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Taxing Capital Gains

By Norris Darrell

We have recently been hearing the oft recurring cry about "loopholes" that enable rich individuals and large corporations to escape the high taxes they are supposed to pay and that are said to place the tax system in disrepute. "Let's close the loopholes" has a ringing, high-sounding appeal, especially to those persons in the lower and middle income brackets who are burdened with what they feel is an unduly high incidence of taxation upon them in comparison to that borne by high income taxpayers. However, the thrust of this appeal seems largely misguided in two respects. First, it is doubtful that even if all the so-called loopholes were eliminated the incidence of taxation on those feeling most aggrieved would be significantly different. Hence, the complaint really serves to focus attention away from a principal cause of high taxation – the large budgetary requirements of the Federal government. Whatever reforms are adopted, the bulk of the income tax must still be raised from lower and middle income bracket taxpayers. Moreover, there is great confusion over the tax effects of the proposed reforms. For example, under high tax rates it seems inappropriate to assume that realized capital gains would be the same as when the tax was limited to 25 percent, or that corporate taxable income would not be affected adversely by removal of incentives to capital formation and corporate growth.

Secondly, many of the statutory provisions complained about are not loopholes in the sense implied by the term – i.e., an ambiguity or omission in the revenue laws through which the intent of the law may be evaded. Rather they are reflections of deliberate Congressional policy. Whether or not they should be changed is a matter for serious study and reconsideration – not for oratory. The decisions should be based on what is best for the economy as a whole and what is fair and just as among taxpayers; and in reaching these decisions and determining the manner of their expression, careful consideration should be given to their effect upon statutory complexity to which I have referred.

Wilbur Mills, Chairman of the House Ways and Means Committee, has expressed the essence of the problem very well.*

> ". . . , in the review of our tax system, as a guiding principle, tax exclusions and tax allowances should be continued only if they can be

* Address at Securities Industry Association Management Conference in New York City, Sept. 8, 1972.

This Issue in Brief

Taxation of capital gains, an area of continuing controversy, is reviewed here by Mr. Darrell back to 1921 when the special treatment of capital gains and losses first appeared in the tax law.

Noting that the last significant change in the taxation of capital gains occurred in 1969, he presents a series of "important controversial points" that should be taken into account before further changes are enacted.

Mr. Darrell concludes by supporting recent proposals that would restore a system similar to that between 1934 and 1938 when capital gains and losses were included in income in percentages descending after two years according to the holding period.

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demonstrated to be beneficial and in the public interest. And, in considering what is beneficial and in the public interest, we must examine carefully all the equity, economic and administrative considerations. This will not be a simple job, because frequently each of these considerations conflict. What has desirable equity effects does not always have desirable administrative or economic effects. As a result, we will have to arrive at our conclusions on particular provisions on the basis of the considerations involved."

80% of Preferences Involve Capital Gains

For illustrative purposes, let us consider the special treatment of capital gains and losses. For convenience, I refer here only to true capital gains and losses realized by the casual investor and not to the periphery areas to which capital gains treatment has been extended.

According to Treasury studies in 1972, capital gains involve a larger amount of minimum tax than all the other identified preferences combined; more than 80 percent of the preferences reported on minimum tax returns for 1970 represented the excluded half of net long-term capital gains and it was expected by the Treasury that this percentage would rise to more than 90 percent in 1971 and 1972.

Provision for special treatment of capital gains and losses first appeared in the Revenue Act of 1921. Under that Act, taxpayers were permitted to elect to pay a tax of 12½ percent, in lieu of the normal tax and surtax ranging up to 51 percent, on net gain derived from the sale or exchange of capital assets held for more than two years. The purpose was to stimulate profit taking and to give relief from bunching of income accrued over a period of years. Net losses from sales of such capital assets were treated as deductible as in the case of other losses. Except for limiting the treatment of net capital losses on capital assets held more than two years to a maximum credit of 12½ percent against tax on ordinary income, the 12½ percent maximum tax on net capital gains continued until changed by the 1934 Act.

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Investigation Brings Major Change in Law

Prior to the 1934 Revenue Act, the definition of capital assets excluded property held by the taxpayer primarily for sale in the course of his trade or business whether or not held as a dealer for sale to customers. The early Thirties were years of generally declining security prices, and consequently taxpayers who were carrying on business as traders or dealers in securities could take losses to offset their income from other sources. When Congress learned through testimony before the so-called Pecora Senate Investigation Committee that J. P. Morgan and his partners had paid no Federal income taxes in the early Thirties for this reason, it first provided a temporary and one-sided solution in the National Industrial Recovery Act of 1933 and thereafter, in the Revenue Act of 1934, it adopted an entirely new formula for the treatment of capital gains and losses.

In place of the alternative 12½ percent tax on net capital gains, it substituted a new formula, namely, that there should be taken into account in computing net income various percentages of capital gains and losses from the sale of capital assets running from 10 percent on assets held for not more than one year to 30 percent on assets held for more than ten years. Net capital losses were made deductible from ordinary income up to a maximum of $2,000; and the definition of capital assets was broadened but it excluded securities held primarily for sale to customers in the ordinary course of trade or business. These provisions of the 1934 Act were in general continued until the Revenue Act of 1938 when the 1934 Act system was abandoned in favor of the now familiar concept of long-term and short-term

gains and losses with net long-term capital gains subject to a tax ceiling.

In support of this change, the abandoned 1934 Act system was said, among other difficulties, to have had an inhibiting effect on the mobility of capital markets because of the tax incentive to individuals to defer realization of capital gains longer than they otherwise would. Although many changes technical and otherwise were subsequently made in the capital gain and loss area for equity or economic reasons and tightening up purposes, the basic 1938 Act system was continued until 1969 when the long-term capital gains tax ceiling of 25 percent, applicable to capital gains realized on securities held for more than six months, began to move up.

Maximum Tax Is 36-1/2%, And Sometimes Higher

Today the 25 percent ceiling has limited applicability and, as the result of the operation of the provisions governing the minimum tax on preferences, the maximum tax on large capital gains is 36½ percent and in some circumstances, by virtue of the provisions relating to tax on earned income, the effective tax rate could be much higher. Thus, while the maximum tax rate on ordinary income and especially earned income has decreased, the maximum tax on large capital gains has increased substantially.

During the 1972 political campaign, it was urged that our long standing capital gains tax system should now be abandoned and that money made by money should be taxed as ordinary income under a reduced rate schedule and a suitable averaging system. This, of course, is not a new suggestion; it has been made many times before.

The true nature of capital gains has long been debated, and respectable arguments can be made both for and against their full taxation. In considering the question, the following are among the important controversial points that should be taken into account.

One is: Who benefits from special capital gains treatment? It has generally been thought that capital gains are largely attributed to upper bracket taxpayers while middle and lower bracket taxpayers bear a disproportionate share of capital losses. However, recent Treasury studies indicate that from 1960 through 1970 50 percent of all capital gains was realized by persons with adjusted gross income of less than $50,000; and in 1970, a depressed year, 50 percent of all capital gains was realized by persons with adjusted gross income under $30,000. To the extent that reliance can be placed on adjusted gross income statistics that exclude tax exempt interest and one-half of realized long-term capital gains and that are arrived at after tax sheltering deductions, they indicate that any increase in capital gains taxation would fall nearly as heavily on "victims" of the present system as on the so-called "transgressors."

Another is: If all capital gains are to be taxed as ordinary income, should not capital losses in all equity again be deductible as ordinary losses? But would this not encourage early realization of losses and have an unacceptable effect on the predictability and certainty of income tax collections? Would it survive a Pecora-type investigation such as I mentioned earlier?

Inflationary Changes Affect Capital Gains

Another is: To what extent are capital gains attributable to inflationary factors, that is changes in price level? Are not capital gains illusory to that extent? Is not the inflationary shrinking value of the dollar normally of greater significance in the case of capital gains computed on dollar costs expended in earlier years than in the case of salaries, pensions and other ordinary income which have no bases but which may or may not have been contracted for in prior years? Of course not all capital gains are attributable to inflationary factors. Gains from increased real estate values resulting from population growth or nearby land development, gains from increased capital stock values resulting from successful marketing of new products or from increased earning power due to good management or strong market position and gains due to accumulated undistributed corporate earnings, are not to that extent attributable to price level changes. Yet gains from sales of private homes that usually occur after many years of continuing inflation are normally so attributable.

As to gains on corporate stock attributable to undistributed corporate earnings, there is a further question. What account, if any, should be taken of the element of double taxation involved in imposing corporate tax on accumulated earnings without

credit to the shareholders and another tax on the gains attributable to such earnings on sale of the stock? Actually, in the long run, only people bear the tax burden.

Still another important point to consider is: Would not ordinary taxation of all capital gains at high rates have a detrimental effect upon savings, investments, capital formation, economic growth and our country's position in world markets? In my judgment great weight should be given to these factors.

Somewhat related questions are these: To what extent is there continuing validity to the old conception followed in various countries, including Great Britain where the principal capital assets consisted of land usually entailed, that proceeds of sales of capital assets are capital and not income at all, and to what extent do taxpayers today in fact treat capital gains as capital and not expendable income?

Minimum Valuation Date Seen Needed

Finally, if the decision is to tax capital gains as ordinary income, would it not be unfair under the new rules to tax prior unrealized appreciation at the new high ordinary income tax rates on subsequent realization? In other words, should there not be a new minimum valuation date for purposes of the new system? This consideration would also apply to the proposal to tax unrealized appreciation at death, a proposal not considered here because of its close relationship to gift and estate taxation.

The foregoing controversial considerations among others, including particularly the magnitude of the proposed ordinary income tax rates, would have to be carefully weighed in arriving at a sound decision. If the decision is in favor of retaining capital gains taxation on a special basis as I believe it should and as most industrial countries that tax capital gains do, there remains the question whether the capital gains umbrella should continue to cover all the other areas to which present law extends it. I refer to such special provisions as those relating to timber and coal, qualified stock options, and the capital gains provision of Section 1231. While the recapture provisions of Sections 1245 and 1250 have done much to reduce the arbitrage between ordinary deductions and capital gains income, this entire area is deserving of thorough review.

Chairman Mills has suggested that perhaps a fair compromise solution should be to restore for capital gains and losses a system somewhat like that in force between 1934 and 1938 when capital gains and losses were included in income in percentages descending after two years according to the holding period. Professor Dan Throop Smith strongly favors such a system because among other things it gives greater recognition to the capital nature of gains from long-term holdings. Former Under Secretary Cohen has also referred to this as a matter for consideration. I myself am sympathetic to this, as I recall was the late Randolph Paul some years ago. Perhaps the considerations that influenced the abandonment of that system after so short an experience during the troubled 1930's would not prove so formidable in the 1970's.