CHANGING CONCEPTS OF CAPITAL GAINS TAXATION

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CHAPTER I

WHAT ARE CAPITAL GAINS AND LOSSES

A capital gain or loss results from the sale or exchange of a capital asset. It is the difference between the purchase price or acquisition value and the selling price or taxable exchange value of a capital asset. A capital asset is often defined as any asset held not in the ordinary course of the individual's business. Unless otherwise provided by law, capital assets are all assets except: (1) stock in trade or property held primarily for sale to customers; (2) depreciable property or real estate used in trade or business; (3) Federal, State, and Municipal obligations issued after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date; and (4) personal consumption goods.[1]

Capital gains fall under two general classifications. They are derivative gains and economic gains. Derivative gains are those gains which do not enhance the individual's economic power. Some examples of derivative gains are:

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[1] O. K. Burrell, "The Capital Gains Tax," Oregon Business Review (March-April, 1945).

(1) gains from the sale of bonds which are caused by the prevailing rate of interest being less than the rate of interest on the bonds. If A purchased a $1,000 bond at a net yield of four percent and later sold the bonds when interest rates on comparable risks had declined to three percent, he would realize a capital gain. If after the sale was consummated, he undertook to purchase bonds which would enable him to eatn the same interest income as he received from the $1,000 bond, it would utilize all the capital gain he received to put himself into a similar financial position. (2) gains derived during periods of inflation. If A purchased some properties for $10,000 and after several years, during a period of inflationary prices, he sold the properties for $12,000, he has derived a capital gain of $2,000. Now if he reinvests into other properties, if he is to achieve properties of similar value as that disposed of, he would have to pay $12,000. It is evident that this individual has received no economic gain. The only advantage this individual has received is, now he owns properties which might be of greater use to him.

Other capital gains reflect improvements in economic position. Examples of such gains are: If A purchased a lot and built a new house in an unsettled residential area and if after several years the value of this property had increased greatly, due to the locational value, caused by

becoming an attractive residential area, the gain derived on the sale of this property would increase A's financial power. If an individual purchases stocks, and holds them over a period in which they rise in value as a result of the accumulation of earnings, the gain derived from the sale of such stock would be the result of improvement in the owner's economic position.

Where a preferential rate is established for the taxing of capital gains, a problem of preventing the avoidance of tax by conversion of ordinary income into capital gains is present.

This problem arises in respect to allowing corporate earnings to accumulate instead of paying the earnings out in dividends, this allows the holders of the shares of the corporation to sell his stock and realize the earnings on his stock and pay a tax on a capital gain instead of ordinary income. Of course, Section 102 of the present Revenue Act tends to eliminate this conversion feature, but it is difficult to administer.

Other conversions of ordinary income into capital gains have been done by the movie industry. The stars of the picture received a minority interest in a subsidiary corporation which was set up to produce a particular picture. The star would receive a nominal salary, and if the picture was a success, surplus would accumulate in the

subsidiary corporation and after a year or two the minority stock would be sold, and the resulting profits would be taxed as long-term capital gains.

The problem with which we are dealing is that of devising a tax statute that will tax capital gains equitably and prevent avoidance by conversion of ordinary income into capital gains. The historical development and evolution of the present system of preferential taxation of capital gains is the principal subject of this thesis.

CHAPTER II

CAPITAL GAINS IN THE CIVIL WAR INCOME TAX

The first experience of the Federal Government with income taxation occurred during the period of 1861-1872. An income tax designed to raise $3,000,000 had been proposed by Secretary of Treasury Dallas, January 17, 1815, but this proposal was not adopted.

The first income bill passed in 1861 recognized no distinction between capital gain and other profits. The tax was levied upon "the annual gains, profits or income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment or vocation carried on in the United States, or elsewhere, or from any other source whatever."[1]

The Act of 1861 provided for a rate of three percent on incomes of over $800. The rates under the law of March 3, 1865, were:

Over $600 and not exceeding $5,000 .... 5%
Over $5,000 ....10%

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[1] K. K. Kennan, Income Taxation (Wisconsin: Burdick and Allen, 1910), p. 248.

The taxpayers were particularly dissatisfied with the definition of income. Whenever they sold real estate which had been held for several years for a gain, the complete gain was considered as income for the year in which the sale was consummated. These taxpayers realized that this gain in many cases had accrued during the time the property was held, and not necessarily in the year the property was sold. If an individual purchased real estate in 1863 for $10,000 and sold it for $14,000 in 1865, he would have to report a gain of $4,000. If his other income during this period was $2,500, the additional $4,000 income would put him in the ten percent bracket and he would have to pay ten percent on $1,500 of this income; but if this gain was broken down as a $2,000 gain for each of the years held, his income for each of the years would fall under the five percent bracket.

This created such dissatisfaction that the income tax law of 1867 took cognizance of capital gains and limited such profits to those sales on real estate purchased within two years. They were not referred to as capital gains, but as profits from real estate.

The problem arose whether the unearned increment of each year is income to be taxed. This problem was settled by the decision of the court in the case Gray v Darling,[1]

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[1] 15 Wall. 63, 66. 1872.

which read:

> The mere fact that property has advanced in value between the date of acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value, in no sense constitutes the gain, profit or income. It constitutes and can be treated merely as increment of capital until the sale of the property.

The Civil War Income Tax was closed out as a chapter of history in 1872.

Except for the Income Tax Bill of 1894, which was declared unconstitutional before it became operative,[1] no taxation of incomes was attempted until after the ratification of the sixteenth amendment to the Constitution.[2] The sixteenth amendment provided for the right to levy a tax on income without apportionment between the states.

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[1]Pollock v The Farmers' Loan and Trust Company, 157 U. S. 429; 158 U. S. 601 - 1895.

[2]There was a tax based upon corporate income in 1909, but it was not considered an income tax, but a "special excise tax" to be paid by corporations in return for the privilege of exercising their francise rights.

CHAPTER III

TAXATION OF CAPITAL GAINS 1913-1921

The Revenue Act of 1913, did not provide for separate treatment for gains or losses from the sale of capital assets. The gains were treated as ordinary income. This does not mean that gains or losses from the disposal of capital assets were not given consideration.

Although the Revenue Act of 1913 was drawn up in a secret Democratic caucus, thus eliminating public record of the debate, it is evident that they gave gains from sales of capital assets much study. The income tax section was modeled from England's income tax statute, but differed in respect to taxation of gains from capital assets. England did not tax these gains or make any allowance for their losses, but had a strict classification of what composed capital assets.

The Act did not provide for taxation of the unearned increment each year or allow any decline in value similar to allowing depreciation, probably because of two main reasons: (1) the difficulty of obtaining honest and accurate appraisal values of real estates and securities not

listed, (2) the decision in the case, Gray v Darling.[1]

The next problem encountered was, "How should we tax the gain from sale of real estate which had been purchased several years prior to the time of the Act?" It was decided that for constitutional reasons, that these assets should be given the market value as of March 1, 1913, so that the income tax would not be retroactive or a tax upon capital.

It was not certain that the bill could make any attempt to define or specify the tax to be imposed except on income. They were not sure that Congress had a right to employ a definition of income, because, although the people had granted Congress the power to levy a tax on income, possibly it was a judicial question as to whether a particular thing was income or whether it was principal.[2] Realizing this fact, yet believing it was necessary to put the act into operation, provisions were laid down as to gains that were taxable.

Many members of the legislative body did not feel that gains made from the sale of property held for several years constituted a gain. This reasoning was based on the sale or

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[1]15. Wall. 63, 66. 1872. Cited on p. 5.

[2]Senator Cummings, Senate, Congressional Record (August 28, 1913).

disposal of property which had risen in value due to a price level change over a span of years. A member of senate urging the non-taxation of this gain said:

> In respect to selling stock that has increased or declined in value, that is not a gain or loss, but merely a mere change of capital and principal from stock into money.[1]

He explained his case; that to replace these stocks sold, at prevailing market price would utilize all the so-called gain to put himself into a similar financial position, but to tax this gain, he would be unable to replace the stock and maintain his former capital position.

The Committee of Ways and Means reported, that there was an income to be taxed. They believed the individual had a greater control of wealth than before the sale. They reasoned that if the individual used this gain for other purposes, such as paying rent or buying commodities, he had greater economic power than before. They also advocated taxing this gain as income for the 12 months in which the property was sold.[2]

In the light of these varied opinions, one is lead to wonder why no provision for the taxation of capital

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[1]Senator Williams, Senate, Congressional Record (August 28, 1913).

[2]Committee of Ways and Means, House, Congressional Record (May 6, 1913).

gains was included in the bill. The reason hinges on Mr. Cordell Hull's explanation of this feature of the bill. Speaking before the House he said:

> In construing all these laws . . . . unless the unrealized increment is expressly made income, it is not considered income in any sense of the word, but simply increases of value or capital . . . . in respect to an individual not an ordinary dealer or one making the buying and selling a business, this bill would apply only to those profits on sales where the property was purchased and sold during the same year.[1]

The bill was adopted reading: "Taxable income comprises gains, profits, and income derived from . . . . dealings in property whether real or personal . . . ." The bill did not contain Mr. Hull's definition, nor did the bill specifically provide for losses on capital transactions.

Even before the passage of the bill, it was realized that it would have to be adjusted and revised in the future. It was plain that the founders of the bill knew that their bill would need revision as was shown by Mr. Hull addressing Congress:

> Like any new tax, it will be necessary for the people to become acquainted with the proposed law and for it to become adjusted to the country before

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[1]Cordell Hull, House, Congressional Record (May 6, 1913).

> extending its classifications, abatements, deductions, exemptions and so forth, to the extent which in all respect would make it as comprehensive as it should later be made. It was therefore deemed sufficient at present that the bill contain only the essential features of a modernized income-tax law.[1]

It soon became necessary for the Treasury to define what were taxable gains or allowable losses in respect to the sale of these capital assets. The Treasury laid down the following decision in respect to taxable income and allowable losses on real estate:

> The proper increase in the value of a piece of property held over a number of years is recognized as is the fact that any loss sustained through the sale of real estate in any one year in which the property is sold. Therefore, in ascertainment of the amount of income derived or loss sustained in the sale of property, will be found by prorating either the profit or the loss without attempting to show that the total increment in the value of the property occurred during the taxable period, and without admitting voluminous and contradictory evidence as to the increase in value having occurred prior to the incident of the tax. The simple device of prorating the profit or loss in accordance with the number of years the property had been in possession of the selling party has been adopted. The amount of profit or loss to be accounted for in the return of annual net income for the year in which the property was sold shall be prorated in the proportion which the number of taxable years bears to the total number of years the property was held.[2]

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[1]Cordell Hull, House, Congressional Record (April 26, 1913).

[2]Treasury Decision 2005, July 8, 1914.

This decision was necessary because the holders of these properties were either all claiming that the appreciation of value occurred before March 1, 1913, or that the loss had occurred after March 1, 1913.

Taxpayers immediately started selling securities which had declined in value, then buying them back at the lower market price and including this loss as a deduction when filing their income tax return. To offset this practice, the Treasury decided that:

> The shrinkage in value of bonds, stock and other such securities due to fluctuation in market value, when demonstrated by their sale constitutes a loss within the meaning of the act, but it is also provided that only those losses are deductible which are sustained during the year in trade, and such losses to be deductible must be actually sustained and ascertained during the year for which the deduction is sought to be made; it must be incurred in trade and be determined and ascertained upon an actual, a completed, a closed transaction.[1]

This decision was necessary to explain: (1) that there had to be an actual sale, and market decline could not be considered as a loss, (2) that selling stocks which were selling for less than their purchase price, than rebuying them at the lower cost, did not constitute a loss within the meaning of the act. Gains from wash sales were taxable as ordinary income.

This decision said that "losses in trade" were

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[1]*Ibid.*

deductible if they were absolute, but it did not define what was meant by a "loss in trade." Therefore, the Treasury laid down the following decision to clarify the term:

> A Loss in Trade: A person not a recognized or licensed dealer in stock and bonds makes $5,000 profit during the year on a stock purchase and sale, and makes a loss during the same year of $4,000. The tax office holds that the profit of $5,000 is income to be included in a return of income, and that the $4,000 loss is not such a loss as may be deducted in a return of income, for the reason that it is not incurred "in trade" within the accepted definition of that term.[1]

No provision of the 1913 law met with more criticism and objection. Corporations were permitted to deduct all losses,[2] and it seemed just to tax corporations and individuals alike in this respect. So long as the gains from trading were taxed, it was felt discriminating to omit losses from allowable deductions. Frequently an individual's gains and losses from a series of trades are about equal, which as to the 1913 law resulted in a tax being assessed against one's other income upon something which had not any relationship to such income. As losses to one taxpayer usually represent gains to another, and as certain securities and real estate changes hands many

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[1]Treasury Decision, 2135.

[2]Robert Montgomery, Income Tax Procedure 1917 (New York: The Ronald Press Company, 1917), p. 166.

times, it seemed possible that under the decision, an amount equal to the value of one lot of securities or one parcel of real estate might over a period of years be taxed one hundred percent.

The demand became so strong for a change, that Congress was forced to provide a means of relief. It was believed that all losses could not be allowed without restrictions, or the taxpayer would take advantage by selling for a loss only in the years when their regular income was high, also it might increase the incentive of taxpayers to sell their stock for a loss and then repurchase them, endeavoring to use this loss as a deduction to their income. To provide this relief, Congress added to the income tax bill of 1916, the following provision:

> In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom, shall be allowed as deductions . . . .[1]

No longer would a taxpayer have to pay a tax on the gains made from capital assets, and not be able to offset his losses as a deduction. Although this relief was granted to the taxpayer, it was still highly criticized, because, yet a taxpayer must pay a tax on all of his

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[1]*Ibid.*, p. 165.

profits; therefore, it was believed that he should be allowed to make deductions in the same manner on all of his losses. It was immediately pointed out that profits and losses other than those connected with one's business are not apt to be constant. There are good years and bad years, and where there is no opportunity to average, some taxpayers may be obliged to pay on large profits one year and yet be unable to claim deductions for losses the next year.[1]

There was a great demand for relief to the taxpayer, not only were they wanting to be able to deduct capital losses in full, but a great many taxpayers were paying the taxes on capital gains under protest. This group was making the way for the Supreme Court to make a decision, possibly deciding that these gains were not taxable income.

With the higher surtax rates established during World War I, there was a great demand for the allowance of all losses on capital asset sales. The allowance for the full amount of the loss was becoming more and more important, due to the higher surtax rates.

To alleviate a part of the injustice that the tax laws of 1916 and 1917 were now imposing, Congress found it

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[1] Ibid., p. 173.

necessary to grant the necessary relief in the Revenue Act of 1918. Under the new law an individual could deduct all net losses, "if incurred in any transaction entered into for profit, though not connected with the trade or business."[1] The chief factors which decided the deductibility of this class of losses were: (1) The loss had to be an absolute loss rather than a conjectural loss. In other words, it had to be an "out of the pocket loss," (2) The loss must be sustained within the taxable year. If, at the end of the preceding taxable year the taxpayer had mentally "charged off" a loss, it would not come within the Treasury's interpretation of when a loss occurred. The Treasury, in its regulation dealing with a closed transaction, fixed the date practically at the time of obsequies and not at the time of death. For example, if a taxpayer purchased stock for $50 a share in 1916 and sold it on January 3, 1918 for $1 a share, the Treasury holds that the loss was not sustained until 1918, even though the value of the stock on December 31, 1917, was the same as on January 3, 1918. (3) The transaction must have been "undertaken for profit." That is to say, if a taxpayer purchases a car for pleasure purposes, or buys or builds a residence for his own occupancy, and sells

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[1] Income Tax of 1918, Section 214 (a-5).

either for less than the cost, that loss is not deductible. This cannot be claimed as a deductible loss as neither were undertaken for profit, although profits from this source are taxable. If, however, the residence or car is destroyed by casualty and not compensated by insurance, the actual loss is deductible.[1]

A capital loss had to be on a completed, closed transaction. Is a wash sale a completed, closed transaction? So long as accrued losses (shrinkage in value of securities) were not deductible until evidenced by a closed transaction, it is only natural that attempts would be made to convert paper losses into actual losses in order to obtain the benefit of the deduction. If securities are sold at a loss to a bonafide buyer, the loss has become legally established and should be an allowable deduction.

It was pointed out that sales through the stock exchange are actual and completed transactions because the seller has no control over the buyer. Subsequent repurchase of a similar amount of securities should not affect the validity of the transaction, because the buyer takes a chance of having to pay a higher price, and therefore the transaction is in fact a new deal. It was pointed out that the repurchase established a new cost, and if

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[1]Treasury Decision B. 43-20-1259; O.D. 698.

sold later for a higher price, the gain would be taxable. The Treasury hesitantly accepted the facts presented and laid down the "Wash Sale Ruling" which read:

> If a taxpayer makes an actual bonafide sale of securities at a loss in 1918, the loss is deductible even though the taxpayer repurchases the securities in the succeeding year at the same price for which they were sold. However the burden of proof will be on the taxpayer to show that the sale was not fictitious.[1]

At the same time they said:

> If a taxpayer buys 'futures' hoping to sell the contract at a profit, and instead is compelled to sell at a loss, the loss is deductible, within the meaning of the act.[2]

In the debate on the Income Tax Bill of 1918, the question arose, "Can a taxable income result from an exchange of property?" Following is part of the discussion that took place in Congress:

> Mr. Hardy: If A. and B. owning two tracks of land, exchange those tracts without any money being paid, although each one of them has enhanced in value, is there any tax on that exchange?[3]
>
> Mr. Fordney: No, they have received nothing. They have had no income. You do not have an income until you convert the property into money. I may own a piece of land and exchange with you for another piece

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[1]Treasury Decision, B. 2-19-149; O.D. 103.

[2]*Ibid*.

[3]*Congressional Record* (September 16, 1918), pp. 10351-10352.

> of land today worth twice what the property cost me when I gave it to you, but there is no income because I have not converted it into money.[1]

This should have been considered as the authority in laying down any rules of interpretation, since no dissent was recorded. But, immediately after the passage of the bill, the following contrary decision was laid down:

> Under the provision of the statute and in accordance with article 1563 of regulation 45, the exchange of farm land in all cases in which the farm land exchanged has a market value constitutes a completed or closed transaction from which a gain or loss is realized, even though the land received in exchange may be of a similar kind and of similar value.[2]

The question, whether a tax on capital gains is a tax on income or capital, was being brought before the courts. The majority of the lower courts upheld that a tax on capital gains is a tax on income; but in the case, Brewster v Walsh, held in a U. S. District Court, a contrary decision was given that read:

> . . . . I feel constrained to hold that the appreciation in value of the plaintiff's bonds, even though realized by sale, is not income taxable as such. It follows that The Income Tax Law of 1916, in so far as it attempts to tax such increases, is in conflict with the apportionment required of the First Article of the Constitution, being a

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[1] _Ibid_.

[2] Treasury Decision, B. 14-20-821; O.D. 429.

> direct tax and not apportioned among the several states according to the population . . . .[1]

This was a drastic decision, and if it was to be upheld by the Circuit Court and Supreme Court, it would cause drastic effects, as the government was in no position financially to pay the refunds which would be claimed if the tax imposed on all c apital gains were held to be unconstitutional. The Supreme Court was presented with the question in the case of Brewster v Walsh. The majority decision was the words of an earlier case which read as follows:

> The definition of the word "income" as used by the 16th Amendment, which has been developed by this court does not recognize any such distinction between gains from sale of capital assets, and other business income. We find there is no e ssential difference in the nature of the transactions, or in the relation of the profits to the capital involved, whether the sale or conversion be a single isolated transaction or one of many.[2]

Now at last the question whether these gains on the sale of capital assets were taxable income, as provided by the 16th Amendment, was settled. The legislative body was now in a position to move forward in capital gain taxation since the constitutional question was resolved.

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[1]U. S. District Court (Conn.) December 16, 1920.

[2]Merchant's Loan and Trust Co., trustee v Smietanka, Commissioner, 225 U. S. 509 (1920).

With the increase in the general price level, which followed World War I, capital assets in many cases had a dollar value much higher than their acquisition value, or their value as of March 1, 1913. If a taxpayer sold such an asset at that time, at the inflated prices, he would show a large book gain, a gain which would put him in a much higher tax bracket. With the higher surtax rates, the taxpayers were of the opinion, that they were unable to sell at that time. If they consummated the sale, they would be unable to repurchase or reinvest the proceeds to earn the same rate of income. It was believed, by the taxpayer, that the government by their taxing power was hindering them. No longer could their own prudent judgment direct the formulation of policy in the acquisition and sale of capital assets. Tax consideration would outweigh business judgment in making such decisions.

Congress realizing more fully the validity of the criticism placed on the taxation of capital gains as ordinary income, set about to devise a solution which would be more fair, yet one which would bring in revenue from these capital gains.

The desirability of a different method of taxing capital gains was best presented in the brief of Mr. Kellogg before the Committee of Finance. He outlined three important features where the income tax bill was

not satisfactory. First, the existing method of taxation of capital gains was injurious of the Treasury of the United States, because it was killing transactions which would be made, if the taxation was more reasonable. He explained, that in a great many cases the people who would make these transactions could not stand the burden of the tax which would be imposed upon the profits resulting from them, in addition to such taxes as were levied upon their ordinary income. This, he claimed, was lessening the amount of revenue that could be received from taxation, if the rate was less confisticatory. Mr. Kellogg pointed out, that working in his capacity as a lawyer, he had advised numerous clients not to make a particular sale because of the income tax provision. He also pointed out, that when he attended the United States Chamber of Commerce Convention in 1918 and 1919, he did not meet a man there he that had talked with, who did not know of a large number of transactions of that nature that had been killed because of the income tax feature. Mr. Kellogg believed, that the countless number of transactions which were not consummated because of tax reasons, that the Treasury was losing instead of gaining in the existing method of taxation. A large number of transactions taxed moderately would yield more than a few transactions taxed prohibitive.

This point was affirmed by Senator Smoot, who replied:

> I am perfectly aware that it would release a good many transactions in real estate. In fact, there is not a month, I think, but that I get letters calling attention to just such cases as you refer to now.[1]

Mr. Kellogg's second point was, that the present method of taxation was bad for the country, economically considered, because it tends to augment the condition of frozen capital and eliminating the natural flow of capital into productive enterprise.

The third criticism was the injustice to the taxpayer to be taxed upon derivative gains. To explain this point, three examples will be cited.[2]

Example I

A salesman in New York had a home for which he paid four thousand dollars, and during the housing scarcity after World War I it rose to a value of $7,500. The salesman was transferred to Chicago, so he sold the house, but when he got to Chicago he had to put all of the $7,500 into a house of the same value as the one he owned in New York. Yet, he had to pay an income tax on the $3,500.

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[1]Senator Smoot, Committee of Finance Hearings on Revenue Act of 1921, p. 540.

[2]Mr. Kellogg, Brief presented to Committee of Finance, on Hearing of Revenue Act of 1921, pp. 534-540.

Example II

A man had some properties costing about $1,800,000. He bought them in November of 1918. In June of 1919 he organized a $4,000,000 corporation and took those properties in without consulting counsel who had made any study of the situation. He did not sell a share; and when the transaction was over he had exactly what he had before, only the piece of paper held by him read a little differently, but his actual interest was identical. He received a bill from the Treasury for a tax on $1,600,000 for that transaction.[1]

Example III

A man invents something after years of effort. He wants to sell it out for a large price, but under the income tax law he would have to pay something like 75 percent of his profits to the United States Government.

These three examples show the inequity of taxing these transactions at the same rate whidh fall under the existing income tax schedule.

It was realized a change was necessary, but what plan would be most equitable, yet bring sufficient revenue into the United States Treasury?

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[1]Actual case, Committee of Finance Hearings on Revenue Act of 1921, p. 536.

CHAPTER IV

TAXATION OF CAPITAL GAINS, 1921-1934

The inequities of the existing concept of taxing gains from capital assets, clearly indicated a need for separate tax treatment of capital gains. Three possible plans seemed to be indicated.

The first plan was to follow the English System of non-taxation of capital gains. This was necessarily eliminated, because the United States Treasury needed revenue to pay off its debt in Liberty Bonds issued during World War I.

The second plan considered was the carry back plan. That is to say, a person who purchased a capital asset in 1915 and sold it in 1921 would be taxed at the 1921 rate on one-sixth of the gain and the rest of the gain would be allocated over the years held. Of course, no capital gain could be carried farther back than March 1, 1913. This amounted to an allocation of the gain over the number of years held, with amended returns for each year. In the same manner losses would be allocated over the years held, and amended returns for refund would have to be made. It was at this time suggested that instead

of allowing the gain or loss to be carried back possibly to 1913, it would be better to set a number of years which it could be carried back, and three or five years was given as an example. The method of carry back was by far the most accurate in respect to the theory of Progressive Taxation, but there were several disadvantages to such a method. One criticism was that this method would not be as advantageous to the taxpayer as anticipated. It was believed that 1917, 1918, and 1919 were periods of high income, while 1921 and 1922 were going to be periods of low incomes. This would mean that if this method of relief was utilized, that in many cases it would be additional burden instead of a relief. For example: Suppose an individual purchased a capital asset in 1917 and sold it in 1921 for a gain of $5,000. Now suppose, he along with the majority of taxpayers made high incomes in 1917, 1918, and 1919, but in 1920 and 1921 his income was quite low. To carry back a portion of this gain to be taxed in the years 1917, 1918, and 1919, could quite possibly have the taxpayer paying a greater sum, than if he added the full amount to his low ordinary income for 1921.

The major criticism of such a method of taxing capital gains was an administrative criticism. A much larger force would be needed to handle the matter, and the cost

of administration would be raised to such a degree that taxation of capital gains as prescribed would be financially prohibitive. It was estimated that to tax capital gains in this manner, a vast number of lawyers and auditors would be needed.[1] The complexity which would result as a means of the "carry back" method of taxing capital gains, was believed to make it unsatisfactory.

The third method of taxing capital gains was unique to those plans studied in the past. It pertained to the possibility of segregating those gains from capital assets, and taxing them at a flat rate, which would not be so high, as to prohibit the taxpayers making these transactions. That is to say, capital gains in this manner would not be treated the same as ordinary income. The main criticism of such a method of taxing capital gains was the lack of conformity with the progressive method of taxation. It gave persons with high income a greater percentage in tax saving than those with low incomes. This plan had several advantages; it would not provide administrative difficulties; it would not prevent certain transactions because of the high tax on the gain, and lastly, it was believed that it would provide adequate revenue.

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[1] Senator Smoot, Committee of Finance, Hearings on the Revenue Act of 1921, p. 543.

The last plan received the popular support of Congress, and was enacted into the Revenue Act of 1921. Section 206 of the bill applies only to sales or exchanges of capital assets consummated after December 31, 1921. It provides that any taxpayer other than a corporation may, if he so desires, state separately in his return his net gains on sales or exchanges of capital assets and pay on such capital net gains a flat rate of 12½ percent in lieu of the tax that he would otherwise pay on such income. On his net income from other sources, termed "ordinary income" he would be taxed as otherwise provided by the statute in section 210-211.[1] The taxpayer had the option to segregate his capital net gain and pay a tax of 12½ percent, or he could include the capital net gain in his ordinary net income and pay the tax on the amount under the regular tax brackets. If however, he elected to segregate his capital net gain, his total tax on the aggregate amount of both kinds of income must have amounted to 12½ percent thereof.

The term capital asset was defined to mean, property of any kind whatever acquired and held by the taxpayer for profit or investment for more than two years, whether or

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[1]Regulation 62, Income Tax and War Profits and Excess Profits Tax, under the Revenue Act of 1921 (Washington: Government Printing Office, 1922).

not connected with his trade or business. Not including property (for example, a dwelling) held for personal use or consumption by the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind properly included in an inventory. The specific property sold or exchanged must have been held for more than two years, but in the case of a stock dividend, the prescribed period applies to the original stock, and the stock received as a dividend considered as a unit, and where property is exchanged for other property and no gain or loss recognized under the provision,[1] the prescribed period applied to the property exchanged and the property received in exchange is considered as a unit.[2]

This was a new concept of capital assets, not only did it include those assets held not in the normal course of business, but now the act included as capital assets, those depreciable properties that had been held for two years or more. If a firm purchased a building in 1915 for $50,000 and had provided depreciation of $10,000, and the building was sold in 1922 for $100,000, the taxpayer

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[1] _Ibid._, Section 202.

[2] _Digest of the Federal Revenue Act of 1921_ (New York: The National City Co., 1922), p. 9.

could segregate this capital gain and pay a flat tax of 12½ percent on the $60,000, and include it in his tax return with his normal income. But, the bill provided:

> If however, he elects to segregate his capital net gain, from his ordinary income, his total tax on the aggregate amount of both kinds of income must be at least 12½ per cent thereof.[1]

Suppose that B, a married person had a capital net gain of $60,000 and ordinary income of only $2,000. His $2,500 personal exemption would more than offset his ordinary net income, but he could not apply any part of it to reduce his capital net gain, nor could he allocate any part of the $60,000 capital gain to his ordinary income. He must pay either the normal and surtax on the $60,000 as normal income, or pay the flat 12½ percent tax which would amount to $7,500.

It should be noticed, that while the Revenue Act of 1921 allowed the gains from the sale of capital assets to be taxed at 12½ percent, it made no percentage limitation for capital losses. Under the Revenue Act of 1921, losses from the sale of capital assets held over two years were deductible in full from ordinary income, or from capital gain at the taxpayers option.

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[1]Regulation 62, op. cit.

This alternative flat rate of taxation of capital gains did not apply to corporations. It would be of no advantage to corporations inasmuch as the tax base on corporations was the same as the rate provided for capital gains.

The 1921 law applied no limitations to capital net losses, corresponding to the 12½ percent limitation applied to capital net gains. It profited taxpayers to bunch their capital gains in one taxable year and to bunch their capital losses in another taxable year, when they could be offset against ordinary capital gains.

Secretary Mellon in his letter to the Chairman of the Committee of Ways and Means, recommended that a new revenue act which provided for a limitation of deduction of capital losses to 12½ percent should be provided. The taxpayers were realizing their losses and deducting them in full, yet were paying a maximum or 12½ percent on capital gains.[1]

Secretary Mellon's suggestion was followed in framing the Revenue Act of 1924.[2] Under the Revenue Act of 1924, the gains on the sale of capital assets are taxed

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[1]Letter to Mr. Green, Chairman of the Committee of Ways and Means, written by Secretary Mellon, dated November 11, 1923.

[2]*Ibid.*

the same as under the Revenue Act of 1921, but no longer are losses from the sale of capital assets to be deducted without limit. The losses from capital assets could not reduce the tax by more than 12½ percent of the loss.

Now suppose an individual earned an ordinary income of $8,000, and had a profit of $108,000 from the sale of an office building, and a loss of $6,000 from the sale of some securities, which were classified as capital assets; in making his tax return, he would compute the normal and surtax on the $8,000, less exemptions and allowable deductions, then he would compute 12½ percent of the $108,000, then would deduct from these figures, 12½ percent of the $6,000 loss. The remainder would be the amount of his tax. In this manner, both capital gains and losses are treated consistently.

This method of taxing capital gains was criticised most highly because it was of no advantage to the individuals of low incomes. Under the prevailing tax rates, it proved of no advantage unless the net income is large, around $30,000 at least. The critics said:

> There is no conformity between the taxation of capital gains and ordinary income. They have completely set aside the theory of progressive taxation in favor of giving great advantages to the individuals with high incomes.[1]

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[1]"Democratic National Committee," <u>New York Times</u> (November 2, 1924).

This type of relief was to be expected, as this was a period when big business was in the saddle. The President's friends were those of wealth and his sympathies were with them and the property-owning class.[1] In Congress there was much the same point of view.

With the cry of anti-progressive, it might be expected that the act would be modified. Instead, ten years elapsed before the method of taxation of capital gains were materially changed. For the next ten years, the 1924 regulation remained into effect, and it was not until 1932, that serious consideration was given to modification.

It must be noted that the wording of the definition of a capital asset was changed in the Revenue Act of 1924.

> The term capital asset means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer, if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.[2]

The important clause which was left out read:

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[1]The Administration was described as "flat and dull" with less life and color and sparkle in Congress, or in the Cabinet than for years. New Republic, 46:169 (March 31, 1926).

[2]Revenue Act of 1924, Section 208 (a) 8.

> . . . . but does not include property held for the personal use or consumption of the taxpayer of his family. . . .[1]

Did this mean that a residence or an automobile used for pleasure was to be treated as a capital asset? The Bureau of Internal Revenue was not long in bringing forth the answer. They said that these were capital assets, and the gains were taxable as such, but the losses were not deductible as capital assets, as they do not fall within Section 214 of the Revenue Act of 1924, which provides for deductions for losses, sustained by individuals during the taxable year which read:

> (1) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business.
>
> (2) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business.
>
> (3) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of nonresident alien individual only property within the United States) if arising from fire, storm, shipwreck or other casualty, or from theft, and if not compensated by insurance or otherwise.[2]

Because of the fact that losses sustained on the sale

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[1] Revenue Act of 1921, Section 206 (a) 6.

[2] Revenue Act of 1924, Section 214.

of an automobile used for pleasure purposes or a personal residence does not come within the above provisions of the Revenue Act of 1924, it is held that such loss is not deductible for income tax purposes.[1]

Not only were the holders of such property questioning the definition of a capital asset, but real estate dealers immediately began to interpretate the act to suit their business. They maintained that under the Revenue Act of 1924, the gain in the sale of any property which they had held for over two years would be taxed as a capital gain. To support their case, they quoted the part of the act reading:

> The term capital asset means property held by the taxpayer for more than two years, whether or not connected with his trade or business.[2]

Their claims were refused by the Treasury, who claimed that the real estate dealers were not using the interpretation as set up by Congress. The Treasury concluded that there was more to the definition which read:

> . . . . but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in an inventory. . . .[3]

The Treasury decision read:

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[1]A. W. Green, Internal Revenue Decision 2598.

[2]Revenue Act of 1924, Section 208 (a) 8.

[3]Ibid.

> Real property owned by real estate dealers constitute their stock in trade, and therefore, the profits from the sale of such property does not constitute capital gains within the meaning of Section 206 of the Revenue Act of 1921, or Section 208 of the Revenue Act of 1924. Even though the property has been held for more than two years. It should be noted that a real estate dealer is not in the position of a person carrying on an ordinary commercial or manufacturing enterprise in connection with which it is found necessary for the purpose of the business to purchase additional property. In the case of real estate dealers, the land constitutes the commodity which is to be sold and bought. Such property could not become capital assets even if held by the taxpayer for more than two years. However, if a dealer can establish that any of the property sold by him was held primarily for investment rather than for sale, the provision of Section 206 (a) 6 of the Revenue Act of 1921 and Section 208 (b) of the Revenue Act of 1924 will apply to the taxation of the profits realized from the sale thereof.[1]

The Revenue Act of 1926 provided a more stringent interpretation in respect to handling "wash sales" than in the Revenue Act of 1921. The Act read:

> If substantially identical properties was acquired in place of stock or securities which are sold or disposed of, the basis in the case of the new properties shall be the same as the basis of the old stock or securities so sold or disposed of, increased in the amount or any excess of the repurchase price over the sales price, or decreased by the amount by which the sales price exceeds the repurchase price as the case might be. The two year holding period runs from the date of the repurchase in the case of wash sales and not from the date of the original purchases.[2]

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[1]U. S. Bureau of Internal Revenue, Cumulative Bulletin No. 5 (Washington: Government Printing Office, 1926), Ruling No. 2837, pp. 109-110.

[2]Revenue Act of 1926, Section 214 (a) 5.

Example:

A purchased a share of stock for $100 in 1921, which he sold January 15, 1925 for $80. On February 1, 1925, he repurchased a share of stock in the same corporation for $90. No loss from the sale is recognized under Section 214 (a) 5. The basis for determining gain or loss from the sale of the new share is $110; that is, the basis of the old share ($100) increased by($10), the amount of the difference between the price for which it was sold ($80) and the repurchase price ($90).

To be classified as a capital asset, the repurchased stock would have to be held for two years from the date of repurchase, then sold in such a manner not to constitute a "wash sale."

This was naturally criticised on the ground that, the original acquisition date should be the basis for determining the two year period. It was argued that the original share was used for the tax basis of the new share, with adjustments for the sale; therefore, the original acquisition date should be the basis from which the two year period should run. Since this claim seemed reasonable the Revenue Act of 1928 was modified to read:

> In the case of 'wash sales' the 2 year period during which property must be held to constitute capital assets, within the meaning of Section 101 of the Revenue Act runs from the date of acquisition of the original security and not from the date of repurchase.[1]

This meant that under the Revenue Act of 1928, where securities held for more than two years and sold and substantially identical securities acquired within a period of 30 days,[2] the two year period ran from the date of acquisition of the original securities. Therefore the repurchased securities would be capital assets within the meaning of the Revenue Act of 1928.

With the fall of the "stock market" in 1929, prices of securities on hand in 1930, 1931, and 1932 were much less than their purchase or acquisition value in the majority of cases. It became an excellent time to dispose of these securities and claim the losses as a deduction. The testimony of J. P. Morgan before the Senate Committee on Banking and Currency, informed the Committee that Mr. Morgan and his partners had paid no income taxes for 1931.[3] They had written off a loss in depreciation of

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[1] Revenue Act of 1928, Article 501.

[2] *Ibid*., Section 118.

[3] J. P. Morgan, *Hearings before the Senate Committee on Banking and Currency, on Stock Exchange Prices*, 1933.

securities of $21,000,000 as of January 2, 1931, at the time of the reorganization of the partnership upon the admittance of S. Parker Gilbert. This news startled the country, the public was given to understand by the press that, in spite of large incomes, these bankers had found "loopholes" by means of which they could legally avoid the income tax. Little publicity was given to the fact that tremendous capital losses had been sustained in the depression and that, while in Great Britain these same firms had paid taxes continuously, because capital gains and losses were not treated as ordinary income in computing taxable net income. The amount of the tax paid there in the years of prosperity was much less than it would have been if there had been a tax on capital gains like that of the United States.

The newspapers carried the story that J. P. Morgan and others in similar position had found means to avoid taxation of their ordinary incomes by writing off losses from sales of securities. Many of these newspaper accounts presented the facts in a manner that aroused the public. They accused J. P. Morgan of "malpractice" and "tax advoidance."

The public reaction to these reports was so great that it forced the Committee of Ways and Means to consider

changing the tax program, so that these losses would be limited to gains from such sales, with a carry over privilege of one year. The Revenue Act of 1932 read:

> Losses from sales or exchanges of stock and bonds are limited to the gains from such sales. Such losses disallowed in one year, to an amount not in excess of net income may be carried over and applied against gains from such transaction in the succeeding taxable year.[1]

The plan was never put into effect as it was superseded by the National Industrial Recovery Act before it became effective. The National Industrial Recovery Act, still allowed losses from sales or exchange of stock and bonds only to the limit of the gains from such sales, but the provision which provided for the disallowed losses to be carried forward and offset against similar gains in the succeeding year was eliminated. This was found to be necessary, because at this time, Congress was searching for means of increasing revenue, and if this carry-over privilege was eliminated, a greater source of revenue would be created.

The flat rate method of taxing capital gainx was coming under fire from many sources. Mr. Murphy, Democrat from Iowa, started the fire works rolling in his speech before Congress.[2] He supported his speech with statistics,

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[1] Revenue Act of 1932.

[2] Mr. Murphy, Congressional Record, Vol. 78, p. 6099.

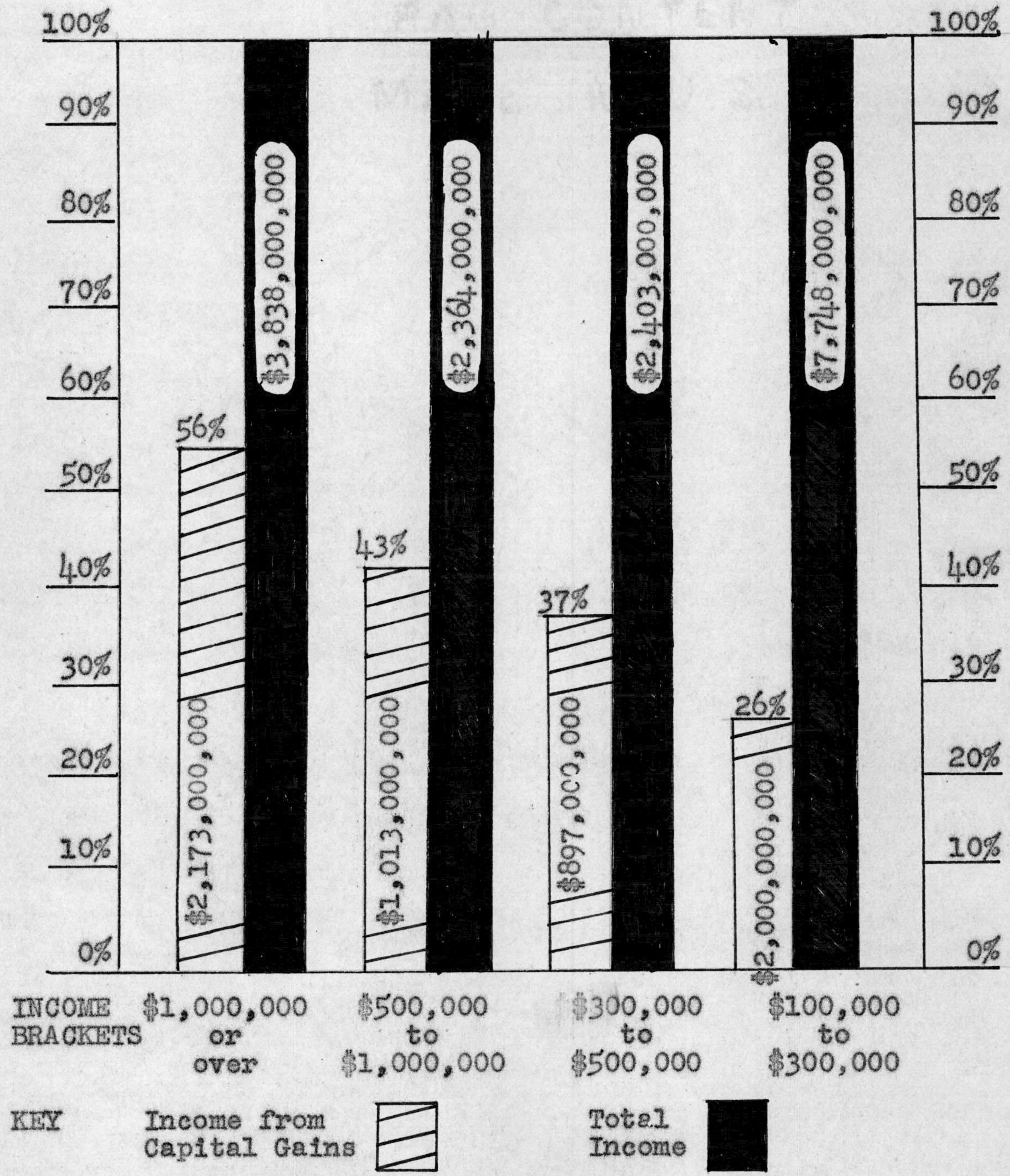
by which he endeavored to prove that the present method of taxing capital gains was allowing too great of a relief to the wealthy individuals, and was providing them means of avoiding taxes they should rightly be paying.

Beginning with 1922, when the 12½ percent rate took effect, from 70-88 percent of all such gains had been in incomes of $100,000 or more.

In the five years from 1925 to 1929 (See Table I) there were 1,752 individual tax returns showing incomes of $1,000,000 or more. The total income disclosed in those returns was $3,838,000,000, and of this total $2,137,000,000 or nearly 56 percent was from capital gains and received benefit of the 12½ percent rate. On incomes amounting to $2,364,000,000 disclosed in returns showing individual incomes from $500,000 to $1,000,000, a total of $1,013,000,000 or close to 43 percent was from capital gains. On incomes amounting to $2,403,000,000 disclosed in returns showing individual incomes from $300,000 to $500,000, capital gains totaled $897,000,000 or over 37 percent, and of incomes amounting to $7,748,000,000 disclosed in returns showing incomes from $100,000 to $300,000, capital gains totaled $2,000,000,000, or nearly 26 percent.

TABLE I

Table Showing the Total Amount of Income, and the Amount of Capital Gains Received for Five Years, 1925-1929 inc., In Respect to Certain Classes of Income



Source: Congressional Record, Statistics Given by Mr. Murphy, Volume 78, pages 6099-7005.

In 1929 (see Table II) when the orgy of speculation reached its peak, the proportion of capital gains to total income, among the very wealthy, became even greater. Of $4,368,000,000, received in that year by persons reporting individual incomes of $100,000 or more, $2,060,000,000 or more than 47 percent was from capital gains. Because of the relief provision these taxpayers--14,816 of them--paid 12½ percent on their capital gains, whereas most of them would otherwise have paid 24 percent, 20 percent surtax and four percent normal tax.

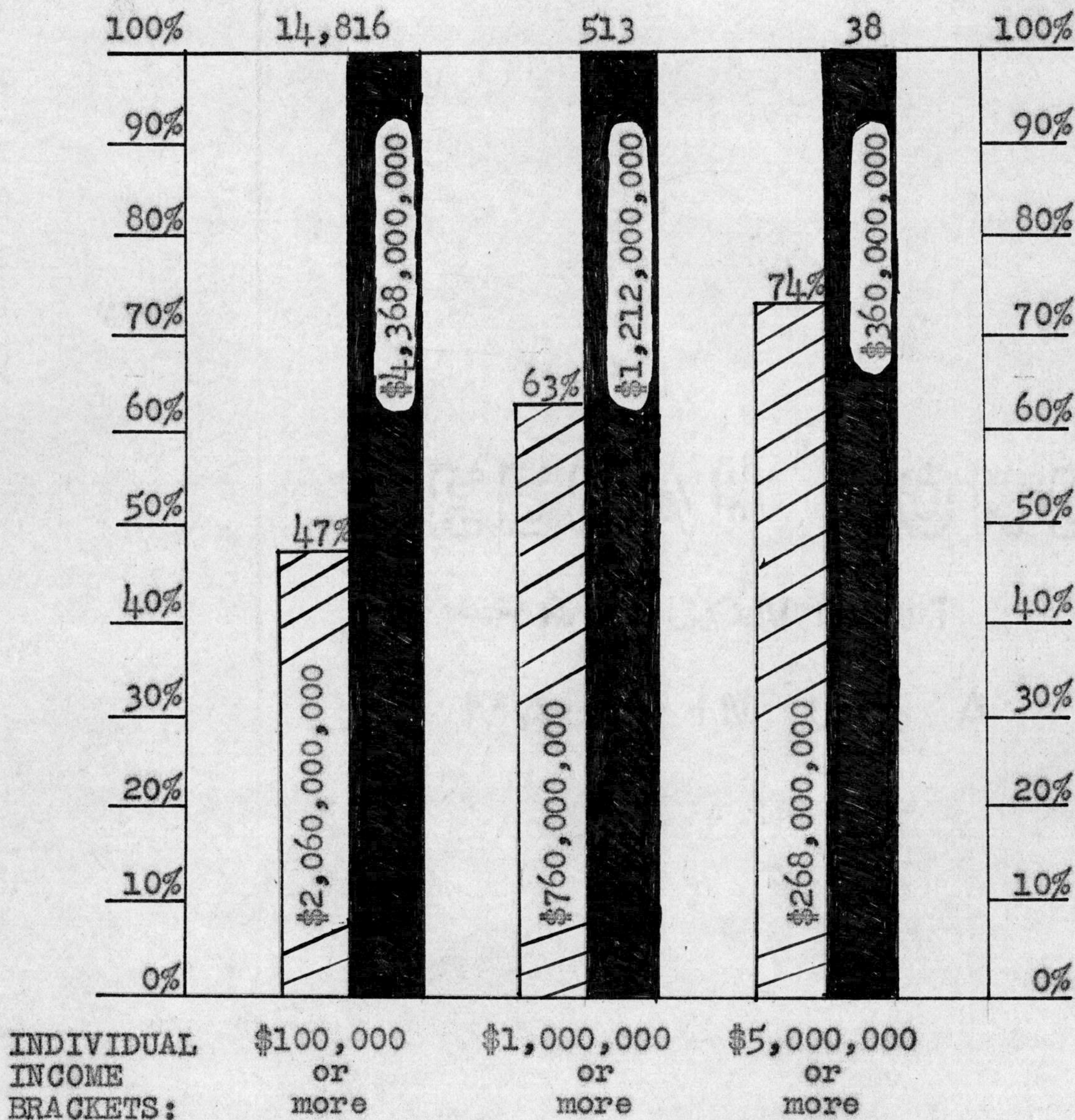
Thus they escaped nearly one-half of the tax they would otherwise have paid on nearly one-half of their total incomes.

Of these persons, 513 reported individual incomes of $1,212,000,000, of which sum $760,000,000, or nearly 63 percent was derived from capital gains. Thirty-eight persons reported individual incomes of $5,000,000 or more. Their total incomes amounted to $360,000,000, of which $268,000,000, or more than 74 percent was capital gains. For these 38 persons the capital gains relief provision almost halved the tax on nearly three-fourths of their total income.

The total of capital gains reported by all taxpayers in five years, 1925 to 1929, was $7,137,000,000, of this total, $6,048,000,000 was reported by taxpayers having

TABLE II

Table Showing the Amount of Income and the Amount Derived from Capital Gains for the Year 1929, In Respect to Certain Classes of Income



KEY: Income from Capital Gains (hatched) — Total Income (solid)

SOURCE: Congressional Record, Statistics Given by Mr. Murphy, Volume 78, pages 6099-7005.

individual incomes of $100,000 or more. According to the best estimate that can be made from the published figures, the capital gains provision reduced the tax on that $6,048,000,000 of capital gains by more than $750,000,000.

For the ten years from 1922 to 1931, inclusive, it is a safe estimate that the relief granted by means of capital gains provisions was not less than $1,000,000,000, enough to pay all war pensions for an entire year.

Generally speaking, these profits were nothing more or less than the profits of stock market speculation, and speculation in land and the treasures of the earth, but most largely from stock market speculation. Being that, they add nothing directly to the national wealth and are therefore, less worthy of encouragement than productive business activity. Because of their special and occasional character they are not ordinarily depended on by the taxpayer to meet his customary expenses; consequently, they increase his ability to contribute to the support of the government more, perhaps, than any other kind of income. The tax on such gains is a tax on unearned income, and unearned income is not entitled to special consideration. A method of taxation that in five years gave $750,000,000 to persons filing 61,057 tax returns possibly the same persons in each of the five years, or 20,000 persons at the most is undeniably a method that accords special

privilege to the few.

One must applaud Mr. Murphy's criticism. He did point out that the flat rate method was not one of the greatest of equity between high and low income groups, but also one must remember that in this respect that municipal, public utility, school district, state, etc. bonds pay an interest, which is not taxable to the individual. If the tax was applied too greatly to capital gains, it is quite possible that they would vanish, and the non-taxable income from these state and city bonds would take its place. If this happened the government would lose instead of gaining by applying a higher tax.

A Sub-committee of the Committee of Ways and Means was appointed to make a study, relative to methods of preventing the avoidance and evasion of the Internal Revenue Laws, together with suggestion for the simplification and improvement thereof. In their study of capital gains they pointed out what they considered the main defect of the capital gains tax treatment as:[1] (1) It produces an unstable revenue, large receipts in prosperous years, low receipts in war and depression years. This meant that when larger revenue was needed, the receipts were lower,

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[1]Sub-committee of the Committee of Ways and Means, <u>Prevention of Tax Avoidance</u> (Washington: Government Printing Office, 1933).

while during prosperous years a very large revenue was present. The Sub-committee discovered that in Great Britain the range between the minimum and maximum revenue, between the 11 year span of 1923 to 1933, inclusive, was only 35 percent; while in the United States the range was 280 percent. Of course the variation between Great Britain and the United States, was not all chargeable to capital gains and losses, but they accounted for a very substantial portion of the difference. (2) In many instances our tax reached the mere increase in monetary value resulting from the depreciation of the dollar instead of reaching a real increase in value. (3) Taxpayers take their losses within the two year period and get full benefit therefrom, and delay taking their gains until the two year period has expired, thereby, reducing their taxes. (4) The relief afforded in the case of long term gains (capital gains) is inequitable under the 1933 normal and surtax rate, it gives relief mainly to taxpayers with net income of over $16,000. (5) The present tax system is unfair, in that it taxes short-term gains in full, but does not allow short-term losses, except to the extent of the gain. (6) In some instances, normal business transactions are still being prevented on account of the tax.

CHAPTER V

TAXATION OF CAPITAL GAINS, 1934-1938

The Sub-committee of the Committee of Ways and Means sought a method of taxing capital gains, which would eliminate or minimize the defects of prior revenue acts. The method recommended to the Committee of Ways and Means read:

> (1) Put all gains and losses from the sale of the property of the taxpayer (whether or not connected with his trade or business, but not including stock in trade, or property included in inventory, or held primarily for sale to the customers of the taxpayer in his trade or business) into one group.
>
> (2) Compute the 'capital net gain' if any, from this group of transactions by computing the excess of the sum of the 'capital gains' over the sum of the 'capital losses' after multiplying each 'capital gain' or 'capital loss' by 100% if the capital asset has been held for not more than one year; 80% if the capital asset has been held for more than one year but not more than two years; 60% if the capital asset has been held for more than two years but not more than three years; 40% if the capital asset has been held more than three years but not more than five years; 20% if the capital asset has been held for more than five years.
>
> (3) Include in gross income subject to tax the 'capital net gain' if any, as computed in (2) above. If there is a 'capital net loss', it is not to be deducted from gross income.[1]

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[1] Prevention of Tax Avoidance, op. cit.

In their study they included the British System, because they believed that:

> If we balance these defects of our own systems and the probable defects in the British System, if applied in this country, there appears to be little choice. It is true, however, that both of these systems might be perfected. Therefore, this office is proposing for consideration a plan which takes a middle ground between the two systems and, it is hoped, eliminates in part some of the defects of both.[1]

The defects of the British System if applied to the United States, as set down by the committee, are: (1) a somewhat less revenue over a period of years; (2) greater opportunity for tax evasion through the conversion of income into gains from sale of capital assets; (3) it would allow the escape from taxation, the mere speculative stock market gains, which are perhaps more able to bear tax than almost any other type of income; (4) accumulation of wealth would be somewhat easier; (5) the present time would be a poor time to change to the British System, as we are at the bottom of price levels.

The Sub-committee believed their proposed plan eliminated many present defects because: (1) a more stable flow of revenue, which would be somewhat less in prosperous years, but substantially greater in depression years than the present system, (2) minimization of the tax on

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[1] *Ibid.*

income created by depreciation of the dollar, (3) the elimination of the opportunity which afford to taxpayers the ability to realize their losses within the two year period and their gains outside of the two year period. This would be largely eliminated by the graduated scale extending over a period of years, (4) greater equity would be afforded to taxpayers. The proposed plan would give relief to those taxpayers whose income is under $16,000. The defect in the flat rate would be eliminated here, as all taxpayers are given equal treatment. (5) The proposed system is somewhat fairer than the present system. All short-or long-term losses can be charged off against short- or long-term gains. Under the existing law, a short-term loss could not be charged off against a long-term gain. (6) Normal business transaction should be somewhat encouraged rather than discouraged by the proposed plan.

The Sub-committee believed that their proposed modification was based on the following principle:

> The tax on the capital gain should approximate the tax which would have been paid if the gain had been realized in equal annual amounts over the period for which the asset was held.[1]

Table III shows the effect of $100 capital gains under the Revenue Act of 1932, and the proposed plan of

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[1] Ibid.

SUMMARY OF RATES OF TAX ON AN A[illegible]

ACT AND THE SUB-COMMITTEE PROPOS[illegible]

Net income before additional amounts indicated	Rate on $100 additional ordinary net income	Rat[illegible]		
		1 year or less		Over 1 not ov[illegible]
		1932 Act	Proposed	193[illegible] Act
5,000	4	4	4	4
10,000	10	10	10	10
20,000	16	16	16	16
30,000	21	21	21	21
40,000	26	26	26	26
50,000	31	31	31	31
60,000	36	36	36	36
70,000	41	41	41	41
80,000	46	46	46	46
90,000	51	51	51	51
100,000	56	56	56	56
500,000	61	61	61	61
1,000,000 (Over)	63	63	63	63

$100 OF GAINS UNDER THE 1932

INCOMES OF SPECIFIED AMOUNTS

ains from assets held for specific periods					
Over 2 years but not over 3 years		Over 3 years but not over 5 years		Over 5 years	
1932 Act	Proposed	1932 Act	Proposed	1932 Act	Proposed
4	2.4	4	1.6	4	0.8
10	6.0	10	4.0	10	2.0
12½	9.6	12½	6.4	12½	3.2
12½	12.6	12½	8.4	12½	4.2
12½	15.6	12½	10.4	12½	5.2
12½	18.6	12½	12.4	12½	6.2
12½	21.6	12½	14.4	12½	7.2
12½	24.6	12½	16.4	12½	8.2
12½	27.6	12½	18.4	12½	9.2
12½	30.6	12½	20.4	12½	10.2
12½	33.6	12½	22.4	12½	11.2
12½	36.6	12½	24.4	12½	12.2
12½	37.8	12½	25.2	12½	12.6

the Sub-committee.

Acting Secretary of Treasury, Mr. Morgenthau criticised the plan of the Sub-committee, because he believed it put a premium on holding appreciated assets five years, in which case only one-fifth of the actual profit would be recognized. This would encourage taxpayers to hold appreciated assets for over five years instead of the present two year period, which would be an undesirable result. Mr. Morgenthau also criticised the plan for the reason it discriminates against earned and business income in favor of investment income, and that a loss on property held one year only, would completely wipe out a gain five times as large made on property held over five years. Although this might reduce the fluctuation of revenue received, the net revenue received from capital gains would be seriously reduced. To illustrate the discrimination between earned and investment income, that was possible, see example below.

Example:

A taxpayer sells a six-year investment at a $60,000 profit, under the plan proposed by the Committee of Ways and Means, he would be taxed on 20 percent of the profit, or $12,000, at the current rate. In fact he has had a gain accruing at the average rate of $10,000 per year for six years. He might therefore reasonably be subjected to

six taxes on an item of $10,000, instead as the plan suggests, once on $12,000. The tax of six times on $10,000 would be greater undoubtedly than one tax on $12,000.

The Treasury was against the plan conceived by the Committee of Ways and Means, as they believed it was not equitable, and submitted two plans; the first plan providing for a flat rate on capital gains; the second was an alternative plan which was a combination of the flat rate plan and the plan of the Committee of Ways and Means.

The first plan provides for a tax at a flat rate on capital net gains, and permits the deduction of capital net losses only from the capital gains of the same year or the succeeding year. This is similar to the 1932 law, but proposes further restrictions upon the deduction of losses. This plan would be simple in operation and administration.

The alternative plan provides for segregation of capital gains and losses as before; and to provide that capital losses shall only be deductible from capital gains of the same year or the succeeding year. The general method proposed by the Sub-committee for the taxation of capital net gains might then be employed, with an adjustment of the rates, however, to make the resulting tax in so far as possible approximately the same as the total taxes would be if the capital gain were spread over the

period during which the assets were held.

The aim of the alternative plan, is to subject capital gains to progressive surtax rates, but to make the applicable tax rates approximately equivalent to the tax rates which would have been applied if the capital gains had accrued evenly over the years during which the asset was held.

The Revenue Act of 1934 was a compromise act. After much deliberation in both the House and Senate, the proposed bill was amended in many respects, but the proposed step-down system proposed by the Committee of Ways and Means remained in the bill, although the percentage rates were varied.

The Revenue Act of 1934 made the following provisions relating to capital assets:

> (1) A capital asset means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,[1]

In other words, capital assets were all classes of property not specifically excluded by Section 117 (b).

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[1] Revenue Act of 1934, Section 117 (b).

The term is not limited to stocks and bonds, nor to property held for more than two years. In determining whether property is a capital asset, the period for which it has been held was immaterial.

In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

> (2) 100 per centum if the capital asset has been held for not more than one year;
>
> 80 per centum if the capital asset has been held for more than one year but for not more than two years;
>
> 60 per centum if the capital asset has been held for more than two years but not more than five years;
>
> 40 per centum if the capital asset has been held for more than five years but not more than ten years;
>
> 30 per centum if the capital asset has been held for more than ten years.[1]

In respect to limitation of losses allowed:

> (3) Losses from the sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of the whole business is the receipt of deposits, sells any bonds, debentures, notes, or certificates or other evidence

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[1] *Ibid*., Section 117 (a).

of indebtedness issued by any corporation (including one issued by a government or political sub-division thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted bases of such instrument exceeds the par of face value thereof) shall not be subject to the forgoing limitation and shall not be included in determining the application of such limitations to other losses.[1]

For application of the capital gains and loss section of The Revenue Act of 1934, Section 117, see Table IV on the following page.

Loss from wash sales:[1]

Section 118: Loss from wash sales of stock and securities:

(a) In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days, before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by Law), or has entered into a contract or option so to acquire, substantially identical stocks or securities, then no deduction for the loss shall be allowed. Nor shall such deduction be allowed unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of business. (b) If the amount of stock or securities acquired (or covered by the contract or option to acquire) is less than the amount of stock or securities sold or otherwise dis posed of, then the particular shares of stock or securities the loss

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[1]*Ibid.*, Section 117 (d)

[2]*Ibid.*, Section 118.

> from the sale or other disposition of which is not deductible shall be determined under the regulations prescribed by the Commissioner with the approval of the Secretary. (c) If the amount of stock or securities acquired (or covered by the contract or option to acquire) is not less than the amount of stock or securities sold or otherwise disposed of, than the particular share of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility of the loss shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Treasurer.

The length of the capital asset "holding period" for stocks and securities required in a wash sale transaction is:

> In the case of securities, the acquisition of which resulted in the nondeductibility of the loss from the sale or other disposition of substantially identical stock or securities, the period for which the stock or securities the loss from the sale or other disposition of which was not deductible were held, must be added to the period for which the stock or securities acquired were held by the taxpayer.[1]

To determine the basis of the reacquired stock or securities, the following regulation is to be followed:

> The bases shall be the base of the stock or securities sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.[2]

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[1] *Ibid.*, Section 117 (3).

[2] *Ibid.*, Section 113 (a) 10.

TABLE IV

APPLICATION OF THE PER CENTUM RATES TO CAPITAL GAINS AND LOSSES UNDER THE REVENUE ACT OF 1934

Item	Gains recognized under Sections 111 and 112	Losses recognized under Sections 111 and 112	Time Held	Per cent applicable	Gains taken into Account under Section 117 (a)	Losses take account und Section 117
Corporate stock		$5,000	9 months	100		$5,000
Bonds	$4,000		1½ years	80	$3,200	
Real estate		$1,000	2½ years	60		600
Government bonds	$3,000		6 years	40	1,200	
Other securities		$1,000	12 years	30		300
Fail to exercise option to buy property		$1,700		100		1,700
Gains and losses taken into account					$4,400	$7,600

Applying the limitation of Section 117 (d) the losses of $7,600 taken into account are allowable as a deduction only to the extent of $6,400 ($2,000 plus the gain of $4,400 taken into account).

The taxation of capital gains and losses, as provided under the Revenue Act of 1934, did not prove to be as successful as anticipated. Much criticism was placed against the taxation of capital gains and allowances for losses. The Secretary of Treasury soon discovered that much avoidance and evasion was taking place; therefore, he addressed a letter to the President, explaining that a study should be made with the aim to revise the Revenue Act. The President sent a letter to Congress asking them to make a study of the present Revenue Act in respect to avoidance and evasion and prepare a new bill or amendments to the old Revenue Act.

The Committee of Ways and Means in their study[1] soon found themselves faced by the following objections:

1. Capital losses after application of the statutary percentages were deductible only to the extent of $2,000 plus taxable gains, with no carry forward of loss. It was felt that the widespread sense of injustice flowing out of this treatment might impair cooperation between the taxpayer and the Government in the administration of the income tax.

2. Wealthy individuals were discouraged from

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[1] 75th Congress, 3d session, Hearing before the Committee of Ways and Means on Revenue Revision, pp. 36-50.

embarking their capital in new enterprises because, the prospect that much of the gains, if any, will go to the tax collector, while the losses, if any, will be allowed only in part as a deduction against taxable income. Here it was contended, such treatment removes much of the incentive for so-called "enterprise capital."

It should be pointed out here, in rebuttal to such an objection, that a striking characteristic of the existing tax treatment of capital gains, due to the step-scale and the existence of the graduated surtax rate was an inducement is offered to wealthy individuals to make their new investments precisely in such manner as will cause the returns to take the form of capital gains. The distribution of the gains by the number of years that the assets are held, as indicated in Table V, tends to show that the benefits received by the step-down arrangement and individuals with large incomes.

3. The most persistent objection voiced against capital gains taxesis the contention that they greatly obstruct the trade in securities and other capital assets. It is maintained that the mobility of capital and enterprise is retarded because many potential transactions that would otherwise be undertaken, are postponed for varying period in order to avoid or reduce the tax on capital gains.

COMPARISON OF TAX ON AN ADDITIONAL $100 OF ORDINARY INCOME,[1] WITH TAX ON AN ADDITIONAL $100 OF CAPITAL GAINS UNDER THE 1936 ACT FOR NET INCOME SUBJECT TO TAX OF GIVEN AMOUNTS

Net income subject to normal tax and surtax before $100 additional income[2]	Normal taxes and surtax on $100 additional ordinary net income	Tax on $100 additional capital gains from assets held for speci				
		1 year or less	Over 1 year but not over 2 years	Over 2 years but not over 5 years	Over 5 years but not over 10 years	Over 1 years
$ 5,000	$ 8	$ 8	$ 6.40	$ 4.80	$ 3.20	$ 2.40
10,000	11	11	8.40	6.60	4.40	3.30
20,000	19	19	15.20	11.40	7.60	5.70
30,000	23	23	18.40	13.80	9.20	6.90
40,000	28	28	22.40	16.80	11.20	8.40
50,000	35	35	28.00	21.00	14.00	10.50
60,000	39	39	31.20	23.40	15.60	11.70
70,000	47	47	37.60	28.20	18.80	14.10
80,000	55	55	44.00	33.00	22.00	16.50
90,000	59	59	47.20	35.40	23.60	17.70
100,000	62	62	49.60	37.20	24.80	18.60
500,000	74	74	59.20	44.40	29.60	22.20
1,000,000	77	77	61.60	46.20	30.80	23.10
2,000,000	78	78	62.40	46.80	31.20	23.40
5,000,000	79	79	63.20	47.40	31.60	23.70

[1] Income other than capital gains.

[2] Statutory net income less exemptions and credits.

Source: Treasury Division, Division of Research and Statistics, November 6, 1937.

It was also urged that when stock prices are rising, the liquidation of overpriced securities which might check and moderate any unhealthy rise was discouraged, thus contributing to an exaggeration of the rise and to a sharper subsequent decline. On the other hand, by applying the step-down schedule to the amount of capital losses deductible, the existing law encouraged an early realization of losses; consequently, it is argued, stock market booms and collapses are accentuated.

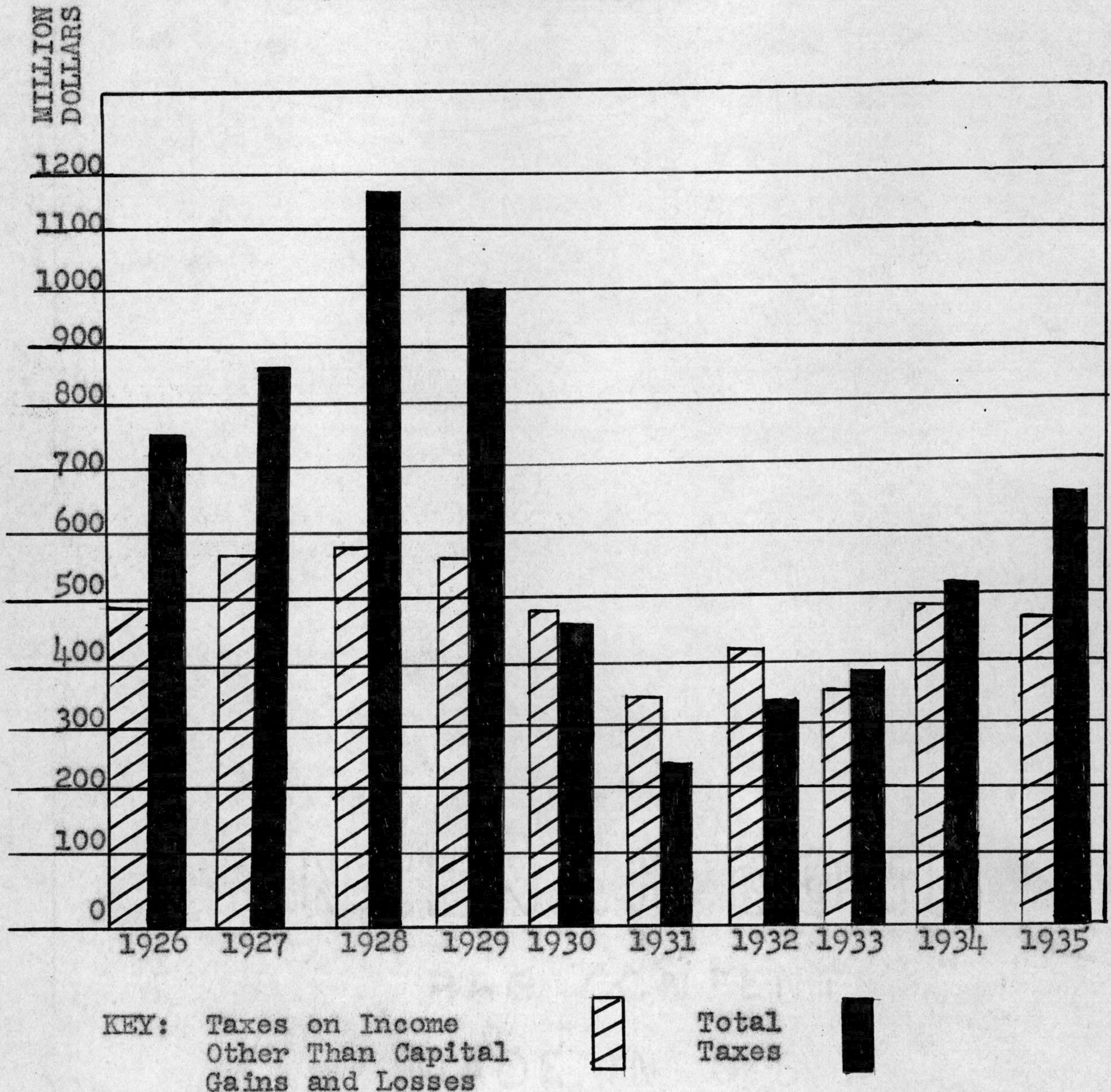
The Committee of Ways and Means studying the complaint that the tax on capital gains perpetuate artificial bull markets, pointed out that the alleged moderating influence of a drastic reduction in capital gains taxes, upon the rising trend of security markets was particularly doubtful during a period of underlying business improvement. They conceded that such reduction would have the technical effect of removing existing deterrents to the immediate reinvestments of the sales proceeds inother securities, but felt that if capital gains taxes were substantially reduced, it would make the stock market more attractive than before. Stock market gains, which even then enjoyed preferential tax treatment if the securities are held for more than one year, would be given even more privileged tax status among the various sources of individual income.

The graph on Table VI shows, over a period of ten years, the importance of taxes on capital gains as a source of revenue, and how the tax treatment of them effected total revenue.

TABLE VI

Individual Income Taxes* 1926-1935[1]

Total Taxes and Taxes on Other Income Other Than Capital Gains and Losses[2]



KEY: Taxes on Income Other Than Capital Gains and Losses — Total Taxes

* Based on tax liabilities reported in Statistics of Income.

[1]75th Congress, 3rd Session Hearings before the Committee of Ways and Means on Revenue Act 1938, p. 117.

[2]As defined by 1936 Revenue Act.

CHAPTER VI

TAXATION OF CAPITAL GAINS, 1938-1942

In constructing a new tax bill for capital gains, the Committee of Ways and Means had three main objectives in mind which they stated as:

> 1. A smoother and more graduated step-down of the percentage of gains or losses to be taken into account for tax purposes, thus eliminating the inducement of concentration of transaction at certain intervals, with its accompanying accentuation of rises or declines in value.
>
> 2. Elimination, as to capital gains of individuals, of the high sur-tax brackets provided for other income, thus accelerating liquidation of large blocks of over-priced securities and giving added mobility to the capital market as well as encouraging investment of capital in new productive enterprises.
>
> 3. More liberal deductions of capital losses in the interest of greater equity and in order to minimize the tax risk of investments in new enterprises (while at the same time preventing the loss of revenue which would result if such deductions were to be applied extensively to reduce taxable net income from sources other than capital gains).[1]

The following proposed changes were submitted by the Committee of Ways and Means:[2] For the purpose (to apply

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[1] 75th Congress, 3rd Session, *Hearings before the Committee of Ways and Means on Revenue Revision*, p. 41.

[2] *Ibid*.

to individuals only) of separating speculative transactions from investment transaction, capital gains and losses should be divided into two groups, "long-term capital gains and losses" from sale of assets held for more than a year, and "short-term capital gains and losses" from sale of assets held for not more than a year. Short-term losses should be offset against short-term gains only and not against ordinary income or against long-term gains. If the losses exceeded the gains, the excess could be carried forward one year and applied against the short-term capital gains of the next year. If the short-term gains exceeded the short-term losses, the excess was to be added to the ordinary income and taxed at the full normal and surtax rate. Long-term capital losses could be offset against long-term capital gains, but if the losses exceeded the gains, $2,000 of the excess could be charged against ordinary income as under the 1937 law. Net long-term capital losses, reduced by $2,000 could be carried forward for one year and applied to offset any long-term capital gains in such years.

New brackets were proposed for the percentages of taxable gains and losses. The taxable proportion of such gains began at 100 percent in cases of assets held 13 months or less and were reduced by two percent for each month the asset was held until the rate became 76 percent

of the gain or loss on assets held for more than 24 months, but not more than 25 months. After the 76 percent bracket was reached, the rate was reduced one percent for each additional month until, in case of assets held over five years, the percentage became 40 percent. No further reductions were allowed.

The Senate Committee of Finance did not agree with the recommendations proposed by the Committee of Ways and Means, and discarded the House plan because it was "excessively complicated and would obstruct the free flow of capital into productive enterprises."[1] The Senate Committee drastically changed the method of computing the tax on capital gains and losses. They favored the method used from 1924 to 1932, that is, the separation of capital gains of individuals from ordinary income and a flat tax thereon. They favored 15 percent instead of the 12½ percent used during the 1924 to 1932 period. The Senate Committee favored the limitation of deductibility of capital losses as prescribed by the Committee of Ways and Means. The capital gains and losses section in the Revenue Act of 1938 is the result of a compromise between the House and Senate.

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[1]Roy Blakey, The Federal Income Tax (London, New York, Toronto: Longmans, Green and Co., 1940), p. 443.

The summary of the Revenue Act of 1938[1] in respect to capital gains and losses disclosed that, in order to differentiate in the taxation of speculative and investment gains, an arbitrary period of ownership was taken as determinative. Profits from the sale of capital assets held for not more than 18 months, assumed to be speculative, were designated "short term capital gains," profits from sale of capital assets held for more than 18 months, assumed to be non-speculative, were designated "long term capital gains."

Short-term capital gains were taxable in full at regular normal and surtax rates. Short-term losses were allowed only to the extent of short-term capital gains; but if short-term losses exceeded short-term gains in any year, the resulting net loss might be carried forward for one year to the extent that it did not exceed the ordinary net income of the year in which such short-term net loss was sustained as an offset against short-term capital gains in such succeeding year. The following percentages of long-term capital gains and losses were recognized for tax purpose according to the length of time the asset had been held: 66 2/3 percent if the asset had been held for

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[1]Revenue Act of 1938, Sections 117, 23.

more than 18 months, but not more than 24 months; 50 percent if the asset had been held more than 24 months. Long-term capital losses were deductible from other income.

A new device was provided as an alternative method of handling long-term capital gains. If a taxpayer has realized a net long-term capital gain, the tax due was the lesser of that computed at regular normal and surtax rates and that derived by the following method: compute a tentative tax on the net income exclusive of the net long-term capital gain, to this add 30 percent of the taxable long-term gain. The 30 percent is not computed on the total amount of such gain, but on the fraction of the taxable gain. The tax therefore could not exceed 20 percent of the actual gain in the case of assets held 18 months to two years, and 15 percent in the case of assets held over two years.

For computing the tax in case of long-term capital losses an alternative plan was also provided. The tax due is the greater of that computed at regular normal and surtax rates and that computed as follows: compute a partial tax on net income without regard to the capital loss, from this tentative tax deduct 30 percent of the taxable amount of the net long-term capital loss. This 30 percent is again computed on the fractional capital loss. The maximum deduction for such losses therefore is 20 percent

for assets held 18 months but not over two years, or 15 percent on assets held over two years.

This section of the Revenue Act of 1938 also contained a new definition of "capital asset" which excluded property subject to depreciation allowance used in the taxpayer's trade or business. This was a relief provision, in as much as it allowed taxpayers to deduct the loss in full from machinery and other equipment sold or abandoned.

The practical result of the change in the law was to increase the tax on gains from property held not more than 18 months but more than 12 months. The taxpayer whose income fell in the higher bracket received a greater advantage than the small taxpayer, particularly in the case of property held over two years. The law gave no inducement to hold property for more than two years.

A new rule was established for partnerships. Every partnership must separate from other income, gains or losses from sale of capital assets. The tax on capital gains were computed as in the hands of an individual, and each member of the partnership must include with his individual income his distributive share of partnership ordinary net income and short-term capital gains or losses, and combine with his long-term capital gains his distributible share of partnership long-term gains or losses.

Under Section 23, losses from worthless securities such as stocks, uncollectible bonds, notes, etc. issued by corporations were restricted by the rules previously given for calculation of capital gains and losses. That is, such securities are defined as capital assets, and therefore subject to the limitations applicable to loss from sale of capital long-term or short-term assets. Previously, such losses were deductible in full as bad debts from ordinary income.

The capital gains section of the Revenue Act of 1938, remained without any important changes, and was not criticised by the general public. The surtax rate on ordinary income was being increased each year as the demand for more revenue became imperative. The general attitude of the taxpayer seemed to be, "let well enough alone." This sentiment was present in the Hearings conducted by the Committee of Ways and Means on Revenue Revision of 1942, as is shown by the statement of Mr. Ellinsworth C. Alvoid, Attorney, Washington, D. C., Chairman, Committee on Federal Finance, United States Chamber of Commerce:

> We believe that the existing plan of taxation of capital gains and losses adopted in 1938, has worked satisfactory. It should not be disturbed.[1]

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[1]Mr. Alvord, Chairman, Committee on Federal Finance, United States Chamber of Commerce, Hearings before the Committee of Ways and Means on Revenue Revision of 1942, p. 2758.

The cry for revision of the law as adopted in 1938 came from the office of the Secretary of Treasury. The Secretary, through his Tax Advisor, Mr. Randolph Paul, reported to Congress that:

> The present maximum tax rates applicable to gains from capital assets held 18 months or more are unusually low. They have been left at their 1938 level, while the rates on other income have been substantially increased. Also the present privilege of deducting capital losses from ordinary income has under recent rate increases, encouraged an unusually large amount of capital loss realization. The present holding-period provisions are too complicated and the alternative provision of 15 and 20 per cent reduce revenue.[1]

The preceding statement did not represent an intention of the Secretary of Treasury to improve the method of taxing capital gains but as a device for increasing revenue. The President's Budget Message in January, 1942, called for the raising of $7,000,000,000 in new revenue from taxes, together with an additional $2,000,000,000 to be obtained from the Social Security Program. Besides the request for the additional amount from taxes, the President's Budget provided that $39,000,000,000 would have to be borrowed in the following fiscal year.[2]

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[1]Mr. Randolph Paul, Tax Advisor to the Secretary of Treasury, Hearings before the Committee of Ways and Means on Revenue Revision of 1942, p. 85.

[2]*Ibid*., President's Budget Message, p. 2.

CHAPTER VII

TAXATION OF CAPITAL GAINS, 1942-1949

The Treasury not only asked Congress to revise the taxation of capital gains, but described the plan that the Treasury Department supported. The Treasury plan reads:

> As to long-term capital gains, one holding period of over 18 months would be substituted for the present complicated double holding period of 18 months and 24 months. Such long-term capital gains would be included in income at 50 per cent of the amount of the gain, which is the present percent for assets held over 2 years. At the same time the maximum effective rate on long-term capital gains would be increased from the present 15 per cent and 20 per cent to a single rate of 30 per cent. As to long-term capital losses, it is suggested that such losses would not be permitted as a deduction against ordinary income, but only against long or short-term capital gains. Short-term capital losses can be applied under the present law only against short-term capital gains. It is suggested that they be permitted as a deduction from long term capital gains as well. To prevent hardships in the case of a taxpayer having a small income and sporadic losses, it is suggested that $1,000 of capital losses, whether long-term or short-term be allowed against ordinary income, more over, a 5-year-carry-over would be allowed for the excess of capital losses over capital gains.[1]

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[1] Hearing before the Committee of Ways and Means on Revenue Revision of 1942, op. cit., p. 86.

Another bill submitted to Congress, which was in strict contrast to the above mentioned bill was the Boland Bill.[1] In the Boland Bill, no distinction was made as to the holding period for which the capital asset is held. The percent of gain or loss taken into account is 100 percent. The entire amount of capital losses is to be allowed against capital gains, but none is to be allowed against other income. The bill provided for a net loss carry-over period of two years, against capital net gains only. The net capital gains were to be taxed at a flat ten percent.

The Boland Bill was opposed for several reasons. The major reasons are: (1) There was no distinction between long-and short-term gains. It was believed that a great loss of revenue would be the result of the bill. Under the existing system of taxation of short-term gains, they were subject to the full normal and surtax rate; while under this bill, short-term net gains would be taxed at ten percent. In respect to long-term gains, they would, under the Treasury's recommendation be subject to a maximum 30 percent tax; while under this bill, long-term net gains would be taxed a flat rate of ten percent. (2) Under

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[1] *Congressional Record*, 77th Congress, 2nd session. H. R. 6358, introduced in the House by Patrick J. Boland, January 12, 1942.

the Treasury's recommendation, up to $1,000 of capital net loss would be deductible from other income in the current year while under the Boland Bill there was no deduction of capital net loss from other income. It was believed, this provision would be inequitable. (3) The Boland Bill abandoned the principle of ability to pay. Capital gains would be removed entirely from the progressive income tax structure, and would be taxed ten percent regardless of whether the other net income was large or small or there was no net income at all. (4) The flat rate of ten percent would favor a relatively small group of taxpayers in the high income brackets since capital transactions are largely concentrated in the higher income groups. In 1938, statutory net capital gains constituted 64.7 percent of the income of individuals with net incomes of $1,000,000 and over, but less than one percent of the net income of individuals with net income under $5,000.[1] (5) The Boland Bill would facilitate tax avoidance, as the taxation of short-term net capital gains at ten percent would encourage the practice of using capital gains as a means of realizing corporate earnings. The Boland Bill would

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[1]Treasury Department Statistics for 1938, submitted to the Committee of Ways and Means, March 12, 1942, by Randolph Paul, Special Tax Advisor to the Secretary of Treasury.

permit securities to be bought just after the payment of one year's dividends and sold just before the payment of the next year's dividends.

It might be supposed that this would result in widespread tax avoidance and loss of revenue to the Government. But, it must be remembered that if an attempt to convert ordinary income into capital gains by this method became widespread it would be self-defeating. The offering of a large number of shares would unbalance the equilibrium between supply and demand; therefore, selling price of these shares would not indicate the anticipated earnings of the corporation for the year. (6) The effective rate of taxation on one type of income, capital gains, would be drastically reduced at a time when all other income of the taxpayers is called upon to pay a higher rate of taxation than ever before.

The Treasury proposal was severely attacked by the supporters of the Boland Bill on three main grounds: (1) Over the period of years of capital gains taxation, allowance for capital losses has wiped out the revenue received from capital gains taxes. Under the Boland Bill capital losses are only deductible against capital gains and not ordinary income, and once the revenue is received, it can not be offset by allowances for losses against ordinary income in other years. (2) The five year carry-over

provision was attacked because:

> Why should we go through the agony of levying administrating, litigating, and collecting these microscopic and evanescent taxes on capital gains and then finally end up with a zero by carrying losses forward for 5 years?[1]

Also it was believed to be futile to promise in 1942 a carry-over of losses for five years, since the capital gains tax had been revised in 1917, 1918, 1921, 1924, 1926, 1928, 1932, 1934, and 1938. (3) The arbitrary definition of a long-term capital gain on the basis of time drew special criticism by E. M. Friedman:

> Why should a capital gain pay a tax of 90 per cent on one day and 30 per cent 2 days later, that is, one day before the imaginary dividing line between long-and short-term gains?[2]

It was the duty of the Committee of Ways and Means to formulate a more workable tax program. After consideration of the various proposals, of which the two most important has been previously explained, they attempted to devise a plan which contained the best attributes of each plan, yet which eliminated each plan's weakness.

The Committee of Ways and Means discarded the flat ten percent tax on capital gains for three reasons, (1) increased revenue was needed by the Treasury, and they

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[1]Elisha M. Friedman, Hearings on Revenue Revision of 1942, Committee of Ways and Means, p. 1664.

[2]Ibid., p. 1662.

believed that looking ahead for the next several years, that the flat ten percent bracket would not yield as great a revenue as would a plan similar to the Treasury's recommendation. (2) The taxing of only a flat ten percent was of too great an advantage to those individuals in the high surtax brackets. (3) The ten percent bracket was not in conformity with the progressive method of taxation. With this view the committee accepted the Treasury's recommendation and followed a policy of taxing long-term gains at 50 percent and short-term gains at 100 percent. The next problem faced was the designation between long-and short-term capital gains. The Boland Bill made no distinction between them, while the Treasury's recommendation set a 18 month holding period. The committee believed that some designation should be made, so as to capture under full normal and surtax rates speculative gains. The 18 month period as provided in the Treasury's recommendation was believed too long. If a period was to be designated to spearate speculative and non-speculative gains, it should be sufficiently short so that holders of capital assets would not delay the flow of money into productive enterprise. A study by the committee on the average holding period of assets held for speculative gain, showed the usual period to be under six months. The committee then based the definition of long-and short-term capital gains

on a holding period of six months. The committee accepted the Treasury's advice in respect to the five year carry-over provision for net capital losses as they believed that allowance should be made to provide a relief to those taxpayers who had capital losses in excess of the amount which could be deducted. The allowance feature in reality was added as an attempt to eliminate the continuous cry of, "The Government is our partner as long as we make gains, but discards us whenever we show a loss."

The capital gains section of the bill as drawn by the Committee of Ways and Means was passed with only minor changes. The Bill defined a capital asset as:

> Capital assets- the term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business of a character which is subject to the allowance for depreciation provided in section 23(1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political sub-division thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the day of issue, or real property used in the trade or business of the taxpayer.[1]

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[1]Revenue Act of 1942, Section 117 (a)1.

In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income.

> 100 per centum if the capital asset has been held for not more than 6 months;
> 50 per centum if the capital asset has been held for more than 6 months.[1]

Net capital gain was defined to mean:

> (A) Corporation - In the case of a corporation, the term 'net capital gain' means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges - no holding period is present.
>
> (B) Other Taxpayers - 'Net capital gain' means the excess of the sum of the gains from sales or exchanges of capital assets, plus net income of the taxpayer on $1,000, whichever is smaller, over the losses from such sales or exchanges.[2]

The Revenue Act of 1942 permitted the allowance for capital losses in respect to corporations only to the extent, of gains from sales or exchanges of capital assets. For other taxpayers, losses from sales or exchanges of capital assets were allowed only to the extent of the gains from such sales or exchanges, plus the net income of the taxpayer or $1,000, whichever is smaller.

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[1] *Ibid.*, Section 117 (a) 11b.

[2] *Ibid.*, Section 117 (a) 10.

If the taxpayer has a net capital loss disallowed in one year, the amount is treated as a short-term capital loss in each of the five succeeding taxable years to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. This carry-over privilege does not extend to corporations.

The Revenue Act of 1942, carried an alternative tax plan for capital gains which read:

> If for any taxable year the net long-term capital gains of any corporation exceed the net short-term capital loss, a partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rate and in the manner as if this subsection had not been enacted, and that total tax shall be the partial tax plus 25 per centum of such excess, ... for a taxpayer the partial tax shall first be computed upon the net income reduced by the amount of the excess, at the rates and manner as if this subsection had not been enacted and the total tax shall be the partial tax plus 50 per centum of such excess.[1]

In other words the maximum amount of tax to be paid, on long-term capital gains by both a corporation and other taxpayers, is 25 percent of the gain.

It should be noticed that the definition of a capital asset was changed to exclude real property (land) used in trade or businessof the taxpayer. This exclusion also

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[1] Ibid., Section 117 (10) 1.

included depreciable property such as buildings and equipment.

If these properties were no longer considered capital assets, then the gains or losses from compulsory and involuntary conversions (as a result of destruction in whole or in part, theft, seizure, or an exercise of the power of requisition or condemnation) would be subject to the same treatment as ordinary gains or losses. In other words any gain from involuntary conversion would be taxed on the full normal and surtax rate, and any losses would be fully deductible from ordinary income.

Logical reasoning showed the unfairness of an individual having to pay full tax on a gain from involuntary conversion; therefore section 117 (j) was added to aleviate this situation. In respect to this matter the Statute read:

> (1) Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Properties used in the Trade or Business.
>
> For the purpose of this subsection the term 'Property used in trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation, held for more than 6 months, and real property used in the trade or business held for more than 6 months which is not (A) property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

> (2) If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the involuntary or compulsory conversion of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceeds the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from the sales or exchanges of capital assets held for more than 6 months, if such gains do not exceed such losses, such gains and losses shall not be considered as gains or losses from sale or exchange of capital assets.[1]

This was a relief provision granted to the taxpayers who involuntary made certain conversions, and those who sold depreciable property, or real property used in their trade or business. If a gain was derived on the sale or conversion of these assets held over six months, the gain would be treated as a capital gain; therefore, they would be taxed at no more than the maximum 25 percent rate. If a loss resulted from the sale or conversion of these assets, the loss is not to be considered as a capital loss, but was deductible in full against ordinary income as a business loss.

It must be noticed that the definition of a capital asset excludes real property and depreciable property used in the trade or business, but did not exclude real or depreciable property not used in trade or business; therefore, the personal residence or automobile used for

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[1] *Ibid*., Section 117 (1) 1,2.

pleasure by the taxpayer is included as a capital asset. Any gain derived from the sale or exchange will be treated as a gain from a capital asset, but any loss is not deductible, as only losses are deductible which are incurred in any transaction entered for profit, but need not be connected with the taxpayer's trade or business.[1]

The capital gains section of the Revenue Act of 1942 has not been substantially modified. The Revenue Act of 1949 made only insignificant changes in the taxation of capital gains. Any difference in respect to capital gains pertains to different choice of words and clarification in respect to interpretation.

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[1]Ibid., Section 111 (a).

CHAPTER VIII

CAPITAL GAINS TAXATION IN OTHER COUNTRIES

The British Income Tax is based upon a division of income into five classes or "Schedules" called A, B, C, D, and E, and the plan adopted has been not to attempt a general covering definition of income, but to define the income that falls under each of these five divisions. If there is any class of income that does not fall within the words that impose the charge in any one of the Schedules, that class of income is not within the scope of the Income Tax.

The five schedules read:

> Schedule A. Tax under Schedule A shall be charged in respect of the property in all lands, tenements, hereditaments, and heritages in the United Kingdom. . . .
>
> Schedule B. Tax under Schedule B shall be charged in respect of the occupation of all lands, tenements, hereditaments, and heritages in the United Kingdom. . . .
>
> Schedule C. Tax under Schedule C shall be charged in respect to all profits arising from interest, annuities, dividends, and shares of annuities payable out of any public revenue.
>
> Schedule D. Tax under this Schedule shall be charged in respect to:

> (a) The annual profits or gains arising or accruing (I) To any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere; and (II) to any person residing in the United Kingdom from any trade, profession, employment, or vocation, whether the same be respectively carried on in the United Kingdom or elsewhere; and (III) to any person, whether a British subject or not, although not resident in the United Kingdom, from any property whatever in the United Kingdom, or from any trade, profession, employment or vocation exercised within the United Kingdom; and (b) All interest of moneys, annuities, and other annual profits or gains not charged under Section A,B,C, or E, and not specially exempted from tax;
>
> Schedule E. Tax under Schedule E shall be charged in respect of every public office or employment of profit, and in respect of every annuity, pension, or stipend payable by the Crown or out of the public revenue of the United Kingdom, other than annuities charged under Schedule C.[1]

It is evident that only Schedule D has any possible application to capital gains, and that phrase in that Schedule:

> The annual profits or gains arising or accruing . . . . from any property whatever . . . . or from any trade, profession, employment or vacation

may easily be interpreted as not including profits from casual transactions not in the course of a trade.

In general, the British decision on capital gains may be summarized, as the Report of the British Royal Commission states:

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[1]Roswell Magill, "Great Britain's Income Tax," Taxable Income, pp. 83-84.

> Casual, non-recurring or occasional profits arising from transactions that do not form part of the ordinary business of the person who makes them are accordingly held not to be within the scope of the Income Tax, and consequently escape taxation.[1]

The British decisions to this effect may technically be regarded, not as expressing a general limitation of the judicially recognized concept of income to annual or recurrent gains, but rather as interpretations of statute, which purports to tax "the annual profits or gains . . . . arising . . . . from any trade." The retention of this limitation in the British statute for over a hundred years is evidence, at least, of the desire on the part of Parliament to restrict the concept of income in this way. Also the report of the Royal Commission in 1920 recommended that:

> . . . . any profit made on a transaction recognizable as a business transaction, i.e., a transaction in which the subject matter was acquired with a view of profit-seeking, should be brought within the scope of the income Tax, and should not be treated as an accretion of capital simply because the transaction lies outside of the range of the taxpayer's ordinary business, or because the opportunities of making such profits are not likely, in the nature of things, to occur regularly or at short intervals.[2]

This recommendation has been disregarded by Parliament since 1920; therefore, Parliament seemingly has not considered it very important.

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[1] _Ibid_., Report of the British Royal Commission.

[2] _Ibid_.

The courts have set down the policy that if the sale occurred "in trade" the profit is taxable; otherwise it is not. The word "trade" includes "every trade, manufacture adventure or concern in the nature of trade"[1] but is not otherwise defined by the statute. Consequently, many controversies have arisen over the question whether a particular sale, in its own setting of facts, constituted a sale in trade. Over the past years the courts have set up a precedent that covers different situations, but in a case that does not fit readily into a similar past circumstance, there is a problem whether there is income to be taxed.

One of the most complete definitions "of trade," was given by the Master of the Rolls, Lord Hanworth, who said:

> Now you may have an isolated transaction so independent and separate that it does not give you any indication of carrying on a trade. It must be remembered that under the interpretation clause, trade 'includes every trade, manufacture adventure or concern in the nature of trade'. When, however, you come to look at four successive transactions you may hold that what was, considered separately and apart, a transaction to which the words 'trade or concern in the nature of trade' could not be applied, yet when you have that transaction repeated, not once nor twice but three times, at least, you may draw a completely difference inference from those incidents taken together. That is what the Commissioners have done . . . . They go on: 'The question, as we have stated it, is we think a question of degree,' and they deal with the matter further. I think they are right. If it is a

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[1] Income Tax Act, Section 237.

> question of degree it is a question of fact, and in my judgment, the Commissioners were quite right in applying, or in reconsidering, the facts known to them beforehand in the previous case which they had decided, but the true measure of which they had not taken from the point of view of whether a particular individual was carrying on a trade or an adventure in the nature of trade when those several matters are threaded up together and considered from a general point of view.[1]

In considering these income tax matters, the Commissioners decide whether a particular transaction falls within or without the income tax statute. These matters are decided by either the Commissioners for the General Purpose of the Income Tax or the Special Commissioners. The Commissioners for the General Purpose of the Income Tax are the bodies theoretically responsible for the administration of the income tax in their respective districts. There are 725 districts in Great Britain. The Commissioners are men of standing in their respective communities, businessmen, landowners, or professional men. Their position is purely honorary, no salary being attached to it, and is independent of the Board of Inland Revenue. The Special Commissioners are full-time officials, with headquarters in London. The body consists of eight men, and the positions are permanent until the incumbent reaches the retiring age. After the taxpayer receives his notice of assessment he may appeal either to

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[1] Pickford v Quirke, 13 Tax Cas. 251 (K.B. and C.A., 1927).

the General Commissioners of his district, or to the Special Commissioners in London. From a decision of either of these bodies, an appeal on a question of law lies as a matter of right to the Kings Bench Division in England. In England appeals may be taken as of right to the Court of Appeal and then to the House of Lords.[1]

Another excellent definition of trade was given by Lord Justice, clerk, Sir J. H. A. Macdonald who said:

> It is quite a well settled principle . . . . that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D . . . . But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable where . . . . an act (is) done in what is truly the carrying on or carrying out of a business . . . .
>
> The question . . . . (is), is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?[2]

When one views the British system, it appears that the limitation of the taxation of the profits on sales to sales made in the trade or business of the taxpayer gives rise to difficult questions of fact in borderline cases.

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[1]Roswell Magill, Taxable Income, Chapter 3.

[2]Lord Justice, clerk (Sir J. H. A. Macdonald), Californian Copper Syndicate (Limited and Reduced) V. Harrison, 6 F. 894, 5 Tax Cas. 159. 1904.

The question largely turns upon the intent of the taxpayer. Intent may be determined from the character of the commodity sold, the nature of the taxpayer's ordinary activities, the number of his transactions in the commodity in question.

Some theoretical considerations in favor of the British system are obvious. Since the statute does not undertake to tax casual capital gains; therefore, it does not provide for any allowance for capital losses on non-business transactions. The revenue from taxes can probably be more accurately estimated from year to year, and there will be less fluctuation over a span of years in the annual amount of revenue received than is found in the United States. It is clear in the long run by not taxing capital gains, the Treasury will not lose money. Mr. Boland supported the theory that the non-allowance of capital losses, would offset the amount received by taxing capital gains over a long period of time which includes both periods of prosperity and depression. Mr. Boland and his supporters used this argument as evidence in favor of the Boland Bill. The British taxing system eliminates the deterrent effect upon prospective non-business transaction, because there is no steeply graduated tax, nor is there any encouragement to the investor to sell in a depressed market to take a tax loss.

If one attacks the British method on a more practical ground, he will notice several discrepancies which seem questionable. It is difficult to see why the recurrent profits of the Hudson's Bay Company[1] from its sale of lands are not as true a measure of its taxable capacity as its profits from its dealing in furs or other transaction. Even in the case of single transaction, like that in Jones v Leeming[2] if the sole object of the purchase was to make a profit as soon as possible by a resale, there seems little justification for exempting the realized profit from tax. It seems that the major criticism or objection to the British system is the difficulty of weighing accurately the given circumstance in each situation presented. The English inspector (and courts) must decide whether the transactions in question are a part of the taxpayer's ordinary business, whether they have to do with vocation or advocation.

Capital Gains Taxation in France:[3]

In a study of both the French and German Income Tax

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[1]Thev v The South West Africa Co., Ltd., 131 L.T. 248, 1924.

[2]Jones v Leeming, A. C. 415, 1930.

[3]Haig, "Taxation of Capital Gains," Wall Street Journal (April 2, 1937).

statutes one is faced with the lack of present day material. Therefore, the following discussions of capital gains taxation in both France and Germany pertain to the period prior to World War II.

The French formula for taking capital gains is, in general, quite similar to the British, but it is by no means identical with that of England. The French have a series of schedular taxes surmounted by a progressive "Personal tax" which is called "impot complimentaire." Unless a capital gain comes under one of the schedular taxes, it does not become subject to the income tax.

Two of the schedules involve the taxation of capital gains. The first schedule imposes a tax on industrial and commercial profits. In the case of these strictly business enterprises, the French prescribe a very broad base, defined in the law as "the net profit, determined according to the results of all operations of every nature, carried on by the enterprise, including the transfer of any kind of asset whether in the course or upon the termination of the undertaking."[1]

The second schedule contains most of the debatable grounds and doubtful cases. This is a catch-all schedule,

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[1]Ibid.

which levies a tax on the profits of the so-called non-commercial "professions." A more literal interpretation of this schedule would read, "a tax on the profits of speculation." The test of liability here is the habitual character of the activity giving rise to the profit. Casual transactions in property made by a person not reached by the first schedule escapes liability under the second schedule as well. The difference between a speculator and one who makes a gain from a casual transaction in securities is not definite; it is a matter of interpretation of the courts.

The narrow, technical definition of taxable income offers speculators, of course, an attractive avenue of escape. No transaction that can be made to appear "casual" is likely to be recorded either as the transaction of a commercial or industrial enterprise, or as the transaction of a professional speculator. Tax on capital gains have been avoided often by converting them to casual sales, for example: A French banker desiring to dispose of securities at a price above cost, will commonly carry through the transaction in the name of a third person, perhaps one of the partners or officers acting in his capacity as an individual.

Experience in France has shown the taxpayer that there are no substantial risks of being called to account,

even though the transactions be large or numerous.

The favorite procedure of evading the income tax among those whose affairs are substantial appears to be, to seek the shelter afforded by foreign markets. It is perhaps also significant that when French securities are purchased, the investor almost universally insists on the bearer type rather than the registered type. The French investor can buy and sell securities in Wall Street as economically and almost as conveniently as the New Yorker. If this investor does not choose to disclose his transactions voluntarily to the "Fonctionnaire," the chances that they will be discovered is almost negligible.

The inadequacy of the French income tax administration; therefore, renders complete evasion so easy that the taxpayers have made little use of converting income into non-taxable casual capital gains.

Capital Gains Taxation in Germany:[1]

In France and England the income tax statute makes a distinction between casual transactions and transactions made in the course of business. Germany likewise taxes gains on all transactions made by enterprises classed as

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[1] *Ibid.*, April 8, 1937.

business concerns (whether or not incorporated); but when Germany deals with casual transactions, Germany taxes certain gains which France and England exempt. Germany uses a formula designed to separate, by a time test, the speculative transactions from the investment transactions. In Germany the profits of casual transactions are taxed, and the capital gains of investors are ignored.

The time test defines a speculation as a short-term transaction and an investment as a long-term venture. The dividing line between the taxable speculation and the exempt investment is fixed at one year in the case of securities and at two years in the case of real estate. But, transactions in bonds are not considered speculation regardless to the time held. Speculative profits of less than 1,000 marks in any one year are ignored.

If a German buys a bond for 101 and sells it an hour later (or ten years later) at 103, he has not speculated according to the statutory test and he pays no tax on the gain. On the other hand, if he buys a block of stock at 101 and sells it 365 days later at 103, he is considered to have indulged in a speculative transaction and is liable for tax on the gain. However, by holding the block of stock another day, he is transformed into an investor and the gain is exempt. If this hypothetical German buys a piece of real estate for 50,000 marks and sells it 24

months later for 60,000 marks, he is held to have realized a taxable speculative profit; but if he sells it a day later, the 10,000 marks become legally exempt as the fruit of an investment transaction.

The formula generates four working tendencies: (1) a tendency to favor transactions in bonds rather than transactions in stocks or other property; (2) a tendency to favor long-term rather than short-term transactions in stocks; (3) a tendency in favor of stock rather than real estate transactions; and (4) a tendency in favor of long-term rather than short-term real estate transactions.

In general, subject to the limitations stated above, the German formula offers a reward to the taxpayer who can transform taxable income into capital gains of the exempt class. For example, stock heavy with dividends can be sold "cum" and bought back "ex" with advantage, providing the security has been held a year before the sale. Furthermore, there is a substantial inducement to invest in the type of stock that offers a prospect of appreciation in market value rather than dividend distribution.

The German formula certainly cannot be recommended as one that will insure against artificial market transactions by taxpayers. Under American conditions, indeed, it would be reasonable to expect that such a formula would interfere seriously with the "normal" behavior of investors.

CHAPTER IX

CURRENT THEORIES OF CAPITAL GAINS TAXATION

The Twentieth Century Fund recommends[1] that shareholders be required to value their shareholdings each year and enter the plus or minus difference for the year in their personal income tax return.

The value of the stockholder's shares could be computed in either of two ways: (1) If the stock is listed, the market value as of the end of the year could be used. (2) In the case of unlisted stock, each corporation could be required to report to its shareholders the percentage change in book value of each share during the year, and the shareholder might then be required to adjust the value declared the year before up or down by the percentage. The market value or the book value will reflect the degree of which profits have been undistributed, or losses sustained, as well as any increase or decrease in the value of asset from other causes. In this manner the shareholder will be put upon the same basis of tax justice as the

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[1]Harold M. Groves, "Twentieth Century Fund," Viewpoint on Public Finance (New York: Henry Holt and Company), p. 151.

individual owner or partner.

In the case of stock sold during the year the seller would report the realized gain or loss represented by the difference between the reported value the year before, or the purchase price if the stock was purchased during the year, and the selling price.

They also recommended that the capital losses in any one year that are in excess of capital gains for the same year be deducted from other income, and if, there is an excess remaining, this excess be carried forward and deducted from incomes of all kinds in tax returns of future years until it is entirely absorbed. The Committee of the Twentieth Century Fund realized that taxing capital gains on an accrual basis might be unconstitutional, so they recommended a constitutional amendment to ensure the legality of this particular form of income taxation by the federal and state governments.

The Committee recommends that, whether the compulsory inventorying method or some alternative method is used, consideration should be given to devising machinery for distinguishing the capital increase or decrease due to a change in price level from real c apital increase or decrease. If a substantial inflation or deflation occurs, it would be highly desirable to adopt some method whereby the portion of the dollar increase or decrease in capital

value due to change in price levels could be eliminated for tax purpose and only the real capital increase or decrease taken into consideration.

The accrual basis of valuation of stockownership would be extended to all forms of property. This would involve an annual inventory of all holdings of capital assets each year in terms of market value.

Criticism of the recommendations of the Twentieth Century Fund are many. The problem of valuation would be difficult. Listed and over the counter stock would present few problems, but the valuation of closely held securities and real estate would be very difficult. The recommendation does avoid the bunching of an income in a single year, and such a method might possibly contribute to economic stabilization. The selling of securities to pay taxes on capital accrual might operate as a restraining factor on security prices during a boom period, however, in periods of depression, the holders of capital assets would be able to write off the accrued capital loss, thus they might be virtually excused from paying a tax, and the unlimited carry-over of loss might carry foward into the period of recovery.

The Committee suggested that capital gains and losses arising from a general change in the price level are illusory, and some plan should be adopted to avoid the taxation

of such gains or the deduction of such losses. They did not make a specific proposal, as to how this end could be accomplished. The main objection to such a proposal is that it is administratively unworkable. The yearly appraisal of real estate, would be a good estimate at best, and the cost of the yearly appraisal would be costly. This would lead to confusion of appraisals and open the way for greater tax evasion, which would be costly to investigate. The problems which would be created by such a method of taxing capital gains make it impracticable.

Brookings Institution - Kimmel:

Mr. Kimmel points out[1] that one class of investor fares badly under the present capital gains taxation. The investor who selects a limited number of common stocks, frequently of new companies, with the expectation that the income derived over a number of years will not only offset his losses but yield an adequate return on investment. This type of investor may to some extent offset capital losses against capital gains, but this will be true if some of his holdings have appreciated in value sufficient to cover his losses. Mr. Kimmel suggested that this

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[1]Oregon Business Review, op. cit., p. 7.

difficulty might be eliminated if the investor was permitted to offset capital losses against both capital gains and dividends. Mr. Kimmel recommended the retention of the present system of taxing capital gains unless the general price level after the war should be high.

Committee of Postwar Tax Policy:

The Committee of Postwar Tax Policy says[1] that the existing capital gains and loss provision represent a compromise which was achieved after extensive consideration of the problem by the Congress in 1942. Like all compromises, it is not entirely satisfactory. The provisions have been criticised on the ground that they are not entirely equitable because they do not permit complete allowance of capital losses against ordinary income. It also has been urged that six months is too short a period to distinguish between long-term and short-term gains and losses. However, one of the greatest difficulties of the capital gains and loss provision has been their constant revision and the consequent uncertainty which this has caused

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[1]The Committee of Postwar Tax Policy, A Tax Program for a Solvent America (New York: Ronald Press Co., 1945).

in the minds of the taxpayers. The Committee of Postwar Tax Policy recommended that at least for the next five years, (1945-1950), the taxation of capital gains and losses should be continued according to the present provisions of the Internal Revenue Code.

Committee of Economic Development:

The Committee recommends that:[1]

> Present differential treatment of capital gains and losses should be retained until substantial reduction in corporate and personal income taxes have been effected, and adequate provision for averaging income over a period is permitted. If and when these conditions are met, capital gains should be fully taxable like other income and full deductions for capital losses should be permitted, until such circumstances, capital gains and losses should be recognized at transfer by gift or death.[2]

The committee recognized the fact that heavy taxation of capital gains is a deterrent to investment in new and risky enterprises, and believed that full deduction of capital losses should be permitted even against ordinary income, because the fear of loss is a potent deterrent to risk investment. If the full deduction of losses were permitted, the committee believes that the adverse effect of capital gains taxation on risk taking would be largely

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[1]Committee of Economic Development, "Monetary and Fiscal Policy for Greater Economic Stability."

[2]*Ibid*.

eliminated. And if capital gains and losses were treated as income realized at death or gift, there would be less reluctance on the part of wealthy investors to dispose of capital assets and invest the proceeds in new and risky enterprises that may be equally promising.

Mr. Flanders, chairman of the Committee of Economic Development believed that the committee did not give adequate consideration to the problem of getting financial backing for new enterprise with uncertain prospects. He believed that the administrative problem of defining new investment and offering really adequate relief to the investor must be faced. This he points out can be done by relieving from taxation income devoted to such investments; or it can be done by relieving from taxation the profits of such investment. Mr. Flander's choice is a third suggestion, which is the possibility that the increase in value from such investments can be left free of the capital gains tax.

It has been pointed out that Mr. Flanders did not mention whether or not he believed that such capital losses from "new investment" should be deductible from ordinary income. If the capital gain is not to be taxed, neither should capital losses from new investments be

deductible from the taxpayer's ordinary income.[1]

The recommendations of the Committee for full taxation of capital gains and for the full allowance for capital losses, are suggested only after certain changes are brought about and were based on three considerations:

(1) The principal inequity of capital gains taxation is believed to be the result of bunching of the income in a single year, when in fact the income has accrued over several years. The committee recommends the averaging of income over a period, if this is done, the inequity of bunching of income in one single year would be eliminated.

(2) The committee feels that the fear of loss is regarded as a major deterrant to risk investment. The allowance of full deductibility of loss from ordinary income would provide at least some incentive for risk investment.

(3) The committee recommends the adjustment of the corporate income tax to the level of the standard personal tax and its conversion to an "at the source" tax. This would be a device to tax corporate income to the real owner, the stockholder.

It is pointed out that presumably the Committee of Economic Development has in mind capital gains resulting

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[1] Oregon Business Review, op. cit., p. 6.

from the reinvesting of corporate earnings. Under the Committee proposal, the corporation would pay a tax on such income and this tax would be regarded as advance withholdings from future dividends.[1] Such a solution would call for a fundamental over-hauling of our tax system, with no accurate base to be used for the calculation of the averaging of income; this would result in an estimate at best.

Twin Cities:

This plan recommends[2] that the gains or losses from assets held six months or less should be treated as ordinary gains and losses. Corporations should report 100 percent of long-term capital gains and losses and other taxpayers should report 50 percent, to be taxed at ordinary rates. The Committee also recommended an alternate tax[3] which is computed by taking the tax on net income, excluding capital gains or losses, at the regular rate, plus 12½ percent of the capital gains or less 12½ percent of the capital loss for corporations; and plus or minus 25 percent of the capital or loss for other taxpayers. The 25 percent is used in the case of other taxpayers because they would under this plan report only

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[1] Ibid.

[2] "Postwar Tax Structure," Journal of Accountancy (October 1944).

[3] To be used only if less than the tax computed at regular rates on the entire net income including the capital gains or losses.

50 percent of their long-term capital gains or losses.

The Twin Cities plan suggests that the present treatment of gains and losses from involuntary conversion or from the sale or exchange of certain properties used in the trade or business should be continued.

The alternative plan in effect limits the tax reduction for long-term losses to 25 percent of the loss; but it would also be possible for some taxpayers during periods of declining capital values to escape any taxation by realization of capital losses.

American Institute of Accountants:

The Committee on Federal Taxation of the American Institute of Accountants recommends[1] that the revision of the capital gains tax should be handled only as a part of the long-range objective of over-all simplification, intergration and coordination of the tax laws, and the establishment of a relatively permanent peacetime tax program, subject only to changes in rates. The Committee recommends that capital losses should be given immediate attention, and that capital losses should be allowed as deductions with tax benefit limited to the same maximum rate as is applied in taxing capital gains.

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[1] "Postwar Taxation," Journal of Accountancy (November 1944).

In the case of long-term capital losses, this would presumably mean that a taxpayer would be allowed to deduct net capital losses from ordinary income to the point where the tax advantage from such deductions would exceed 50 percent of the recognized loss.

The Commission believes that the present restriction upon allowance of deduction for capital losses act as deterrents to investment of capital in corporate enterprises and therefore should be modified to provide treatment of losses corresponding to the treatment of gains.

Mr. Emil Schram, President, New York Stock Exchange:[1]

Mr. Schram believes that a levy on capital is completely unsound and un-American, that such a levy does not belong in the tax system and it should be abolished entirely. He believes that investments have been punished long enough, which has had the effect that business now is unable to raise ownership capital. Mr. Schram feels that action should be taken so that people can become owners of business. He believes that it should be preferably to revamp the entire tax structure and to be more realistic because of a $40,000,000,000 budget. The size

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[1]Emil Schram, New York Times (July 12, 1949 and August 17, 1949).

of that budget makes it necessary to broaden the tax base--to permit industries to expand and thus create something to tax. Mr. Schram states that this can be accomplished by the following changes:

> (1) Revise existing restrictions to permit individuals to deduct from their tax liability an amount of 10 per cent of dividends received on common stock, this tax credit to increase in subsequent years.
> (2) A change in the law to permit the offsetting of capital losses against ordinary income to the extent of $5000 in the year the loss occurs, plus an equal amount in each of the five carry-over years.
> (3) The application of a flat 10 per cent tax on long-term capital gains instead of the present law, under which the tax ranges from 10 per cent in the lowest taxable bracket to a maximum of 25 per cent.
> (4) A reduction from six to three months in the time that assets must be held before a realized gain is taxed as long-term capital gains.[1]

The limited tax credit on dividend income is believed to be a ready method of partially eliminating a serious tax injustice and encouraging equity investment. This approach involves essentially a return to the tax treatment accorded dividends in the United States between 1918 and 1936.

Mr. Schram believes this tax credit on dividends would decrease revenues greatly,[2] but believes that it would partially be made up by an increase in taxable

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[1] Ibid.

[2] It is estimated this decrease would be around $600,000,000.

income at the personal level by encouraging larger dividends and by incentive effects, and that in latter years, the greater amount of investment capital would increase the tax base more than sufficient to cover the present revenue loss.

The proposal by Mr. Schram has received quite a bit of attention during the 81st Congress. The main objections to the recommendations of Mr. Schram are: (1) It would decrease greatly the amount received as revenue, and that it would not be compensated by larger dividend payments as Mr. Schram suggests. (2) The allowance of $5000 deduction for capital losses against ordinary income in the year the loss occurs, plus an equal amount in each of the five carry-over years, would materially reduce revenue in a period when the need for revenue is high. (3) The application of a ten percent limitation on capital assets would encourage speculation, and gains derived from speculation would receive too great of a tax differential.

Reformation of the system of taxation of capital gains and losses involves at least two dilemmas. Both dilemmas have to do with harmonizing what is equitable with what is administratively feasible and politically acceptable.[1]

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[1]_Oregon Business Review_, _op_. _cit_., p. 8.

The first of these dilemmas has to do with the deduction of capital loss. It appears fair to allow deductions of capital loss from ordinary income in the same manner and to the same extent that capital gains are required to be added to ordinary income. Neither capital gains or capital losses reflect the taxpayers true ability to pay; therefore it seems equitable to allow deductions for loss to the same extent that capital gains are taxed.

With a short holding period for capital assets such as the present six months, if recognized losses (whatever the discount factor) were to be made fully deductible from ordinary income, it would exclude a class of income from taxation during periods of depression and the early recovery period.

With a short holding period it is quite possible for taxpayers to arrange their capital transaction in such a way for capital losses to offset capital gains. A taxpayer cannot create too great a damage to revenue as long as the allowance for capital loss deductions are limited. But if they were allowed without limit, the short holding period might well result in greatly diminished revenues.

The second dilemma according to Mr. Burrell,[1] has to do with the administrative problem of distinguishing

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[1] Ibid.

between capital transactions and ordinary transactions. It has been accepted that capital gains and losses do not have the same tax significance as ordinary profits and losses, and that it is equitable to apply a discount factor to true capital gains and losses.

The existence of a wide variance between tax rates on ordinary income and tax rates on capital gains creates powerful inducements on the part of the taxpayer to attempt to convert his ordinary income into capital gains. This may lead to the allowing of corporate earnings to accumulate instead of paying earnings out in dividends. Of course, Sec. 102 of the present Revenue Act lays a penalty tax on unreasonable accumulation of earnings, but this is hard to administer.

Few of the current recommendations provide for fundamental reorganization of the present system of taxing capital gains or losses. The changes suggested are: a more liberal deduction for capital losses; a change in the length of the holding period and changes in the maximum tax rate applicable to capital gains.

It seems to be clear that the existing method of taxing capital gains is best. It is widely accepted that capital gains and losses do not have the same tax significance as ordinary profits and losses; therefore, it is deemed equitable to apply a discount factor to true

capital gains and losses.

The existing discount factor of 50 percent applied to capital gains held over six months allows a substantial relief to the taxpayer. The holding period is arbitrary, but a lesser period would give a great advantage to speculative gains and a longer period would tend to hinder the flow of capital into other enterprises. To eliminate tax avoidance by converting ordinary income into capital gains, the variance between the taxation of capital assets and ordinary income must not be too great. The existing method sets a maximum rate of 25 percent on capital gains. A lower maximum rate would increase the incentive to convert ordinary income into capital gains and a higher rate would not give adequate relief to capital gains.

Most of the current theories recommend that a more liberal allowance should be made for the deduction of capital losses. It seems that such a change is necessary. But with the assumption that the existing holding period of six months is best for handling capital gains, it is necessary to consider two factors: (1) If recognized losses (whatever the discount factor) were to be made fully deductible from ordinary income, it would exclude a class of income from taxation during depressions and the early recovery period; and (2) with a six month holding period it would be possible for a taxpayer to manipulate their

capital transactions in such a way for capital losses to offset capital gains.

The need for revenue makes it necessary that capital losses be limited in the amount allowed for deduction against other income. The plan recommended by Emil Schram which would allow capital losses offset against ordinary income to the extent of $5,000 in the year the loss occurs, plus an equal amount in each of the five carry-over years, would be a more equitable arrangement. This is an arbitrary amount, and it seems that the amount allowed is probably too great; therefore, instead of a $5,000 offset against ordinary income in the year the loss occurs, plus an equal amount in each of the five carry-over years, it would be better to allow an amount of $3,000. This is the mid point between Emil Schram's recommendation and the existing method.

There seems to be no particular reason for the exclusion of real property used in the trade or business from capital assets. There is no need to offer this special relief. Why should the profits of these properties held over six months be treated in the same manner as capital gains, but the losses be fully deductible from other income? There is no logical reason why they are not defined as capital assets and treated in the same manner as other capital assets.

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APPENDIX

HISTORICAL SUMMARY OF TAX TREATMENT OF CAPITAL GAINS AND LOSSES 1913-1949

INDIVIDUALS

REVENUE ACT	INCOME YEAR	TREATMENT OF: GAINS FROM SALE OR EXCHANGE OF ASSET	LOSSES FROM SALE OR EXCHANGE OF ASSET
1913	Mar. 1, 1913 to Dec. 31, 1915	Included with ordinary income subject to full normal and sur-tax rates.	Not allowed.
1916	1916	Same as above.	Allowed only to the extent of the gains from such sales.
1917	1917	Same as above.	Same as above.
1918	1918-1921	Same as above.	Allowed in full against income of any kind.
		ASSETS HELD TWO YEARS OR LESS	
1921	1922, 1923	Included with other income subject to full normal and sur-tax rates.	Allowed in full.
		ASSETS HELD OVER TWO YEARS	
		At the election of the taxpayer, capital net gains were taxable at 12½% in lieu of normal and sur-tax rates; but if such election were made, the total tax, including the tax on capital net gain, could in no case be less than 12½ per cent of the total net income.	Allowed in full against income of any kind.

REVENUE ACT	INCOME YEAR	TREATMENT OF: GAINS FROM SALE OR EXCHANGE OF ASSET	TREATMENT OF: LOSSES FROM SALE OR EXCHANGE OF ASSET
		ASSETS HELD TWO YEARS OR LESS	
1924	1924, 1925	Same as 1921 Act.	Allowed in full against income of any kind.
		ASSETS HELD OVER TWO YEARS	
		At the election of the taxpayer, capital net gains were taxable at 12½% lieu of the normal and surtax rates.	Could be segregated from ordinary net income and a tax credit of 12½% of the capital net loss taken, but in no case could the tax be less than the tax (computed at normal and sur-tax rates) would be if the capital net loss was deducted from ordinary income.
1926	1926-1927	Same as 1924 Act.	Same as 1924 Act.
1928	1928-1931	Same as above.	Same as above.
		ASSETS HELD TWO YEARS OR LESS	
1932	1932	Same as 1924 Act.	Losses from sales or exchange of stock and bonds were limited to the gains from such sales. It was provided, however, that such losses disallowed in one year (to an amount not in excess of net income) could be carried over and applied against gains from such transactions in the succeeding taxable year.[1] Other losses were allowed in full against income of any kind.

[1] The provision relating to the carry-forward of disallowed losses from sale or exchange of stocks and bonds held two years or less was repealed by the National Industrial Recovery Act before it became effective.

REVENUE ACT	INCOME YEAR	TREATMENT OF: GAINS FROM SALE OR EXCHANGE OF ASSET	TREATMENT OF: LOSSES FROM SALE OR EXCHANGE OF ASSET
		ASSETS HELD OVER TWO YEARS	
1932	1932	Same as 1924 Act.	Same as 1924 Act.
		ASSETS HELD TWO YEARS OR LESS	
N.I.R.A.	1933	Same as 1924 Act.	Losses from sales or exchanges of stocks and bonds were limited to the gains from such sales. Other losses were allowed in full against income of any kind.
		ASSETS HELD OVER TWO YEARS	
		Same as 1924 Act.	Same as 1924 Act.
		PERCENTAGE OF GAINS OR LOSSES RECOGNIZED	
1934 1936	1934	Period Assets Are Held	Percentages
		1 year or less	100
		Over 1 year but not over 2 years	80
		Over 2 years but not over 5 years	60
		Over 5 years but not over 10 years	40
		Over 10 years	30
		Capital gains so computed are included in net income subject to full normal and surtax rates.	Capital losses so computed are recognized in determining net income to the amount of the recognized gains plus $2000.

REVENUE ACT	INCOME YEAR	TREATMENT OF: GAINS FROM SALE OR EXCHANGE OF ASSET	TREATMENT OF: LOSSES FROM SALE OR EXCHANGE OF ASSET
		PERCENTAGE OF GAINS OR LOSSES RECOGNIZED	
1938	1938-1942	Period Assets Are Held — Percentages 18 months or less.................100 Over 18 months but not over 24 months.................. 66 2/3 Over 24 months.................... 50	
		ASSETS HELD 18 MONTHS OR LESS (Short Term)	
		Capital gains not off-set by allowed losses included with other income subject to full normal tax and sur-tax rates.	Capital losses allowed only to the extent of gains of such transactions, but losses dis-allowed in one year (to an amount not exceeding net in-come) may be car-ried forward and applied against gains from such transactions in the succeeding taxable year.
		ASSETS HELD MORE THAN 18 MONTHS (Long Term)	
		Net capital gains com-puted on basis of foregoing percentages are included with other income and sub-ject to normal tax and sur-tax rates, or segregated and taxed at 30%, whichever method results in lesser total tax.	Net capital losses computed on basis of foregoing percentages are deducted from other income or 30% of such losses is credited against the tax, computed on net income before de-ducting the net loss, whichever method gives the greater tax.

REVENUE ACT	INCOME YEAR	TREATMENT OF: GAINS FROM SALE OR EXCHANGE OF ASSET	TREATMENT OF: LOSSES FROM SALE OR EXCHANGE OF ASSET
1939	1939-42	Same as previous Act.	Same as for an individual for this Act.
1942-49	1943-49	Net capital gains means the excess of the gains from sale or exchange of capital assets over the losses from such sales or exchange no holding period is present. They are figured at 100 per cent. An alternative method is allowed which limits the tax on capital gains to no more than 25 per cent on the actual amount of long-term capital gains.	Allowed to the extent of capital gains, but may be carried forward to 5 subsequent years and offset against capital gains.

HISTORICAL SUMMARY OF TAX TREATMENT OF CAPITAL GAINS AND LOSSES 1913-1949

CORPORATIONS

REVENUE ACT	INCOME YEAR	TREATMENT OF: GAINS FROM SALE OR EXCHANGE OF ASSET	LOSSES FROM SALE OR EXCHANGE OF ASSET
1913-28	1913-31	Included with other income subject to full rate.	Allowed in full against income of any kind.
1932	1932	Same as above.	Losses from sales or exchanges of stocks and bonds held 2 years or less were limited to the gains from such sales. It was provided, however, that such losses disallowed in one year (to an amount not in excess of the net income) could be carried over and applied against gains from such transactions in the succeeding taxable year.[1] Other losses were allowed in full against any kind of income.
N.I.R.A.	1933	Same as above.	Losses from sale or exchange of stocks and bonds held two years or less were limited to the gains from such sales. Other losses were allowed in full against income of any kind.
1934-38	1934-39	Same as above.	Allowed only to the extent of $2,000 plus capital gains.

[1] The provision relating to the carry-forward of disallowed losses from sales or exchanges of stocks and bonds held 2 years or less was repealed by the National Industrial Recovery Act before it became effective.

REVENUE ACT	INCOME YEAR	TREATMENT OF:	
		GAINS FROM SALE OR EXCHANGE OF ASSET	LOSSES FROM SALE OR EXCHANGE OF ASSET
1942 1949	1943-1949	100 per cent applied to ordinary income if the capital asset has been held less than 6 months. 50% applied to ordinary income if the capital asset has been held for more than 6 months. An alternative tax can be taken on long-term capital gains which limits the maximum tax paid to 25% of the gain.	Losses on capital assets are figured as 100% on assets held not over 6 months; 50% on assets held over 6 months. The capital losses are deducted against capital gains, and any excess is treated as a short term capital loss and may be used to offset "net capital gains" in succeeding years, plus other income to the extent of $1,000 for a period of 5 years.

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