DIARY

Book 83

Tax Revision Studies, 1937 - Volume III

Tax Revision Studies, 1937: Volume III

Capital Gains Tax

VOLUME III

TAX REVISION STUDIES, 1937

TAX TREATMENT OF CAPITAL GAINS AND LOSSES

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Summary

AUG 31 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - TAX TREATMENT OF CAPITAL GAINS AND LOSSES

SUMMARY

1. The subjection of income derived from capital gains to the progressive income taxes is justifiable on economic, equitable and practical grounds. From the standpoint of taxation, the kind of income that is relevant and significant is the income that measures taxpaying ability. Capital gains constitute real taxpaying ability no less than equivalent income derived from other sources.

2. The tax treatment of capital gains and losses in Great Britain, France and Germany provides no satisfactory model on which to build a system for the United States. In each country, the differentiation of taxable from non-taxable gains is by a process so arbitrary as to create severe inequities between taxpayers of substantially identical circumstances but with unimportant differences in the form of income received. Moreover, there is a strong inducement to taxpayers to convert taxable income into non-taxable gains, thus making tax considerations an extremely important influence on investment activities and policies.

3. The tax treatment of capital gains and losses of individuals in the United States has ranged from the complete inclusion of capital gains and losses in the tax base in the years 1916-1921, to the present treatment which includes in taxable income certain percentages of capital gains and losses (subject to limitation) which vary with the years assets have been held. From 1922 to 1933, the taxpayer was allowed, at his option, to segregate from his ordinary income the gains from assets held more than two years, and subject them to a 12½ percent flat rate. Losses from assets held more than two years could likewise be segregated, except for 1922 and 1923, and allowed a tax credit of 12½ percent subject to certain limitations. Gains and losses from assets held two years or less were included in ordinary income.

4. The existing tax treatment of individuals is inequitable as respects both gains and losses. It is not intolerable as respects

capital gains, however, and in this respect is greatly superior to the treatment that it displaced. The limitation on capital losses, however, is so unjust as to be indefensible.

Capital gains are now given decidedly preferential tax treatment as compared with other sources of individual income. Wealthy individuals, especially, are offered an extremely strong tax inducement to make their new investments in such manner as will permit their returns therefrom to take the form of capital gains.

The chief effect of the present system on the securities markets arises through the influence on timing. At the option of the taxpayer, income taxes on capital gains may be postponed by delaying the formal realization of gains, reduced by deferring formal realization until one or more of the four "step-down" intervals provided in the law has elapsed, and completely avoided by foregoing formal realization, leaving such realization to be accomplished by the taxpayer's heirs.

5. Although the influence of tax considerations is real, their effects upon the movements and volume of activity of the securities markets are far less substantial than is often contended. The bulk of capital assets is relatively insensitive to the character of our capital gains taxation. This is true of the part held quasi-permanently for purposes of control and income. It is also true of the part employed in the short-term operations of traders and speculators, operations which normally account for a large fraction of the total trading in listed securities. For intermediate-term speculators and investors, tax considerations necessarily operate among a welter of other factors which usually provide stronger incentives to action.

The available statistical evidence, though by no means conclusive, does not support the contention that the tax treatment of capital gains since 1922 has been of more than modest influence upon the level and activity of the securities markets. The underlying business situation and the related speculative temper of the times are primarily responsible for stock market booms and collapses.

6. The capital gains and losses of corporations have not created tax problems in any way similar to those of individuals. Special treatment was not needed as long as there was a relatively low flat corporation income tax; and the enactment of graduated rates beginning in 1936 created no practical problem, because the range of graduation is relatively narrow.

Imposition of the surtax on undistributed profits has raised a new problem for corporations with respect to the tax treatment of capital gains and losses. If the capital gains of good years must be paid out currently to avoid surtax liability, but no carry-forward of the capital losses of bad years is allowed, the tendency over a period of years will be to shrink the value of capital assets. The most practicable method of minimizing or eliminating this tendency appears to be that of allowing net capital losses in full as a deduction in computing adjusted net income, with a carry-forward for two years of any excess losses.

7. It is recommended that capital gains and losses of individuals be subjected to tax treatment on the basis of what may be called the average accrual method. According to this method the amounts of gain and loss realized are averaged separately over the number of years the assets were held, and taxed at rates determined on such average amounts when added to ordinary income. The increment of tax resulting on the average gain and tax credit on the average loss are multiplied by the average number of years respectively the assets were held, and the combined products represent the tax on capital gains. The objective of the plan is to recognize more adequately the fact that the realized gains and losses frequently accrue over several years.

In more detail the procedure under this method is as follows:

a. Capital gains are segregated from capital losses. The average investment period for gains and the average annual gain during this period are determined; and the average investment period for losses and the average annual loss during this period are determined.

b. The average annual gain and the average annual loss are combined to determine a net average gain or loss applicable to the shorter of the two investment periods. The tax or tax credit on the resulting figure is computed with reference to the surtax net income, and this tax or tax credit is multiplied by the number of years in the shorter average investment period to determine the tax or tax credit on capital gains and losses during this period.

c. The tax or tax credit on the average annual gain or the average annual loss, whichever accrued for the longer average investment period, is computed with reference to the surtax net income, and multiplied by the number of years by which the longer average investment period exceeds the shorter, to determine the tax or tax credit applicable to those years.

d. The taxes or tax credits thus obtained are combined, the result representing the total tax or tax credits on capital gains and losses. Any unused tax credit is carried forward for two years, to be allowed only as an offset against tax liability on capital gains realized in those years.

e. In computing the tax, no allowance is given for any portions of the personal exemption, credit for dependents, or minimum earned income credit not utilized in computing the ordinary income tax. If there is no surtax net income, the tax or tax credit is computed, assuming surtax net income to be zero rather than a negative quantity.

If legally feasible, contributions to charitable and similar institutions should be regarded as occasioning the realization of capital gains and losses by their donor; and such capital gains and losses should be included with other capital gains and losses for tax purposes. If this is not feasible, it is recommended, for purpose of determining the deduction for charitable contributions, that the value of such contributions in kind be fixed at the adjusted basis (Section 113) or market, whichever is lower.

If legally feasible, transfers by inter vivos gifts should be regarded as occasioning the realization of capital gains and losses by the donor. If this proposal is not deemed feasible, it is suggested that a supplementary gift tax be levied, measured by the capital gains and losses incorporated in such transfers. In the event that this should also be unacceptable, it is recommended that, for the purpose of determining both capital gains and losses, the basis for property acquired by gift be made either the base in the hands of the donor or market value at time of transfer, whichever is lower.

It is recommended that the capital gains and losses of corporations be included in ordinary income in full, except that for purposes of determining the normal-tax net income, capital losses be allowed only to the extent of capital gains. Any excess of capital losses not allowed in the current year in determining normal-tax net income is carried forward for two years to be credited against the capital gains of those years. In determining adjusted net income capital losses are allowed in full against income from any sources. Any excess of capital losses not so utilized is carried forward for two years for use as a deduction in determining adjusted net income of those years.

8. Next to the recommended average accrual plan, the most superior alternative would be a continuation of the present five-step system with an improved scale of percentages designed to approximate more closely the resulting taxes to taxes applicable to other sources of income; and with a liberalization of the present loss limitations.

All of the other alternative tax treatments of the capital gains and losses of individuals possess weaknesses which make their adoption unwise.

The undistributed profits tax will tend to diminish one important source of capital gains, but will leave a number of other sources unaffected. Hence it does not obviate the justification for the tax on capital gains.

Economic
Justification

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE AUG 11 1937

TO Mr. Magill

FROM Mr. Haas

Subject: TAX REVISION STUDIES, 1937 - TAX TREATMENT OF CAPITAL GAINS AND LOSSES

I. ECONOMIC JUSTIFICATION FOR TAXING CAPITAL GAINS

Economists differ in their concepts of income; and such differences are valid and inevitable, in many cases, when the concept is employed for different purposes. From the standpoint of taxation, the kind of income that is relevant and significant is the income that measures tax-paying ability. This kind of income is not necessarily synonymous with any of the numerous concepts of income commonly used by economists. The law properly regards a gambler's income, for example, as taxpaying ability despite the fact that his income does not represent a net addition to the collective social income. In the same way, capital gains constitute real tax-paying ability to the recipient no less than equivalent income derived from other sources.

Professor Irving Fisher questions this view on the ground that capital gains do not conform to two tests which he has set up to determine what constitutes income; namely, (1) it must be susceptible to capitalization; and (2) it must yield psychic income (in Professor Fisher's view, psychic income results only from spending). It cannot be denied that capital gains do not represent income if one accepts these tests. Professor Haig's definition of income as ".....the money value of the net accretion to one's economic power between two points of time" 1/ provides a very different test which seems more appropriate for tax purposes.

Whether such taxation results in a diminution in the country's capital resources depends upon the uses made by the Government of the revenues so derived, and upon the indirect effects of such uses. If these revenues are employed for debt retirement, or for the construction of public works, or in ways that indirectly stimulate capital investment, no reduction in the country's capital resources results.

Further, the fact of the matter is that the great bulk of capital gains realized in the United States is realized in connection with transactions entered into for profit. This is true not only of gains realized by individuals and enterprises that make a primary business of trafficking in capital assets, but it is also true of a large proportion of casual gains realized by individuals whose primary income is derived from other sources. The sale of houses and farms which had previously been occupied

1/ The Concept of Income in the Federal Income Tax, 1921, page 7.

or operated by their owners occasions many individual realizations of capital gains; but the great mass of even casual gains is derived from the sale of corporate securities, unimproved real estate, business properties, and other assets which had been acquired with a view to profitable investment.

Finally, it is important to emphasize that there is no clean separation, in practice, between capital gains and ordinary income; and that the complete exemption of capital gains from income taxes might well stimulate the conversion of other types of income into the form of capital gains. Second mortgages, land contracts, et cetera, are frequently sold at substantial discounts. From a legal standpoint, the difference between the principal amount and the purchase price is regarded as a capital gain; but from an economic standpoint the discount is merely the means whereby the effective annual yield of the instrument is raised from, say, 6 percent to 12 or 15 percent. A bond purchased at a premium results in a capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain. Yet it is the everyday practice in investment circles to quote both these types of bonds in terms of their effective yields to maturity or call date. The sale of almost any capital asset on the installment plan can be so arranged as to convert a large part of the interest income into the form of a capital gain merely by reducing the nominal rate of interest and raising the principal price by a compensatory amount.

To some extent, at least, capital gains frequently reflect increases in the general price level rather than real increases in taxpaying ability. It has been suggested that a corrective factor for this may be obtained through the use of an index of prices in determining the volume of capital gains subject to taxation.

The wisdom and practicability of attempting to go behind pecuniary income for this purpose are extremely dubious. An adequate attempt to do so would involve innumerable complexities. The same rising price levels that may be responsible for some capital gains will also reduce the real purchasing power and wealth of individuals whose pecuniary incomes are derived from bonds, mortgages, leases, and other fixed contracts; and such individuals should properly be allowed deductions against their taxable incomes if fair allowance were to be made for changing price levels. Wages, profits, rents, and interest rates also tend to increase, but in uneven degree, during periods of rising price levels. Part of the capital gains realized by common stockholders and direct proprietors of tangible property during such periods are obtained at the expense of their creditors, whose monetary claims are fixed.

The adjustments that could feasibly be made in our tax structure to accommodate the diverse results of changes in the purchasing power of money would inevitably be arbitrary, inadequate, and inequitable. The proper place to attack the problem of monetary instability is on its own ground.

Foreign
Methods

II. FOREIGN METHODS OF TAXING CAPITAL GAINS 1/

A. Great Britain

The British formula for the taxation of capital gains is as follows: Capital gains and losses on assets are not included in the computation of net income except when the taxpayer makes transactions in such assets his trade or business. Annual profits, in the sense that such profits are likely to recur annually, are taxable; 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 non-taxable.

The inherent difficulty in this formula lies in the impossibility of arriving at a satisfactory definition of annual profits or gains. There is no simple test. The number of transactions consummated is not a reliable guide. A reading of British cases shows that the line dividing taxable and non-taxable profits or gains is thin, wavering and arbitrary. As a consequence, it must be expected that considerable inequity as between individuals in substantially similar circumstances will result.

A severe indictment of the British formula was made in 1920 by the latest Royal Commission to consider broad questions of income tax policy. The report of the Commission deplored the narrow scope of the existing charge and strongly recommended that the limitation of the taxability of capital gains to "annual" profits be removed. A definite recommendation was made that any profit on a "transaction in which the subject matter was acquired with a view to profit seeking" be taxed. British economists, officials and business men do not defend their formula on the grounds of economic principle or of equity. There is general acceptance of the Royal Commission's criticism. Defense of the formula consists, first, of an argument against change per se, and secondly, of an argument in favor of administrative simplicity. The British are not satisfied with their formula and they certainly do not regard it as a model for others to adopt.

The British formula tends to encourage various types of artificial transactions to transform taxable income into exempt profits. One way of accomplishing this end is to buy stocks for the rise and not for the dividends, inasmuch as casual transactions in stocks are exempt; whereas dividends are taxable. Secondly, a taxpayer

1/ This section is adapted from a series of articles by Robert Murray Haig in the Wall Street Journal, March and April, 1937.

may purchase bonds bearing a relatively low interest rate at a discount and sell such bonds at or near par just before maturity. The profit so made would not be taxable even though such profit merely represents interest in another form. In the third place, despite an effort to plug this loophole in the Finance Act of 1927, a taxpayer may sell stock "cum dividend" and buy it back "ex dividend". Such a transaction would result in a non-taxable gain in place of the receipt of taxable dividends. A fourth method utilized by British taxpayers to avoid the income tax on ordinary income has been the transfer of assets to a foreign corporation organized for the purpose, in order to convert taxable interest and dividends into non-taxable capital gains. Attention was given to this loophole in the Finance Act of 1936, but the effectiveness of the provision adopted to eliminate it is impaired by the necessity of proving the intent of the taxpayer to avoid taxes.

B. France

The French formula is in general similar to the British. In the case of strictly business enterprises, the net profit from the transfer of any kind of asset, whether in course or upon the termination of the undertaking, is included in the tax base. In the case of other taxpayers, gains from capital transactions are taxable if the activity giving rise to such gains is "habitual". Gains from casual capital transactions made by business enterprises are taxable, but gains from casual transactions made by other taxpayers are not taxable.

A narrow technical definition given the term "taxable speculator" aids the escape from taxation. Business enterprises escape the tax placed upon their gains from casual capital transactions by carrying through the transaction in the name of a third person, such third person acting in his capacity as an individual. French tax administration is lax, there being no serious risk that a corporation so evading the tax will be brought to account.

The French formula, like the British, runs an arbitrary line between taxable and non-taxable capital gains. The French do not resort to widespread use of devices designed to transform taxable income into non-taxable gains, largely because easier methods of avoiding the income tax are available to the French taxpayer. Two favorite methods of avoiding the tax are either to purchase bearer type securities in preference to the registered type when buying in a French market, or to trade in foreign markets. The Government has no adequate check on either bearer type securities or foreign market transactions. The taxpayer merely forgets to disclose such transactions. The chance that he will be discovered in his iniquity is negligible. Evasion is so easy, in fact, that no present use need be made of loopholes in the capital gains formula. The loopholes are present to be used at any time the tax administrators close presently utilized avenues of escape.

C. Germany

The German formula for the treatment of capital gains under the income tax includes gains on all transactions made by business concerns (whether or not incorporated) and also includes gains from speculative transactions made by taxpayers other than business concerns. Gains from investment made by taxpayers other than business concerns are exempt. An arbitrary time test is used to determine whether a given transaction is a speculation or an investment. The present law arbitrarily sets the dividing line between speculation and investment at two years for real estate transactions and one year for transactions in stocks; transactions in bonds are not considered to be speculation.

Under the German formula as it now stands, there are substantial tax-free areas to which taxpayers are tempted to gain access. To avoid taxation, the fruits of a transaction must first avoid inclusion in the accounts of a business enterprise. Secondly, the transaction must avoid classification as a speculation. The line separating speculation from investment is clear and definite but arbitrary to a high degree.

The present formula generates four working tendencies: (1) A tendency to favor transactions in bonds; (2) A tendency to favor long-term rather than short-term stock transactions; (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.

The formula offers a reward to the taxpayer who transforms taxable income into non-taxable capital gains. Stocks heavy with dividends can be sold "cum" and bought back "ex" with advantage, provided the security has been held a year or more. There is also an inducement to invest in stocks likely to appreciate in market value rather than in big dividend stocks.

The German formula automatically generates irresistible incentives to avoid and evade the tax. The time test as to investment versus speculation causes market transactions to be carried through at "unnatural" times; and the evasion and avoidance devices involve "unnatural" transactions and thereby create abnormal market conditions.

Historical
Background

III. HISTORICAL SUMMARY OF OUR TREATMENT OF CAPITAL GAINS

From the enactment of the 1913 income tax law until 1921, capital gains realized by individuals, irrespective of the period held, were treated like any other source of income and subjected to the full normal and surtax rates in the year of realization.

Partly in order to eliminate the disproportionately high taxes on gains from long-held assets, but mainly because of a belief that high tax rates on capital gains were obstructing normal transactions in capital assets, Congress drastically altered the tax treatment of capital gains in the Revenue Act of 1921. It was provided that gains from assets held for two years or less must continue to be included in ordinary income in full; but, at the election of the taxpayer, "capital net gains," from the sale of assets held for more than two years, could be segregated from other income and subjected to a tax of 12½ percent in lieu of normal and surtaxes; provided, if such election were made, the total tax, including the tax on capital net gains, could in no case be less than 12½ percent of the total net income. The latter restriction was dropped in 1924; but in other respects this treatment of capital gains was continued unchanged through the Revenue Act of 1932.

The substantial increases in individual income-tax rates that were effected by the Revenue Act of 1932 greatly accentuated the disparity in the tax treatment of capital gains as compared with income derived from other sources. This disparity was substantially reduced by the adoption in the Revenue Act of 1934 of the prevailing plan whereunder the income derived from capital gains is subjected to the ordinary income-tax schedule, but the proportion of capital gains made taxable varies inversely — though somewhat arbitrarily — with the number of years during which the asset is held.

The capital losses of individuals have received varying treatment in the several revenue acts. No allowance whatever was made for capital losses in the Revenue Act of 1913, and in the Acts of 1916 and 1917, they were allowed only to the extent of capital gains. The 1918 Act provided full allowance for capital losses against income of any kind.

In the 1921 Act the distinction between assets held two years or less and assets held more than two years was first introduced. Losses on assets held two years or less were allowed in full against other income but not against capital net gains; losses on assets held more than two years were allowed in full against income of any kind. In the Revenue Act of 1924, the limitation upon losses on assets held two years or less was removed so that such losses were allowed against income of any kind; with respect to the losses on assets held more than two years, the taxpayer was granted the option of segregating such losses from ordinary net income and taking a tax credit of 12½ percent of the capital net loss, provided that the total tax could not be less than that derived by treating the capital net loss as a deduction from ordinary net income. This treatment remained in force through the Revenue Act of 1932, which added a limitation restricting the allowance of losses from sales or exchanges from stocks or bonds held two years or less to gains from such sales. Under the Revenue Act of 1934, the percentages for the step-down system were applicable to losses in the same manner as to gains, with the limitation that losses so determined could not be included for purposes of determining net income except to the amount of the included capital gains plus $2,000.

The capital gains of corporations throughout the period 1913 to date have consistently been treated in the same way as other sources of corporate income. Special treatment was not needed as long as there was a relatively low flat corporation income tax; and the enactment of graduated rates beginning in 1936 has created no practical problems, because the range of graduation is relatively narrow. The imposition of the surtax on undistributed profits has, however, created new problems.

The tax treatment of capital gains and losses, for both individuals and corporations, during the period 1913 to date is detailed in the following summary, to which there is appended an analysis of the historical treatment respecting the carry-forward of capital losses:

Individuals

Historical Summary of Tax Treatment of Capital Gains and Losses, 1913-1936, inclusive

Part I. Individuals

Revenue Act	Income year	Treatment of: Gains from sale or exchange of assets	Losses from sale or exchange of assets
1913	Mar. 1, 1913 to Dec. 31, 1915	Included with other income subject to full normal and surtax rates	Not allowed
1916	1916	do	Allowed only to the extent of the gains from such sales
1917	1917	do	do
1918	1918-1921	do	Allowed in full against income of any kind
1921	1922, 1923	Assets held 2 years or less	
		Included with other income subject to full normal and surtax rates	Allowed in full against other income, but not against capital net gains.
		Assets held over 2 years	
		At the election of the taxpayer, capital net gains were taxable at 12½ percent in lieu of the normal and surtax rates, but if such election were made the total tax, including the tax on capital net gains, could in no case be less than 12½ percent of the total net income	Allowed in full against income of any kind

Part I. Individuals (Continued)

Revenue Act	Income year	Treatment of: Gains from sale or exchange of assets	Losses from sale or exchange of assets
1924	1924	Assets held 2 years or less	
		Same as 1921 Act	Allowed in full against income of any kind
		Assets held over 2 years	
		At the election of the taxpayer, capital net gains were taxable at 12½ percent in lieu of the normal and surtax rates	Could be segregated from ordinary net income, and a tax credit of 12½ percent of the capital net loss taken, but in no case could the tax be less than the tax (computed at normal and surtax rates) would be if the capital net loss were deducted from ordinary net income
1926	1926-1927	Same as 1924 Act	Same as 1924 Act
1928	1928-1931	do	do
1932	1932	Assets held 2 years or less	
		Same as 1924 Act	Losses from sales or exchanges of stocks 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 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 income of any kind

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

Part I. Individuals (Continued)

Revenue Act	Income Year	Treatment of: Gains from sale or exchange of assets	Losses from sale or exchange of assets
1932 (Continued)		Assets held over 2 years	
		Same as 1924 Act	Same as 1924 Act
N.I.R.A.	1933	Assets held 2 years or less	
		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 2 years	
		Same as 1924 Act	Same as 1924 Act
1934-1936	1934	Percentages of gains or losses recognized	

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 capital gains plus $2,000

Corporations

Part II. Corporations

Revenue Act	Income year	Treatment of: Gains from sale or exchange of assets	Treatment of: Losses from sale or exchange of assets
1913-1928	1913-1931	Included with other income subject to full rate	Allowed in full against income of any kind
1932	1932	do	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 income of any kind
I.R.A.	1933	do	Losses from sales or exchanges of stocks and bonds held 2 years or less were limited to the gains from such sales Other losses were allowed in full against income of any kind
1934-1936	1934-	do	Allowed only to 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 two years or less was repealed by the National Industrial Recovery Act before it became effective.

General note relating to the carry-forward of capital losses

Capital losses from sale or exchange of assets could not in general be carried forward to succeeding years under any of the Revenue Acts of 1913 to 1918.

Under the Revenue Act of 1918, however, capital losses on plant, buildings, machinery, etc., acquired by the taxpayer on or after April 6, 1917, and used in the production of articles contributing to the prosecution of the war entered into the computation of "net losses" 1/. The "net loss" provisions of this Act related only to "net losses" sustained in the period beginning after October 31, 1918, and ending prior to January 1, 1920. The 1918 law permitted the application of the "net loss", first against income of the preceding taxable year (involving a redetermination of the preceding year's tax and a refund or credit) and the application against the following year's income of any excess of "net loss" over income of the preceding year.

Beginning with the Revenue Act of 1921, the application of "net losses" to succeeding periods became a regular feature of our income tax laws until the practice was discontinued by the National Industrial Recovery Act of 1933. Capital losses (subject to somewhat different limitations for individuals and corporations) entered into the computation of such "net losses" and were carried forward for varying periods as follows:

Revenue Act	Number of years that "net losses" were carried forward	Extent that capital losses entered into the computation of "net loss": For individuals	Extent that capital losses entered into the computation of "net loss": For corporations
1921	2	Included, if capital assets are used in the conduct of trade or business regularly carried on by the taxpayer.	
1924-1928 2/	2	Losses on assets held 2 years or less: Included.	Included.
		Losses on assets held over 2 years: Included only to the extent of the capital gains.	Included.
1932 2/	1	Losses on assets held 2 years or less: Included, except that losses from sales or exchanges of stocks and bonds were limited to gains from such sales. It was provided, however, that 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. 3/	
		Losses on assets held over 2 years: Same as 1924-1928 acts.	
1934-1936	None	- -	

1/ "Net loss" (subject to certain exceptions and limitations) means the excess of the deductions allowed over the gross income.
2/ The deduction for "net losses" carried forward by taxpayers other than corporations applied first as a deduction in computing ordinary net income excluding capital net gains and any excess over ordinary net income in each year of the carry-forward period applied to the reduction of the capital net gains, if any.
3/ The provision relating to the carry-forward of disallowed losses from sales or exchanges of stocks and bonds held two years or less was repealed by the National Recovery Act before it became effective.

Present Tax
Treatment

IV. CRITICAL ANALYSIS OF PRESENT TAX TREATMENT OF CAPITAL GAINS AND LOSSES OF INDIVIDUALS

If income taxes applicable to individuals were levied at a single uniform proportional rate, and if the rate remained unchanged, the fact that gains realized in a single year may represent those that had accrued over a long period of years would create no problem. The aggregate taxes paid by a taxpayer on a given amount of gain would be the same whether portions of that gain were realized each year, or whether the whole gain was realized in a lump sum in a single year.

Under a system of graduated progressive rates, however, the realization in a single year of gains that had accrued over five or ten years subjects such gains to higher taxes than are applicable to sources of income realized during the years of accrual.

The present tax treatment accorded the capital gains and losses of individuals was designed primarily to solve this problem, by including in taxable income capital gains and (subject to the limitation) losses to the extent of certain percentages which vary with the length of time assets are held. The percentages are as follows:

Years asset held	Percentage of gain or loss included in income
1 or less	100
1+ to 2	80
2+ to 5	60
5+ to 10	40
Over 10	30

A. Equity with Respect to Gains

Arbitrary though the present system may be in many respects, it constitutes an improvement over the previous system in two important respects. In the first place, the taxation of capital gains is not divorced from the progressive individual income tax schedule. Secondly, all classes of income taxpayers enjoy favored treatment of their capital gains, and not only the upper income classes, as formerly.

To measure the degree to which the present treatment conforms to the requirements of equity, some standard must be agreed upon. Ideally such a standard might be found in the aggregate taxes that would have been payable if the realized capital gain had been reported in segments, year by year, as it in fact accrued, and subjected to the tax rates then in force. The tax under this standard would vary with fluctuations in the individual's ordinary income, with changes in the tax rates, and with changes in the annual amounts of appreciation in value. The practical difficulties of applying such a standard appear to be insuperable, for the present at least.

A more practicable approach to a standard of equity may be made by assuming that an average amount of capital gains had been realized evenly over the number of years during which the asset was held; that the individual's other income remained constant; and that the current tax rates were in force throughout the period. A fair tax on a realized capital gain under this standard would be determined by dividing the capital gain by the number of years during which the asset had been held, adding the average amount to the individual's other income in the year of realization, determining the tax applicable to this average amount, and multiplying this tax by the number of years during which the asset had been held.

Judged by this standard -- which may be called the "accrual basis" --, capital gains are now subjected to decidedly preferential treatment as compared with other forms of income. Concrete measures of the extent to which the taxes now imposed upon capital gains are less than those that would be imposed by the standard just described are presented for selected cases in Table I. (For tables, see Appendix A.) It will be observed that the present taxes range from 20 percent to 70 percent lower in these selected cases than the taxes which would be payable under the standard described.

If the effect of the present tax treatment of capital gains were merely confined to a uniform preferential treatment of this type of income, this could conceivably be justified on grounds of practical expediency, and on the further ground, perhaps, that our treatment of capital losses is unduly harsh. The fact of the matter, however, as is illustrated in the table, is that the present treatment, while decidedly preferential to capital gains in practically all cases, is whimsical in its effects; and its general tendency is to give disproportionate tax preference to individuals with large incomes.

The difficulty does not lie primarily in the specific step-down percentages contained in the present law. The fact of the matter is that it is inherently impossible, under a progressive rate system, to design any series of step-downs in the proportions of taxable capital gains which would yield results entirely consistent with the standard described above.

B. Inequity with respect to losses.

Capital losses, after application of the statutory percentages, are deductible only to the extent of $2,000 plus taxable capital gains, with no carry-forward of losses.

This treatment of capital losses is inequitable. In the first place, the limitation means that no consideration whatever is given excess losses in the current year. Thus, a taxpayer may be required to pay an income tax on ordinary income in spite of the fact that he has excess capital losses to an extent sufficient to more than offset his ordinary income. In the second place, the taxpayer is not allowed to carry forward capital losses against future capital gains. The widespread sense of injustice flowing out of this treatment impairs cooperation between taxpayers and the Government in the administration of the income tax. In the minds of many, the present treatment is so patently unjust as to be repugnant to all sense of fair play.

C. Encouragement of capital gains as source of income.

One of the most important criticisms levied against the present tax treatment of capital gains has been that wealthy individuals are discouraged from embarking their capital upon new enterprises. Large-scale ventures into new fields cannot commonly look to public financing to provide their capital requirements. Most such ventures require one or more men of large means who are willing to take the risks involved. What we may term the "enterprise capital" provided by such individuals performs a highly useful economic and social service; and it is precisely such individuals who are best fitted to assume the necessary risks. But 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, it is contended, removes much of the incentive for "enterprise capital".

Now the most striking characteristic of our tax treatment of capital gains, in conjunction with the schedule of individual income tax rates, is that an extremely strong inducement is offered to wealthy individuals to make their new investments precisely in such manner as will cause their returns to take the form of capital gains. This may best be made clear by concrete examples.

Assume an individual with other surtax income of $200,000 who has $1,000,000 to invest. If he can find an investment which, over a period of 10 years, will return him a capital gain averaging only 5 percent per annum, compounded annually, he would discover upon calculation that his net return, after taxes, would be equivalent to a 12.8 percent annual yield on an ordinary income-producing investment. He would find that over a period of 5 years he would need to obtain an annual yield of 11.5 percent from an ordinary income-producing investment to equal the net return, after taxes, that he might obtain through a capital gain averaging only 5 percent per annum. Even on an investment for only 1 year (1 day should be added to each of these periods), a 5 percent capital gain would give him just as large a return after taxes as a 7.1 percent yield in interest, dividends, rents or royalties.

Similarly, a capital gain averaging 10 percent per annum, compounded annually, would give him the equivalent, after taxes, of annual yields of fully taxable income of 27.7 percent, 24.6 percent and 14.5 percent respectively, according as he held the capital gain investment for just over 10, 5, or 1 years.

He would need a capital gain averaging only 1.5 percent per annum, compounded annually, over a period of 10 years, to obtain the same net income, after taxes, that he would derive from a 3½ percent bond; and even over a period of only 1 year and a day, a capital gain of 2½ percent would equal his net yield after taxes from a 3½ percent bond; etc.

These and other examples illustrating the preferential tax treatment now accorded income obtained in the form of capital gains, as compared with other forms of income, are presented in greater detail in Tables II, III, IV, and V. The clear conclusion of these considerations is that well-informed wealthy men possess a very powerful incentive under present law to take a large proportion of their total income in the form of capital gains.

D. Effect on tax-exempt investment.

There is no doubt that capital gains taxes, like any taxes on investment income, increase the relative attractiveness, other things being equal, of tax-exempt investments. But the fact is that capital gains themselves constitute, in effect, a partially tax-exempt type of income under present law. Exemption from income taxes is of greatest value, of course, to individuals subject to the highest surtaxes. An individual with $200,000 of other surtax net income need obtain a capital gain averaging only 3.7 percent per annum, compounded annually over a ten-year period, on a new investment of $1,000,000, to obtain the same net yield after taxes that he could obtain from a 3 percent wholly tax-exempt bond; and a capital gain averaging only 5 percent per annum would give him a net tax-free income averaging 4.1 percent per annum. (See Tables II, III, IV, and V.)

E. Variability in Revenue

The inclusion of capital gains and losses for purposes of determining the income tax base accentuates the instability of income tax revenues. This is true of the present and past treatment, and doubtless would be true under any of the hitherto untried plans. The fact that capital gains constitute an erratic source of income is not sufficient reason for affording them preferential tax status. It would be a mistake to design the character of capital gains taxation with stability of revenue as the primary objective. Stability of income tax revenues, if it be at all attainable, must be reached by stabilizing our entire economy, or by a system of averaging the tax base. It cannot be reached, whether capital gains are included or excluded in the income tax base, under a system of progressive income tax rates in an economy that is characterized by severe business depressions.

In such an economy, the desirability of stable Federal revenues is extremely doubtful. There are broad economic grounds for the position that, within limits, fluctuations in Federal revenues in response to fluctuations in business conditions are highly desirable. Federal Government finance is capable of providing one of the most important elements of flexibility in the economic structure. In periods of depression, when bank credit has been or is being contracted and other avenues of investment are temporarily unattractive to those with idle funds, an excess of Government expenditures over tax receipts, financed by debt instruments, serves the important function, among others, of moderating the decline in the Nation's purchasing power, and an excess of tax receipts over ordinary expenditures in prosperous times is capable of moderating booms.

F. Effect on Securities Markets 1/

There are three chief respects in which our present capital gains tax provisions may be said to influence the timing of capital transactions:

(1) Income taxes on capital gains may be postponed, at the option of the taxpayer, by delaying the formal realization of such gains.

1/ For a general discussion of the effects of capital gains taxation on securities markets, see Section V.

(2) Income taxes on capital gains may be reduced, at the option of the taxpayer, by deferring formal realization until one or more of the four "step-down" intervals provided in the law has elapsed.

(3) Income taxes on capital gains may be completely avoided, at the option of the taxpayer, by foregoing formal realization during his lifetime, leaving such realization to be accomplished by his heirs.

In analyzing the effects of these influences upon the decisions of the investors, it is important to bear in mind that though real, they are modifying rather than primary influences; and that they operate among a myriad of other forces.

1. Postponement of Tax Liability

There can be little doubt that the mere fact that an individual may definitely postpone or avoid liability for additional income taxes by refraining from consummating a capital transaction, constitutes in itself a motive to so refrain. Capital gains taxes of the present character may be regarded, from this point of view, as a species of substantial transfer tax. Like brokerage commissions and stamp taxes, but far more heavily, in many cases, they interpose a cost, and therefore an obstacle, against the sale of capital assets.

Further, the proceeds of most sales of capital assets are converted into new investments. Most investors must face the consideration, therefore, that the superiority of their contemplated substitute investments is yet to be proved, whereas the additional tax liability arising out of the sale of the old investments is certain. A new investment must not only be more attractive than the old, but sufficiently more attractive, in addition, to offset the capital gains tax which the transfer will entail. The policies of trustees and managers of estates are sometimes decisively influenced by these considerations. Because these factors are hard to weigh, many investors are apt to place an irrationally heavy weight upon the tax factor.

The psychological obstacle to the realization of large capital gains by investors with substantial taxable incomes may easily be illustrated:

In 1933, an investor purchased 2,000 shares of Phelps-Dodge common stock at $10 a share. When the stock reached $58 a share in 1937, the owner concluded that it was time to sell, particularly in view of his belief that copper prices and perhaps business generally were due to decline. Before selling, the investor computed his prospective taxes. He estimated that his surtax net income from other sources would be $50,000. The sale of his Phelps-Dodge stock would give him $96,000 of profit, of which 60 percent, or $57,600, would be subject to income tax. His normal and surtaxes on the taxable portion of his Phelps-Dodge profit would amount to $29,012, equal to about 14½ points in the price of the stock. The market price of his Phelps-Dodge stock could decline by 25 percent without the decline quite equaling the amount of tax he would have to pay if he sold before the decline. If he contemplated the purchase of a different stock with the proceeds of his sale, he would have to take account of the fact that after allowing for his tax he would have available only 75 percent of these proceeds for the substitute investment. Though persuasive to some investors, these grounds for delaying liquidation are not altogether sound, as is brought out in Section V. (Page 24)

Likewise, the existing or any other restrictions on the deductibility of losses on capital transactions influence the timing of the latter. On the one hand, the existing law, by limiting the deductibility of capital losses to the amount of taxable capital gains plus $2,000, provides a definite incentive to concentrate the realization of losses in years when capital gains are large and to defer the realization of capital losses in years when capital gains and other income are small. On the other hand, by applying the step-down schedule to the amount of capital losses deductible, the present law encourages an early realization of losses. In practice, these conflicting tendencies are further complicated by the fact that the very business and market conditions that favor the possibility of realizing large capital gains reduce the possibility of realizing large capital losses, and vice versa.

2. Reduction in Tax Liability through Postponement of Realization

The existence of tax differentials based upon definite time intervals should logically influence the timing of many capital transactions. Particularly where the gains are large, and subject to high surtax rates, the privilege of avoiding taxes on 20 to 70 percent of such gains by postponing legal realization for one to ten years may naturally be expected to provide a powerful inducement for such postponement.

The degree of this inducement is closely dependent upon the surtax bracket in which additional income will fall. An individual with a surtax net income of $10,000, who has an unrealized capital gain of $2,000 on a stock held for just over two years, would be subject to an additional income tax of $132 if he realized his gain immediately, and could look forward to a tax saving of only $44 if he delayed realization for an additional three years. An individual with a surtax net income of $100,000, with the same unrealized capital gain, would be liable to an additional tax of $744 if he sold the stock immediately, but could save $248 in taxes by delaying liquidation for an additional three years.

Some investors may also be influenced by the consideration that postponement of realization of capital gains until after the close of a taxable year gives them, in effect, a free loan, for an additional year of an amount equal to the taxes that would have been payable on the capital gains if realized; and that this allows them to maintain a larger position in the market.

3. Complete Avoidance of Capital Gains Taxes

Capital gains taxes may be avoided completely if realization of gains is not made during an individual's lifetime and the assets incorporating gains are bequeathed to his heirs.

Any individual well past middle life who possesses securities or other properties acquired at costs substantially below the prices that he might currently realize thereon, is thereby provided with a distinct and powerful incentive to refrain from selling them. If he does sell them, he will be subject to income taxes on at least 30 percent of all the capital gains that he realizes, unless he has suffered offsetting losses. If he does not sell them, he and his heirs escape tax liability on such gains forever.

In addition, the ability to make gifts directly, or indirectly through trusts, as well as charitable contributions, in the form of assets incorporating capital gains, likewise provides a deterrent to realization, because the capital gains incorporated in the assets are not subjected to income taxes at the time of transfer.

G. Tax Avoidance on Capital Gains Increments Included in Property Transferred at Death, by Inter Vivos Gifts and in Charitable Contributions

At first glance, it may appear that the tax avoidance arising through the transfer at death of capital assets incorporating capital gains is largely offset by the higher total estate taxes which result because the total bequest is larger by the amount of the capital gains tax avoidance. It should be noted that the loophole cannot be completely sealed by this offset so long as the estate tax rates are under 100 percent.

The situation with respect to inter vivos gifts is somewhat similar in character. An individual who divides among his children properties incorporating large unrealized capital gains is not subject to capital gains taxes on the gains included in the gifts. The children are likewise not subject to capital gains taxes in connection with these gifts, unless and until they liquidate the properties. What is more, the distribution of the gains among several individuals and, commonly, among individuals of smaller income than the transferor, reducesthe aggregate tax liability upon the capital gains. As in the case of the estate tax, the avoidance of the tax on capital gains cannot be offset completely so long as the gift tax rates are under 100 percent.

In addition, an individual making donations to charity in the form of assets incorporating capital gains also avoids taxes because the law does not recognize that such transactions result in realization of capital gains by the donor; and the charitable and similar institutions are not subject to taxation.

Securities
Market

V. CAPITAL GAINS TAXATION AND THE SECURITIES MARKETS

The most persistent objection voiced against capital gains taxes is the contention that they greatly obstruct the trade in securities and other capital assets. It is argued that many potential transactions that would otherwise be undertaken are postponed for varying periods, or indefinitely, to avoid or reduce taxation on the gains that would be realized in connection therewith. The mobility of capital and enterprise is thereby retarded.

It is also urged that when stock prices are rising, the liquidation of over-priced securities, which might check and moderate an unhealthy rise, is discouraged, thereby contributing to an exaggeration of the rise and to a sharper subsequent decline. In consequence, it is held, stock market booms and collapses are accentuated.

There is some measure of truth in these contentions; but it must be emphasized that, except in certain special cases, the scope and force of tax influences upon the sale of securities may be easily exaggerated. In general, neither the available empirical evidence nor analysis of the underlying factors supports the large claims often made in this connection.

A. General Limitations upon the Tax Influence.

1. Immobility of Mass of Capital Assets

In practice, we know that the great mass of capital assets is owned by persons, natural or legal, whose continued ownership of such assets would be largely unaffected by the character of our capital gains tax provisions. This is not only true of most physical properties, but it is also true of the great mass of securities. A large proportion of the latter is held by controlling stockholding interests in the various corporations, and a large part of the remainder is held for long-term investment for the interest and dividend income.

2. Short-term Speculation not Greatly Affected

Further, even the effectively mobile fraction of the country's capital assets is not uniformly sensitive to the character of our capital gains tax provisions. It is important to distinguish, in this connection, between traders, speculators, and investors in securities. The securities operations of traders are not directly affected by the capital gains tax provisions because it is of the essence of their function that their operations are extremely short-term in character--well within one year. Gains from transactions in capital assets constitute their normal source of income; and such gains on the part of professional traders would presumably be taxed as ordinary income, as they are in England, even if taxes on capital gains generally were abolished. A substantial proportion of speculators in securities also seek to exploit short-term movements primarily; and the operations of such individuals are likewise relatively insensitive to capital gains tax provisions. Traders and short-term speculators in securities account for a very significant fraction of the total volume of trading in securities.

Data made available in recent years indicate that the operations of stock exchange members alone, among traders and speculators, bulk surprisingly large in the total volume of trading in listed securities. Thus, the figures compiled by the Senate Committee on Banking and Currency for the month of July 1933, disclosed that the percentage of members' trading in relation to all shares bought and sold on the New York Stock Exchange was 27.01 percent, and on the New York Curb Exchange, 27.48 percent, and on 27 other exchanges, 12.36 percent(Senate Report No. 1455, 73rd Congress, 2nd Session, pages 19-21). Likewise, the Securities and Exchange Commission, in its report of June 20, 1936, on the "Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker" (pages 12-13) noted that in the 25 weeks between June 24, 1935 and December 14, 1935, members' trading in all stocks on the New York Stock Exchange, exclusive of transactions by odd-lot dealers, totaled 24 percent of the reported purchases and sales; and that the average weekly percentage of the total trading accounted for by members of the exchange was also 24 percent. The proportion of the total trading on the New York Curb Exchange accounted for by members during substantially the same period was not greatly different from the proportion cited for the New York Stock Exchange.

3. Greater Importance of Business Factors to Investors

Even among investors, it must be emphasized that tax factors operate in practice among a welter of other considerations, and that, by reason of this fact, they are commonly robbed of a great deal of their force. An individual who comes to the conclusion that the competitive position and profits prospects of the two leading American producers of tin cans are going to be undermined by the entrance into this field of the Owens-Illinois Glass Company and other important container manufacturers, is very unlikely, if well advised, to postpone for eight or nine months the sale of American Can or Continental

Can common stocks in order to obtain tax exemption for an additional 20 percent of his possible profits from the sale of such stocks. A much smaller decline in the market price of the stock would more than offset the reduction in taxes. This is true in nearly all cases where the motive of the sale is withdrawal from a declining, threatened, or embarrassed industry or enterprise.

Assume an individual with other surtax net income of $50,000 who has an unrealized profit of $2,000 on 100 shares of Continental Can that he has held for just over 18 months. If this individual sells his stock immediately, $1,600 of his profit will be subject to income taxes of 35 percent, or $560. If he holds his stock for an additional six months, only $1,200 of his profit would be taxable, and the tax would be $420 — a tax saving of $140. A decline of less than 2 points in the price of the stock would wipe out the tax advantage of holding.

The same considerations apply more generally. When owners of securities conclude that the business situation as a whole is deteriorating, or, more narrowly, when they conclude that the stock market faces a substantial decline, the possible tax economies of delaying liquidation are in most cases considerably less than the depreciation that seems imminent in the market value of securities. The cyclical and even some of the secondary fluctuations in securities prices are so great as to overshadow tax considerations on a purely rational basis; though there is little doubt that irrational repugnance to incurring an avoidable or postponable tax liability gives the tax consideration somewhat greater weight in practice than it would merit on a purely rational basis.

4. Contingent Tax Liability of Unrealized Capital Gains

The importance of these market and business factors, even in the case of a wealthy individual who hesitates to realize large capital gains, may be illustrated by referring again to the example previously given (page 19) of an individual who purchased 2,000 shares of Phelps-Dodge stock in 1933 at $10 a share and faced the question of whether, in view of the income tax of $29,012 on his capital gains, he could afford to sell the stock at $58. It was pointed out as an illustration of the psychological obstacle to such sale that the stock could decline by slightly more than 25 percent before the depreciation would equal the tax liability that would be incurred by the investor as a result of the sale. The intelligent investor, however, would also take account of the fact that the continued holding of the Phelps-Dodge stock during a period when it depreciated by 25 percent would still leave him a large contingent tax liability, whereas the sale of the stock at $58 would discharge this contingent tax liability.

Unless the investor hopes to avoid capital gains taxes entirely by holding the stock until his death, or expects the existing capital gains tax provisions to be greatly relaxed or eliminated, or counts on the availability of future capital losses to offset his capital gain, he must regard his contingent tax liability on unrealized capital gains as a real factor.

5. Explanations of Concentration of Long-Held Assets Among the Wealthy

Data obtained from income tax returns over a period of years clearly reveal that the bulk of the net capital gains realized by members of the upper income groups have been realized consistently on assets held for more than two years. The 1934 figures, (Table VIII) which are available in greater detail, show what was probably true in previous years — that the great bulk of capital gains realized by members of the highest income groups was realized on assets held for very long periods. Although our capital gains tax provisions no doubt contribute to this result, it is extremely doubtful that they have been of decisive importance in this connection.

The most important of these factors is that very sizeable capital gains normally arise only over a fairly long period of years. The owner of a valuable piece of urban real estate can usually realize a net gain of several hundred percent, if he realizes such a gain at all, only by holding the property for a prolonged rise. In the same way, a man who multiplies his capital in an industrial enterprise by 20 or 30 times cannot normally realize such results except over a long period.

A sizeable proportion of the large capital gains realized by members of the highest income groups, moreover, is realized in connection with the sale to the public, after many years, of what had previously been family or other closely held corporations. Small machine shops, largely owned by single individuals, or a few partners, for example, have frequently grown into sizeable automobile accessory producers before their securities have been distributed, with the aid of investment bankers, to investors generally. The capital gains incorporated in such enterprises, when formally realized, are bunched in the year or years of sale to the public, though they had accrued over a period of many years.

These forces operating toward the concentration of long-held assets as the major source of capital gains among members of the higher income groups would appear to be the primary ones, and they would operate powerfully in the same direction, even if complete income tax exemption were accorded capital gains. To a considerable degree, the step-downs in the taxable proportion of realized capital gains, according to the length of time during which the asset is held, serve not so much, in practice, to cause individuals to delay liquidation as to confer tax benefits upon individuals who, for other reasons, would hold their assets for long periods of time in any event. And the chief beneficiaries of the present "step-down" treatment of capital gains are, in practice, individuals with large incomes.

6. Average of Stock Prices not Necessarily Affected by Realization of Gains

It should be emphasized that the level of stock market prices would not necessarily be lowered if a drastic reduction in capital gains taxes led to a greatly increased volume of realizing sales. If those who took advantage of the relaxation in capital gains taxes to realize their gains, purchased other securities with the proceeds of their sales, the increase in the demand for stock market securities in the aggregate would be just as great as the increase in the supply of securities. A significant reduction in the average level of stock market prices could be expected to follow a substantial lowering of capital gains taxes only if the latter induced an important fraction of large holders of stocks to liquidate without using the proceeds to buy other stocks. Such an effect is unlikely during a period of widespread recovery in corporate earning power.

The alleged moderating influence upon the rising trend of the securities markets of a drastic reduction in capital gains taxes is particularly debatable during a period of underlying business improvement. It is true that such reduction would have the technical effect of removing existing deterrents to the sale of particular securities by particular individuals holding large unrealized gains therein. But it would provide no deterrent whatever to the immediate reinvestment in other securities by these individuals of the proceeds of their sales. On the contrary, the very fact that the taxation of capital gains had been substantially reduced would make the stock market more attractive than ever. Stock market gains, which even now enjoy preferential tax treatment if the securities are held for more than one year, would be given an even more privileged tax status among the various sources of individual incomes.

D. Analysis of the Effects of Past Tax Treatment of Capital Gains and Losses on the Securities Market

The evidence provided by the stock market history of the last 15 years reinforces the conclusions drawn from other considerations in indicating that the role played by the tax treatment of capital gains as a determinant of the speculative climate is not of major importance.

1. The Twenties

a. Overshadowing Importance of Non-Tax Influences: It has already been observed (page 6) that the principal motivation for the optional exclusion of capital gains from ordinary income and the taxation of such excluded gains at a flat rate of 12½ percent, as was incorporated in the Revenue Act of 1921, was the belief that high tax rates on capital gains were obstructing normal transactions in capital assets.

Now the influence of the alteration in tax treatment, if it was a significant influence, was only one of many factors that operated during this period to swell the volume of capital transactions and the volume of realized capital gains. The aggregate volume of bank deposits in the United States increased by more than $18 billions between June 30, 1921 and June 30, 1929, an increase of 50 percent. The Federal Reserve Board index of industrial production rose from 67 in 1921 to 119 in 1929, or by 78 percent. The middle Twenties, as everyone knows, saw a widespread wave of speculation in urban real estate; the later Twenties, an unparalleled volume of speculation in the stock markets. The period as a whole was marked by numerous large corporate mergers, rising corporate profits, and a stimulus to domestic industry created by our large foreign loans. The later Twenties was marked by the receipt of substantial amounts of foreign funds attracted to our markets in response to both the high rates of interest in our call money market and the rising trend of our securities prices; and it was marked by, among other relevant factors, the availability for stock market speculation of huge sums of capital raised by corporations and loaned out at call through New York banks, and, most of all, by a pronounced speculative temper.

It seems reasonable to believe that a careful historian who attempted to appraise the factors contributing to the rising volume of realized capital gains during the Twenties would give most of his attention to the factors cited in the preceding paragraph, and only a very small part to the changes in the tax treatment of capital gains.

b. The Rising Stock Market: The period of extraordinarily large capital gains may be said to begin with 1924. The Dow-Jones index of industrial stock prices in December of that year averaged 114.3, as compared with 94.1 in December 1923. Between December 1924, and December 1925, the monthly average of the daily figures of the Dow-Jones index of industrial stock prices rose from 114.3 to 154.3; and the total net profits from the sale of capital assets reported by individuals nearly doubled. Between December 1925 and December 1926, this index showed a relatively small net increase, 5 points, and there was a decline in 1926 in the total net profits from the sale of capital assets reported by individuals. In 1928, the year for which the largest volume of profits from the sale of capital assets was reported, the December average of this index was 280.8. In 1929, the year for which the second largest volume of such profits was reported, this index averaged 246.9 for December and 311.2 for the year as a whole.

It seems clear that the extraordinary volume of realized capital gains during the Twenties was primarily a function of the rising stock market and of the underlying factors that this market reflected.

c. Effect of Tax Treatment on Liquidation of Securities: Curiously enough, the maximum rate of 12½ percent on capital net gains, which in 1921 was urged as a stimulus to transfers of capital assets, was being widely charged in 1928 and 1929 with obstructing the liquidation of securities and thereby contributing to the high and rising level of stock prices. It is true, however, that the relative value of the 12½ percent rate had been reduced by reductions in the surtax rates applicable to individual incomes. Thus, the maximum individual income-tax rate, which had been 73 percent between 1919 and 1921, inclusive, was reduced to 58 percent for the years 1922 and 1923 1/; to 46 percent for 1924; and to 25 percent for the years 1925 to 1931 2/, inclusive; reductions which were accompanied by downward revisions in most of the other surtax rates. In the later Twenties therefore, the 12½ percent maximum rate on capital gains compared with a 25 percent maximum income tax rate (24 percent in 1929) on ordinary income.

The charge that the 12½ percent tax on capital gains was obstructing liquidation was made despite the fact of the unprecedented volume of market transactions then taking place. In 1928 and 1929, the average monthly number of shares sold on the New York Stock Exchange constituted 11.2 percent and 9.9 percent, respectively, of the average number of shares listed, as compared with 8.3 percent in 1925, 7.0 percent in 1926, and 7.8 percent in 1927; and between 1925 and 1929 the average number of shares listed more than doubled.

Such a volume of trading could conceivably be reconciled with an underlying scarcity of securities if this volume were primarily a product of an enormous turnover in a small fraction of the volume of securities outstanding.

1/ This rate was retroactively reduced by 25 percent in June 1924.
2/ In December 1929, normal tax rate was reduced by one percent.

The evidence points in the other direction, however. Berle and Means, in "The Modern Corporation and Private Property" (page 56), cite an estimated increase of 50 percent in the number of book stockholders of American corporations between 1920 and 1928. Three of the largest American corporations, the American Telephone and Telegraph Company, the Pennsylvania Railroad, and the United States Steel Corporation, according to Berle and Means, increased the number of their book stockholders between 1920 and 1929 by 237 percent, 47 percent, and 26 percent, respectively.

The numbers of stockholders registered on the books of corporations contain considerable duplications of ownership. A single individual may be counted thirty times as the owner of stocks in thirty different corporations, and the same is true of holding companies and other institutions. Mr. N. R. Danielian, in Chapter 3 of a study by the Twentieth Century Fund, Inc., entitled "The Security Markets," presents estimates of the increases between 1927 and 1930 in the numbers of actual stockholders, based largely upon income-tax data published in Statistics of Income. The mid-point of Mr. Danielian's estimate of the number of actual stockholders in 1927 is 5.5 millions; for 1929, 8 millions; an increase of 45 percent.

Other evidence also exists to indicate that the taxes applicable to profits from the sale of capital assets did not prevent a very substantial volume of liquidation by those holding such assets in the late Twenties. The total amount of net profits from the sale of capital assets reported by individuals in the years 1928 and 1929 greatly exceeded the aggregate volume of such net profits reported during any of the preceding six years (comparable data are not available for the years prior to 1922). Further, there were substantial increases in 1928 and 1929 in the volume of capital net gains reported from the sale of assets held for more than two years by individuals who otherwise would have been subject to income taxes thereon of more than 12½ percent. (Table VI)

Mr. George Buchan Robinson in an article in The Annalist of June 11, 1937, entitled "A Reply to Recent Criticism of Capital-Gains Tax: Implications of Repeal" cites the case of Mr. Pierre du Pont. The following is quoted from Mr. Robinson's article:

> "On Monday, May 10, the New York World-Telegram published an interview with Arthur A. Ballantine, formerly Under-Secretary of the Treasury, dealing with the subject of taxing capital gains. Mr. Ballantine would either abolish capital-gains taxation entirely or substantially modify the present treatment of such profits. He noted that the method and rates which prevailed from 1921 to 1934 were much more 'favorable'.

"As luck would have it, Mr. Ballantine's views were published in the same issue of The World-Telegram which carried the first news story of Pierre du Pont's whopping capital gain of 1929. Mr. du Pont appears to have made a profit of some $35,000,000 in General Motors stock which he had held for more than two years, and to have paid a tax thereon of about $4,375,000. The incident provides a timely-offered vantage point from which to glance at Mr. Ballantine's views.

"There is, of course, nothing new in the broad view. There was quite as much complaint against the taxing of capital gains when the rate was a flat 12½ percent and very much the same arguments were presented against it.

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"But Mr. du Pont appears not to have been discouraged from selling by the taxes which selling faced. If other persons were, at or about the same date (June, 1929), it may be hoped that they will read of Mr. du Pont's better judgment not merely with such regrets as they may have but with some determination never to be so deterred again. For the reading, there is a good lesson available to all less experienced investors and speculators in Mr. du Pont's action.

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"It is impossible from the published data to compute what the tax on such a profit would be under the present law, but it can be estimated roughly, if it be assumed that the stock has been owned for more than five years, but less than ten. In that case, of a $35,000,000 profit, 40 percent, or $14,000,000 would be taxed for normal tax and surtax. The sum of these on $14,000,000 would be not less than $10,901,000 (though possibly not much more), or some $6,526,000 greater on $35,000,000 than under the 1929 law. But even at that figure, there would be no tax percentage whatever against 60 percent of the profit, which in itself is a considerable preferential."

It is extremely doubtful that the tax advantage of realizing losses in years when capital gains and other incomes are large has been of great practical importance, save in those cases, some of which have been widely publicized, where the realization of loss has been more nominal than real — as in sales to and by related interests. The business and market conditions which favor large capital gains and a high level of income derived from other sources are precisely those which minimize the possibilities of realizing large capital losses. It will be noted in Table VI that the total losses from the sale of capital assets were relatively small in the years 1926, 1927, and 1928, when the volume of capital gains was very great. The drastic decline in the securities market in the fall of 1929 forced or enabled some individuals to realize a total of $1,039 millions of net losses from their transactions in capital assets as a whole in that year, as compared with total net gains, realized by other individuals on their capital transactions as a whole, of $4,685 millions. The heaviest losses were realized in the two years immediately following, when the market trend was substantially though irregularly downward, and when the level of income from other sources was likewise declining sharply.

Those who held during the late Twenties that a capital gains tax of 12½ percent (less for individuals subject to maximum income taxes of less than 12½ percent, and ranging up to 25 percent (24 percent in 1929) for gains on assets held for two years or less) constituted a major obstruction to adequate liquidation, and therefore fostered the stock market boom, are confronted with the fact that the period was one in which an unparalleled volume of securities trading took place and an unparalleled volume of gains was realized from the sale of capital assets. (Table VI)

On the other hand, those who argue that a drastic reduction in the tax rates applicable to capital gains from those now in effect is essential to encourage the liquidation needed to moderate a boom, are confronted with the fact that a maximum rate of 12½ percent on assets held for more than two years, and rates ranging up to a maximum of 24 or 25 percent on assets held for two years or less, though substantially lower than those now existing, did not prevent the greatest stock market boom in our history.

d. Effect of Tax Treatment on Timing. Evidence available in the income tax returns, though not at all conclusive, does not indicate that the time differentials in the taxation of capital gains have been important in determining the timing of the transactions that have actually accounted for a very substantial proportion of the aggregate capital gains reported for income tax purposes. By reason of the varying normal and surtax rates in force during the period 1922-1933, the level of income at which it was profitable to report capital gains separately was not uniform throughout the period. Roughly, the breaking point ranged between $16,000 and something less than $50,000 between 1924 1/ and 1933, inclusive;

1/ Breaking points for 1922 and 1923 were somewhat different because of the restriction that if the optional treatment were used, the total tax could in no case be less than 12½ percent of the total net income.

so that we are sure that all well-advised individuals with incomes from other sources of $50,000 or more took advantage in their returns of the 12½ percent option rate on capital gains throughout these years.

Virtually all of those with incomes, inclusive of profits on the sale of capital assets, of less than between $16,000 and about $32,000, varying in the different years, did not avail themselves of the option, and therefore included in their ordinary income the gains realized on assets held for more than two years. It is significant that not a single individual reporting a net income of $25,000 or less actually obtained any benefit from the 12½ percent optional rate between 1922 and 1931, inclusive.

During the period 1922-1933, only 37.9 percent of the aggregate net profits from the sale of capital assets reported by individuals with net incomes received the benefit of the 12½ percent maximum rate on capital gains. Even for individuals reporting net incomes of $50,000 to $100,000, the tax advantage obtainable by delaying liquidation until a capital asset had been held for more than two years, was not sufficient to bring about such delay in the case of transactions accounting for 50.9 percent of the aggregate net capital gains reported by members of this group during this period. On the other hand, individuals reporting net incomes of $100,000 and over realized only some 21 percent of their aggregate net capital gains from assets held for two years or less. (Table VII.)

It was only in the year 1929, that as much as one half of the aggregate profits from the sale of capital assets received the preferential tax treatment open to those with large incomes <u>on gains from assets held for more than 2 years.</u> In the years 1922 to 1928, inclusive, between 60.9 and 74.9 percent of the reported aggregate net profits from the sale of capital assets was reported by individuals who could not enjoy the preferential tax treatment of capital gains, either because the assets involved had been held for less than 2 years, or because their incomes from other sources were not large enough to subject their capital gains to a tax rate of more than 12½ percent if included in ordinary income. (Table VII.)

The Revenue Act of 1934 incorporated the five-step system whereby varying percentages of capital gains were included in ordinary taxable income, and whereby a distinct tax advantage was given to those who held their assets for longer periods of time, up to just over ten years, before realizing gains thereon. This Act was preceded and accompanied by very pronounced increases in individual income-tax rates. If the tax treatment of capital gains exerted a very considerable influence upon transactions in capital assets, the joint effect of these two changes might have been expected to reduce sharply the proportion of total capital gains which was realized on assets held for two years or less.

Although it is impossible to obtain the relevant figures for the year 1934 in a form fully comparable with those of preceding years, the evidence provided by the individual income tax returns for 1934 is entirely consistent with that provided in preceding years. More than 50 percent of the total net gains from the sale of assets reported by individuals for 1934 was derived from assets held for two years or less. Likewise, about 51.7 percent of the total net gains from the sale of capital assets reported by individuals with net incomes of $50,000 to $100,000 in 1934 was derived from assets held for two years or less. For individuals reporting net incomes of $100,000 and more in 1934, 22.3 percent of their total net capital gains was derived from assets held for two years or less. (Table VIII.)

2. 1935-1937

In March 1935, the average of the daily closing prices of the 30 stocks included in the Dow-Jones Index of industrial stock prices was $99.8. By March, 1937, this average price had risen to $188.4, an increase of 89 percent. During this period, the volume of trading, though increasing, remained at relatively low levels. Thus, the ratio between the monthly average number of shares sold and the monthly average number of listed shares on the New York Stock Exchange was only 2.4 percent in 1935 and 3.1 percent in 1936, as compared with ratios more than twice as great in the years 1925 to 1929, inclusive. This measure of the volume of trading is far from perfect because additions to the list of relatively inactive securities previously traded only on other exchanges or over the counter have probably caused some downward bias in the ratio; but the effect of such bias is probably of relatively small proportions as compared with the substantial decline in the ratio.

There are some who contend that the rise of securities values since the spring of 1935, attended by a volume of stock market trading very substantially below that which obtained in the late Twenties, is conclusive evidence that the existing capital gains tax provisions are seriously retarding the liquidation of securities and thereby contributing to an unhealthy stock market boom. In view of numerous other factors that have operated to raise securities prices and to restrict the volume of stock market trading, this contention would seem to give undue weight to the restrictive influence of our capital gains tax provisions.

a. Improvement in Business and Profits: In the first place, the rising stock market of the last two years is much more obviously explained in terms of the enormous improvement that has taken place in the volume of business activity and in the level of corporate profits. The aggregate statutory net income of corporations (excluding intercorporate dividends) increased from less than $3 billions in 1933 to about $4.3 billions in 1934, and to some $5.1 billions in 1935. The 1936 figure was estimated at $7.2 billions by the Treasury in a report to the House Ways and Means Committee.

The pronounced upward course of business activity between May 1935 and May 1937, was reflected by a rise of 39 percent in the adjusted index of industrial production of the Board of Governors of the Federal Reserve System.

When the general business situation is undergoing solid and rapid improvement, there is a natural tendency, irrespective of the tax treatment of capital gains, for investors to retain their securities for higher prices, particularly in the case of common stocks, but only somewhat less so in the cases of speculative preferred stocks and defaulted and other speculative bonds. The very facts that securities prices and corporate earnings continue to rise provide the strongest possible inducement for investors to retain their securities pending a change in the outlook. Conditions such as these naturally reduce the disposition of investors to sell their holdings.

<u>b. Low Interest Rates</u>: In the second place, the low level of interest rates, both short- and long-term have operated powerfully to raise the market values of income-yielding securities. Stock prices averaging 12 or 14 times current earnings may well appear high when the yields obtainable on good bonds are $4\frac{1}{2}$ to 6 percent; but when no more than 3 to 4 percent can be obtained on good bonds, stock prices averaging 15 to 20 times earnings may well appear reasonable. The latter is apt to be particularly true if dividend distributions are in generous volume; and the most striking effect of the undistributed profits tax provisions of the Revenue Act of 1936 has been very greatly to increase the volume of dividend disbursements.

<u>c. Foreign Purchases of American Securities</u>: In the third place, the business revival in the United States and the continuing favorable outlook, as well as the existence of great uncertainties abroad, has made American securities extremely attractive to foreigners. Between January 2, 1935 and March 31, 1937, total foreign purchases of domestic securities amounted to $4,941 millions, and total sales to $3,865 millions. The weekly figures of foreign purchases and sales of domestic securities as presented in the Treasury's third report on capital movements,1/ and in the two previous reports, indicate a clear tendency for the amounts of net foreign purchases of domestic securities to vary directly with upward and downward movements in our stock markets. There can be no doubt that the foreign demand for American securities has helped to raise their prices.

1/ Statistics of Capital Movements between the United States and Foreign Countries and of Purchases and Sales of Foreign Exchange in the United States; Report No. 3; United States Treasury Department, Division of Research and Statistics; Table E.

4. New Government Restrictions on Trading: Thus far, we have explained the reluctance of investors to liquidate capital assets in terms of fundamental improvement in business conditions and in the business outlook; and we have explained the rise in securities prices both in these terms and in the terms of the declining interest rates and the addition to domestic demand created by foreign purchasers of American securities.

The decline in the aggregate volume of stock market trading during the past few years, as compared with the late Twenties, is to be explained partly in terms of the greatly different speculative temper of the times and partly in terms of the very substantial structural changes in our stock markets effected by the Securities Exchange Act of 1934, and the subsequent regulations of the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System, including the newly required publicity respecting corporate acts and the securities transactions of officers, directors, and principal stockholders of corporations.

The abnormal character of the stock market speculation of the late Twenties requires little more than mention; and there are few persons who would regard the volume of that period as a standard by which the adequacy of the present volume of activity should be gauged. Apart, however, from this difference, the chief explanation of the reduced volume of securities trading must be sought in the elimination, as the result of new legislation, of a very considerable fraction of the speculative activity which formerly constituted one of the mainsprings of the market. The more important of the new restrictive provisions which are operating to reduce the volume of stock market trading are summarized below:

(1) Requirements for substantial margins have been established under rules and regulations prescribed by the Federal Reserve Board. The maximum loan value for a registered security is now set at 45 percent of its current market value, except in certain special instances. Banks, brokers, et cetera, cannot extend credit for the purchase or carrying of securities without collateral. Undermargined accounts are subject to trading restrictions and in all margin accounts no trading activities can be conducted which would undermargin such accounts.

(2) The sources of borrowing on securities by stock-exchange members, brokers and dealers are restricted to member banks, non-member banks which have filed with the Federal Reserve Board certain prescribed agreements, and other members, brokers, and dealers to a limited extent. At the present time, it is unlawful for a broker to allow his aggregate indebtedness to persons other than the foregoing to exceed 2,000 percent of the net capital employed in his business; and it is unlawful for a broker to lend securities carried for a customer without

his consent, or to hypothecate such securities for a sum in excess of the customer's aggregate indebtedness in respect to such securities.

(3) Prohibitions have been set up against the manipulation of security prices. It is unlawful to create a false appearance of active trading in any security by effecting transactions involving no change in beneficial ownership; or by effecting transactions, knowing offsetting orders will be offered; or by inducing sales by circulation of rumors that certain operations are to be conducted affecting the price of a security; or by effecting transactions for the purpose of pegging or fixing prices in contravention of regulations prescribed by the Commission.

(4) Regulations have been prescribed covering transactions on over-the-counter markets, and providing for the registration of brokers and dealers. Activities of brokers and dealers on the over-the-counter market have been limited, except where full disclosure of the broker's position or activity is made to the customer, and, in certain cases, where the broker obtains the customer's written consent to each transaction.

(5) Reports of securities transactions are required each month of directors, officers and beneficial owners of more than 10 percent of any equity security. When new securities are registered, such owners, officers or directors must file statements of their beneficial interest at the time the registration becomes effective.

(6) Profits realized from any purchase and sale of a corporation's securities within any period of less than six months by its officers, directors, or beneficial owners of more than 10 percent of any of its equity securities inure to and are recoverable by the issuer of such securities. Arbitrage operations by such persons in such securities are unlawful unless the profits are accounted for to the issuing corporation.

(7) Certain limitations are placed upon the functions of persons who are both brokers and dealers, particularly in connection with transactions in securities which are a part of a new issue, in the distribution of which such persons participated as members of a selling syndicate.

Corporations

VI. CORPORATIONS

The problem of the tax treatment of capital gains and losses has been of much more restricted significance for corporations than for individuals. The need for special treatment naturally did not arise so long as there was a relatively low flat corporation income tax; and even the enactment of graduated rates beginning in 1936 has created no practical problem, because the range of graduation is relatively narrow.

A. Market Effects

Most of the broader considerations involved in the relation between capital gains taxation and the securities markets apply to the securities transactions of corporations, trusts, and associations, no less than to those of individuals. So far as the securities markets are concerned, the chief effects of the existing capital gains provisions relating to corporations are exercised through their influence upon the actions of financial corporations and associations. Of these, investment trusts, which in this country characteristically employ their funds in speculative and semi-speculative investment, and other corporations which, though often ostensibly or actually engaged in other activities primarily, also maintain sizeable portfolios of speculative and semi-speculative securities, are most important in this connection.

In a general way, it may be said that professional managements of investment portfolios are less likely to allow irrational repugnance to the occurrence of avoidable or postponable tax liabilities to influence their decisions than is the case with many investors. Hence, tax considerations constitute only a minor deterrent to liquidation by such managements in all cases where the motive for liquidation is the desire to withdraw from a threatened or embarrassed industry or enterprise, or to reduce investments generally because of an anticipated decline in business and the securities markets. When substantial declines are anticipated — and even secondary fluctuations in stock prices are often substantial —, the profits safeguarded and the losses avoided by properly-timed liquidation overshadow the tax liabilities incurred by the realization of gains.

The tax provisions exert a greater influence upon switching, as contrasted with liquidating operations. The management of a corporation's speculative-investment portfolio may become convinced that, although the market as a whole is going to continue to rise for some little time, certain groups of stocks in which it is interested are not likely to rise as much as certain other stocks in which it is less heavily, if at all, committed. To make the switch may involve the realization of very substantial capital gains in the securities to be liquidated, and a related substantial increase in tax liability. If safe and adequate provision is to be made for the increased tax liability, the funds available for the substitute investments may be sufficiently reduced to eliminate the superior attractiveness of the projected substitute investments.

This consideration was probably of importance to various personal holding companies in 1934, 1935, and 1936, because of the special surtaxes to which they were subject on their undistributed incomes. The owners of many such companies were subject to relatively high individual income surtaxes if the gains were distributed; and their personal holding companies were subject to relatively high surtaxes if the gains were not distributed. Hence, the certainty of substantial tax liabilities on realized capital gains, in such cases, provided a strong motive against undertaking ordinary switching operations designed to improve profit prospects rather than to avoid losses. In addition, it probably deterred real liquidation, as contrasted with switching operations, in some cases.

B. Effect of Undistributed Profits Tax

So long as the tax applicable to capital gains was limited to 15 percent or less, the tax influence was minimized, especially for investment trusts and financial corporations. Imposition of the surtax on undistributed profits, however, made the tax consideration important to all corporations with substantial portfolios of speculative and semi-speculative securities, and particularly to those which shift their portfolios frequently. Unless it qualifies as a "mutual investment company", a corporation subjects itself to surtaxes (as well as normal taxes) on all capital gains that are not distributed in taxable dividends. This is of particular importance to investment trust corporations. If they plan to distribute all of the capital gains realized during periods of rising stock prices, they must contemplate a net shrinkage in their effective capital funds in periods of declining stock prices, unless (1) they time the liquidation of their stock holdings so well as to avoid depreciation in the market value of their portfolios; or (2) they recoup their capital gains distributions by additional stock issues.

This consideration may well deter such companies from transferring funds from one group of stocks to another as promptly and to the same extent as might be the case if tax considerations were altogether neutral. On the other hand, as already cited, the tax factor loses much or all of its weight even for such enterprises when liquidation is contemplated because of actual or expected adverse developments in business and the markets as a whole, or in particular industries or enterprises.

Further, if capital gains of good years must be paid out currently to avoid surtaxes on undistributed earnings, but no carry forward of the capital losses of bad years is allowed, the tendency over a period of years will be to shrink the value of capital assets of corporations. The most practicable method of minimizing or eliminating this tendency would appear to be that of allowing net capital losses as a deduction in computing adjusted net income with the further provision that any excess of such net capital losses may be carried forward for purposes of determining adjusted net income of future years. Such a provision would permit corporations to repair the inroads made upon their capital funds by net capital losses.

Recommendations

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VII. RECOMMENDATIONS

A. Individuals

In Section IV of this memorandum, a standard of equity was set up to judge the present tax treatment of the capital gains of individuals. It will be recalled that the standard was determined by dividing a capital gain by the number of years during which the asset had been held, adding the quotient to the individual's other income in the year of realization, determining the tax applicable to this added segment, and multiplying this tax by the number of years during which the asset had been held. The recommended plan for the treatment of the capital gains of individuals is based on the principle incorporated in the standard of equity.

In the standard of equity only a single capital gain is involved. The recommended plan -- called the average accrual method -- is designed to operate equally well where there are several transactions, while retaining the principles of the standard of equity.

1. Procedure for Individuals Reporting Capital Gains but No Capital Losses from Sales or Exchanges

a. An average investment period is first determined by computing a weighted average (the years being weighted by the gains) of the years assets incorporating capital gains were held. In this computation, one-half of a year or more is considered a full year, and less than one-half of a year is disregarded. The resulting average investment period is likewise rounded off to an even number of years.

b. The average annual gain for this period is then determined by dividing total gains by the average investment period.

c. The tax on this average annual gain is then computed with reference to the surtax net income excluding capital gains; and the resulting tax is multiplied by the number of years in the average investment period to determine the total tax on capital gains.

d. In computing the tax on the average annual gain, no allowance is given for any portions of the personal exemption, credit for dependents, or minimum earned income credit not utilized in computing the ordinary income tax. If there is no surtax net income, the tax is computed on the average annual gain, assuming surtax net income to be zero rather than a negative quantity.

e. The same procedure as above is followed where an individual has capital losses but no capital gains. In such cases, a tax credit would be computed instead of a tax. This tax credit is carried forward for two years, to be allowed only as an offset against tax liability on capital gains realized in those years.

The following example illustrates the procedure for gains only:

Assume an individual with other surtax net income of $10,000 having a capital gain of $10,000 on an asset held 10 years and a capital gain of $10,000 on an asset held 5 years.

<u>Computation of average investment period</u>:

$10,000 multiplied by 10	$100,000
10,000 multiplied by 5	50,000
Total weighted gains	$150,000
Divided by total gains of	20,000
Average investment period	8 years 1/

<u>Computation of average annual gain</u>:

Total gain	$ 20,000
Divided by average investment period of	8
Average annual gain	$ 2,500

<u>Computation of tax</u>:

Tax on $12,500 (other surtax net income plus average annual gain)	$ 980
Tax on $10,000 (other surtax net income) ...	700
Tax on average annual gain	$ 280
Multiplied by average investment period of .	8
Total tax on capital net gain	$ 2,240

The following example illustrates the procedure for losses only:

Assume an individual with other surtax net income of $10,000 having a capital loss of $10,000 on an asset held 10 years and a capital loss of $10,000 on an asset held 5 years.

1/ 7 1/2 years raised to 8 years.

Computation of average investment period:

$10,000 multiplied by 10	$100,000
10,000 multiplied by 5	50,000
Total weighted losses	$150,000
Divided by total losses of...............	20,000
Average investment period	8 years 1/

Computation of average annual loss:

Total loss	$ 20,000
Divided by average investment period of .	8
Average annual loss	$ 2,500

Computation of tax credit:

Tax on $7,500 (other surtax net income minus average annual loss) .... $	455
Tax on $10,000 (other surtax net income).	700
Tax credit on average annual loss .... $	245
Multiplied by average investment period of	8
Total tax credit on capital net loss ... $	1,960

2. Procedure for Individuals Reporting Both Capital Gains and Capital Losses from Sales or Exchanges.

Where there are both gains and losses, the tax treatment is the same as that described above, except that the actual computation is somewhat more complex.

a. Capital gains are segregated from capital losses. An average investment period for gains and the average annual gain during this period are determined; and an average investment period for losses and the average annual loss during this period are determined.

b. The average annual gain and the average annual loss are combined to determine the net gain or loss applicable to the shorter of the two investment periods. The tax or tax credit on the resulting figure is computed with reference to the surtax net income excluding capital gains and losses, and this tax or tax credit is multiplied by the number of years in the shorter investment period to determine the tax or tax credit on capital gains and losses during this period.

1/ 7 1/2 years raised to 8 years.

c. The tax or tax credit on the average annual gain or the average annual loss, whichever accrued for the longer average investment period, is computed with reference to the surtax net income excluding capital gains and losses, and multiplied by the number of years by which the longer investment period exceeds the shorter, to determine the tax or tax credit applicable to that period.

d. The taxes or tax credits thus obtained are combined, and the result represents the total tax or tax credit on capital gains and losses.

The following example illustrates the procedure where there are both gains and losses:

Assume an individual with other surtax net income of $10,000 having a capital gain of $10,000 on an asset held 10 years and a capital loss of $15,000 on an asset held 5 years. It is not necessary to compute the average investment period for the gains and the average investment period for the losses in this illustration. If there were several transactions resulting in gain and several transactions resulting in loss, an average investment period for the gains and an average investment period for the losses would be computed in the same way as illustrated above.

<u>Computation of average annual gain</u>:

Total gain	$10,000
Divided by average investment period of.......	10 years
Average annual gain	$ 1,000

<u>Computation of average annual loss</u>:

Total loss	$15,000
Divided by average investment period of	5 years
Average annual loss	$ 3,000

Net average annual loss applicable to the shorter of the two investment periods ($3,000 minus $1,000)	$ 2,000

<u>Computation of tax credit on the net loss applicable to the shorter investment period</u>:

Tax on $8,000 (other surtax net income minus net average annual loss)	$ 500
Tax on $10,000 (other surtax net income)	700
Tax credit on net average annual loss	$ 200
Multiplied by average investment period of ...	5
Total tax credit	$ 1,000

Computation of tax on average annual gain applicable to the number of years by which the longer investment period exceeds the shorter:

Tax on $11,000 (other surtax net income plus average annual gain)	$810
Tax on $10,000 (other surtax net income)	700
Tax on average annual gain	$110
Multiplied by number of years by which the longer investment period exceeds the shorter	5
Tax total	$550

Combined tax and tax credit ($550 minus $1,000) or tax credit of $450

Proposed capital gain and loss schedules for individual income tax returns are presented in Appendix B, together with the computation of tax or tax credit for illustrated cases.

3. Treatment of Capital Gains and Losses of Partnerships and Fiduciaries

Fiduciaries and partnerships furnish each individual the figures for his pro rata share of total gains and total losses, and weighted gains and weighted losses, computed in the same way as described above for individuals; these figures are combined by the individual with the corresponding items respecting his other capital gains and losses.

4. Treatment of Capital Gains and Losses in Property Donated to Charitable Institutions

a. If legally feasible all contributions to charitable and similar institutions should be regarded as occasioning the realization of capital gains and losses by the donor; and such capital gains and losses should be included with other capital gains and losses.

b. If this proposal is not deemed legally feasible, or if practical considerations seem to bar its adoption, it is recommended, for the purpose of determining the deduction for charitable contributions, that the value of such contributions in kind be fixed at the adjusted basis (Section 113) or market, whichever is lower.

5. Treatment of Capital Gains and Losses in Property Transferred by Inter Vivos Gifts

a. If legally feasible, all transfers by *inter vivos* gifts should be regarded as occasioning the realization of capital gains and losses by the donor and such capital gains and losses accorded the same tax treatment as other gains and losses realized by the donor.

b. If this proposal is not deemed legally feasible, it is suggested that a supplementary gift tax be levied, measured by the capital gains and losses incorporated in such transfers. This tax could be determined in a similar way to that applicable to capital gains in property transferred at death as described in the estate and gift tax memorandum.

c. If practical and legal considerations should likewise bar the adoption of the latter proposal, a part of the tax on capital gains avoided by *inter vivos* transfers of property could be recouped if Section 113(a)(2) were amended to provide that, for the purpose of determining both capital gains and losses, the basis for property acquired by gift were made either the base in the hands of the donor or market value at time of transfer, whichever is lower.

B. Corporations

The capital gains and losses of corporations are included in ordinary income in full, except that for purposes of determining the normal-tax net income, capital losses are allowed only to the extent of capital gains. Any excess of capital losses not allowed in the current year is carried forward for two years to be credited against the capital gains of those years.

In determining adjusted net income, the excess of capital losses over capital gains not allowed for purposes of determining the normal-tax net income is allowed in full against income from other sources. Any portion of capital losses not so utilized is carried forward for two years for use as a deduction in determining adjusted net income of those years.

Alternative
Treatment

VIII. ALTERNATIVE TAX TREATMENTS OF CAPITAL GAINS AND LOSSES OF INDIVIDUALS

A. Proposals Designed Primarily in the Interests of Expediency

1. Complete Exclusion of Capital Gains and Losses from the Income-Tax Base

The objections to this proposal have already been covered: Capital gains constitute taxpaying ability; they are not sharply distinguishable from other types of income; the bulk of them are realized in connection with transactions entered into for profits; and their exemption from income taxes would be extremely inequitable.

The case for the complete exclusion of capital gains and losses from the income-tax base is believed by some, including Mr. L. H. Parker, Chief of the Staff of the Joint Committee on Internal Revenue Taxation, to have been strengthened by the enactment of the surtax on undistributed profits in 1936. Mr. Parker maintains that if the undistributed profits tax is continued in substantially its present form, "the question of capital gains will become comparatively unimportant in the long run as a revenue producer." His argument is summarized in the statement that: "The increased value of corporate stock comes about largely, of course, because a considerable portion of the net earnings are retained in surplus and used in increasing the earning power of the corporation." (See address before the Institute of Public Affairs, July 9, 1936.)

Mr. Parker's argument, while applicable to one important source of capital gains, is by no means applicable to many others; and his simple generalization seems to be in conflict with some of the facts of common observation.

(1) If reinvested earnings constitute the chief explanation of increases in the values of corporate stock, a high degree of correlation should tend to exist between the book and market values of securities. The absence of any high degree of such relationship is, however, notorious. To illustrate the prevailing absence of any such close relationship, there is presented in Table XII a comparison of the book values and market values per share as of December 31, 1936 of the fifteen common stocks that were traded in the largest volume on the New York Stock Exchange on this date.

(ii) Anyone who makes an even casual study of the stock market averages over a period of years notices that wide swings in these averages take place cyclically. Mr. Parker's argument and conclusion would appear to rest upon the assumption, which is contrary to the facts, that no important capital gains (or losses) are realized as a result of these cyclical fluctuations.

For example, many investors and speculators have purchased iron and steel and railroad equipment common stocks since the beginning of 1933. There are presented in Table XIII comparisons of the changes between December 31, 1932 and December 31, 1936, in the market and book values of the common stocks of all the railroad equipment and iron and steel companies included in the Standard Statistics Company's indexes for these industrial groups. It will be observed that, whereas only one of the ten railroad equipment stocks increased in book value during this period (and by only 1.1 percent), the smallest percentage appreciation in the market value of the common stocks of any of the ten companies was 111 percent; and the average of the rates of appreciation, unweighted, of all ten stocks was 454 percent. In the case of the eleven steel companies, only four showed increases (and relatively small ones) in the book value of their common stocks between these two dates; but the appreciation in the market values of these stocks ranged from 113 to 914 percent; the average of the rates of appreciation, unweighted, of the eleven stocks was 444 percent. In the case of some of these companies, though by no means all, special writedowns in the balance sheet values assigned to various assets, and charged directly against the surplus accounts, as well as operating losses, accounted for reductions in the book value of the stocks. The figures nevertheless provide vivid illustrations of the fact that, in appraising the changed earning power and outlook for these stocks, the market did not wait upon commensurate additions to their book values through reinvested earnings. Speculators and investors who purchased these stocks in 1932 or 1933 have therefore enjoyed very substantial capital gains, realized or open to realization, primarily as a result of the cyclical recovery in the heavy industries, and not because of significant additions to their book values through the retention of earnings.

(iii) The market's evaluation of securities is essentially a process of capitalizing current and prospective earnings and dividends. A change in a company's earnings prospects arising out of factors altogether unrelated to the company's investments, such as a new and important contract, is a common cause of substantial changes in the market value of a company's securities. A general improvement in the business outlook will frequently send up the prices of virtually all stocks; a change for the worse in this outlook will send down the prices of virtually all stocks; a decline in the level of interest rates tends to enhance the market value of virtually all securities.

(iv) In the treatment of capital gains and losses for tax purposes, we do not deal with aggregates or with averages, but with the experience of individuals. Individuals differ considerably in their ability to appraise the securities of particular companies and the general outlook for business. One group of individuals may enjoy substantial net capital gains during the very same year that another group of individuals suffers heavy capital losses. Hence the taxation of net capital gains, because of the uneven distribution of capital gains and losses among reporting individuals, is capable of producing substantial revenues even for a period inwhich the aggregate of reported net capital losses exceeds the aggregate of reported net capital gains.

The undistributed profits tax will tend to reduce only one of several important sources of capital gains. The other sources would remain of considerable importance. Structural changes in particular industrial fields give rise to the early capitalization by the market of unrealized large earnings prospects for particular companies — well in advance of any commensurate increase in the book value of the securities arising out of the reinvestment of earnings. Likewise, capital gains arising out of the exploitation by individuals of cyclical fluctuations would not be affected. The superior ability of some individuals to appraise investment situations, even under static conditions of general business, and the weaknesses of other individuals for unprofitable commitments, would remain as sources of capital gains and losses. The changes in the rate of interest and in the speculative temper of the moment, which powerfully affect the capitalization ratio by which the earnings of any capital instrument are translated into a capital value, will likewise remain as sources of capital gains and losses. Finally, mention need hardly be made of the unaffected possibilities of such speculative gains as flow from discoveries of oil wells and metal mines, the exploitation of new patents or secret processes, appreciation in the value of improved and unimproved real estate, et cetera.

2. Complete Segregation of Tax Treatment of Capital Gains and Losses

It has also been suggested by Mr. Parker that capital gains and losses be completely segregated from other sources of income for tax purposes. In the Tax Magazine for October 1936, Mr. Parker wrote:

> " ..... suppose we do not add capital gains to other income or subtract capital losses therefrom. Conceive of capital gains and losses going into a separate basket by themselves. Now, if you will imagine a capital gains tax with graduated rates approximating one-half our present tax rates, and imagine capital losses as an offset against gains with a provision whereby the capital net losses may be carried forward for a period of six years, it will be found that a fairly equitable result will be obtained."

Mr. Parker's suggestion differs from that of some others in that he would graduate the separate taxes applied to capital gains, whereas others would apply only a low flat tax. Neither of these types of separate taxation of capital gains would eliminate the legal and administrative difficulties that have been encountered in taxing this type of income. The great sacrifice of equity involved in divorcing the tax treatment of capital gains from that of other types of income is very inadequately reduced by graduating the separate taxes on capital gains. Such graduation would have no reference to the amount of income from other sources, and, hence, the progressive character of our income-tax system would be grossly impaired.

The revenue raised under any rate scale that is applied separately to different parts of income must inevitably fall far below the amount of revenue that could be raised if the same rate scale were applied to the entire income. Substantially higher, rather than lower rates on capital gains would be necessary to raise the same amount of revenue if capital gains were taxed separately. Mr. Parker, on the contrary, suggests rates equal to one-half those applied to ordinary income. Although the contention is often made that low rates on capital gains would allow more rather than less revenue, because of the increase in the volume of capital transactions, this contention has yet to be supported by convincing evidence. Revenues lost through reduced taxation of capital gains must be raised from other sources. The existing tax treatment of capital gains, we have previously demonstrated, already gives excessive preference to recipients of this source of income.

3. Segregation of the Type in Force between 1922 and 1933

This type of segregation was highly inequitable. Its effect was to give no benefit whatever to taxpayers with small or moderate incomes, and to confer highly preferential tax treatment to the capital gains of individuals with large incomes.

4. Segregation with Respect to Capital Losses only

The same considerations that argue in favor of the inclusion of capital gains in ordinary taxable income also argue in favor of the deductibility of capital losses from such income -- though special treatment for capital losses sustained on assets held for more than one year is supported by the same considerations that support such treatment for capital gains on assets held for more than one year.

While equitable considerations clearly call for greater liberality in the deductibility of capital losses, it is extremely doubtful that a substitute treatment based upon equitable considerations alone can long endure. It is precisely in periods when large capital losses are, or may be, realized, that the Government's revenues tend to shrink, and its expenditures to rise. The record of the past clearly indicates that if the deductibility of capital losses is too freely allowed, such liberality would be unlikely to withstand the pressure for additional revenues that will arise in some future period of business decline. It thus appears altogether probable that some measure of segregated tax treatment of capital losses is expedient to protect revenues in periods of declining business activity and declining markets.

Apart from revenue requirements as such, there are certain practicable and even equitable considerations that have influenced Congress to restrict the deductibility of capital losses. When capital losses are liberally deductible, an incentive is provided many taxpayers to design artificial transactions for the sole purpose of wiping out or greatly reducing tax liability on ordinary income. Further, since the tax treatment of capital gains and losses has been confined to realized gains and losses, the taxpayer has been given the valuable privilege of choosing the time for realizing both gains and losses; and this choice, other things being equal, can be expected to operate regularly to the advantage of the taxpayer and to the disadvantage of the Government. The mere power of a taxpayer to postpone the realization of capital gains is itself a great advantage. Not only can he choose the timing of realization to minimize his tax liability, other things being equal, but he also enjoys, interest-free, the funds that would be payable in taxes if he realized his gains as they accrued. In addition, there has been a vague feeling, only partly warranted, that capital losses in general are suffered by substantially the same persons as, at other times, enjoy capital gains; and, hence, that any preferential treatment accorded capital gains justifies some measure of harshness in the tax treatment of capital losses.

5. Complete aggregation of capital gains with other income but only partial association for purpose of tax computation

Of the four variants of this proposal that appear to be current, the first three, cited below, were outlined by Professor Maguire in an undated memorandum filed in the Treasury, entitled "Taxation of Capital Gains and Deduction of Capital Losses."

(i) Apply the regular rate scale to ordinary income and apply the top rate reached by ordinary income to the capital gains.

(ii) Begin the aggregation of income with capital gains, apply perhaps one-half of the regular rates to these gains, and the aggregate thereon to ordinary income, to which the regular rates will apply.

(iii) Apply the regular rate scale to ordinary income, compute the effective totality rate of tax on ordinary income, and apply this rate to the capital gains.

(iv) Aggregate capital gains with other income, and apply the regular income-tax rates until the segments of income representing capital gains are reached; at this point, reduce the rates otherwise applicable by perhaps one-half.

The first three of these plans appear to possess no special merit whatever. They are merely alternative means of reducing the effective taxes on capital gains, with no especially logical basis for the reduction in each base. The first plan breaks down in all instances where all other sources of income result in a deficit. A special flat rate would obviously have to be applied to the capital gains of the taxpayers who reported no other income. Further, the method might produce exceedingly whimsical results. Thus, an individual with $10,000 of ordinary surtax net income, but $1 million in capital gains, would be subject to $100,000 of taxes on his capital gains. Another individual who also reported $1 million of capital gains, but had $100,000 of ordinary surtax net income, would be subject to $590,000 of taxes on his capital gains. In other words, $90,000 of difference in ordinary surtax net income would create a difference of $490,000 in the tax applicable to the same amount of capital gains.

The second variant appears to be nothing more than a more circuitous and less defensible method for reducing the effective rates on capital gains than is presented in the fourth variant.

The third variant would yield results just as whimsical as those of the first variant. Thus, because the effective totality rate of $10,000 of ordinary surtax net income is 7 percent, and on $100,000 34 percent, the taxes on $1 million of capital gains would be $70,000 for an individual reporting $10,000 of ordinary surtax net income and $340,000 for an individual reporting $100,000 of ordinary surtax net income. A difference of $90,000 in ordinary surtax net income occasions a difference of $270,000 in tax liability on the identical amount of capital gains.

The fourth variant, whereunder capital gains would be aggregated with ordinary income but subjected to perhaps half the surtax rates that would otherwise be applicable, is worthy of some consideration. It recognizes both the size of ordinary income and the size of the capital gains in determining the taxes on the latter. On the other hand, it substitutes for the present step-down provisions, according to the number of years during which an asset was held, an all-over tax reduction on capital gains irrespective of the length of the period during which such gains accrued. Careful analysis of the effects of applying this proposal to selected cases demonstrates that the proposal would be less meritorious on equitable grounds, and more whimsical in its effects, than the existing step-down provisions, and far more so than the average accrual method which is recommended herein.

The effects of applying this proposal, as compared with the present treatment and as compared with the "accrual basis" which we have previously used as a standard of equity, are illustrated in selected cases in Tables XIV and XV.

B. Proposals for Complete Association of Capital Gains with Other Income

1. Procedure Followed under the Revenue Act of 1918

Under this Act, which was applicable to the taxable years 1918 to 1921, inclusive, gains and losses from the sale of capital assets were included with income and deductions from other sources, without any special treatment whatever for either. We have already cited the fact that this procedure is inequitable because capital gains realized in a single year often represent the gains accrued over a number of years; and the full taxation of such gains in the year of realization, because of our system of progressive rates, would result in substantially larger taxes than would have been payable had the gains been taxed as they accrued. For this reason the reintroduction of this procedure is not advocated.

2. Inventory Method

The inclusion in taxable income of accrued though unrealized gains and losses, as well as realized gains and losses, has recently been recommended, with some reservations, in a volume published by the Twentieth Century Fund, Inc. (Facing the Tax Problem). Such a treatment would obviate the necessity for rate differentials based upon duration of ownership, and would automatically eliminate the possibility of avoiding capital gains taxation by delaying transfers of assets until death. It would also permit an accurate application of the progressive income-tax schedule to the annual increases or declines in the economic power of individual taxpayers. Because it would do these things, and because, at the same time it might accomplish some of the essential purposes of the tax on undistributed corporate earnings, this possible method possesses considerable theoretical appeal — granted that its constitutional difficulties could be overcome.

There are, however, grave and decisive practical objections to this method. In the first place, it may be noted that this method of determining income, while widely employed among business enterprises, is entirely alien to the practices of the majority of individuals; and would strike many of them as being grossly unfair. An individual who had no intention of selling his house would be asked to pay an additional income tax because the tax assessor or someone else asserts that the market value of his house has risen. Or an individual deriving an unchanged income of 5 percent from certain listed bonds would be asked to pay an additional income tax because, interest rates having fallen, the market prices of his bonds, which he has no intention of selling, have risen. Every time that there is a speculative rise or fall in the stock market or in local real estate markets, individuals who did not participate at all actively or consciously in such a speculative movement, would be told that their taxable incomes must be computed with reference to these paper changes in value.

The contention that this type of tax treatment of capital gains and losses would be utterly neutral in its effect upon the securities markets by no means holds. Taxpayers who might otherwise take little notice of changes in the market values of their securities and other assets would be put on notice to take active heed of such changes; would be warned in many cases that they must sell securities that they would otherwise keep, in order merely to obtain funds with which to pay their income taxes. The practical role of speculative changes in the market values attached to capital assets would be vastly increased.

For unlisted securities and physical properties, the practical difficulties involved in obtaining accurate appraisals of changes in value are admittedly great. We have already called attention to the striking discrepancies among listed securities between book and market values. Such discrepancies are presumably no less in magnitude among unlisted securities. For physical properties, the unreliability of assessment figures, particularly as between one jurisdiction and another, are notorious.

Finally, the effect upon income-tax revenues in periods of declining capital values would be catastrophic, unless the income tax base were averaged for several years. Between December 1930 and December 1931, the aggregate decline in the market value of securities listed on the New York Stock Exchange alone amounted to more than $30 billions.

C. Modification in Present Step-Down Provisions

If the recommended plan for the tax treatment of capital gains and losses is for any reason deemed unsuitable, the most superior alternative would be a system similar to that now in effect, with liberalization of the limitations upon the deductibility of capital losses. The major inequities of the present method could be greatly reduced if the reductions in the taxable proportions of capital gains were made less pronounced; and if the loss limitation provisions were altered in the manner recommended below. (Tables IX and X compare this improved step-down schedule with the present step-down schedule and with the standard of equity described in Section IV.)

(1) Taxable proportions of capital gains under improved step-down schedule compared with those under present schedule.

Asset held	Proposed	Present
	(Percent)	
Under 1 year	100	100
1 - 2 years	80	80
2 - 3 years	75	60
3 - 4 years	70	60
4 - 5 years	65	60
5 - 10 years	60	40
Over 10 years	55	30

(2) In addition to the capital losses allowed in the current year through operation of the step-down percentages to the extent of the included capital gains, the excess of such included losses should be carried forward for use in the next two years as an offset against the included capital gains in those years.

D. Proposals to Tax Capital Gains on an Average Basis

To obviate the more important legal and other difficulties involved in the inventory method, but nevertheless to approximate the equitable advantages of such a method, various types of averaging devices for capital gains and losses have been proposed. None of these plans would necessarily diminish the deterrent influence of capital gains taxes upon transactions in capital assets for they are all based upon the tax treatment of realized gains and losses.

1. Proposal to Average Total Income Including Capital Gains and Losses in Full

The most usual form taken by the averaging proposals is that in which all income of the taxpayer including capital gains and losses is averaged for a period of years to determine the tax base. Great Britain formerly employed a 3-year average of income for income-tax purposes generally (though gains and losses from casual sales of property were excluded); but objections from taxpayers who were called upon to pay relatively heavier taxes in periods of declining incomes led to the abandonment of the averaging system in 1927.

Professor Henry C. Simons has suggested that capital gains and losses be reported fully with other income in the year realized, but that every five years or so the Treasury make rebates to those individuals whose actual tax payments exceeded by more than five percent the aggregate taxes that would have been payable if their taxable incomes each year had equalled their average income for the period. This proposal is attractive in many respects; but it would involve an enormous administrative burden upon the Bureau of Internal Revenue, which would be required to compute the putative tax liability for each taxpayer who reported gains or losses from capital transactions in the average period fixed upon.

2. Proposal to Average Capital Gains and Losses Separately from Other Sources of Income

The proposal to average capital gains and losses separately from other sources of income has not been incorporated in the income tax law of any major country so far as known. This proposal has the merit of ironing out severe fluctuations in capital gains and losses, but is subject to somewhat the same limitations as the plan for averaging capital gains and losses together with other income.

3. The Average Accrual Method (Recommended Plan)

Among the various proposed methods of averaging capital gains and losses and associating them with ordinary income, the method that appears to be freest from anomalies is the average accrual method, recommended in Section VII.

The essential merit of the average accrual approach to the tax treatment of capital gains is that it places the treatment on a definitely uniform basis for all classes of taxpayers, and that it appears to represent the nearest practicable approach to perfect equity in such treatment. The treatment accorded net capital losses may be debatable, because of the limitations placed upon their deductibility; but, as previously noted, it is virtually impossible to design an equitable tax treatment for capital losses that can be expected to override revenue requirements in years when opportunities for loss realization are great. The computation of the tax may conceivably be deemed unduly complicated for the average taxpayer; but this difficulty, if it be a real one, is worth facing if the primary object is to obtain the most equitable and continuing tax treatment of capital gains that seems practicable.

The most serious objection that may be raised to this method, in the minds of many, is to be found in its results upon the effective rates of taxes applied to capital gains. While the essential effect of this method would be merely to subject capital gains to substantially the same rates of tax that apply to other sources of income, a measure of the extent to which the method would raise the taxes now applicable to capital gains is presented in Table XI. The claim will be made that these increases will seriously constrict the volume of transactions in capital assets. On this point, the available evidence does not permit a conclusive position.

It is important to emphasize two considerations in this connection, however. In the first place, if the conviction became widespread that the application of this method marked the end of our long period of experimentation with the taxation of capital gains, and if the existing opportunity for the complete avoidance or substantial reductions in such taxes by transfers at death and through inter vivos gifts were eliminated, the incentive for delayed realization of capital gains would be greatly reduced. In the second place, and because of the same factors, the contingent tax liability involved in unrealized capital gains could be expected to exercise a far more powerful influence in counteracting any existing tendency to delay liquidation than it does today.

There are several important reasons for the latter expectation. An investor who today holds assets incorporating unrealized capital gains is offered a definite tax reduction, assuming a constant future income, to delay liquidation for a period up to just beyond ten years in any event; and even until death. This tax inducement would be eliminated if the recommendations were adopted. The investor might still obtain a tax advantage by delaying liquidation if he expected his ordinary income in some future year to be substantially below his present income, or his capital losses greater, provided that he could look forward confidently to realizing much of his present possible gain in such a year. It should be noted that the conditions which are unfavorable for large amounts of other income, and favorable for the realization of capital losses, tend to be unfavorable for the realization of capital gains. Hence, it can be said that the subject proposal would greatly diminish this deterrent influence to the liquidation of capital assets.

Another consideration which is important in the minds of large investors is the possibility that our long period of experimentation with capital gains taxation will be indefinitely continued, with recurring opportunities, by reason of favorable alterations in tax treatment, to liquidate capital assets with far lesser tax liability than would be incurred today. Thus, many persons at this moment are doubtless contemplating the possibility of the return to the 12½ percent maximum rate that was in force between 1922 and 1933, inclusive, or one even lower. If it appeared that the adoption of the average accrual plan, because of its preeminent equity, as compared with practicable alternatives, and because of its consistency with the remainder of our income-tax structure, definitely settled the problem of capital gains taxation, a very considerable part of the existing tax influence upon capital transactions would be removed.

Appendix A
Tables

APPENDIX A- TABLES

Table I

Percentages by which Income Taxes payable upon Capital Gains are less under the present Five-Step System than they would be if the Realized Gains were Taxed on the "Accrual Basis", for Selected Surtax Net Incomes 1/

Surtax net income from other sources	Number of years assets were held 2/ 1	2	5	10
A. Assuming net capital gains equal to surtax net income from other sources				
5,000	21.7	39.5	57.5	68.8
10,000	25.0	39.0	58.2	69.1
20,000	22.7	39.3	58.0	67.9
50,000	24.3	37.7	56.5	67.3
100,000	20.3	39.7	60.0	70.0
500,000	20.3	39.7	60.0	70.0
B. Assuming net capital gain of $50,000 for each selected surtax net income from other sources				
5,000	29.4	34.7	46.1	60.4
10,000	28.9	36.1	48.5	59.8
20,000	27.6	37.3	56.4	66.8
50,000	24.3	37.7	56.5	67.3
100,000	20.0	40.0	60.0	70.0
500,000	20.0	40.0	60.0	70.0

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1/ For a description of the "accrual basis", see p. 14.
2/ Plus one day.

Table II

Gross Annual Investment Yields Required to Equal the Average Net Returns after Federal Income Taxes of Gross Capital Gains Averaging Five Percent per Annum, Compounded Annually, for Selected Cases

Selected Cases	Years capital assets held 1/ 10	5	2	1
1. Other surtax net income = $200,000; original investment = $1,000,000;				
Average annual yield from capital gains after Federal income taxes	4.1	3.7	3.0	2.4
Gross annual investment yield required for equal return after Federal income taxes	12.8	11.5	9.2	7.1
2. Other surtax net income = $100,000; original investment = $500,000;				
Average annual yield from capital gains after Federal income taxes	4.2	3.8	3.2	2.5
Gross annual investment yield required for equal return after Federal income taxes	11.1	10.1	8.3	6.6
3. Other surtax net income = $50,000; original investment = $250,000:				
Average annual yield from capital gains after Federal income taxes	4.4	4.2	3.9	3.5
Gross annual investment yield required for equal return after Federal income taxes	7.2	6.9	6.3	5.7
4. Other surtax net income = $20,000; original investment = $100,000:				
Average annual yield from capital gains after Federal income taxes	4.7	4.6	4.4	4.2
Gross annual investment yield required for equal return after Federal income taxes	5.9	5.8	5.5	5.3
5. Other surtax net income = $5,000; original investment = $25,000:				
Average annual yield from capital gains after Federal income taxes	4.9	4.8	4.8	4.7
Gross annual investment yield required for equal return after Federal income taxes	5.3	5.3	5.2	5.1

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1/ Plus one day.

Table III

Gross Annual Investment Yields Required to Equal the Average Net Returns after Federal Income Taxes of Gross Capital Gains Averaging Ten Percent per Annum, Compounded Annually, for Selected Cases

Selected Cases	Years capital assets held 1/			
	10	5	2	1
1. Other surtax net income = $200,000; original investment = $1,000,000:				
Average annual yield from capital gains after Federal income taxes	8.5	7.6	6.1	4.7
Gross annual investment yield required for equal return after Federal income taxes	27.7	24.6	19.2	14.5
2. Other surtax net income = $100,000; original investment = $500,000:				
Average annual yield from capital gains after Federal income taxes	8.6	7.8	6.4	5.0
Gross annual investment yield required for equal return after Federal income taxes	23.5	21.2	17.1	13.4
3. Other surtax net income = $50,000; original investment = $250,000:				
Average annual yield from capital gains after Federal income taxes	8.8	8.2	7.5	6.8
Gross annual investment yield required for equal return after Federal income taxes	16.4	15.1	13.4	12.0
4. Other surtax net income = $20,000; original investment = $100,000:				
Average annual yield from capital gains after Federal income taxes	9.4	9.2	8.7	8.3
Gross annual investment yield required for equal return after Federal income taxes	12.0	11.7	11.1	10.6
5. Other surtax net income = $5,000; original investment = $25,000:				
Average annual yield from capital gains after Federal income taxes	9.8	9.7	9.5	9.3
Gross annual investment yield required for equal return after Federal income taxes	10.7	10.6	10.4	10.2

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1/ Plus one day.

Table IV

Average annual rate of gross capital gains, compounded annually, required to equal net yield after Federal income taxes from 3½ percent taxable bond

Selected cases	Years capital asset held 1/			
	10	5	2	1
1. Other surtax net income = 200,000; bond investment = 1,000,000				
Bond yield after taxes	1.2	1.2	1.2	1.2
Average annual capital gain required for equal return after Federal income taxes	1.5	1.6	2.0	2.5
2. Other surtax net income = 100,000; bond investment = 500,000				
Bond yield after taxes	1.3	1.3	1.3	1.3
Average annual capital gain required for equal return after Federal income taxes	1.6	1.8	2.1	2.6
3. Other surtax net income = 50,000; bond investment = 250,000				
Bond yield after taxes	2.2	2.2	2.2	2.2
Average annual capital gain required for equal return after Federal income taxes	2.5	2.6	2.8	3.1
4. Other surtax net income = 20,000; bond investment = 100,000				
Bond yield after taxes	2.8	2.8	2.8	2.8
Average annual capital gain required for equal return after Federal income taxes	3.0	3.0	3.2	3.3
5. Other surtax net income = 5,000; bond investment = 25,000				
Bond yield after taxes	3.2	3.2	3.2	3.2
Average annual capital gain required for equal return after Federal income taxes	3.3	3.3	3.4	3.4

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1/ Plus one day.

TABLE V

Average annual rate of gross capital gains, compounded annually, required to equal net yield after Federal income taxes from 3 percent fully tax-exempt bond

Selected cases	Years capital asset held 1/			
	10	5	2	1
1. Other surtax net income = 200,000; bond investment = 1,000,000				
Bond yield	3.0	3.0	3.0	3.0
Average annual capital gain required for equal return after Federal income taxes	3.7	4.0	4.9	6.4
2. Other surtax net income = 100,000; bond investment = 500,000				
Bond yield	3.0	3.0	3.0	3.0
Average annual capital gain required for equal return after Federal income taxes	3.6	3.9	4.7	6.0
3. Other surtax net income = 50,000; bond investment = 250,000				
Bond yield	3.0	3.0	3.0	3.0
Average annual capital gain required for equal return after Federal income taxes	3.4	3.5	3.8	4.2
4. Other surtax net income = 20,000; bond investment = 100,000				
Bond yield	3.0	3.0	3.0	3.0
Average annual capital gain required for equal return after Federal income taxes	3.2	3.3	3.4	3.6
5. Other surtax net income = 5,000; bond investment = 25,000				
Bond yield	3.0	3.0	3.0	3.0
Average annual capital gain required for equal return after Federal income taxes	3.1	3.1	3.2	3.2

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1/ Plus one day.

Table VI

Profits and Losses from Sale of Assets as Reported in Individual Returns Showing Net Income 1/

(In millions of dollars)

Taxable year	Profits from sale of assets: Taxed as capital net gain	Other than taxed as capital net gain	Total	Losses from sale of assets: Total capital net loss 2/	Net loss from sale of assets other than reported for tax credit on capital net loss	Total	Aggregate profits less losses
1922	249.2	742.1	991.3		3/		
1923	305.4	866.8	1,172.2		3/		
1924	389.1	1,124.6	1,513.7	72.0	3/		
1925	940.6	1,991.7	2,932.3	61.6	3/		
1926	912.9	1,465.6	2,378.5	34.4	178.2	212.6	2,165.9
1927	1,081.2	1,813.4	2,894.6	48.0	227.9	275.9	2,618.7
1928	1,879.8	2,928.1	4,807.9	40.8	171.7	212.5	4,595.4
1929	2,346.7	2,337.9	4,684.6	43.2	995.9	1,039.1	3,645.5
1930	556.4	636.7	1,193.1	80.8	1,232.8	1,313.6	- 120.5
1931	169.9	301.7	471.6	239.9	1,160.8	1,400.7	- 929.1
1932	50.1	112.8	162.9	832.4	375.4	1,207.8	- 1,044.9
1933	133.6	419.6	553.2	553.8	365.8	919.6	- 366.4

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1/ The comparability of the figures between years is affected by (1) changes in individuals required to file returns; (2) estimates for net incomes under $5,000; and (3) changes in the statutory treatment of capital gains and losses, which are detailed in Section III (pages 8, 9, 10 and 12).

2/ No figures for capital net losses are available for years prior to the taxable year 1924. The figures shown for the years 1924 through 1930 were obtained through the capitalization of the 12½ percent tax credit on capital net losses as reported in Statistics of Income; and are incomplete because the tax credit was computed only on that amount of the taxpayers' capital net loss which was necessary to offset his tax. The figures for the years 1931-1933 are the actual capital net losses which were tabulated and reported in Statistics of Income.

3/ Not available

Source of data: Statistics of Income.

Table VII

Percentage of total net profits on sale of capital assets
derived from assets held for two years or less, or
from assets held for longer periods by persons
subject to tax thereon of 12½ percent or less 1/

Date	Net income classes: Under 50,000 2/	Net income classes: 50,000-100,000	Net income classes: 100,000 and over	Aggregate - all classes
1922	97.6	45.2	17.6	74.9
1923	97.4	33.4	6.9	73.9
1924	96.6	46.4	16.3	74.3
1925	98.2	58.0	24.3	67.9
1926	97.7	46.2	18.0	61.6
1927	97.7	51.1	24.2	62.6
1928	97.5	58.9	31.3	60.9
1929	98.4	49.1	15.9	49.9
1930	97.6	32.8	8.3	53.4
1931	98.4	33.7	11.0	64.0
1932	91.7	30.4	15.6	69.2
1933	95.3	67.6	29.8	75.9
1922-1933	97.6	50.9	21.3	62.1

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1/ For factors effecting the comparability of the data from year to year, see note 1 to Table VI.

2/ The percentages for the income class of less than $50,000 are not comparable with the percentages for the other groups, because the former include a substantial part of the profits on sale of assets held for more than two years, whereas the others do not.

Source of data: Statistics of Income.

Table VIII

Net Gains from Sale of Capital Assets in 1934 by Net Income Classes and Statutory Periods that Assets Were Held 1/

Net income classes	1 year and under	1 - 2 years	2 - 5 years	5 - 10 years	Over 10 years	Not stated	Aggregate
	(In thousands of dollars)						
0 - 5	21,875	8,982	6,205	2,900	13,577	2,870	56,409
5 - 25	45,382	21,975	9,397	2,727	28,830	4,178	112,489
25 - 50	15,150	6,868	3,293	253	15,499	1,548	42,611
50 - 100	8,888	4,907	962	1,389	9,558	971	26,675
Over 100	6,772	4,143	138	2,077	34,396	1,480	49,006
Aggregate	98,067	46,875	19,995	9,346	101,860	11,047	287,190
	(Percentages of totals for each class)						
0 - 5	38.8	15.9	11.0	5.1	24.1	5.1	100.0
5 - 25	40.4	19.5	8.4	2.4	25.6	3.7	100.0
25 - 50	35.6	16.1	7.7	.6	36.4	3.6	100.0
50 - 100	33.4	18.4	3.6	5.2	35.8	3.6	100.0
Over 100	13.8	8.5	.3	4.2	70.2	3.0	100.0
Aggregate	34.1	16.3	7.0	3.3	35.5	3.8	100.0

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1/ Excludes net capital gains of returns reporting net deficits.

Note: The change in treatment of capital gains and losses by the Revenue Act of 1934 makesthe statistics on capital gains and losses for that year incomparable with those for prior years. In the first place, the capital gains realized by members of partnerships and beneficiaries of trusts and estates cease to be detailed in their individual returns; so that the data for capital gains realized by individuals in 1934 do not include the capital gains realized by partnerships and fiduciaries in which they held interests.

In the second place, the abandonment of the special treatment of capital gains and losses from the sale of assets held for more than two years, and the substitution of the five-step system, results in the offsetting, in some cases, of gains realized from the sale of assets held two years or less, against losses from the sale of assets held

(Continued on next page)

Note: (Continued)

more than two years, and vice versa. Previously, a net positive or negative balance was determined both for the capital gains and losses included in ordinary income and for the capital gains and losses subjected to the special treatment. Thus, where two separate net balances have been determined, only one net balance is available under the five-step system.

Finally, the five-step system makes it possible for returns showing net capital gains, when 100 percent of their capital gains and losses are considered, to show net capital losses after application of the percentage brackets, and, similarly, returns showing aggregate net capital losses before application of the statutory percentages may show net capital gains after the percentages are applied. Hence, the statistics for 1934, wherein the net capital gains returns are separated from the net capital loss returns on the basis of the net balance existing after the operation of the statutory percentages, necessarily include certain amounts which would have formerly been excluded, and vice versa.

The tabulations of the 1934 data were the result of a Work Relief Project sponsored by the Division of Research and Statistics, Treasury Department. Not all of the 1934 returns were included in the survey, however, inasmuch as certain returns were in the field or in Washington in the process of audit, et cetera. In general, the incompleteness was concentraded in the lower income classes where, because of the larger number of cases, it had the minimum effect upon the reliability of the figures. In addition to these differences from the Statistics of Income data, the source of the figures for the special tabulation was Schedule C (Statement of Capital Gains and Losses), whereas the Statistics of Income data were tabulated from the face of the return.

Table IX

Percentages whereby Capital Gains Taxes Payable under Improved Step-Down Schedule would be Greater than those under Present Schedule, for Selected Cases

Surtax Net Income From Other Sources	No. of Years Assets were Held 1/ 1	2	5	10
A. Assuming net capital gains equal to surtax net income from other sources				
5,000	0.0	28.8	52.9	90.4
10,000	0.0	31.3	56.5	92.6
20,000	0.0	28.8	54.8	94.3
50,000	0.0	32.0	62.1	102.9
100,000	0.0	25.7	50.8	83.9
500,000	0.0	25.6	50.7	83.8
B. Assuming net capital gain of $50,000 for each selected surtax net income from other sources				
5,000	0.0	38.9	82.7	149.7
10,000	0.0	36.6	72.0	125.1
20,000	0.0	35.1	63.9	104.9
50,000	0.0	32.0	62.1	102.9
100,000	0.0	25.0	50.0	83.3
500,000	0.0	25.0	50.0	83.3

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1/ Plus one day.

Note: The improved schedule would provide for the inclusion in net income of the following percentages of net capital gains and losses, according to number of years held: 1-2 years, 80 percent; 2-3 years, 75 percent; 3-4 years, 70 percent; 4-5 years 65 percent; 5-10 years, 60 percent; over 10 years, 55 percent.

Table X

Percentages by which Income Taxes Payable upon Capital Gains would be Less under Improved Step-Down Schedule 1/ than they would be if the Realized Gains were Taxed on the "Accrual Basis" 2/ for Selected Cases

Surtax Net Income From Other Sources	No. of Years Assets were Held 3/ 1	2	3	4	5	10
	A. Assuming net capital gains equal to surtax net income from other sources					
5,000	21.7	22.1	26.2	30.5	35.0	40.5
10,000	25.0	19.9	23.7	29.0	34.5	40.5
20,000	22.7	21.7	24.8	29.5	35.0	37.6
50,000	24.3	17.8	19.1	23.3	29.5	33.6
100,000	20.3	24.2	29.4	34.5	39.7	44.8
500,000	20.3	24.3	29.5	34.6	39.7	44.9
	B. Assuming net capital gain of $50,000 for each selected surtax net income from other sources					
5,000	29.4	9.3	- 1.1	- 3.1	1.5	1.2
10,000	28.9	12.7	9.1	8.9	11.5	9.6
20,000	27.6	15.2	16.9	21.9	28.6	32.0
50,000	24.3	17.8	19.1	23.3	29.5	33.6
100,000	20.0	25.0	30.0	35.0	40.0	45.0
500,000	20.0	25.0	30.0	35.0	40.0	45.0

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1/ The improved schedule would provide for the inclusion in net income of the following percentages of net capital gains and losses, according to number of years held: 1-2 years, 80 percent; 2-3 years, 75 percent; 3-4 years, 70 percent; 4-5 years, 65 percent; 5-10 years, 60 percent; over 10 years, 55 percent.
2/ For a description of the "accrual basis," see p. 14.
3/ Plus one day.

Table XI

Percentages by which Income Taxes Payable upon Capital Gains would be greater under the "Accrual Basis,"1/ than under the Present Five-Step System for Selected Surtax Net Incomes

Surtax Net Income From Other Sources	Number of Years Assets were Held 2/ 1	2	5	10
A. Assuming net capital gains equal to surtax net income from other sources				
5,000	27.8	65.4	135.3	220.0
10,000	33.3	63.9	139.1	223.5
20,000	29.4	64.6	138.1	211.5
50,000	32.1	60.5	129.9	205.4
100,000	25.5	65.8	150.0	233.3
500,000	25.4	65.9	150.0	233.3
B. Assuming net capital gain of $50,000 for each selected surtax net income from other sources				
5,000	41.7	53.2	85.5	152.7
10,000	40.7	56.5	94.3	148.9
20,000	38.1	59.4	129.6	201.5
50,000	32.1	60.5	129.9	205.4
100,000	25.0	66.7	150.0	233.3
500,000	25.0	66.7	150.0	233.3

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1/ For a description of the "accrual basis," see p. 14.
2/ Plus one day.

Table XII

Book Value and Closing Market Prices of the Fifteen Most Active Stocks on the New York Stock Exchange on December 31, 1936
(Listed in order of activity)

	Book value per share	Market price per share
Ohio Oil Company	$ 11.86	$ 17-3/4
General Motors Corporation	18.46	63-1/2
Paramount Pictures, Inc.	11.23	24-1/2
Socony Vacuum Oil Company, Inc.	19.98	16-7/8
Consolidated Oil Corporation	17.86	16-7/8
Columbia Gas and Electric Corporation	17.36	18-3/8
Pure Oil Company	22.60	20-7/8
Radio Corporation of America	3.10	11-1/2
United Air Lines Transport Corporation	8.48	22
United States Steel Corporation	138.37	78
Warner Bros. Pictures, Inc.	22.69	17-3/4
Pierce Petroleum Corporation	7.55	3-1/2
Commonwealth and Southern Corporation	5.27	3-3/8
Consolidated Textile Corporation	1.14	7/8
Anaconda Copper Mining Company	55.88	53-1/2

Source: Moody's Investment Service.

Table XIII

Comparison of changes in market and book values of common stocks of railroad equipment and iron and steel companies, 1932-1936 1/

Company	Book value per share: Dec. 31, 1932	Book value per share: Dec. 31, 1936	Book value per share: Percent change	Market value per share: Dec. 31, 1932	Market value per share: Dec. 31, 1936	Market value per share: Percent change
Railroad Equipment						
American Brake Shoe and Foundry Company	$ 27.67	$ 27.98	+ 1.1	$ 9.63	$ 69.00	+616.5
American Car and Foundry Company 2/	99.88	90.10	- 9.8	7.00	59.25	+746.4
American Locomotive Company	68.80	20.91	-69.6	5.88	45.75	+678.1
American Steel Foundries	42.11	38.10	- 9.5	5.63	61.88	+999.1
Baldwin Locomotive Works	40.55	13.78	-66.0	4.50	9.50	+111.1
General American Transportation Corporation	64.82	62.64	- 3.4	17.00	73.38	+331.6
General Railway Signal Company	32.91	29.55	-10.2	13.25	56.50	+326.4
Pullman, Inc.	69.58	60.72	-12.7	18.88	68.50	+262.8
Union Tank Car Company	30.26	29.65	- 2.0	12.00	26.75	+122.9
Westinghouse Air Brake Company	17.65	14.43	-18.2	11.25	50.00	+344.4
Steel and Iron						
American Rolling Mill Company	30.84	31.74	+ 2.9	8.00	34.75	+334.4
Bethlehem Steel Corporation	126.60	113.02	-10.7	14.75	75.50	+411.9
Byers (A. M.) Company	56.43	44.06	-21.9	13.25	28.25	+113.2
Colorado Fuel and Iron Corporation	38.77	32.63	-15.8	4.50	45.63	+914.0
Crucible Steel Company of America	150.56	160.80	+ 6.8	20.00	53.63	+168.2
Inland Steel Company	49.28	53.27	+ 8.1	12.75	117.50	+821.6
National Steel Corporation	47.41	50.97	+ 7.5	20.00	71.50	+257.5
U. S. Pipe and Foundry Company	37.38	37.17	- .6	9.50	63.00	+563.2
U. S. Steel Corporation	168.84	129.03	-23.6	27.50	78.00	+183.6
Youngstown Sheet and Tube Company	91.53	76.66	-16.2	9.88	78.00	+689.5
Republic Steel Corporation	68.47	38.53	-43.7	5.50	28.75	+422.7

1/ All railroad equipment and iron and steel companies included in Standard Statistics Co. averages.
2/ 1932 figures for year ended April 30, 1933; 1936 figures for year ended April 30, 1936.

Table XIV

Percentages by Which Present Capital Gains Taxes would be Reduced or Increased by Subjecting Capital Gains to Normal Tax Plus one-half of Surtax Rates, in Lieu of Present Step-Down Provisions, for Selected Cases

Surtax net income from other sources	Number of years assets were held 1/ 1	2	5	10
	A. Assuming net capital gains equal to surtax net income from other sources			
5,000	- 8.3	+ 26.9	+ 94.1	+ 164.0
10,000	- 13.7	+ 22.2	+ 91.3	+ 158.8
20,000	- 24.2	+ 5.0	+ 62.5	+ 123.8
50,000	- 28.5	+ 1.9	+ 65.2	+ 129.5
100,000	- 33.3	- 10.4	+ 35.1	+ 80.1
500,000	- 33.9	- 11.4	+ 33.4	+ 77.9
	B. Assuming net capital gain of $50,000 for each selected surtax net income from other sources			
5,000	- 16.5	+ 27.8	+ 133.4	+ 262.9
10,000	- 18.6	+ 21.8	+ 109.4	+ 209.3
20,000	- 22.1	+ 15.2	+ 88.8	+ 162.7
50,000	- 28.5	+ 1.9	+ 65.2	+ 129.5
100,000	- 33.5	- 11.3	+ 33.1	+ 77.4
500,000	- 34.1	- 12.2	+ 31.8	+ 75.7

1/ Plus one day.

Table XV

Percentages by which Capital Gains Taxes would be Smaller or Greater if Capital Gains were subjected to Normal Tax Plus One-half of Surtax Rates than they would be under the "Accrual Basis" 1/ for Selected Cases

Surtax Net Income From Other Sources	Number of Years Assets were Held 2/: 1	2	5	10
A. Assuming net capital gains equal to surtax net income from other sources				
5,000	- 28.3	- 23.3	- 17.5	- 17.5
10,000	- 35.3	- 25.4	- 20.0	- 20.0
20,000	- 41.4	- 36.2	- 31.8	- 28.2
50,000	- 45.9	- 36.5	- 28.1	- 24.9
100,000	- 46.8	- 46.0	- 46.0	- 46.0
500,000	- 47.3	- 46.6	- 46.6	- 46.6
B. Assuming net capital gain of $50,000 for each selected surtax net income from other sources				
5,000	- 41.1	- 16.6	+ 25.8	+ 43.6
10,000	- 42.1	- 22.2	+ 7.8	+ 24.2
20,000	- 43.6	- 27.8	- 17.8	- 12.9
50,000	- 45.9	- 36.5	- 28.1	- 24.9
100,000	- 46.8	- 46.8	- 46.8	- 46.8
500,000	- 47.3	- 47.3	- 47.3	- 47.3

1/ For a description of "accrual basis", see page 14.
2/ Plus one day.

Appendix B - Proposed Schedules and Examples

Schedule C

Statement of Gains, Where There Are No Losses, from Sale (or Exchange) of Assets
(In cases where there are losses and no gains from sale (or Exchange) of assets, this form may be used by treating losses as gains after inserting a minus sign before each loss)

1. Description of Property and Period Held	2. Date Acquired	3. Date Sold or Exchanged	4. Gross Sales Price (Contract price)	5. Cost or March 1, 1913, Value if Acquired Before that Date. (Indicate basis)**	6. Cost of Improvements Subsequent to Acquisition or March 1, 1913	7. Depreciation Allowed (or Allowable) Since Acquisition or March 1, 1913 (Furnish details)	8. Gain	9. No. of years held*	10. Weighted gains (Col. 8 X Col. 9)
Partnerships & fiduciaries									
1. Total							......	XXXXX.	....

2. Average investment period for gains* (Line 1, Col. 10 divided by Col. 8) .... : ....
3. Average annual gain (Line 1, Col. 8 divided by line 2) .... : ....
4. Surtax net income (From item 24 page 1 of return; if none, enter a zero) .... : ....
5. Surtax net income plus net average annual gain (Line 3 plus line 4) .... : ....
6. Tentative tax on line 5 (Use rate schedule below) .... : ....
7. Tentative tax on line 4 (Use rate schedule below) .... : ....
8. Tax on average annual gain (Line 6 minus line 7) .... : ....
9. Total tax on capital gains (Line 8 multiplied by line 2) .... : ....

*Disregard fractional parts of a year unless they amount to one-half or more, in which case, count them as a full year.

Schedule C – Part 1

Statement of Gains and Losses from Sale (or Exchange) of Assets

1. Description of Property and Period Held	2. Date Acquired	3. Date Sold or Exchanged	4. Gross Sales Price (Contract price)	5. Cost or March 1, 1913, Value if Acquired Before that Date. (Indicate basis)**	6. Cost of Improvements Subsequent to Acquisition or March 1, 1913	7. Depreciation Allowed (or Allowable) Since Acquisition or March 1, 1913 (Furnish details)	8. Gain	9. Loss	10. No. of years held*	11. Weighted gains (Col. 8 X Col. 10	12. Weighted losses (Col. 9 X Col. 10
Partnerships & fiduciaries											
1. Total									XXXXX		

2. Average Investment period for gains* (Line 1, Col. 11 divided by Col. 8)		
3. Average investment period for losses* (Line 1, Col. 12 divided by Col. 9)		
4. Average annual gain (Line 1, Col. 8 divided by line 2)		
5. Average annual loss (Line 1, Col. 9 divided by line 3)		
6. Net average annual gain or loss (Line 4 minus line 5; if line 5 exceeds line 4, indicate net average annual loss by using minus sign)		
7. Average annual gain or loss for longer investment period (Enter line 4 if line 2 is greater than line 3; otherwise enter line 5, preceded by a minus sign)		

*Disregard fractional parts of a year unless they amount to one-half or more, in which case, count them as a full year

Schedule C - Part 2*

Computation of Tax or Tax Credit on Capital Gains and Losses

8. Surtax net income (From item 24 page 1 of return; if none, enter a zero)	
9. Surtax net income adjusted for net average annual gain or loss (Line 6 plus line 8)	
10. Tentative tax on line 9 (Use rate schedule below)	
11. Surtax net income adjusted for average annual gain or loss for longer average investment period (Line 7 plus line 8)	
12. Tentative tax on line 11 (Use rate schedule below)	
13. Tentative tax on line 8 (Use rate schedule below)	
14. Annual tax or tax credit with respect to shorter average investment period (Line 10 minus line 12)	
15. Total tax or tax credit with respect to shorter average investment period (Line 14 multiplied by line 2 or line 3, whichever is smaller)	
16. Annual tax or tax credit with respect to longer average investment period (Line 12 minus line 13)	
17. Total tax or tax credit with respect to longer average investment period (Line 16 multiplied by line 2 or line 3, whichever is greater)	
18. Aggregate tax or tax credit on capital gains and losses (Line 15 plus line 17)	

*For a discussion of the tax computation procedure followed in this schedule, see page 69.

Combined normal tax and surtax rates*

Amount of surtax net income	Rate (percent)	Total normal tax and surtax
0 - 4,000	4	$ 160
4,000 - 6,000	8	320
6,000 - 8,000	9	500
8,000 - 10,000	10	700
10,000 - 12,000	11	920
12,000 - 14,000	12	1,160
14,000 - 16,000	13	1,420
16,000 - 18,000	15	1,720
18,000 - 20,000	17	2,060
20,000 - 22,000	19	2,440
22,000 - 26,000	21	3,280
26,000 - 32,000	23	4,660
32,000 - 38,000	25	6,160
38,000 - 44,000	28	7,840
44,000 - 50,000	31	9,700
50,000 - 56,000	35	11,800
56,000 - 62,000	39	14,140
62,000 - 68,000	43	16,720
68,000 - 74,000	47	19,540
74,000 - 80,000	51	22,600
80,000 - 90,000	55	28,100
90,000 - 100,000	59	34,000
100,000 - 150,000	62	65,000
150,000 - 200,000	64	97,000
200,000 - 250,000	66	130,000
250,000 - 300,000	68	164,000
300,000 - 400,000	70	234,000
400,000 - 500,000	72	306,000
500,000 - 750,000	74	491,000
750,000 - 1,000,000	76	681,000
1,000,000 - 2,000,000	77	1,451,000
2,000,000 - 5,000,000	78	3,791,000
5,000,000 and over	79	

Note: Where the amount to be subjected to tax is preceded by a minus sign, compute the tax disregarding the minus sign, then insert a minus sign before the resulting tax to indicate a tax credit.

*In order to simplify as much as possible the actual tax computation for the taxpayer, it is advisable to print in the capital gains schedule a table showing the combined normal and surtax rates. It is possible to combine the two rates because the recommended treatment disallows, in computing the tax or tax credit on capital gains and losses, any portions of the personal exemption and credit for dependents, and the minimum earned income credit, which are not utilized in computing the tax on ordinary income.

Note on Tax Computation Procedure Used in Part 2 of Proposed Schedule

The tax computation procedure described in the recommended plan may be shown symbolically as follows:

Let T = total tax on capital gains.
Let S = number of years in shorter average investment period.
Let L = number of years in longer average investment period.
Let O = total tax on surtax net income.
Let A = total tax on sum of surtax net income, average annual gain, and average annual loss.
Let B = total tax on sum of surtax net income and average annual gain or average annual loss, whichever accrued for the longer average investment period.

Then, $T = S(A - O) + (L - S)(B - O)$

or, $T = SA - OS + LB - SB + OS - OL$

from which, $T = SA + LB - SB - OL$

or, $T = S(A - B) + L(B - O)$

This latter tax procedure has been adopted in the proposed schedule (Schedule C, Part 2; see page 67) because it produces identical results with the tax procedure under the recommended plan while substituting simpler computations.

Illustrative Examples

For purposes of illustrating the operation of the recommended plan for the tax treatment of the capital gains and losses of individuals, twelve cases, with varying assumptions respecting surtax net income and capital gains and losses, have been chosen. These cases, which follow immediately, are reported in the same form as the proposed schedules for capital gains. The assumptions for each case appear in the respective schedules.

It will be noted that Cases I and II have capital gains and no capital losses; Cases III and IV, capital losses and no capital gains; and Cases V through X both capital gains and capital losses. Cases I, III, V, and VIII have no surtax net income, while the remaining cases have surtax net incomes of varying amounts.

Cases I and II

Schedule C

Statement of Gains, Where There Are No Losses, From Sale (or Exchange) of Assets
(In cases where there are losses and no gains from sale (or exchange) of assets, this form may be used by treating losses as gains after inserting a minus sign before each loss)

	8. Gain	9. No. of years held*	10. Weighted gains (Col. 8 X Col. 9)
	2,000	1	2,000
	3,000	2	6,000
	4,000	3	12,000
	5,000	4	20,000
	1,000	5	5,000
	5,000	6	30,000
	70,000	7	490,000
	10,000	8	80,000
	5,000	9	45,000
	5,000	10	50,000
1. Total	110,000	XXXXXX	740,000

	Case I	Case II
2. Average investment period for gains* (Line 1, Col. 10 divided by Col. 8)	7	7
3. Average annual gain (Line 1, Col. 8 divided by line 2)	15,714	15,714
4. Surtax net income (From item 24 page 1 of return; if none, enter a zero)	0	10,000
5. Surtax net income plus net average annual gain (Line 3 plus line 4)	15,714	25,714
6. Tentative tax on line 5 (Use rate schedule below)	1,383	3,220
7. Tentative tax on line 4 (Use rate schedule below)	0	700
8. Tax on average annual gain (Line 6 minus line 7)	1,383	2,520
9. Total tax on capital gains (Line 8 multiplied by line 2)	9,681	17,640

* Disregard fractional parts of a year unless they amount to one-half or more, in which case, count them as a full year.

Cases III and IV

Schedule C

Statement of Gains, Where There Are No Losses, from Sale (or Exchange) of Assets
(In cases where there are losses and no gains from sale (or exchange) of assets, this form may be used by treating losses as gains after inserting a minus sign before each loss)

							8. Gain	9. No. of years held*	10. Weighted gains (Col. 8 X Col. 9)
							- 2,000	1	- 2,000
							- 3,000	2	- 6,000
							- 4,000	3	- 12,000
							- 5,000	4	- 20,000
							- 1,000	5	- 5,000
							- 5,000	6	- 30,000
							- 70,000	7	-490,000
							- 10,000	8	- 80,000
							- 5,000	9	- 45,000
							- 5,000	10	- 50,000
1. Total							-110,000	XXXXXX	-740,000

	Case III	Case IV
2. Average investment period for gains*(Line 1, Col. 10 divided by Col. 8)	7	7
3. Average annual gain (Line 1, Col. 8 divided by line 2)	- 15,714	- 15,714
4. Surtax net income (From item 24 page 1 of return; if none, enter a zero)	0	10,000
5. Surtax net income plus net average annual gain (Line 3 plus line 4)	- 15,714	- 5,714
6. Tentative tax on line 5 (Use rate schedule below)	- 1,383	- 297
7. Tentative tax on line 4 (Use rate schedule below)	0	700
8. Tax on average annual gain (Line 6 minus line 7)	- 1,383	- 997
9. Total tax on capital gains (Line 8 multiplied by line 2)	- 9,681	- 6,979

* Disregard fractional parts of a year unless they amount to one-half or more, in which case, count them as a full year.

Cases V, VI and VII

Schedule C - Part 1

Statement of Gains and Losses from Sale (or Exchange) of Assets

	8 Gain	9. Loss	10. No. of years held*	11. Weighted gains (Col. 8 X Col. 10)	12. Weighted losses (Col. 9 X Col. 10)
	2,000		1	2,000	
	3,000		2	6,000	
	4,000		3	12,000	
	5,000		4	20,000	
	1,000		5	5,000	
	5,000		6	30,000	
		70,000	7		490,000
	10,000		8	80,000	
		5,000	9		45,000
		5,000	10		50,000
1. Total	30,000	80,000	XXXXXX	155,000	585,000

2. Average investment period for gains*(Line 1, Col. 11 divided by Col. 8)	5
3. Average investment period for losses*(Line 1, Col. 12 divided by Col. 9)	7
4. Average annual gain (Line 1, Col. 8 divided by line 2)	6,000
5. Average annual loss (Line 1, Col. 9 divided by line 3)	11,429
6. Net average annual gain or loss (Line 4 minus line 5; if line 5 exceeds line 4, indicate net average annual loss by using minus sign)	- 5,429
7. Average annual gain or loss for longer investment period (Enter line 4 if line 2 is greater than line 3; otherwise enter line 5, preceded by a minus sign)	-11,429

* Disregard fractional parts of a year unless they amount to one-half or more, in which case, count them as a full year.

Cases V, VI, and VII
Schedule C - Part 2
Computation of Tax or Tax Credit on Capital Gains and Losses

	Case V	Case VI	Case VII
8. Surtax net income (From item 24, page 1 of return; if none, enter a zero)	0	10,000	100,000
9. Surtax net income adjusted for net average annual gain or loss (Line 6 plus line 8)	- 5,429	4,571	94,571
10. Tentative tax on line 9 (Use rate schedule below)	- 274	206	30,797
11. Surtax net income adjusted for average annual gain or loss for longer average investment period (Line 7 plus line 8)	- 11,429	- 1,429	88,571
12. Tentative tax on line 11 (Use rate schedule below)	- 857	- 57	27,314
13. Tentative tax on line 8 (Use rate schedule below)	0	700	34,000
14. Annual tax or tax credit with respect to shorter average investment period (Line 10 minus line 12)	583	263	3,483
15. Total tax or tax credit with respect to shorter average investment period (Line 14 multiplied by line 2 or line 3, whichever is smaller)	2,915	1,315	17,415
16. Annual tax or tax credit with respect to longer average investment period (Line 12 minus line 13)	- 857	- 757	- 6,686
17. Total tax or tax credit with respect to longer average investment period (Line 16 multiplied by line 2 or line 3, whichever is greater)	- 5,999	- 5,299	- 46,802
18. Aggregate tax or tax credit on capital gains and losses (Line 15 plus line 17)	- 3,084	- 3,984	- 29,387

Cases VIII, IX and X
Schedule C - Part 1
Statement of Gains and Losses from Sale (or Exchange) of Assets

	8. Gain	9. Loss	10. No. of years held*	11. Weighted gains (Col. 8 X Col. 10)	12. Weighted losses (Col. 9 X Col. 10)
	2,000		1	2,000	
	3,000		2	6,000	
	4,000		3	12,000	
	5,000		4	20,000	
	1,000		5	5,000	
	5,000		6	30,000	
	70,000		7	490,000	
	10,000		8	80,000	
		5,000	9		45,000
		5,000	10		50,000
1. Total	100,000	10,000	XXXXXX	645,000	95,000

2. Average investment period for gains*(Line 1, Col. 11 divided by Col. 8)	6
3. Average investment period for losses*(Line 1, Col. 12 divided by Col. 9)	10
4. Average annual gain (Line 1, Col. 8 divided by line 2)	16,667
5. Average annual loss (Line 1, Col. 9 divided by line 3)	1,000
6. Net average annual gain or loss (Line 4 minus line 5; if line 5 exceeds line 4, indicate net average annual loss by using minus sign)	15,667
7. Average annual gain or loss for longer investment period (Enter line 4 if line 2 is greater than line 3; otherwise enter line 5, preceded by a minus sign)	- 1,000

* Disregard fractional parts of a year unless they amount to one-half or more, in which case, count them as a full year.

Cases VIII, IX and X
Schedule C - Part 2
Computation of Tax or Tax Credit on Capital Gains and Losses

	Case VIII	Case IX	Case X
8. Surtax net income (From item 24, page 1 of return; if none, enter a zero)	0	10,000	100,000
9. Surtax net income adjusted for net average annual gain or loss (Line 6 plus line 8)	15,667	25,667	115,667
10. Tentative tax on line 9 (Use rate schedule below)	1,377	3,210	43,714
11. Surtax net income adjusted for average annual gain or loss for longer average investment period (Line 7 plus line 8)	- 1,000	9,000	99,000
12. Tentative tax on line 11 (Use rate schedule below)	- 40	600	33,410
13. Tentative tax on line 8 (Use rate schedule below)	0	700	34,000
14. Annual tax or tax credit with respect to shorter average investment period (Line 10 minus line 12)	1,417	2,610	10,304
15. Total tax or tax credit with respect to shorter average investment period (Line 14 multiplied by line 2 or line 3, whichever is smaller)	8,502	15,660	61,824
16. Annual tax or tax credit with respect to longer average investment period (Line 12 minus line 13)	- 40	- 100	- 590
17. Total tax or tax credit with respect to longer average investment period (Line 16 multiplied by line 2 or line 3, whichever is greater)	- 400	- 1,000	- 5,900
18. Aggregate tax or tax credit on capital gains and losses (Line 15 plus line 17)	8,102	14,660	55,924

Appendix C - Controversial Statements

APPENDIX C - STATEMENTS BY SOME LEADERS IN THE CONTROVERSY RESPECTING THE TAXATION OF CAPITAL GAINS

Pro:

R. H. Montgomery, in reply to a questionnaire submitted by Professor R. M. Haig 1/

"Although I made many attempts to find an answer to this question, my experience led me to believe that no categorical answer would be accurate. Many of my clients refused to sell, ostensibly on account of high tax rates, but on being closely questioned I think without exception they were all holding off for higher prices. As far as I could learn they did sell when they believed that the highest price obtainable had been offered and I think that most of them were satisfied that their profit was big enough to take care of the high tax.

"By the end of 1929 I had reached the conclusion that high tax rates retarded very few sales."

Eisner vs. Macomber, 252 U. S. 189, 207

"Income may be defined as the gain from capital, from labor, or from both combined provided it be understood to include profit gained through sale or conversion of capital assets."

Hays vs. Gauley Mountain Coal Company, 247 U. S. 189

"* * * since a conversion of capital often results in gain, the general purpose of the Act of 1909 to measure the tax by the increase from invested property, leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the Act, must be regarded as 'gross income;' * * * "

Seligman, E. R. A., Studies in Public Finance, page 108

"The gain in the form of accretion to capital is income only when it is * * * actually realized."

1/ R. M. Haig, "The Treatment of Capital Gains and Losses Under the Federal Income Tax (confidential report to the Secretary, November 1934), pp. 71-72.

Haig, R. M., The Concept of Income, in the Federal Income Tax, 1921, page 7 1/

"Income is the money value of the net accretion to one's economic power between two points of time."

Haig, R. M., The Taxation of Excess Profits in Great Britain, page 72 1/

"When one asks an Englishman why capital gains are not taxed the first reply is almost invariably a surprised and shocked exclamation to the effect that this would mean the taxation of capital and not of income. If one then asks whether a tax on the increased value of stock-in-trade is a tax on income or a tax on capital he usually forsakes argument on the basis of fundamental principle and pleads the practical necessity for a dividing line. As a matter of fact that dividing line is a thin and tenuous one * * *."

"The fundamental explanation of the British concept is probably to be found in certain facts in the general economic background of England. It is an old, conservative, economic organism where transfers are less frequent than in this country, where fortunes are less often made through trafficking in appreciating assets, where values are dealt with more largely in terms of income and less in terms of sale price and where, above all, the general conception of the economic structure is static rather than dynamic. * * * "

Groves, H. M., A Tax Policy for the United States, 1934, pages 32-33

"It would be a grave mistake to abandon the tax on capital gains * * *. Such gains are usually of a fortuitous and unearned character and are highly concentrated in the returns of large taxpayers. From the fiscal point of view, this income has more ability to pay than ordinary income. From the point of view of social control the tax on capital gains is very important. Much of this income is a direct result of speculation. * * * The present system of granting favored treatment to capital gains encourages the reinvestment of corporate earnings, and the latter in turn is responsible for much of the overbuilding of plant capacity which has gone on in this country.

"From this it appears evident that capital gains should be taxed and that they should be taxed at the same rate as other income, without a special top limit."

1/ Cited by Dr. Robert Murray Haig in his 1934 memorandum.

Hewett, W. W., The Definition of Income and its Application in Federal Taxation, page 31

"If the social group gains in wealth then social income has accrued. If an individual gains in control over part of the social income, income has accrued to that individual. Income value is only an expression of real income in terms of money, and unless real income is received, capital gains are not income."

Report of the Committee of the National Tax Association on Simplification of the Income Tax, Proceedings of the National Tax Association, 1927, page 144

"This committee is not prepared to advocate the abolition of the tax on capital gains. * * * And until our income tax system is more highly developed, the possibilities of evading taxation by masquerading current income in the guise of capital gains will be too numerous to warrant a complete abolition of tax on capital gains. A tax on capital gains reduces the incentive to such evasion."

Con:

Fisher, Irving, Income in Theory and Income Taxation in Practice. Econometrica, Volume V, No. 1, January 1937, page 47

" * * * in computing income we must not add or subtract any more changes in capital valuations * * *. * * * capital gain or loss of any kind may be great or small without affecting the income of the year. * * * Capital gain merely symbolizes future income. When that income comes will be the time to tax it.

"And, contrarywise, no allowance should be made for losses for a shrinkage in value of property, * * *. Such loss merely symbolizes lack of future income."

Fisher, Irving, The Income Concept in the Light of Experience (1927) page 19

"The present method of taxing capital gains is illogical and unjust. Under the present practice the mere change of investment, with no true income involved, may cost the taxpayer a huge penalty assessed against gains which are capital, not income, and which relate to transactions of many years past, not the current year. That this is unjust is virtually conceded when exceptions are made permitting the exchange of one stock for another, under certain conditions, thus avoiding specific profit-taking in money form. Evidently if it is permissible to exchange one stock for another, it ought to be equally permissible to sell the one and with the proceeds buy other."

May, George O., The Taxation of Capital Gains, Bulletin of the National Tax Association, Volume VIII, No. 3, December 1922, page 78

" * * * it is believed that the revenues can be increased, tax avoidance greatly diminished, and greater equity secured by the abandonment of the rule of taxing of capital gains, and, conversely, of allowing capital losses as a deduction from taxable income."

Plehn, C. C., Income as Recurrent, Consumable Receipts, American Economic Review, Volume XIV, No. 1, March 1924, pages 5, 10.

"Income is essentially wealth available for recurrent consumption recurrently (or periodically) received. Its three essential characteristics are: Receipt, recurrence, and expendability.

" * * * gains and profit on transactions outside of one's regular vocation or line of business, like the profit from the sale of a home, are of doubtful income character."

*Moorhead, W. S., Statement, Hearings, Committee on Ways and Means, 1923, pages 321-327

"I think that there is no question about it at all, that if capital gains had not been taxed as income, and capital losses had not been allowed as deductions, from the beginning, the Government would have been way ahead in revenue."

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*Cited by Dr. Robert Murray Haig in his 1934 memorandum.

*Mitchell, C., National City Bank Bulletin, November 1930, pages 182-183

"It (the capital gains tax) has created artificiality in the security market, in the credit structure and in interest rates. * * * This tax acts as an obstruction to the free transfer of property, whether it be securities, land or what not, retards business and encourages inflation."

*Report of the Tax Simplification Board, December 3, 1923

"The best considered opinions of accountants, actuaries and economists appear to us to indicate that the elimination of both capital gains and losses, even now, would result in no decrease in revenue to the Government over a period of years."

Chamber of Commerce of the United States of America, Referendum No. 70, Federal Taxes and Expenditures, December 11, 1935, page 22

"The recognition of capital gains and losses for income-tax purposes has always been open to the objection that gains resulting from transactions in capital assets are not income in any true sense, and consequently should not be taxed as such. Similarly, loss of capital is no proper basis for credit against income tax liability."

*New York State Economic Council, Report, New York Times, November 24, 1934

"The income tax on capital gains, which never has existed in England, should be abolished, or, if that be not possible, reduced to a small, uniform and definite percent, as in the case of corporations so that when an individual invests his principal, with all the risks that are involved in any investment, he may have some assurance that he may be able to retain a reasonable portion of any profits made as a result of such investment."

*Cited by Dr. Robert Murray Haig in his 1934 memorandum.

Cole, Seth T., Deputy Commissioner and Counsel, New York State, Department of Taxation and Finance. Treatment of Capital Gains and Losses for Income Tax Purposes in The Tax Magazine, October 1936, page 583

"Without doubt, the most unsatisfactory feature of the American system of income taxation is the treatment of capital gains and losses for income tax purposes, a feature that does not enter into the British system. While at first blush it may appear to accord with equitable conceptions to reason that one who increases his capital through appreciation in value is thereby endowed with as much taxpaying ability as one who is the recipient of ordinary income, a careful study of the problem will show convincingly that it is highly inequitable to measure the income tax by capital gains and losses. Furthermore, the evils attendant upon the taxation of capital gains and the allowance of capital losses as an income tax deduction, and the effect of such practices upon the economy of the Nation, are more than sufficient to outweigh any revenue benefits accruing therefrom. Perhaps capital gains ought not to be wholly exempted from tax liability, but, if they are to be taxed at all, it should be at a rate that is extremely moderate and at the same time certain, so that the extent to which the taxes imposed may affect business transactions may be definitely known and calculated."

Tremaine, Morris S., State Controller of New York, Opinion cited in New York Times, April 26, 1937

"The blighting effect of this tax for years has permeated the whole business fabric of this country, and the sooner the Government gets rid of it — and for its own immediate benefit — the sooner we can open the flood-gates of pent-up capital now taking refuge in tax-exempt bonds or taking advantage of unhampered trading opportunities outside the United States.

* * * * * *

"If the tax on capital gains were repealed, or at least placed in a separate column and at a nominal flat percentage that would be calculable, I believe we would soon see unemployment disappear like snow in April." * * *

Chamber of Commerce of the United States, Twenty-fifth Annual Meeting, April 29, 1937, Resolutions Committee

"The present law which taxes capital gains at prevailing income-tax rates, while limiting the right to deduct losses, is both on its face and in application unfair and inequitable. The economic effects are emphasized by the present high tax rates on gains which discourage sales of capital assets, thus creating an artificial and unwholesome situation, with losses in tax revenues."