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Chapter 11

Competing Proposals for the Tax Treatment of Capital Gains and Losses

The wide variety and still changing tax treatment of capital gains and losses in other countries and the repeated shifts in the American treatment clearly demonstrate that a single policy has not been universally accepted. Our analysis has brought out the major reasons. The proper treatment remains a problem everywhere because it presents various unresolved conflicts — in and between concepts of income, equitable considerations, revenue yield, administrative requirements, the desire to avoid harmful effects upon the markets for capital assets and upon investment incentives, and other objectives of tax policy.

In sharp contrast to British practice, the United States taxed capital gains in full as ordinary income at the beginning of its present series of income tax laws (under the 16th Amendment to the Constitution). After 9 years of such taxation and 4 of allowing capital losses in full, Congress responded to strong complaints that this treatment was seriously impeding the sale of assets on which individuals would realize gains and unduly stimulating the sale of those on which they could realize losses. Beginning with the Revenue Act of 1921 (applicable to 1922), a series of compromise measures was enacted. In each, capital gains continued to be classified as income, but the application of the rate schedule, the allowance for capital losses, the definition of capital assets, and other provisions were successively modified in different ways in an endeavor more adequately to satisfy one or more competing objectives. Since each new set of provisions was an *ad hoc* compromise, differences of opinion persisted. Current proposals for modification run the gamut from complete nonrecognition for income tax purposes to full inclusion of unrealized as well as realized changes in market values.

We may best preface a survey of the chief proposals by restating in summary fashion the major considerations, discussed at length in preceding chapters, for and against excluding capital gains and losses from taxable income or treating them differently.

1 GENERAL CASE FOR EXCLUDING CAPITAL GAINS AND LOSSES FROM TAXABLE INCOME OR TREATING THEM DIFFERENTLY

With the impressive support of prevailing practice in the United Kingdom and its dominions, complete exclusion has been urged upon Congress at various times since the adoption of the 16th Amendment. Essentially the same arguments have been offered from time to time for separating capital gains and losses from other taxable income and subjecting the net gains to a small flat rate, such as 5 or 10 percent, while disallowing net losses entirely, or for otherwise severely limiting the application of the income tax to capital gains and losses. The main reasons advanced for these positions are:

1) Capital gains and losses are not valid elements of true income as that term is widely used. The traditional concept of income includes only more or less regular and recurring or in any event, more or less expected receipts. An occasional sporadic gain or loss, especially if unexpected and unsought, does not function like income in guiding conduct or in determining the allocation of economic resources. For this reason many economists, for their general analytical purposes, though not specifically for those of taxation, confine the concept of income to more or less expected or recurring receipts. Similarly, the accountant usually separates capital gains and losses, if substantial, from ordinary income.

2) It is urged that when appreciation in the value of a capital asset is treated as income, it is really capital that is being taxed, for the appreciation usually represents merely an increase in the present value of expected future incomes to be derived from the asset, not an addition to current disposable income. In many instances, capital gains represent merely changes in the values of titles to some of the wealth of the country, not additions to it. Such gains do not constitute disposable income for the country as a whole. Even when capital gains represent real additions to the country's wealth, as when mines or oil resources are discovered, they are not currently disposable income for society as a whole.

To tax them as income, then, puts a double tax on the recipient — first on the capital value of future incomes, then on the incomes themselves as they are received. A man who reinvests a capital gain of $50,000 will be subject to income tax on his future income from the gain. To tax him also on the principal value of the gain itself is to tax him twice. Similarly, there is a double allowance for capital losses when taxable income is reduced by both the capital value of the loss and the subsequent decline in annual income.

3) The exclusion of capital gains and losses from taxable income avoids the unjust and otherwise harmful effects of taxing as income the spurious capital gains that merely reflect a rise in the general price level – a depreciation in the value of the monetary unit. Many home-owners experienced this type of illusory gain during and after World War II, when all the money profit they realized by selling a house in one city or neighborhood was commonly needed to help pay for a similar house elsewhere. It likewise avoids inappropriate allowances for the illusory capital losses that merely reflect a decline in the general price level or a rise in the purchasing power of money.

4) Similarly, capital gains and losses due to changes in interest rates, when realized incidentally to a shift of investments, may leave the investor's actual income unchanged. For example, the income from an investor's securities will remain $4,500 a year if he sells, at a $20,000 profit, $100,000 par value of 16 year 4½ percent bonds he purchased at par and reinvests the entire proceeds in approximately $120,000 of 3¾ percent similar bonds at par. When interest rates rise, the resulting fall in the market value of his securities, whether or not realized by sale, will similarly leave his interest income unchanged, because their smaller capital value, invested at the higher rates, will produce the same income as before.

5) Under the graduated rate schedule of the income tax, the imposition of the standard rates upon capital gains realized in a single year but emerging over a longer period is inequitable because it usually subjects the gain to a higher effective tax rate than would be applicable if the gain had been allocated among the years during which it arose. In the same way long emerging capital losses, if concentrated in the year of realization, have less tax-reducing value.

6) Overshadowing the foregoing economic and equitable considerations has been the emphasis, in statements before Congressional committees and elsewhere, upon various undesirable practical consequences said to flow from treating capital gains and losses as ordinary components of taxable income. A taxpayer usually cannot avoid taxes on ordinary income except by foregoing the income itself. But he can avoid the tax on a possible capital gain by refraining from realizing it, yet enjoy many of the advantages of the gain in the form

of an increase in his wealth and in the increased earning power, dividends, interest, or rent the unrealized gain commonly reflects. Since the investor commonly possesses a wide and often unlimited range of choice whether and when to realize his gains in a legal sense, any substantial tax acts as a deterrent to selling property yielding capital gains. The effect is to impose a heavy tax on transfers of such capital assets. In consequence, it is argued that society does not get the benefit of highly fluid markets for capital assets, and of their easy and continuous redistribution among those most anxious to own and use them. Individuals are deterred from making otherwise desirable shifts in the composition of their assets as their needs change. A conspicuous contention is that price movements in both directions are exaggerated in the markets for common stocks and other equities by the reluctance of owners to sell when prices are rising in the face of an avoidable tax on their gains, and their added disposition to sell when prices are declining in order to benefit from a deductible capital loss. The accentuated fluctuations reduce the attractiveness of equity investments. Further, since venturesome investment depends in considerable degree upon the prospect of exceptional returns, which are often possible only in the form of capital gains, heavy taxes on the latter may discourage the assumption of unusual risks.

Another point made is that the net revenues from any substantial taxation of capital gains and reasonably related allowances for capital losses are negligible over a long period because of the tendency for gains and losses to cancel and because the realization of losses is encouraged while that of gains is discouraged. In this event, excluding capital gains and losses would improve the stability of the yield from the personal income tax without seriously reducing its average amount. Under existing treatment, the freedom of taxpayers to choose whether and when to realize gains and losses enables them to time their transactions so as to minimize their tax liabilities. Well advised taxpayers are fairly certain to avail themselves of the tax benefits from realizing their losses when they have offsetting income, and to minimize taxes on their gains by realizing them mainly when they have offsetting losses or by not taking them at all, leaving them to pass untaxed (as far as the income, but not the estate, tax is concerned) to their heirs. A low flat rate on capital gains without allowance for capital losses has been urged as a means of increasing revenues by encouraging larger transfers of assets embodying capital gains. Finally, it is argued that estate and gift taxes provide rough offsets to the avoidance of income taxes on capital gains.

2 GENERAL CASE AGAINST EXCLUDING CAPITAL GAINS AND LOSSES OR TREATING THEM DIFFERENTLY

The main opposing arguments are:

1) Although different concepts of income may well be valid for other purposes, the proper measure of income for tax purposes is to be found in the actual *ex post* results of economic activity, not in subjective expectations or presumptions. Taxable income, it is urged, should measure the relative capacity of individuals to pay taxes, as indicated by the net annual additions to their wealth from economic activity plus their consumption. Capital gains supply an individual with the same additions as any other kind of personal income to his power to buy consumption goods or investments, and to provide for his family's future. To exclude profits of this kind from income tax or to grant them markedly preferential treatment seriously conflicts with the purposes of a graduated income tax. Capital gains constitute a major source of income for many individuals. Both the average capital gain per taxpayer and the proportion of taxpayers who report capital gains rise sharply from lower to higher incomes. In some years capital gains have exceeded dividends as a source of income for taxpayers reporting incomes above $100,000. And the unequal distribution of capital gains among taxpayers in each income group accentuates the inequity of excluding them from income tax or of giving them unduly preferential rates.

In economic character capital gains differ only in varying degree from other forms of personal income. They are often deliberately sought as a species of profits. They are rarely wholly 'unexpected' but, like ordinary business profits, represent varying mixtures of expected and unexpected elements. In fact, if capital gains did not so commonly constitute a sought reward for exertion and risk, it could be contended that they should be taxed more heavily than ordinary income because they would then not serve any function in spurring initiative and exertion or in allocating economic resources. In practice, capital gains embody large elements of personal compensation, interest, profits, and rents, and often constitute a thinly veiled disguise for these ordinary kinds of income. A conspicuous example occurs when the retention of earnings by a corporation over a period of years causes its stock to rise, enabling its stockholders to obtain a varying proportion of these reinvested earnings in the form of a capital gain by selling the shares, and even to avoid a personal income tax on these earnings by leaving their stock to their heirs.

The difficulty of distinguishing clearly, on economic grounds, between capital gains and other income creates serious administrative difficulties when the gains receive preferential tax treatment, and stimulates efforts on the part of taxpayers and their lawyers to convert ordinary income into this form. It is contended by some that the tax preference and the associated tax avoidance adversely affect the morale of the general body of taxpayers, whose cooperation is essential for the American system of a self-assessed income tax.

The sporadic and lumpy character of capital gains and losses is true also in varying degree of other kinds of income, notably business profits. Moreover, higher rather than lower taxes on long emerging capital gains can be justified as an interest charge: the taxpayer has enjoyed the free use of funds otherwise payable in taxes during the period he has postponed realizing his gain. The logical method of achieving equitable tax treatment of fluctuating incomes under a graduated rate schedule is to adopt some system of averaging, not exclude them.

2) The allegation that taxation is double when both a capital gain and its subsequent annual yield are taxed, and the related contention that this practice reduces the country's stock of capital, are not relevant, it is argued, for a personal income tax. Individuals are free to consume or to reinvest their realized capital gains. They are in the same position as those who have accumulated savings from other current income. The latter are subject to tax on the saved portion of their income and will pay taxes also on the yield subsequently derived from investing these savings. In both cases the income inclusive of current savings and capital gains measures the addition to the taxpayer's power to command and direct economic resources into channels of his own choosing. Income taxes are designed, among other purposes, to divert a fraction of this total power to the government. Were taxable income confined to consumed income, a sizeable proportion of total personal income would be exempt. Conceivably, this exclusion might be desirable under some circumstances, but the case for it would not apply peculiarly to capital gains.

All taxes impinge in some degree upon the capacity of taxpayers to save and to accumulate capital. One purpose of the income tax, as of estate and gift taxes, is to reduce inequalities in the distribution of income and wealth, even if this entails some reduction in private capital or in current additions to it. Whether the aggregate capital of the country is lessened by the same amounts depends upon what the government does with the tax proceeds; public roads, school buildings, and the like are also capital goods.

3) To the extent that capital gains and losses are offset by an opposite change in the purchasing power of money, they are doubtless fictitious in the sense that they do not measure a change in the economic status of the recipient. In the event of a rapid and substantial rise in the price level, such as occurred in various European countries during and after the two World Wars, special measures may well be warranted to exclude the illusory capital gains from income taxes. These could take the form, in inflation, of raising the cost basis of capital assets by stipulated percentages, as has been done recently in France and Belgium. Existing provisions protect holders of business assets in part by permitting them to postpone recognition of capital gains realized when the proceeds are invested in similar property; and a similar rule could be adopted for houses or even for all nonbusiness assets. If prices fell drastically, parallel treatment would call for deflating capital values by the use of indexes or to impose restrictions on the deductibility of capital losses.

Serious administrative and other difficulties would be involved in isolating and providing special treatment for capital gains and losses that reflect changes only in the general price level. Hence it is recognized that such a procedure, if adopted at all, is likely to be confined in practice to periods in which the price level fluctuates violently within a relatively short time. But a gradual price movement, if prolonged, may become sizeable in the aggregate, giving rise to substantial fictitious capital gains and losses. Some would ignore these effects of moderate or gradual changes in price levels. Others would not make any special provision for any illusory capital gains and losses on the ground that the only proper avenue of attack upon unstable price levels is through the broad instruments of monetary and fiscal policy. Still others would treat this problem by according a preferential tax treatment to all capital gains and imposing restrictions on the deductibility of all capital losses – the general manner in which long term capital gains and losses have been treated in the United States since 1921.

4) Capital gains and losses caused solely by changes in interest rates are not really illusory. An investor who realizes a $20,000 profit by selling his bonds after interest rates have fallen can command $20,000 more of the world's real goods. Relative to other individuals, he has gained in net worth, even though his interest income may remain the same.

5) It is argued that the alleged adverse effects upon the capital markets of including capital gains and losses in taxable income are greatly

exaggerated. Empirical evidence indicates that realized gains and losses have fluctuated mainly with stock prices rather than with changes in tax treatment. Much of the actual impediment to transfers of capital assets said to be created by substantial taxes on capital gains is really due to the possibility of avoiding such taxes completely by holding appreciated assets until death and by using them as gifts without incurring tax liability (the donee will incur such liability if he sells). The proper attack upon these impediments, it is urged, is to remove all possibility of avoiding the tax by making every transfer of property, during life or at death, an occasion for recognizing a capital gain or loss, and, possibly, by periodically recognizing accrued but unrealized gains and losses. Because gift and estate taxes are payable also by individuals who do not enjoy capital gains and by those who have paid income taxes on realized gains, they do not offset the inequity of taxing capital gains at lower rates or exempting them.

The point is made that the problem of inducing enough venturesome investment cannot be met equitably or adequately by the preferential tax treatment of capital gains, because the greater part of the rewards of risk-taking are often, perhaps usually, obtained from ordinary business profits, dividends, and rents. As far as we design the tax system to foster this type of investment, we should do so broadly, covering all the rewards for exceptional effort and risk, rather than a single and often spurious form of such rewards.

6) Even though capital gains and losses may conceivably cancel out in the long run for taxpayers as a whole, they do not do so for individuals. Just as we do not allow the aggregate net losses of deficit corporations and individuals to offset the taxable income of others, the net capital losses of some taxpayers do not, it is contended, justify complete tax exemption or preferential rates for the capital gains of others. Our taxation of capital gains, despite preferential rates, has actually yielded substantial revenues, only a portion of which can be attributed to the restricted deductibility of net capital losses. The irregularity of the revenues is not a solid reason for relinquishing them. Business profits too are notoriously unstable as a source of tax revenue. Reduction of the public debt is an excellent use for the surplus revenues of good years, and a revenue source that automatically yields less in bad years has the virtue of reducing the adverse effects of federal tax collections upon private spending in depressions.

The conflict of considerations barely summarized above and elaborated in preceding chapters is the 'problem' of capital gains and losses: to devise a tax treatment that will most nearly satisfy the demands of equity – of giving equal treatment to similarly circumstanced individuals – and at the same time avoid unduly impeding useful transfers of capital assets. The major proposals for meeting this problem fall into two broad groups. One group seeks the full inclusion of capital gains and losses in taxable income while minimizing the undesirable effects by averaging them or by averaging total income over a number of years, or by including unrealized as well as realized changes in market values of capital assets. The other group would compromise the conflicts of equitable and practical considerations by various *ad hoc* measures of the same general character as those employed in the United States since 1922, but with more or less recognition of capital gains and losses as components of taxable income. Common to both groups is the question whether and to what extent unrealized appreciation and depreciation should be recognized, particularly upon transfers of property by gift or at death.

We begin with the more extreme proposals because they best clarify the major issues.

3 FULL ANNUAL RECOGNITION OF BOTH ACCRUED AND REALIZED GAINS AND LOSSES

One line of attack proposed by some students to minimize the inequities and undesired practical effects of full recognition of sporadic capital gains and losses *as realized,* while treating changes in capital values as elements of taxable income, is to include all such changes, whether or not realized by sale, in the income base.[1] Each taxpayer would report on his income tax return the value of all his assets at the beginning of the year, plus the cost of those acquired during the year (legacies and gifts being entered at their value when received), and their value at the end of the year. A net increase, including capital gains realized during the year, would be added to his ordinary income, and a net decrease, including realized capital losses, would be deducted. All special provisions for capital gains and losses, such as

[1] See National Tax Association, *Proceedings, Ninth Annual Conference* (1915), p. 303, which presents a report of a committee of the Association; Committee on Taxation of the Twentieth Century Fund, *Facing the Tax Problem* (1937), p. 490; and *Capital Gains Taxation,* pp. 26-8, 95, which presents a panel discussion.

preferential rates, percentage exclusion, holding periods, maximum alternative rates, and loss limitations would be eliminated.

The advantages claimed for this proposal are:

1) It would achieve a higher degree of uniformity of tax treatment of personal incomes than appears to be possible under any alternative proposal. Individuals who added to their wealth by capital gains would be taxed as fully as those whose additions came from other kinds of income. Deferring the realization of gains until death would no longer permit avoidance of the income tax on them, and postponing them would no longer give the holder the free use of tax money.

2) It would supply a means of subjecting stockholders to personal income tax on their *pro rata* shares of reinvested corporate profits, to the extent that the latter actually added to the market values of the shares. In this degree individuals whose saved income takes the form of corporate earnings reinvested in their behalf would be taxed at the same rates as those whose current savings are invested in other ways. The taxation of only realized capital gains, in contrast, allows large amounts of earnings accumulated through corporations to escape personal income taxes entirely by transfer of the stocks at death, and permits even the realized accumulations to be taxed at preferential rates under existing law.

3) Full recognition of unrealized gains would eliminate the present tax impediments to transfers of property. No additional tax liability would be incurred upon the sale of an appreciated investment, for the tax on the increase in value would be payable even if the asset was not sold. Indeed, the latter tax liability would serve as a spur to the taxpayer to sell any property he did not positively desire to hold. Hence when prices were rising, investors with large unrealized capital gains would no longer be 'frozen' in their assets by their desire to avoid capital gains taxes, and when prices were falling, the decline would not be accentuated by the desire of those with unrealized losses to obtain a tax deduction by selling.

4) Full recognition would probably cause a substantial increase in tax revenue. Some reduction might occur in the net yield from short term gains and losses because the realized gains are taxed in full under present law while the existing severe restriction on the allowance for net short term losses would be removed. But short term gains and losses constitute only a small proportion of the total. The main sources of additional revenue would be the sharply increased tax rates on realized long term gains, the taxability of these gains in full instead of at half their amount, and the inclusion in taxable

income of much appreciation that now escapes the income tax through the transfer of the property at death. The tax rate on capital gains, now limited to a maximum of 25 percent, would become equal to the top surtax bracket rates plus the normal tax rate for the various income groups under the ordinary income tax schedule, and would rise as high as 82.1 percent.

Partly offsetting the larger revenue from net long term capital gains would be the removal of the present limitations on the allowances for realized net capital losses and the full recognition of unrealized losses. In periods of declining values these allowances would wipe out the tax liability on other income for many taxpayers. In 1932, for example, the aggregate market value of the securities listed on the New York Stock Exchange alone declined about $30 billion. Some persons would therefore contend that a limitation on the allowance for capital losses is necessary for practical reasons. Others would welcome such a wholesale automatic reduction of tax liabilities in bad times, as well as the large increase in good times, as a valuable counter-cyclical influence.

Other effects and difficulties

The annual accrual method would be likely to cause alterations in the relative market values of different kinds of assets and shifts in the portfolios of various investors. To the extent that individuals chose their investments primarily because of the preferential tax treatment of capital gains, they would have a motive to shift out of these holdings. In addition, many investors who are content to own assets yielding a small or no current income when they do not incur any immediate tax liability for the price appreciation constituting a part of the total expected return would be unwilling or unable to hold such assets if the unrealized appreciation was taxed as current income. In consequence, assets that promise to yield most of their total return in the form of capital gains would tend to become relatively less attractive, other things being equal, than assets yielding most of their return in the form of current income. Corresponding changes would tend to occur in their relative market values. To the degree that unusually venturesome investments are of the former type, the tax incentive offered them under the present treatment would be removed. On the other hand, the introduction of unrestricted allowances for capital losses would stimulate this type of investment.

Various practical difficulties of the annual accrual proposal may be quickly noted. One is that annual changes in the market values of capital assets do not correspond closely with changes in the actual ability of their owners to obtain the cash required for income tax payments. This difficulty is not serious in the case of ordinary property taxes, as a rule, because they are levied at low rates, rarely exceeding 2-4 percent of the total valuation, and because assessment values and rates do not ordinarily fluctuate sharply. Nor is it serious for most listed securities if the taxpayer holds them in small blocks, for he may sell a portion, if necessary, to raise the tax money. Even in this instance, the selling induced by the tax may be sufficient in the aggregate to depress prices severely. But many kinds of property, such as improved real estate, are not easily divisible or readily saleable, and some assets that appear to be saleable in small portions must be retained in full by their owners for reasons of control, impairment of value by partial sale, etc. While many owners of such properties would doubtless pay the tax out of their other income, others in all except the lowest income groups, because of the high rates applicable on both their unrealized capital gains and their other income, would be compelled to borrow, retrench in personal expenditures, or sell other assets. Peculiarly difficult problems would be raised for trustees, life-tenants, and holders of other interests in property held in trust.

Large numbers of taxpayers would deem the inclusion of unrealized appreciation grossly unfair. Householders who did not intend to sell their homes, and long term investors in common stocks who had not consciously participated in a speculative boom, could be expected to complain strenuously if told that they must include increases in the paper values of their holdings in their taxable incomes. Taxpayers who might otherwise take little notice of the market value of their securities and other assets would be put on their guard to heed such changes. The practical effects of speculative changes in the market values of capital assets would be greatly increased. A pronounced rise in the general level of prices would, under this proposal, have much of the effect of a capital levy.

Since good markets with readily ascertainable prices do not exist for all the lands, buildings, contracts, rights, and equities that constitute capital assets, the annual appraisals of all such property would present formidable difficulties in countless cases.[2] The difficulties would be both those of compliance on the part of the taxpayer and

[2] George O. May stated the valuation difficulties well in a letter published in the *New York Times,* May 9, 1937.

of surveillance by the tax administrators. On small orders, market quotations for many unlisted securities fluctuate widely; sales of larger blocks, on the other hand, are often negotiated at prices materially higher or lower than market quotations. Several European countries, to be sure, have braved these difficulties in connection with annual personal taxes on net worth. The problems of valuation might be manageable for an income tax if close precision were not necessary to achieve rough justice. This would be the situation, however, only if the rate structure of the income tax and the ordinary income of the taxpayer remained relatively stable from year to year. Considerable latitude could then be permitted in the appraisal of assets whose market values were not readily ascertainable. Book values or rough approximations to market values could be accepted because intentional or unintentional errors would be subject to automatic and tolerably equitable adjustment upon actual realization of gain or loss or upon death. The progressive rate structure of the income tax would cause some disparity in the treatment of gains and losses even for a taxpayer with stable ordinary income and under an unchanging rate schedule. For example, under the 1949 rate schedule, a single person with ordinary net income of $20,000 would have his tax increased $2,512 if a $5,000 rise in the value of his capital assets was taxed as income, while a $5,000 decline would reduce his tax liability only $2,195. This discrepancy would be substantial only when the capital gain or loss exceeded the width of several surtax brackets.[3]

But with changing tax rates and fluctuating individual incomes, both of which are more likely, the progressive rate schedule could cause much larger discrepancies. A taxpayer's property might increase $10,000 in value in a year when tax rates were raised and his other income was large, but lose all this gain in one or more following years when, because of a reduction in tax rates or in his other income, the allowance for the decline in value would reduce his taxes by an amount materially smaller than had previously been added to them by the equal appreciation. Further, this defect of the

[3] Under the Revenue Act of 1948 the surtax brackets are $2,000 wide for net incomes of $2,000-22,000; the next $4,000 of income constitutes a single bracket; the brackets are $6,000 wide thereafter up to $50,000 net income; $10,000 wide for incomes of $50,000-100,000; and $50,000 wide for the next $100,000, at which point, $200,000, graduation ceases. For married persons filing joint returns, the surtax brackets are twice as wide, in effect, because additional segments of income are divided between the spouses for the purpose of determining the effective tax rates.

annual accrual method would be magnified by the tendency of capital losses to be larger in years of smaller than average ordinary incomes, and of capital gains to occur more largely in years of higher incomes. In addition, for many taxpayers the severe depreciation of capital values in bad times would exceed their ordinary incomes and would to this extent lose all tax-reducing value unless such unused net losses could be carried back or forward for long periods, or the accrual method was supplemented by an averaging device.

The failure of the annual accrual method to create a perfectly symmetrical tax treatment of capital gains and losses would give considerable importance to the allocation of estimated accruals of unrealized gains and losses as between one year and another. Wide latitude in annual appraisals, necessary for administrative reasons, would therefore create opportunities for tax avoidance and material for litigation. These difficulties would be reduced, however, if the annual accrual method was combined with averaging income for several years to determine each year's taxable income, or with a generous carryback or carryforward of net capital losses against ordinary income.

Constitutional difficulties of taxing unrealized appreciation

Whether the annual taxation of unrealized capital gains as income would be held constitutional under the 16th Amendment is debatable. In the Macomber case (1920), in which ordinary stock dividends were held not to constitute taxable income, the Supreme Court explicitly declared: "enrichment through increase in value of capital investment is not income in any proper meaning of the term"; and it strongly emphasized that a gain must be realized and "separated from capital" to be taxable as income (252 U. S. at 214 and 207). While some students think the Court might now reverse this decision,[4] few appear to believe that it would do so by abandoning the realization requirement, which is strongly rooted in American jurisprudence.

Nevertheless, competent authorities have expressed contrary views. Professor Isaacs contended that the Macomber case does not foreclose inquiry into the possible constitutional basis of an annual accrual plan of capital gains taxation.[5] As noted in Chapter 2, Mr. Justice Douglas, speaking for a minority of three justices in *Helver-*

[4] Rottschaefer, Present Taxable Status of Stock Dividends in Federal Tax Law, 28 *Minnesota Law Review,* 163 (1944).
[5] 46 *Harvard Law Review,* 776, 791 (1933).

ing v. Griffiths (318 U. S. 371, 1943), declared that he did not see any reason why Congress could not treat as income increases in the wealth of stockholders due to the reinvestment of corporate earnings; "the notion that there can be no 'income' to the shareholders in such a case within the meaning of the Sixteenth Amendment unless the gain is 'severed from' capital and made available to the recipient for his 'separate use, benefit and disposal' will not stand analysis. . . ."

The escape of reinvested corporate profits from personal income taxes levied upon shareholders unless the latter realize them in the form of capital gains, as well as the preferential rate at which the earnings are now taxed in the latter event, is perhaps the strongest reason motivating those who urge the taxation of accrued as well as of realized capital gains. Reinvested corporate profits, however, constitute only one source of capital gains, and a special treatment might conceivably be devised for them. It is possible to contend, as well as to deny, that such earnings are truly current income to the stockholders, whereas mere appreciation in land values, for example, is not. The conspicuous role of reinvested corporate profits in the thinking of those who propose changes in the current tax treatment of capital gains and losses is reflected at several other points in this chapter.

As a practical matter, it cannot be said that any strong and widespread demand appears to exist for the annual taxation as income of all unrealized appreciation in capital assets, and strong objections would doubtless be made to full annual allowance for all unrealized capital losses. In the light of this fact, of the constitutional doubts, and of the practical difficulties of requiring and checking annual valuations of capital assets, it seems unlikely that the annual accrual proposal will receive serious consideration by Congress in the near future.

4 CUMULATIVE AVERAGING OF INCOMES AND TAX LIABILITIES

A less familiar radical solution recently proposed for the full inclusion in taxable income of realized gains and losses calls for the cumulative averaging of taxable incomes and tax liabilities from year to year. The taxable income of any year would be defined as the taxpayer's average income over a period of years, including realized gains and losses, and his tax liability would be adjusted annually, for all previous over- or underpayments by reason of the reporting in preceding years of taxable incomes differing from his average income. Such an averaging device, first worked out by William

Vickrey,[6] would leave the aggregate tax burden on an individual unchanged by any shifts in the allocation of his income among the various years included in the averaging period. The scheme is designed to tax equitably all fluctuations in income as well as irregular capital gains and losses. It would not only eliminate the influence of fluctuations in income upon the effective tax rates under a graduated rate schedule but also avoid penalizing taxpayers whose larger incomes happened to be received in years when the entire rate schedule was high, and unduly favoring those whose larger incomes were received when the rate schedule was lower. By taking unrealized capital gains and losses into account only at the end of the averaging period, say every 10 years, or only upon the transfer of property at death or by gift, the device would avoid the need for annual appraisals of capital assets.

The procedure would be as follows: The taxpayer would report an initial valuation of his capital assets, perhaps at cost or on a compromise transition basis, at the beginning of the year in which the system went into effect or in which he entered the system. For the first year the income and calculation of tax liability would be as at present, except that realized capital gains and losses would be taken into account in full (unrealized changes in value would be disregarded). At the end of the second year the taxpayer would add that year's income to the first, and divide by 2 to arrive at his average annual income. From tables prepared by the Treasury Department, which would show the net effect on his average income of the tax rates in force in the preceding as well as in the current year, he would determine his total tax liability for the 2 years on the assumption that the average income had been received in each, and remit to or receive from the Treasury the difference between the aggregate tax due for the 2 years and the amount paid the first year. His return for the third year would contain the cumulated total of taxable income and of taxes paid for the preceding 2 years. He would add the income for the third year to the previous cumulated income, divide by 3 to arrive at the average income, consult the tax tables to determine the total tax liability for the 3 years, and subtract the cumulated sum paid earlier to determine his current tax payment; and so on until the end of the tenth year.

At that time, if this was the end of the averaging period, and if unrealized changes in capital values were then to be accounted for,

[6] *Journal of Political Economy*, June 1939, p. 379; and *Agenda for Progressive Taxation* (Ronald Press, 1947), Ch. 6.

he would present a current valuation of his property, supported in a manner prescribed by regulations. Any changes in the value since the end of the preceding averaging period or since the dates of subsequent purchases, other than those arising from gifts and inheritances, realized capital gains and losses, and other sources previously included in taxable income, would be added to or subtracted from the income of the tenth year; after which that year's income would be added to the cumulated total of the preceding nine years, then divided by 10 to arrive at the average annual income for the 10 years. The aggregate tax liability for this income over the 10 years would be determined by reference to the Treasury's tax tables. From this sum would be deducted total taxes previously paid. The remainder would be the payment due in the tenth year. Conceivably the averaging period could extend from the taxpayer's first income tax return or his majority until his death.

Cumulative averaging would not require the reopening of preceding years' tax returns, for only the number of years elapsed in the averaging period, the cumulated total of taxable income, and the sum of the taxes previously paid would be needed, and these figures could be carried forward from the tax return of each preceding year.

A separate table of effective tax rates would be prepared by the Treasury Department for each span of years covered by different taxpayers during an averaging period: some individuals, more recently become of age or for other reasons more recently entered into the averaging system, might be submitting income tax returns for only the third or fourth time while others were submitting them for the seventh or eighth. If the averaging period was 10 years, the Treasury would have to prepare 10 sets of tax tables, but each taxpayer would have to refer to only one each year. Since cumulative averaging, other things being equal, would reduce tax liabilities for those with fluctuating incomes without raising them for those with stable incomes, a somewhat higher level of tax rates would be needed to raise a given revenue.

With unrealized gains and losses accounted for only every 10 years, or possibly only at death or at the time a gift is made, the valuation problem would become more manageable. Taxpayers would be kept abreast of their tax liabilities, except for the final reconciliation for unrealized gains and losses at the end of the averaging period. With such advance notice, it could be assumed that they will have had ample opportunity to raise the sums required for taxes on unrealized gains. At the same time, the knowledge that unrealized capital gains and losses must be accounted for on these occasions, though on an average basis, might well reduce the influence of tax considerations upon the timing of realizations of gain and loss. Voluntary inclusion of appreciation in capital assets at any time during the averaging period could also be permitted.

For stricter equity and to reduce the incentive offered by the free use of tax funds to defer the realization of capital gains and other income, it has been suggested that an interest adjustment might be incorporated in the cumulative averaging of incomes. Taxpayers would be credited each year with a stipulated rate of interest on the cumulated taxes they had paid during the averaging period, and the same amount of interest would be added to their cumulated incomes. Those who deferred the realization of income would obtain smaller interest credits. This adjustment, however, is not an essential part of the device.

The cumulative averaging method would not avoid a heavy concentration of tax liability or tax credit in the year of realization. Taxpayers would have their preceding years' taxable incomes raised by current realizations of gains and lowered by current losses, and would be required at these times to make up deficiencies in earlier tax payments or to receive credits for previous overpayments. In consequence, an incentive would remain to defer the realization of gains and to speed that of losses. If unrealized gains and losses were to be accounted for at the end of each averaging period, the markets for capital assets would probably be subjected to a large volume of tax-motivated transactions as the end of the period approached. Such transactions would be distributed over time if, instead of uniform dates, the averaging periods of large groups of taxpayers were made to end in different years.

If, on the other hand, unrealized changes in capital values were to be recognized only at death or upon transfer of property by gift, there would be a strong inducement to postpone realizing gains until after the end of the averaging period. The fact that the action of one Congress may be amended or repealed would lead many investors to defer realization in the hope of favorable changes in the law. The treatment of unrealized changes in capital values as income at the end of each averaging period or upon transfer of property by gift or at death would raise the same questions of constitutional validity as under the annual accrual proposal.

As with annual accrual of unrealized changes in capital values, cumulative averaging would accentuate cyclical fluctuations in tax receipts. While taxable incomes would be raised in depression years by being averaged with larger preceding incomes, the average income itself would be smaller and this would create tax credits for preceding years that would tend to reduce the current year tax liabilities. Conversely, in prosperous periods the large incomes would be averaged downward when combined with the lower incomes of preceding years but the cumulated average would rise, thereby increasing current tax liabilities for the underreporting of average income in the preceding years. Nothing in the scheme would prevent raising tax rates in good years and lowering them in bad years to accentuate this effect. Those who favor a strong use of fiscal policy to reduce cyclical fluctuations in private incomes would welcome such sizeable and partly automatic responses in tax receipts to offset movements in national income; others would doubtless be alarmed.

Although cumulative averaging seems to possess many attractive possibilities, particularly in the direction of giving more equitable tax treatment to individuals whose incomes, including capital gains and losses, vary widely, the concept is novel and unfamiliar. It has never been considered by Congress, nor has it yet received any significant public attention. Its merits appear to justify serious study, but it seems unlikely to command legislative attention in the near future.

5 UNREALIZED CAPITAL GAINS AND LOSSES EMBODIED IN PROPERTY TRANSFERRED BY GIFT OR AT DEATH

Many persons who would oppose the inclusion of unrealized capital gains and losses in taxable income under the annual accrual proposal, or at the end of relatively brief averaging periods, favor such a treatment of gains and losses embodied in property transferred by gift or at death. Under any method of taxing only *realized* capital gains, including all devices hitherto tried in the United States, a broad avenue for tax avoidance is created by the exclusion of unrealized capital gains embodied in such transfers. Estate and gift taxes provide only a partial offset. They are payable also on estates that owe nothing to unrealized appreciation in capital assets and on those that have been reduced by income taxes previously paid on realized gains. Although, other things being equal, the taxable estate is increased, and often the marginal tax rate raised, when an estate contains unrealized capital gains, the increase in the estate tax ordinarily constitutes merely a small fraction of the income tax avoided on the capital gains.

To begin with, no addition to a taxable estate takes place when a man consumes during his lifetime the tax saved by not realizing his gains. Even when he consumes none of it, the addition to his estate tax cannot equal the saving in his income tax as long as the effective rate of the former is less than 100 percent. For most estates the effective rate on additions is far below the present top bracket rate, 77 percent, on amounts in excess of $10,000,000 (for the tentative estate tax, which is reduced by the allowable credit for inheritance or estate taxes paid to states). In an estate of half a million dollars, of which $400,000 represents unrealized appreciation, the total federal estate tax under the Revenue Act of 1948 would be $45,300 if half the estate was left to the decedent's widow and half to his children (after the maximum allowable credit for inheritance and estate taxes paid to states). Had the decedent realized the capital gains in the same amount before death and paid the maximum 25 percent rate on them, he would have paid $100,000 more in income taxes while reducing his estate tax only $13,800. The difference, $86,200, represents the net taxes avoided by holding his appreciated assets until death. The increase in the estate tax is a bigger offset in larger estates, but in no case approaches closely the amount of capital gains tax avoided.

Transfers of appreciated property by gifts *inter vivos* usually involve a smaller ultimate tax avoidance and sometimes even a net increase in taxes, because the donee, upon sale of the property, becomes subject to a capital gains tax on the difference between the proceeds and the donor's costs, and because a gift tax is payable by the donor on the value of the gift itself. Nevertheless, transfers by gift without recognition of accrued appreciation make possible extremely long postponement of the capital gains tax, conceivably for several generations; and the effective tax rates on gifts are generally much lower than on estates. Moreover, the present transfer of 'basis' from the donor to the donee is not consistent with the personal character of the income tax, for it permits appreciation accruing during ownership by a donor with a large income to be taxed, if the property is subsequently sold, at the lower rates applicable to donees with smaller incomes.

Gifts of appreciated property for recognized charitable and scientific purposes pose a special anomaly. By permitting the donor to deduct the full current market value of the donated property from his taxable income, up to 15 percent of the taxpayer's adjusted gross income, while not requiring him to include in his income the increase in its value occurring during his ownership, the law, in effect, recognizes the accrued appreciation as a deduction, but not as income. In consequence, taxpayers in high surtax brackets may often make charitable gifts in the form of appreciated assets at little net cost to themselves. In extreme cases, the saving in the donor's taxes is larger than the amount he could realize, net of taxes, by selling the property.[7]

The estate and gift taxes do not provide any offset to the avoidance of capital gains taxes (or the disallowance of unrealized capital losses) whenever the amounts of property transferred are smaller than the substantial exemptions and exclusions under the former. Under the property-splitting provisions of the Revenue Act of 1948, the amount that may be transferred tax-free was greatly increased. For these various reasons, the estate and gift taxes provide relatively small offsets in the aggregate to the capital gains taxes avoided through transfers of appreciated assets at death and by gift.

A major consideration urged in favor of recognizing unrealized capital gains and losses embodied in such transfers as components of income is that this treatment logically complements the use at all other times of the realization principle. To postpone recognition for tax purposes of a capital gain or loss until it is realized by sale or other transfer has many practical advantages over proposed treatments that require annual tax accounting for changes in the market value of capital assets, and is supported by long tradition and business usage. Unless capital gains and losses are finally accounted for at death, however, mere postponement of income tax liability or credit may become transformed into complete avoidance or disallowance. If transfers at death were made occasions for taxing accrued gains, postponement of realization during life would still have the advantage of a free use of funds otherwise currently payable in taxes, but would lose the more powerful advantage of full income tax exemption. Such a change would take most of the force from proposals to tax accrued gains.

[7] Under the 1948-49 rate schedule a single taxpayer with surtax net income of more than $200,000 or a married couple with a joint income of more than $400,000, after deduction of the maximum allowable charitable contribution, would be money ahead if, instead of selling assets that had appreciated approximately 71.5 percent or more, they gave them to charity. The reduction in income tax, 82.1275 percent of the value of the donated assets, plus the avoidance of the 25 percent tax on the appreciation, would exceed the value of the asset. If the taxpayer kept the asset, however, the capital gains tax would not apply. Hence donating it would be more profitable than selling it but not than keeping it.

This change has been urged also as perhaps the simplest and least disrupting means of ensuring that stockholders will ultimately be subjected to personal income tax on their *pro rata* shares of reinvested corporate profits. Such profits now escape the personal income tax unless subsequently received in dividends or through realized capital gains. Though offset in uneven degree for different stockholders by the corporate income tax, this type of tax avoidance is regarded by many as the most serious inequity of the personal income tax.[8]

Apart from the question of equity, the fluidity of the market for capital assets is affected. Even a moderate tax on realized capital gains may be expected to discourage the sale of appreciated assets by aged individuals if gains may pass tax-free at death. This influence is enhanced by the fact that the equivalent of all or much of the gains may nevertheless be enjoyed during life by borrowing against the appreciated assets.

The valuation difficulties that would attend a general inclusion of unrealized capital gains and losses in taxable income would be much smaller if such treatment was confined to property passing at death or transferred by gift. Valuations are already required for estates large enough to be subject to federal or state estate and inheritance taxes, and for gifts subject to the gift tax. Many more valuations would be needed, however, to cover the assets of smaller estates and gifts, and special difficulties would be faced in connection with property held in trust.

The constitutional basis for taxing unrealized capital gains embodied in property transferred at death or by gift may be stronger than that for taxing other unrealized appreciation. It has been suggested that such transfers of property can be legally regarded as occasioning 'constructive realization' of capital gain or loss.[9] Even if this doctrine did not win judicial sanction, the same result might be achieved by imposing an excise tax on the accrued gains at the same rates and in combination with the taxes on ordinary income. Gift and death have been held to constitute appropriate occasions for a federal excise tax on property transfers. The constitutionality of applying an excise tax at graduated rates to only the part of each gift or be-

[8] See, for example, Simons, *Personal Income Taxation*, pp. 164-5.

[9] See remarks of Eustace Seligman and S. S. Surrey in *Capital Gains Taxation*, p. 41; H. M. Groves, *Production, Jobs and Taxes* (McGraw-Hill, 1944), p. 75, and *Postwar Taxation and Economic Progress* (1946), p. 219; Committee for Economic Development, *A Postwar Federal Tax Plan for High Employment* (Aug. 1944), p. 31; Vickrey, *Agenda for Progressive Taxation*, pp. 140-1 and 396.

quest that represents appreciation in the hands of the donor or decedent would appear to turn on whether such a classification is reasonable for the purpose of the tax.

Although the constructive realization proposal has been most commonly made in conjunction with programs for the full inclusion of capital gains and losses in ordinary income, it could be applied also to existing and similar preferential tax treatments of capital gains and limitations on the deductibility of capital losses as a means of reducing tax avoidance and postponement.

Transfer of basis

An alternative method of treating unrealized capital gains transferred at death appears to avoid the constitutional question involved in the doctrine of constructive realization. Bequests of appreciated property would be treated in the same way as gifts of such assets are now treated: the recipient would be required, when he sold the property, to calculate his taxable gain, if any, by the difference between the proceeds and the cost of the property to the decedent, rather than, as at present, by the difference between the proceeds and the value of the property on the date of death.[10] Such a method is open to the objection that, by transferring the 'basis' of one individual to another whose income may be in a much different tax bracket, it departs from the principle of a personal income tax. But Congress has not found this objection decisive in the case of gains embodied in gifts *inter vivos*.

Whether a decedent should be permitted to transfer unrealized capital losses raises a similar question. Much of the value of some bequests would then arise from their power to reduce the tax liability of the recipient, and testators could maximize the tax value of their unrealized losses by bequeathing properties embodying the largest losses to heirs with the largest taxable incomes. Congress shut off these possibilities in the case of gifts *inter vivos* by requiring the donee, upon sale of the property, to use market value on the date of transfer, if this was less than the cost to the donor, as the basis for calculating the capital loss. Congress would probably adopt a similar rule to limit the loss allowance if inheritors of property were required to adopt the basis of the decedent for calculating capital gains and losses.

The objections raised against taxing as income unrealized capital

[10] *Capital Gains Taxation,* p. 37, and Vickrey, *Agenda for Progressive Taxation,* p. 141.

gains embodied in property transferred at death are identical in part with those made against applying income taxes to any capital gains, and, more particularly, against unrealized capital gains. The latter are further removed from the traditional concept of income than realized capital gains. No market transaction has been completed by the decedent to mark the receipt of income represented by the unrealized capital gain. Federal and state death taxes already make up for some of the taxes that would be separately paid if a decedent's unrealized gains were taxed, and the rest would have the practical result of raising the effective rates of tax on estates. In many instances where unrealized gains constituted a large fraction of a sizeable estate, the difficulties already experienced by many executors in liquidating property to raise cash to pay the death taxes would be seriously increased.

6 AVERAGING DEVICES

The characteristically sporadic realization of capital gains and losses has been a main reason for according them special treatment under a graduated income tax. Otherwise they become subject to larger taxes or to smaller allowances than if the same amounts were distributed among the taxable incomes of the years in which they were emerging. The annual accrual proposal would avoid the bunching of tax recognition in the year of realization, but would not meet the problem of fluctuations in the annual accruals themselves. Appreciations in capital values would still tend to be bunched for most individuals in years of rising business activity, when the tax liabilities on them would be increased by the inclusion of the gains with enlarged ordinary incomes, the sum of which would be subject to the progressive rate schedule. For capital losses the tendencies would be opposite. The treatment of death and gift transfers as occasioning realization of gain or loss would, in the absence of countervailing measures, accentuate the tax consequences of concentrated realizations. Cumulative averaging of all incomes would meet this problem, as well as that of changing tax rates, but would be a radical departure from practice.

The special treatments of capital gains and losses under American income tax laws since 1921 have in no case closely approached those of allocating capital gains and losses among the years in which they arose. They have included, among other things, arbitrary narrow limits on the deductibility of net capital losses from other income and on the privilege of carrying forward unallowed net capital losses to future years. Such treatment of losses has been based in part on the assumption, often untrue, that the same taxpayers realize both gains and losses, and partly on the practical view that taxpayers have the initiative in realizing gains and losses, with the result that a more liberal allowance for losses would be likely to motivate wealthy taxpayers in particular to realize their losses but to leave their gains unrealized.

In an attempt to reach a better solution, various devices for averaging capital gains and losses have been proposed from time to time. In recent years the averaging idea has been extended by some to cover all highly fluctuating incomes and, as in the instance of cumulative averaging, even all incomes.[11] The object is to avoid imposing a higher tax upon individuals with variable incomes than upon those with the same aggregate of stable incomes.

Most of the recent averaging proposals contemplate the full inclusion of the averaged capital gains and losses in taxable income, but would restrict it to the realized amounts, except that property transfers at death or by gift would be regarded as occasioning constructive realization. Averaging realized gains and losses is urged as more manageable than the annual accrual proposal, though it too may be combined with the periodic recognition of unrealized capital gains and losses at longer intervals, say every 5 or 10 years. It may be combined also with preferential tax rates on gains and limitation upon the allowances for losses.

All averaging proposals that contemplate the full inclusion of capital gains and losses in taxable income entail sharp increases in the present effective tax rates on gains and in the allowances for capital losses. The equitable and practical effects of such increases, already discussed, should be differentiated, as far as possible, from the relative merits of different averaging devices, for, among other reasons, the latter may be combined with a varying degree of preferential treatment of capital gains and of limitations on the allowances for capital losses. Assuming a given degree of taxation, the relative merits of different averaging schemes turn mainly upon how well they offset the inequitable effects of a graduated rate schedule upon bunched realization of gains and losses, on how they affect the ability and disposition of taxpayers to time transactions with an eye to tax consequences, and their administrative complexity.

In addition to the cumulative averaging proposal discussed, three

[11] Simons, *op. cit.;* Vickrey, *Journal of Political Economy,* June 1939, and *Agenda for Progressive Taxation,* p. 166; Roy Blough, Averaging of Income for Tax Purposes, *Accounting Review,* Jan. 1945, p. 86.

other types of averaging devices may be distinguished: optional periodic averaging of capital gains and losses, their proration over a period of years, and carrybacks and carryforwards.

7 OPTIONAL PERIODIC AVERAGING OF CAPITAL GAINS AND LOSSES

A relatively simple method of providing relief to taxpayers whose annual incomes fluctuate materially was proposed by Henry C. Simons and has been supported by others.[12] A taxpayer would have the option of averaging his income for the preceding 5 years, and of computing his aggregate tax liability as if his annual income, including capital gains and losses, had been the average amount. He could then apply for a refund of the difference between the total tax liability so computed and the taxes he actually paid. To avoid excessive administrative costs when amounts are small, a moderate flat charge of perhaps $20 plus 1 percent or less of the readjusted tax liability, might be made.[13] If this device were applied only to capital gains and losses rather than to all taxable income the administrative burden would be much lighter because fewer returns would be averaged.

Apart from the difficulties of reopening past returns, it has been objected that taxpayers would have to engage in a guessing game as to which of the various 5-year periods available to them should be averaged to give them the biggest refund. Many persons would not receive the relief open to them because of ignorance or faulty choice of the averaging period. Vickrey points out that the plan does not do anything to correct the unduly favorable treatment of taxpayers whose years of high income happen to coincide with years of reduced rates. Such discriminations might become more significant if rates were changed frequently as part of a policy of counter-cyclical manipulation of tax revenues.

Nevertheless, the relative simplicity of the proposal, its effect of permitting a wide offsetting of capital gains against earlier capital losses and vice versa, and the distribution of a gain or loss over 5 years, are highly attractive.

8 PRORATION OF CAPITAL GAINS AND LOSSES

Proration calls for evenly apportioning the amount of a capital gain or loss among the years the asset was held, or over a fixed number of years, such as 5. Five possible methods will be discussed in turn.

a) *Backward proration over a fixed number of years*

If a 5-year period were adopted, the taxpayer would divide the net

[12] *Op. cit.*, p. 154; H. M. Groves, *op. cit.*, pp. 85-6.

[13] Vickrey has suggested this type of charge, *Agenda for Progressive Taxation*, pp. 171-2.

capital gain or loss realized in the current year into 5 equal parts and tentatively compute his tax for the current year, then recompute it for each of the preceding 4 years, on the assumption that one-fifth of his current year's capital gain or loss had been realized in each of the 5 years. The tax on or tax credit for the capital gain or loss would be the difference between the total tax liability for the 5 years and the taxes already paid.

b) *Backward proration over the number of years the asset was held*

If the period for prorating a realized capital gain or loss was the actual number of years the asset had been held, the computations would be much more complex. A gain or loss on an asset held 20 years would require reopening 19 annual tax returns; and a taxpayer who realized gains and losses in the same year from several assets held for varying periods would have to make a separate calculation, involving a different number of previous tax rates, for each gain or loss.

Under both proration devices just described, the necessity of reopening tax returns would create administrative difficulties. The second would be far more cumbersome. Nevertheless, an analogous device is now prescribed in the Internal Revenue Code, Section 107, in connection with income from personal services and "artistic work or invention" requiring 36 months or more to complete. Such income, provided more than 80 percent is received in one taxable year, may be prorated back over the period during which it was earned if the taxpayer chooses. Back pay exceeding 15 percent of the taxpayer's gross income in the year of receipt may also be allocated back to the years in which it was earned. A similar apportionment of realized capital gains over the period during which the asset was held was embodied in a measure (H. R. 14198) passed by the House of Representatives in 1920, but was rejected by the Senate because of its administrative and compliance difficulties. Apportionment backward over a fixed number of years, such as 5 or 10, would be much simpler, but would also necessitate the reopening of past returns. Individuals realizing capital gains or losses each year, of course, vastly outnumber the relatively few who are affected by Section 107.

c) *Backward proration with tax or credit determined by current income and rates*

One proration method that avoids reopening returns would have the taxpayer (1) divide his realized net capital gain or loss (presumably on assets held more than 1 year) into a fixed number of equal parts, say 5; (2) compute the difference in his tax liability before and after adding one-fifth of the capital gain or loss to his other income in the year of realization; and (3) multiply this difference by 5 to arrive at the full amount of the tax or tax credit for the total capital gain or loss. The effective tax rate or tax credit would be determined by the taxpayer's ordinary income and the prevailing rate schedule in the year of realization rather than by the ordinary income and rate schedules during the years the gain or loss actually or presumptively accrued. The results would be identical only if the taxpayer's ordinary net income and the effective tax rate remained constant during the period. The equity sacrificed by assuming constancy of ordinary income and effective tax rate must be weighed against the tremendous reduction in the difficulties of compliance and administration.

Under all three methods of backward proration the tax would be payable or the loss deductible in the year of realization. This has the advantage of synchronizing the tax liability on a gain with the presumable receipt of funds with which to pay it, and of synchronizing the loss allowance with a realized loss. It has the disadvantage of retaining or increasing much of the present influence of tax considerations upon the timing of sales of capital assets. Under the third method, taxpayers would have a motive for bunching realizations of gains in years of low tax rates and small ordinary income and for bunching loss realizations in years of high rates and large ordinary income. If the prescribed averaging period was the number of years the asset had been held, a strong motive would be offered to realize losses quickly but to defer the realization of gains as long as possible.

Were a uniform averaging period adopted (presumably for all gains and losses on assets held more than 1 year), and were the effective tax rates those of the preceding 5 or 10 years, the effect upon the timing of transactions would be somewhat more diffuse, but would still be responsive to calculations of the relative tax liabilities under the income and tax rates of the preceding 5 or 10 years as against those in prospect. Under all three methods, moreover, taxpayers would retain an incentive to defer the realization of capital gains in order to avoid the immediate loss of capital funds to meet the tax liability; and they would be encouraged to take losses quickly to obtain immediate tax reductions.

d) *Forward proration over a fixed number of years*

A fourth method, which would reduce these influences, is to prorate capital gains and losses over the succeeding instead of the preceding 5 or 10 years. The taxpayer would include in his current taxable income only one-fifth of a net realized gain or loss, for example, and would carry forward one-fifth to each of the next 4 years. His tax or tax deduction would be determined by his ordinary income and the prevailing tax schedules in the current and succeeding 4 years, instead of those of the years in which the gain or loss actually or presumptively accrued.

The smaller immediate tax liability could be expected to weaken the deterrent effect of the tax upon decisions to realize gains. An investor contemplating the sale of appreciated property would face an immediate reduction in his liquid funds or earning assets of only one-fifth of the tax liability on his gains, if a 5-year period was adopted, and the remainder would be distributed over the ensuing 4 years. Similarly, if only one-fifth of a loss was deductible in the year of realization, the tax incentive to take losses at particular times would be less pronounced. The effective tax rates and allowances on the gains and losses carried forward would be unknown because they would depend upon the future tax schedules and the taxpayer's future income.

e) *Forward proration with tax or credit determined by current income and rates*

Instead of the amounts of untaxed gains and unallowed losses, the carryforwards might be in the form of a fixed tax liability or tax credit, determined by the taxable income and rate schedule of the year of realization, and payable or deductible in equal annual instalments, such as one-fifth. This scheme would differ from the preceding in that the taxpayer would know the total tax cost or tax allowance of his gain or loss and in that only one year's tax return would have to be looked at to determine the amount.

Forward proration of profits from instalment sales, including capital gains, is now permitted under the Internal Revenue Code, Section 44, the taxes due each year being only in proportion to the payments received. The practical advantage of synchronizing the tax liability with the receipt of income, which is achieved in the instalment sales provision, would be absent under universal forward proration of capital gains and losses. Some loss of revenue could doubtless be expected owing to the inability of some taxpayers to pay the deferred taxes on gains previously realized.

Deferred tax charges and credits easier to administer but less equitable than direct offsetting of gains and losses

Whether or not full deductibility of capital losses from ordinary income is allowed, averaging methods that permit the forward or backward offsetting of capital gains and losses against each other are likely to be more advantageous to taxpayers than those that merely fix the tax rate or tax credit by prorating gains and losses, for a graduated rate schedule causes the tax-reducing value of capital losses to be less than the taxes on equal amounts of capital gains, assuming that other income is constant. The practical importance of the difference is increased by the tendency for larger amounts of capital gains to be realized in higher income periods, and of capital losses to be heavier when ordinary incomes are lower. The difference would be further increased if the federal government adopted a policy of raising and reducing tax rates with upward and downward movements, respectively, in national income.

However, the administrative consideration that the determination of the tax or tax credit by referring to a single year's return is much simpler favors the third and fifth proration methods.

Any variant of the proration technique could be introduced on either a voluntary or compulsory basis. Since the primary objective would be to redress unfairness suffered only by some taxpayers, and since it is desirable to keep the administrative burden as small as possible, a voluntary basis would seem adequate.

9 DESIRABLE LENGTH OF THE AVERAGING PERIOD

If capital gains alone are considered, the averaging period necessary to overcome tolerably well the inequitable consequences of applying graduated rates to bunched realizations is much shorter, in all but exceptional cases, than might be imagined. In effect, averaging multiplies each surtax bracket by the number of years in the averaging period. For example, if the averaging period was 5 years, the whole of a $10,000 capital gain would be taxed at the rate applicable to an addition of only $2,000 a year to the surtax income. The existing surtax brackets are narrowest and the graduation of rates sharpest in the lower part of the surtax schedule; the brackets become fairly wide and the progression of rates small in the upper part. For married persons filing joint returns under the Revenue Act of 1950, the effective surtax brackets were $4,000 wide at the lower end of the surtax scale and $100,000 at the top. With a 5-year averaging period, these surtax brackets would in effect range from $20,000 at the lower end of the scale to $500,000 at the top. For single persons and married persons filing separate returns, the brackets would be half as wide.

These figures suggest that an averaging period as short as 5 or even 3 years would be sufficient in most instances to eliminate any sizeable tax penalties otherwise created by a concentration of capital gains in a single year. If the sole object of the present preferential tax rates on capital gains is to offset the over-taxation of bunched gains under a graduated rate schedule, the offset is excessive. The present rates are materially lower than those that would prevail even under an averaging period as long as 20 years.

Only a relatively small difference in effective rates would be obtained under a 20-year, as compared with a 5-year averaging period, if we assume that ordinary income is constant. For example, for a married couple without dependents filing a joint return reporting a net income of $50,000, the difference in the effective tax rate on a capital gain of $50,000 fully prorated over 20 instead of 5 years would be less than 2 percentage points. It would shrink for smaller capital gains and for larger incomes.

The differences are somewhat more substantial, but not large, for incomes of $25,000 or less. On a joint return reporting ordinary income of $5,000, the difference in effective tax rate between a 5- and a 20-year averaging period, with capital gains fully included, would be 1.6 percentage points for a $5,000 capital gain, less than one point for a $10,000 or $25,000 capital gain, and 2.9 points for a $50,000 capital gain.

A similar comparison with respect to capital losses is presented in Table 89. Since this table shows only the tax value of the deductibility of capital losses from ordinary income, which is limited to $6,000 over a 5-year period under present law, it understates the existing loss allowance to the extent that taxpayers offset their capital losses against capital gains. The tax value of allowances for losses under any system of averaging would depend also in large degree upon the extent to which the taxpayer were permitted and able to utilize his capital losses to offset capital gains. The table clearly shows the small existing allowance against ordinary income for capital losses, and the large increases that would follow from full allowance under averaging. For example, a married couple filing a joint return with a constant ordinary net income of $10,000 and reporting a $10,000 net capital loss now receives a reduction in tax amounting to 11.1 percent of the capital loss over the 5-year carryover period. If the loss was allowed in full and prorated evenly over 5 years, the tax reduction for the loss would be almost double, 20.8 percent.

The equitable treatment of capital losses that are large relative to ordinary income would appear to require either a longer averaging period than that for capital gains or a carryover of unused capital losses from one averaging period to the next. Otherwise a taxpayer's income during the period may be insufficient to permit him to offset his losses for tax purposes. Under a 5-year averaging period a married couple filing a joint return showing a constant ordinary income of $5,000, and realizing a net capital loss of $50,000 in one year, would obtain a total tax reduction equal to only 6.3 percent of the loss, as compared with 12.6 and 16.6 percent, respectively, for 10- and 20-year averaging periods.

10 CARRYING CAPITAL LOSSES BACK AND FORWARD SOLELY AGAINST CAPITAL GAINS

A considerable measure of averaging capital gains and losses could be achieved merely by permitting taxpayers to offset capital gains realized in any year by unallowed capital losses reported during the preceding few years, and by permitting capital losses realized in any year not only to be carried forward against future capital gains but to offset capital gains reported in several preceding years. For example, offsetting could be permitted for 3 years back, and unused losses carried forward 3 years.

The present 5-year carryforward of capital losses against future capital gains is defective in that it benefits only those who realize future capital gains. Losers not lucky enough to obtain offsetting gains receive relief only to the extent that their net capital losses are covered by the existing allowance of $1,000 against ordinary income in each of 6 successive years. If they were permitted to offset losses also against earlier capital gains and to receive an appropriate tax refund or credit, the treatment would be more balanced. The discrimination now suffered by persons whose capital gains precede their capital losses, as against those whose losses come first, would be eliminated.

This method could be combined with any of the proration devices and with restrictions on the deductibility of capital losses from ordinary income and on the proportion of capital gains subject to income tax.

This type of averaging would obviously be more limited in its effects than the more comprehensive methods previously discussed. It would, however, achieve one of the major objectives: a more equitable treatment of taxpayers who realize both capital gains and losses in different years. Many persons who object to the full deductibility of capital losses from ordinary income would support a proposal of this character.

11 CONTROLLING INFLUENCE OF MARKET EFFECTS UPON EVOLUTION OF CAPITAL GAINS TAX TREATMENT IN THE U. S.

The more radical proposed departures from present practice reviewed in the foregoing all place a much greater emphasis upon equitable as opposed to operational considerations than Congress has been disposed to do. Moreover, the desire to avoid undue administrative complexity has been a serious obstacle to their adoption. Other barriers have been the desire to maximize tax revenues and to offer a special tax incentive for venturesome investment. Most important of all has been the fear of unduly impeding transactions in capital assets. In recommending in 1921 the abandonment of the full inclusion of realized capital gains and losses in taxable income, the Ways and Means Committee declared:

"The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law."

Again in 1923, in commenting on the pre-1922 full recognition, the Committee declared:

"But of much greater importance was the decided interference with the normal course of business and commerce. With a maximum tax of 77 percent there was a severe artificial restraint on sales at a profit, and many transfers of property extremely desirable from the standpoint of economic development and general public welfare were not only retarded but actually prevented. In addition, there was a serious loss of revenue, in that the initiative, as is always the case, remained with the taxpayer, who refrained from taking a profit but who did not hesitate to take a loss which could be deducted in full from his taxable income." This consideration has remained a dominant influence in most subsequent revisions of the tax treatment of capital gains.

Had Congress been concerned solely with the effects upon the markets for capital assets, it could have disposed of the problem merely by excluding capital gains from taxable income or by imposing a flat rate. The latter proposal has been strongly urged at various times, and was incorporated in the Boland Bill of 1942 (H. R. 6358). But equitable considerations, in the sense of the equal tax treatment of similarly circumstanced taxpayers, led most legislators to insist upon some degree of integration between taxes on capital gains and on ordinary income. Three aspects of equity have been prominent in this connection: the relative treatment of (a) equal incomes derived from ordinary sources and from capital gains; (b) different amounts of capital gains realized by taxpayers with equal ordinary incomes; and (c) stable ordinary incomes and the characteristically bunched realizations of capital gains emerging over a period of more than one year.

The Revenue Act of 1921 attempted to reconcile these aspects of equity with the demands of practical expediency by the full inclusion of capital gains and losses in taxable income for all individuals whose effective tax rate on capital gains would be 12½ percent or less; and by the separate taxation of the gains realized by others at a flat rate of 12½ percent. Subsequently a parallel treatment for the allowance of capital losses was adopted. These provisions withheld preferential rates from the gains of taxpayers with smaller incomes.

In the early and middle 1930's problems of tax avoidance and of achieving more equity and progressivity in the income tax structure assumed a larger place in public discussions than the maintenance of active securities markets. The desirable degree of preference in tax rates to be accorded capital gains was now thought to turn more largely on their lumpy character and the consequent inequity of taxing them in full under a system of graduated rates. Accordingly, in the Revenue Act of 1934 Congress removed the ceiling on the effective tax rates applicable to capital gains, graduated the degree of preferential treatment in 5 stages according to the length of time the asset had been held by excluding progressively larger fractions of the gains from taxable income, and extended this treatment to all taxable incomes.

Many persons mistakenly believed that the percentage exclusion treatment adopted would yield substantially the same results, with less administrative complexity, as the proration of capital gains and losses over the same periods. But the degree of tax preference needed solely to offset the higher tax rates otherwise applicable to the bunched realization of long-emerging capital gains is smaller than is commonly believed, as previously noted, and varies with income. Since the tax brackets widen considerably and the progression of rates slackens as we go up the income scale, only such bunched gains as are large relative to ordinary income in the lower and middle surtax brackets tend to raise materially the effective rates under the rate schedule then or now in force. Consequently, different rather than uniform percentages of exclusion for different income levels would be needed to achieve results approximating those of proration.

As noted in Chapter 6, the graduated fractional recognition method of 1934-37, which did not stipulate any special maximum rate for capital gains, noticeably discouraged the realization of gains by the upper income groups both because of the sharply increased tax rates and because of the substantial tax reductions offered for continued holding of an appreciated asset beyond the end of each successive holding period. The percentage allowances for capital losses of different age groups created anomalies by stimulating taxpayers to choose the assets on which to realize losses in such ways as to offset relatively large gains from long-held assets with smaller losses from shorter-held ones. On the other hand, the rigid limitation of $2,000 on the deductibility of statutory net capital losses from ordinary income aroused widespread complaint.

When the Revenue Act of 1938 was in the early stages of its legislative history the House Bill sought to reduce the sharp stepdowns in effective rates for capital gains and losses as the period of ownership lengthened. Instead of only 5 age classes it was proposed to substitute 49, with a gently graduated downward movement of effective rates as ownership lengthened. But this provision, which was subsequently eliminated because of its administrative complexity, would have been of doubtful efficacy in reducing the tax incentive to postpone realizations of gains. Under the 1934 Act an investor who had held an appreciating asset for 2 years could not ordinarily obtain a further tax advantage from continued retention unless he was prepared to hold it for at least 3 years more; but under the 1938 House Bill, every additional few months of holding beyond 2 years would confer a tax advantage.

With its eyes fixed once more on the capital markets, Congress finally reduced to only 2 the holding periods entitled to preferential treatment: 18-24, and over 24 months; and it reimposed ceiling rates on capital gains: 15 percent on gains from assets held longer than 2 years, and 20 percent on gains from assets held 18-24 months. At the same time it removed the $2,000 limit on the deductibility of statutory net capital losses from other income, except that net losses on assets held 18 months or less could be carried forward and deducted only from short term gains realized in the succeeding year.

The drastic increases in effective tax rates on ordinary incomes in 1939-41, preceding the entrance of the United States into World War II, were not accompanied by a rise in the maximum rates on capital gains. When further advances in ordinary rates were in process of enactment in 1942, the disparity seemed excessive on both equitable and practical counts, and Congress raised the ceiling rate on capital gains to 25 percent. As contrasted with the new high rates on ordinary incomes, this rate was believed to offer sufficient tax preference to avoid severely impeding transactions in capital assets. At the same time Congress returned to a single holding period for qualifying capital gains for preferential treatment. It merely excluded from taxable income half of the gains from all assets held more than 6 months. The maximum rate, 25 percent of the total gain, applied only when the inclusion of half the gain in ordinary income would impose a higher effective rate. Impressed by the large loss realizations of 1938-41 under the unlimited deductibility of statutory net long term capital losses then in effect, Congress reimposed restrictions on such allowances though in a new manner as discussed in Chapter 7.

Exclusion of short term gains and losses from special treatment

The evolution of American practice with respect to the exclusion of short term gains and losses from special treatment reflects a similar emphasis upon market effects, qualified by equitable considerations and by a desire to withhold preferential treatment from speculative gains. The initial 2-year holding period requirement became a part of the Revenue Act of 1921 through an amendment offered on the floor of the Senate. The bill under consideration proposed to extend preferential treatment to all capital gains, but Senator Walsh of Massachusetts objected to the absence of a distinction between "increased value . . . extending over a long period of years and that sudden and speculative increase that develops within a short period of time". He proposed a 3-year holding period, but compromised on 2-years when a 1-year requirement was suggested to overcome his objection.[14]

The persistence of this attitude toward short term speculative gains is indicated in the report of a subcommittee of the House Ways and Means Committee in 1938:

"It has always been the settled policy of the Congress to tax speculative gains in general in the same manner and to the same extent as earned income and business profits. . . . Your subcommittee believes

[14] *Congressional Record,* 67th Cong., 1st Sess., Vol. 61, Part 7, pp. 6575-6.

that this policy is wise and should be adhered to. It would be against sound public policy to make any changes in the revenue law whose tendency would be affirmatively to encourage speculation by preferential taxation.... Your subcommittee recognizes that a classification based solely upon the period of holding is not an exact method for segregating speculative from investment transactions, but it appears to be the only practicable method and is believed to be a sufficiently fair criterion for practical purposes."

But the unwillingness to grant tax privileges to speculative gains conflicted with the desire to avoid impeding the ready transfer of capital assets. Even under the relatively low income tax rates in force in the latter part of 1922-31, the 2-year holding period was criticized on the ground that it retarded the realization of gains and speeded that of losses. The step-down scale of 1934-37 reduced the minimum required period to 1 year. The Revenue Act of 1938 raised it to 18 months.

During the Congressional hearings on the Revenue Act of 1942 strong representations were made that the 18-month requirement was seriously interfering with the free transfer of capital funds, and the Boland Bill, as already noted, proposed to abolish the holding period. A 1-year period was suggested by others as most consistent with the annual taxation of ordinary income. The 6-month period finally adopted was the most liberal since the holding period concept was first introduced.

The existing tax treatment of capital gains and losses is clearly the product of long legislative experimentation. It would be foolhardy to predict that it will not be modified further, perhaps radically. Nevertheless, barring major alterations in the general income tax structure, it is reasonable to expect that the same group of competing considerations that governed Congress in evolving the present treatment will continue to be coercive, though they will doubtless vary in relative strength from time to time. Consequently, changes that retain the essential form of the present treatment are more likely to receive near-term serious consideration than others.

From a longer range standpoint it is well to emphasize that the whole concept of taxable income is relatively new and still evolving. The acceptance of the income tax as a personal impost, the greater reliance of governments upon it as a major source of revenue, and the tremendous growth in the importance of large scale corporate enterprise have refined and made more complex the concept of taxable income. The prominence of capital gains as a source of private wealth in the United States, and the origin of considerable amounts of them, though far from all, in reinvested corporate profits, early led this country to treat them as ordinary constituents of income. Their peculiar characteristics under an annual income tax thereupon raised problems that have so far defied satisfactory solution. On the one hand, capital gains add to the economic power of individuals no less than ordinary kinds of income. On the other hand, to treat capital gains as such under a graduated income tax raises questions of equity and of adverse operational effects upon transactions in capital assets. In these connections, numerous conflicting contentions have been made. In presenting various aspects of the problem our object is to give the reader analyses and empirical materials on which he can base his own judgments, not to make recommendations.