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Capital Gains, Losses in Income Taxation

By Dan Throop Smith

Capital gains of individuals should be taxed on a sliding scale, with assets held for longer periods subject to successively lower rates of tax. A procedure of this sort, similar to one adopted for a few years under the Roosevelt Administration in the late 1930's would be fairer than the present method. It would also reduce the present tax pressure to consume national capital and to freeze investment portfolios.

It was gratifying to find Wilbur D. Mills, Chairman of the House Ways and Means Committee, quoted in the papers of November 30 as suggesting this tax treatment of capital gains. When there is any substantial tax legislation, adoption of this method would be a major reform.

A sliding scale might provide, for example, that gains on assets held for less than a year or 18 months should be included in full in taxable income. This would be an extension of the present holding period of six months for full inclusion. Gains on assets beyond the first period up to three years might be included to the extent of 80 percent and on holdings of three to five years at 60 percent. At these rates, gains on assets held up to five years would be taxed more heavily than at present. By contrast, 40 percent of gains on assets held between five and ten years might be included in taxable income, with 20 percent of gains on assets held over ten years. The intervals might be longer if that were deemed preferable. Loss offsets would be made on the same sliding scale.

The purpose would be to tax relatively short-term gains at higher rates than at present and relatively long-term gains at lower rates than at present. One reason for this change is that relatively long-term gains seem more likely to be regarded and treated as embodied in capital, while relatively short-term gains are regarded and treated as trading profits, available for consumption or savings as is ordinary income.

The controversy regarding the nature of capital gains will probably continue indefinitely. Our tax law and the tax laws of all other countries treat capital gains differently than income. Some countries do not tax capital gains at all. Those which do tax them do so at tax rates lower than those applied to income.

The distinction between capital and income has been well established in trust and corporate laws and in the traditional concepts of financial management for institutions and families. National income accounting also makes distinction.

This Issue in Brief

A change in the law to permit the taxation of capital gains on a sliding scale would, says Dr. Smith in this **Review**, "reduce the tax pressure to consume national capital and to freeze investment portfolios."

Such a change, he asserts, would have short-term gains taxed more heavily and long-term gains less heavily than at present, and "would be a major improvement in our tax laws." He says that the present method of handling capital gains taxation, on balance, is "not unsatisfactory." A change, he says, is desirable from the standpoint of both fairness and economic consequences.

However, one line of thought in public finance literature, principally associated with the late Professors Haig of Columbia and Simon of Chicago and adopted by many subsequent writers, has proposed a so-called net accretion concept of income. Under this concept, in its pure form, unrealized gains and losses would be added each year to regular income, as ordinarily defined, to determine taxable income. However defined or measured, the fundamental element in the net accretion concept is to treat appreciation in value, whether realized or not, as equivalent for tax purposes to wages and salaries, dividends, interest, rent and other payments for personal services and for the use of capital.

As a practical matter most, but by no means all, of the advocates of the net accretion concept recognize that annual taxation of unrealized gains, with offsets for unrealized losses, would not be practical because of problems of valuation and pressures to secure funds to pay taxes when assets do not consist of listed securities. Full inclusion of realized gains and losses is thus proposed as a concession of practicality—and to taxpayers.

Those of us who reject the net accretion concept, whether it is applied to unrealized or realized gains, regard it as an interesting intellectual exercise, satisfying to some theorists, but unsuitable as a basis for taxation. It virtually wipes out the distinction between capital and income which is basic for prudent family, business and, one may add, national finance. If the distinction were destroyed for tax purposes, it would probably be ignored for other purposes, with consequent spendthrift consumption of capital.

Furthermore, those of us who regard the distinction between capital and income as both valid and important, resent the attempts to undermine it. They believe that in some instances the advocacy of the net accretion concept reflects a punitive attitude towards those with capital. Opinions regarding the ownership of capital are just that—opinions—which each individual will form on the basis of his own judgment and emotion and on which equally intelligent and honorable people will differ profoundly. Tax theorists, as such, have no special expertise on the subject and no right to attempt to impose their special preferences on the public under the guise of economic definitions and doctrines. This is especially true when the new definitions or concepts have no counterpart in any other branch of knowledge or policy.

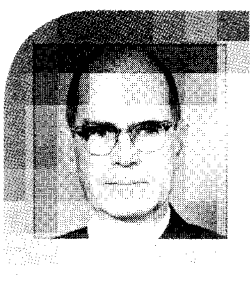
A belief developed during the long depression of the 1930's that Western industrial economies were mature, with a tendency for savings to exceed the demands for capital. This belief was used to justify tax policies which fell especially heavily on large incomes and accumulations of capital, providing in effect an economic rationalization for taxation to redistribute income and wealth, which was popular on social grounds.

Sliding Scale Treatment Would Tend To Favor Reinvested Gains

It is now realized that savings are inadequate to provide the capital needed for housing, business investment, urban renewal, pollution control and other environmental purposes. This fact has not yet been reflected in attitudes and policies regarding taxation. Allowances for rapid depreciation and restraint in forms of taxation which force the sale of capital assets are now important to meet the many recognized needs for capital.

Ideally, it would seem fair to distinguish for tax purposes capital gains which are consumed from those which are reinvested, with no taxation or a lower rate of tax applied to the latter. A precedent for this distinction exists in the provisions regarding owner-occupied houses. There are no significant problems in carrying forward the untaxed gains when a single asset is substituted for another single asset. The administrative problems in maintaining a personal capital account for all combined assets appear to be overwhelming, however, in the absence of a general use of custodian accounts for capital assets.

A sliding scale treatment based on the length of time an asset has been held, is feasible and would tend to favor reinvested gains. This is on the presumption previously noted that the longer appreci-



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ated assets are held, the more likely their values are to be regarded as capital not available to pay for ordinary consumption expenditures. Thus, a tax on reinvested gains is in the nature of a capital levy while gains used for consumption might reasonably be taxed under a regular income tax.

A distinction between reinvested and consumed capital gains for tax purposes may be thought of as consistent with an expenditure tax and indeed it is. It is unfortunate that the expenditure concept of income advanced by Irving Fisher based on consumption did not receive the wide acceptance in theoretical writings which was accorded to that of Haig and Simon. It is probably too complicated for adoption, though vastly less involved than the inclusion of unrealized gains and losses in taxable income. The personal predilections for redistribution of income through taxation, previously alluded to, may have influenced the choice between the two concepts for many writers in public finance theory.

One argument against a sliding scale for taxation of capital gains, especially if the effective tax rate is increased for short-term gains, is that it might impose a strain on financial houses which rely principally on commissions from short-term trading. In view of the vulnerability of some brokerage firms and the impact of distress among them on the whole economy, the point should not be brushed aside, to the extent that it is valid. However, there should be no vested interest in the six-months holding period nor should preference for a particular type of security trading stand in the way of a major tax reform.

It is questionable whether short-term trading really is important in assuring effective financial markets for long-term capital flows. The present six-months rule, coupled with the present high tax rates rising to 35 percent on long-term investments, in the opinion of many people, gives an unjustified tax break to churning in the markets and discourages liquidity and shifts in true investment funds. Churning may in fact accentuate erratic fluctuations in market values which deter smooth flows of capital funds.

The distinction between capital gains and income should not be blurred by including in capital gains items which arise from unnatural maneuvers to come within the letter of the tax law or which are given special statutory recognition with little or no economic justification. Those who wish to continue the separate tax treatment of capital gains should be the first to protect the concept from contamination.

Among the more flagrant abuses in the past were so-called deep discount bonds and bond coupons detached and sold separately long before their due date. Excessive interest rates on municipal bonds to create deductible capital losses unmatched by any taxable income and "daisy-chain" transfers of investment portfolios of municipal bonds among banks which also qualified as dealers are among the manipulations which brought capital gains into disrepute in the past.

Ingenious new schemes are constantly being devised. It usually requires considerable time to secure amending legislation. New provisions are often taken by the schemers as an invitation to redouble their ingenuity and then advertise a new device as one "approved by the Congress and the Treasury." It is perhaps time to have a general provision authorizing the Treasury to disallow capital gains treatment for new forms of transactions in which a principal purpose is the conversion of ordinary income into capital gains.

Instant Impact, Long-Term Effect On Markets, Revenue Hard to Predict

Among statutory provisions which weaken the acceptability of the capital gains concept, in addition to the six-months holding period, are such things as the favored treatment of certain royalties and, until recently, lump-sum withdrawals from pension plans. The fact that there is not complete recapture of depreciation on sales of buildings, comparable to that on machinery and equipment, permits capital gains to arise from excess depreciation. This has always seemed unjustified. The absence of full recapture is also a barrier against allowance for rapid tax depreciation of buildings which might otherwise be appropriate.

It is claimed by some that a succession of descending steps for inclusion of capital gains would deter shifts of securities in investment portfolios because securities would be held to get the benefit of the lowest tax rate. A great many steps, with percentages of inclusion changed on a monthly or quarterly basis, would minimize the inducement for interim holding but complicate the tax forms and calculations. Five steps, as suggested here, should strike a satisfactory balance between complication and deterrence. The fact of lower rates than at present on long-term holdings, which is an essential part of any sliding scale, should on balance substantially increase liquidity.

Both the immediate impact and the long-term effect on activity in the security markets and on revenue are hard to predict. At the outset, the sale of short-term holdings might be deferred beyond six months, though the fact of a smaller percentage reduction in effective tax rates in the first step would be an offsetting influence. The sale of presently frozen long-term investments would greatly increase, both immediately and over the years, as existing investments moved into the longer term categories. There would probably be a surge of immediate activity.

It is also probable that there would be a surge of tax revenue with the increase in volume of sales more than offsetting the reduction in tax rates on very long-term holdings. After a transition period, the impact on revenues is more difficult to predict. The secondary consequences of better liquidity in security markets and greater availability of investment funds for expanding industries and companies will increase the total revenue base.

Thought should indeed be given to possible immediate effects of adoption of a sliding scale method of taxation of capital gains. Perhaps some transition rules would be desirable, though it seems unlikely that any short-term adverse results would be serious enough to justify the complications of transition rules. In any case, the long-term benefits would be so great that transition problems should not stand in the way of adoption of the new method.

It may be argued that a new approach to investment policy for institutions and individuals has so weakened the distinction between capital gains and income for financial purposes that the distinction for tax purposes is no longer justified. Specifically, it is proposed by some that part or all of the appreciation in equity investment should be regarded as income, in view of the low rate of dividend yields on common stocks in growth industries and the long-term appreciation which has developed on many of them. Traditionalists challenge this approach as extremely imprudent. It calls, at the very least, for wisdom and good fortune in the selection and timing of stock transactions and long-term averaging of net gains and losses.

More fundamentally, the proposal to treat appreciation as income requires an offsetting adjustment and allowance for the inflation which decreases the real value of any capital investment stated or thought of in fixed dollar amounts. This fact is recognized and provided for in the more thoughtful analyses and plans for revisions in policies on investment management. Continuing inflation makes it foolhardy to consider all the interest on bonds or mortgages as spendable income. This is a fact which retired people can ignore only at their peril. Present affluence on fixed income on the best of securities will degenerate into penury over a 20 or 30 year period of retirement. Thus, it is equally spendthrift to treat all interest and all appreciation as spendable income.

In a balanced portfolio of bonds and stocks, appreciation on equities may be thought of as offsetting in a very rough way the loss in real value of the capital invested in fixed-dollar assets. A shortfall in dividends, in a sense, may be regarded as an offset to an overstatement of interest income.

The point of this digression is merely to note that if one cites new attitudes and policies on investment management as a precedent for taxing capital gains as income, one must be prepared to go the whole distance and adjust the tax law to cover the implications. If capital gains were to be taxed in full, tax allowances should be made to the extent that appreciation in a equity merely offsets inflation and the consequent decline in the real value of an asset. Tax allowances also should be made in computing taxable interest for the same inflation factor. Perhaps it would become appropriate to base depreciation on replacement instead of historic cost.

The administrative complications of adjustments of the sort just described are so great that they should deter anyone who favors full taxation of capital gains. But they are logical consequences for those who may argue that the financial policies now recommended by some investment advisors for individuals and universities have destroyed the distinction between capital and income.

In summary, a change in the law to include capital gains in full in taxable income would be bad. The present method is on balance not unsatisfactory. A change to a sliding scale with short-term gains taxed more heavily and long-term gains taxed less heavily than at present would be a major improvement in our tax laws. It is desirable from the standpoint of both fairness and economic consequences.