few categories of gains of the top income groups in 1934-37 (Chart 24 and Table 87). Nevertheless, the changes were followed by large increases in realized capital gains. The average annual amount in 1942-46 for returns with net incomes, $3.4 billion, was more than quadruple that of 1938-41, 1934-37, or 1917-21, and was about 71 percent in excess of 1922-33. Nor was the sharp rise in realized gains confined to the middle and lower income groups. Individuals with net incomes of $100,000 or over almost tripled their average annual capital gains over 1938-41.

These figures indicate that severer taxation did not prevent a considerable volume of gains-taking. On the other hand, they do not demonstrate that the higher taxes did not discourage some sales of capital assets. Obscuring the inhibiting effects of the higher rates, and perhaps offsetting them in part, was the stimulus to capital gains arising from the war-created expansion in business activity and in national income. As estimated by the Department of Commerce, national income rose from an average of $81.3 billion a year in 1938-41 to $170.7 billion in 1942-46. The amount of capital gains reported was also increased, it is probable, by the wider use of legal arrangements designed to convert ordinary income into capital gains. The extraordinarily high tax rates on ordinary income were a strong stimulus to many taxpayers to devise and use such expedients. One device, referred to later in this chapter, was the sale or liquidation of a corporation possessing large undistributed earnings rather than the distribution of these earnings in dividends. Another was the incorporation of a separate company for each of a series of ventures that would ordinarily be undertaken by a single enterprise, and the sale or liquidation of each company, after 6 months or more, as its separate venture was completed. These and other devices to convert ordinary income into capital gains will receive further attention in Chapter 9.

Also favoring the realization of capital gains was the reduction
to 6 months and a day of the period an asset had to be held in order
to qualify a gain from it as 'long term'. With so brief a period of
ownership needed to obtain the benefit of tax rates only half or less
of the rates applicable to ordinary income, many investors were
doubtless induced to make some commitments they would not
otherwise have made, and to take their gains sooner. We cannot
measure the results of this influence, but the relatively narrow range
of stock market fluctuations and the low to moderate volume of
stock trading during most of this period suggest that they were not
large. The number of shares traded on the New York Stock Exchange
in 1946 was only about a third that of 1929. We have previously
noted the close relation between short term gains and losses and
fluctuations in stock prices, and between the former and the volume
of stock trading (Charts 17 and 18; Tables 8 and 15).

Despite the substantial capital gains reported in 1942-46, it is
probable that restraining influences were at work. The level and the
recent rate of increase of national income favored larger amounts.
Although national income in 1946 was more than twice that of 1929,
et capital gains realized were only 1.5 times as large ($7.3 vs. $4.8
billion). Doubtless many factors conspired to produce this differ-
ence. Stock prices did not advance violently in 1942-46 as they
had in 1927-29. Between January 1927 and September 1929 they
jumped from 103.1 to 340.6 percent of 1926 prices, as measured
by Standard and Poor's Corporation, while between 1942 and 1944
they rose only from 70.9 to 100.0, then to an average of 137.6 in
December 1945 and to an average of 148.5 in May 1946. The uncer-
tainties created by World War II, together with the increase in
taxes on corporation income and the possibly adverse effects upon
corporate earnings of renegotiations of war contracts, probably
impeded the advance of capital values. And with memories of the
Great Depression of the 'thirties still vivid, the whole tenor of the
times was different from that of the late 'twenties. Among the many
forces that restricted the realization of capital gains, the severer tax
treatment probably played some part.

8 IS THE ABSOLUTE OR THE RELATIVE LEVEL OF CAPITAL GAINS
TAXES MORE SIGNIFICANT?

In the opinion of some students the extraordinarily wide gap be-
tween the rates on capital gains and the rates on ordinary income
in 1942-49 diminished the deterrent influence of the former, thereby
tending to bring about more realization of gains. As against the 25 percent ceiling on long term capital gains, the bracket rates on ordinary income reached as high as 94 percent for amounts in excess of $200,000. Though relatively to the latter, the capital gains rate seemed low, its absolute level was twice as high as the 12½ percent maximum prevailing during the stock market boom of the 1920's and that had been widely charged with contributing to the inflation of stock prices by deterring stockholders from selling their securities. The highest surtax rate during the late 'twenties, applicable to all surtax net income over $100,000, was 20 percent, in comparison with which the capital gains rate of 12½ percent doubtless seemed substantial. Could a capital gains tax rate twice as high, when coupled with very much higher rates on ordinary income, exert a smaller deterrent influence or a positively encouraging one upon sales of capital assets? We may note several ways in which this was possible:

First, there can be little doubt that the 25 percent capital gains tax now looked low relative to the rates on ordinary income. It was therefore a smaller psychological obstacle to sales than its absolute level might suggest. Because it was widely regarded as a 'bargain rate', it probably gave some investors a positive stimulus to 'take' capital gains.

Second, the wide discrepancy speeded some sales of capital assets by creating the fear that Congress might soon reduce the degree of preference accorded capital gains or remove the preference altogether.

Third, the very high rates on ordinary income made it prohibitively costly for wealthy individuals to receive previously accumulated corporate earnings in dividends from corporations they controlled, whereas the sale of their stock would enable them to obtain these previously accumulated earnings (to the extent that they were reflected in the price of the stock) plus any other capital gains subject only to the 25 percent rate. For example, suppose the owner of substantially all the capital stock of a textile mill, who was in the 80 percent tax bracket, desired to obtain for his personal disposition several hundred thousand dollars of the company's previously accumulated earnings. If he paid these earnings to himself in dividends he could keep only 20 percent of them after taxes. On the other hand,

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15 Capital Gains Taxation, p. 57.
if he seized a current opportunity to sell all or a part of his stock at a price per share equaling or exceeding the sum of his original cost and the reinvested earnings, he would have, after taxes, his original cost plus 75 percent of the reinvested earnings plus 75 percent of any additional payment made by the purchaser. Obviously this motive for selling would not exist if capital gains were subject to the same high tax rates as dividends. Even if they were taxable at moderately lower rates, the inducement to sell might well prove insufficient because the remaining advantage of the capital gains over the ordinary tax rate would have to be weighed against the disadvantages of relinquishing part or all of the ownership of the enterprise.

Fourth, the relative levels of the rates on ordinary income and on capital gains favored the sale by wealthy men of assets yielding large incomes but subject to heavy burdens of management or risk. Suppose, for example, the owner in the preceding example received a net income of $60,000 a year from his mill and net income from other sources of $40,000. At the 1944 rates, his total net income, $100,000, would be subject to a tax of $68,565. If his income from the mill were eliminated, his tax would be cut to $19,545. Hence he might reasonably attribute $49,020 of his total tax to his income from the mill, leaving him only $10,980 from the latter after taxes. If he expected such high taxes to persist, he might reasonably decide to relieve himself of the managerial and risk burdens of his business even at the cost of a substantial reduction in his pre-tax income. By transferring his funds to safer and less exacting but lower yielding uses and by forfeiting part of his capital by paying the 25 percent tax on the capital gains he realizes in the transfer, he might sacrifice half of this part of his income. Most of the loss, however, would be borne by the government because of the accompanying reduction in his personal income tax. For example, assuming that the cost basis of the mill to him was $200,000 and that he sold it for $600,000, receiving $100,000 in cash and $500,000 in 6 percent mortgage bonds, he would have to pay a capital gains tax of $100,000, and his income from the mill would be cut in half, to $30,000. But the income tax on his total net income, $70,000, would now be only $42,645, a $25,920 reduction from the amount payable on $100,000 net income. In other words, the $30,000 decrease in his net income would cut his income taxes $25,920. After taxes, therefore, his net income would be reduced only $4,080 a year. He

Assuming he was entitled to four exemptions (himself, his wife, and two dependent children).
might well consider such a reduction a small price to pay for his relief from the exertions and risks of owning and operating his business.

A capital gains tax rate of 25 percent should rationally exert a smaller deterrent influence upon the realization of gains when the effective tax rate on marginal amounts of ordinary income is 80 percent than when it is lower, say 50 percent, because the loss of principal through payment of the capital gains tax entails a smaller loss of income, after income taxes, in the former case than in the latter. If the effective ordinary rate was 80 percent, an investor whose unrealized capital gains of $100,000 are yielding him a pre-tax income of $10,000 and an after-tax income of $2,000 will lose only $500 a year in after-tax income by realizing his gains, paying 25 percent of them in taxes and reinvesting the balance at the same yield as before. With the same 25 percent capital gains tax rate, he would lose $1,250 a year in after-tax income if the effective rate on the relevant amounts of his ordinary income is 50 instead of 80 percent.\(^\text{17}\)

On the other hand, if the wartime high levels of income tax rates were coupled with an effective tax rate on capital gains of 50 or 75 percent, shifts of investments that entailed the realization of large capital gains would doubtless be greatly discouraged. Even though high income investors could derive only a small yield, after income taxes, from their capital funds, they would be loath to pay capital gains taxes that made substantial inroads on their principal when they could avoid these taxes merely by not selling. As was the case in 1917-21, large numbers of them would postpone sales in the hope or expectation that tax rates on both ordinary incomes and on capital gains would not be held at high levels indefinitely, or in the expectation that their properties would be freed from all potential tax liability on the capital gains embodied in them by transfer at death. For these reasons, even the 25 percent rate probably deterred many sales in which large absolute amounts of gains would have been realized.

Finally, although the high tax rates on ordinary incomes rationally favored the realization of gains by some investors in connection with the shifting of their funds from more to less hazardous or exacting uses, they at the same time exerted an opposite influence. They discouraged transfers of funds, and the incidental realization of gains, in the search for higher yields. If a man in the 80 percent bracket

\(^\text{17}\) Cf. Eustace Seligman's remarks in *Capital Gains Taxation*, pp. 57-8.
sees a chance to double his pre-tax yield of 10 percent by selling a property in which he has a large unrealized gain and buying another, he is confronted by the fact that the 10 percent differential in yield will be reduced to 2 percent by the income tax, and will be reduced further by the payment of the 25 percent capital gains tax. Under these circumstances the incentive to transfer funds from less to more remunerative employments, and the incidental realization of capital gains in the process, is greatly impaired.

On the whole, the figures for 1942-46 appear to be a reasonable reflection of the criss-cross influences operating upon investors during this period. Average annual capital gains were substantially higher than in any other period of uniform tax treatment. Although individuals with net incomes of $100,000 or over realized materially larger average annual capital gains than in the preceding period, the percentage increase in amount of gain was only somewhat more than half that of the other income groups. Their capital gains represented 33.9 percent of their total net income in 1942-46; they had been 27.6 percent in 1938-41, 18.2 percent in 1934-37, 41.8 percent in 1922-33, and 4.2 percent in 1917-21.

Summary

Some of the broader conclusions suggested by the evidence reviewed in this chapter are:

1) The disposition of the top income groups to realize or to defer taking capital gains has been clearly and markedly sensitive to the tax treatment.

2) The degree of responsiveness of the middle and lower income groups is less clearly revealed by the figures because the tax rates applicable to their long term gains have generally been substantially lower and have moved, for the most part, within a narrower absolute range (Table 87). The rate on the first dollar of long term capital gains for a $5,000 a year married man with two children, for example, was 7 percent in 1918, .5 percent in 1929, 2.4 percent in 1937, and 11 percent in 1943; whereas the rate for a man with an income of $100,000 was 64 percent in 1918, 12.5 percent in 1929, 35.4 percent in 1937, and 25 percent in 1943. Even after allowing for these differences in level and range, however, the responsiveness of the lower and middle income groups seems to have been less than that of the top income groups. Perhaps the smaller average gain and

18 If the asset had been held 2-5 years.
the smaller absolute amount of capital gains taxes involved contributed, among other factors, to this result.

3) The figures for taxpayers as a whole have shown a much less consistent response to the changing tax treatments than those for the uppermost income groups because, among other reasons, they have most commonly been dominated by the lower and middle income groups. Individuals with net incomes under $25,000 accounted for 37 percent of aggregate net capital gains in 1922-33, 58 percent in 1934-37, 52 percent in 1938-41, and 62 percent in 1942-46; and those with net incomes under $50,000 accounted for 49, 72, 62 and 73 percent, respectively (Table 3).

4) The major influence upon aggregate capital gains realized annually has been neither the tax treatment nor the general level of prosperity as measured by national income. It has been, rather, the extent of changes in the prices and turnover of capital assets, notably common stocks. Total capital gains have varied widely in periods of uniform tax treatment and have not always responded even in direction to the influence of more or less leniency in tax treatment. Nor have they varied consistently even in direction with fluctuations in national income (for example, 1933-34, 1936-37, 1938-39, 1941-42). The much higher level of national income in 1942-46 as compared with that of 1929 was accompanied by a less than proportional increase in capital gains. Changes in taxation, not only on capital gains but also on individual and corporate income and on gifts and estates, and changes in national income are doubtless elements in the complex of forces that determine the price movements and trading in capital assets. But less tangible factors, such as the speculative temper of the times, the domestic and international political atmosphere, and governmental policies sometimes play more immediately important roles.