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## CAPITAL GAINS TAXATION—THE FIRST ONE HUNDRED YEARS

*Van Mayhall\**

The landmark decisions by the United States Supreme Court in *Eisner v. Macomber*<sup>1</sup> and *Merchants' Loan and Trust Co. v. Smietanka*<sup>2</sup> defined the term "income" within the context of the sixteenth amendment<sup>3</sup> to the United States Constitution to encompass "gain derived from capital, from labor or both combined, provided it be understood to include profit gained through a sale or conversion of capital assets."<sup>4</sup> Following those cases, the development of a complete scheme for capital gains taxation has been a vexing and continuing problem to which no real solution has been found. Separate and preferential taxation of capital transactions is a principle unique among most industrialized nations.<sup>5</sup> Indeed, the presence of this principle in the income tax laws of the United States is largely responsible for the complexity of those laws. Not only has separate and preferential taxation of capital gains created theoretical difficulties, but the practical application of the statutes has been uneven and, perhaps in some cases, unjust. While many foreign taxpayers do not understand the rationale for capital gains taxation in the United States, most American taxpayers do not understand how their capital gains are taxed. Seemingly, the very hint of understanding by the American taxpayer of a capital transaction taxing statute has been cause for Congress to scrap mischievously that statute and replace it with a more complex and circumspect model. From the inception of preferential treatment in the Revenue Act of 1921,<sup>6</sup> capital gains taxation has bobbed like an anchorless dinghy awash a turbulent sea of conflicting economic and legislative interests.

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1. 252 U.S. 189 (1920).
2. 255 U.S. 509 (1921). The phrase first appeared in *Stratton's Independence v. Howbert*, 231 U.S. 399 (1913), interpreting the corporation tax of 1909. The proviso was added in *Eisner*.
3. U.S. CONST. amend. XVI.
4. *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).
5. Seltzer, *Evolution of the Special Legal Status of Capital Gains Under the Income Tax*, 3 NAT'L TAX J. 18 (1930).
6. Income Tax Act of 1921, ch. 136, §§ 200-63, 42 Stat. 227.

## THE HISTORICAL PERSPECTIVE

During the early era of capital gains taxation, "profit" from a capital transaction was not thought to be taxable under an "income tax" statute. In this era predating the sixteenth amendment, the federal government made at least two attempts at enacting and administering a federal income tax. The first federal income tax was enacted during the Civil War and was patterned after an earlier proposed tax contemplated shortly after the War of 1812. If the War of 1812 had lasted longer, an income tax probably would have been imposed, but the war's conclusion made further resort to internal taxes unnecessary.<sup>7</sup> The whole system of internal revenue was abolished shortly thereafter. The Civil War tax was classified as a duty or excise in order to avoid direct tax classification.<sup>8</sup> Although enacted under wartime conditions and enforced by an inexperienced and inadequate administrative body, the statute was important because of its revenue production aspects. In the early 1870's contrary public opinion led to the repeal of the income tax statute.

While the statute was still in force, the Supreme Court had the opportunity to determine the meaning of the word "income." The operative language of the 1867 Act<sup>9</sup> provided that a certain tax would be levied, collected, and paid annually upon the amount in excess of \$1,000 of the gains, profits, and income of every person, declaring that "the tax herein provided for shall be assessed, collected, and paid upon the gains, profits, and income for the year ending the thirty-first of December next proceeding the time for levying, collecting, and paying said tax." In the case of *Gray v. Darlington*,<sup>10</sup> the taxpayer sold Treasury notes at an increase of \$20,000 over his costs four years earlier. The Court stated:

The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits, or income of the plaintiff for the year in which the bonds were sold. . . . The advance in the value of property during a series of years can, in no just sense, be considered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. The statute looks, with some exceptions,

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7. See generally Seligman, *The Income Tax*, 7 ENCYCLOPEDIA OF SOCIAL SCIENCES 626 (1935).

8. See Nelson, *Capital Gains and Losses*, 14 TAXES 706 (1936). The tax became known as the income duty.

9. Internal Revenue Act of 1867, ch. 169, 14 Stat. 471.

10. 82 U.S. (15 Wall.) 63 (1872).

for subjects of taxation only to annual gains, profits, and income. . . . The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.<sup>11</sup>

Thus, the United States Supreme Court in 1872, while grounding the *Darlington* opinion on statutory construction, nonetheless apparently held that increases in value built up in securities over a number of years were returns of capital and not within the meaning of the term "income," at least not under the Civil War Income Tax.

The second experiment by the federal government in income taxation was the Income Tax Act of 1894.<sup>12</sup> This statute had a short-lived duration and was declared unconstitutional by the Supreme Court in 1895 in *Pollock v. Farmers' Loan and Trust Co.*<sup>13</sup> This decision ultimately led to amendment of the Constitution.<sup>14</sup>

The sixteenth amendment had the sole purpose of eliminating constitutional restrictions upon income taxation, specifically the requirement of apportionment of a direct tax among the states according to census.<sup>15</sup> It provides that "the Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."<sup>16</sup> Congress availed itself of this power by virtue of its enactment on February 28, 1913, of a revenue bill effective on March 1, 1913.<sup>17</sup> The scene was thus set for another interpretation of the constitutionally undefined term "income."

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11. *Id.* at 65.

12. Income Tax Act of 1894, ch. 349, 28 Stat. 509.

13. *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1894). Under the 1894 Act, it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were, in effect, direct taxes upon the property from which the income arose. Congress could not impose such taxes, by reason of ownership, without apportioning them among the states according to population.

14. U.S. CONST. amend. XVI.

15. U.S. CONST. art. I, § 2 provides, in pertinent part, that

Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers, which shall be determined by adding to the whole Number of Free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other persons.

16. U.S. CONST. amend. XVI.

17. Income Tax Act of 1913, ch. 16, 38 Stat. 114.

To further complicate matters, prior to the constitutional amendment, Congress enacted a tax<sup>18</sup> computed by reference to the incomes of corporations. This earlier tax remained on the federal tax books until the creation of the income tax. The former was an excise tax on the privilege of doing business, calculated by using the corporation's income as the base. It was not a corporate income tax.

Several cases<sup>19</sup> presented to the Supreme Court involved the meaning of the term "income" in relation to this corporate excise tax, but, significantly, they were not decided until after the effective date of the sixteenth amendment.

These cases consistently gave a broad interpretation to the word "income," holding that gains from capital conversions into cash, even though some additional value increment developed over a number of years, were nonetheless "income" and included in the excise tax base. The *Hays v. Gauley Mountain Coal Co.*<sup>20</sup> decision is particularly interesting because, as perhaps realized by the Court, its facts are virtually identical to those in the *Darlington*<sup>21</sup> case. In *Gauley Mountain* the taxpayer sold shares of stock held for investment purposes in another mining corporation for a surplus of about \$200,000 over its costs. Under *Darlington's* rationale the increase would have been treated as capital and held not subject to taxation as it was "built up" over a number of years.<sup>22</sup> The statute in *Gauley Mountain* provided for imposition of a special excise tax with respect to the carrying on or doing of business by the corporation, equivalent to one per centum upon the entire net income over and above \$5,000 received by it from all sources *during such year*.<sup>23</sup> The Supreme Court wrote:

We do not regard . . . [*Darlington*] as controlling, because the language of the act now under consideration is different in material particulars. . . . Gains, profits and income for the year ending the thirty-first of December next preceding [Act of 1867] conveys a different meaning from "the entire net income . . . received by it . . . during such year" [Act of 1909].<sup>24</sup>

The distinction between income "for" a year ending on a certain date and income received "during" the year seems extremely

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18. Corporation Excise Tax Act, ch. 169, § 13, 14 Stat. 471, 477 (1867).

19. See, e.g., *United States v. Cleveland, Cincinnati, Chicago & St. Louis Ry.*, 247 U.S. 195 (1918); *Hays v. Gauley Mountain Coal Co.*, 247 U.S. 189 (1918); *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918).

20. 247 U.S. 189 (1918).

21. *Gray v. Darlington*, 82 U.S. (15 Wall.) 63 (1872).

22. *Id.* at 66.

23. Corporation Excise Tax Act of 1909, ch. 6, 36 Stat. 11, 112 (emphasis added).

24. 247 U.S. at 191 (emphasis in original).

technical as there is no income at all "for" a year unless some conversion of the increased value to cash, or its equivalent, has occurred.<sup>25</sup> It has been suggested<sup>26</sup> that the Court, aware of the sixteenth amendment and the Revenue Act of 1913, recognized in the cases under the 1909 Excise Act the revenue implications of clinging to its *Darlington* position.

With the appearance of the inevitable challenge to the constitutional or statutory basis for taxation of *Darlington*-type capital advances after 1913, the Court could have chosen from two rather distinct lines of cases<sup>27</sup> dealing with the meaning of the word "income." The most notable attack on capital gains taxation was *Merchants' Loan and Trust Co. v. Smietanka*.<sup>28</sup> Factually, it was also virtually indistinguishable from *Darlington*. The taxpayer sold shares of stock held for investment and realized an increase of about \$700,000 over cost some four years earlier. The taxpayer contended that the advance in value, although realized by sale, was not income within the meaning of the sixteenth amendment. The Court believed the definition of "income" "to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution."<sup>29</sup> The Court then backtracked and suggested that the word "income" had the same meaning in the Income Tax Acts of 1913, 1916, and 1917.<sup>30</sup> Additionally, the Court concluded that the word in the 1913 Act had the same meaning<sup>31</sup> as that given it in interpretations of the Corporation Excise Tax Act of 1909:

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25. Comment, *Profits From Sale of Capital Assets as Income: Taxable Under Sixteenth Amendment*, 19 MICH. L. REV. 854 (1921).

26. Note, *Income Tax—Profit on Conversion of Capital Assets is Taxable as Income*, 16 ILL. L. REV. 68 (1916).

27. The line of cases on the 1909 Excise Tax Act and the meaning of the word "income" were not decided until after the enactment of the sixteenth amendment; therefore, these decisions could not have been considered by the drafters of the amendment.

28. 255 U.S. 509 (1921).

29. *Id.* at 519.

30. *Id.* at 520.

31. This conclusion was reached notwithstanding the Court's earlier language, in *Anderson v. 42 Broadway Co.*, 239 U.S. 69, 73 (1915), that "[t]he act of 1909 was in no proper sense an income tax nor intended as such, but was an excise upon the conduct of business in a corporate capacity. The tax being assessed by reference to the income in a manner prescribed by the Act itself."

By contrast, the Court had already, at least impliedly, ruled in *Lynch v. Turrish*, 247 U.S. 221 (1918), that there was no distinction between the 1867 Income Tax Act, under which *Darlington* was decided, and the 1913 Income Tax Act. "Granting that there is a shade of difference between the words [of the two Acts], it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the disputes of purists." *Id.* at 224.

The question is one of definition, and the answer to it may be found in recent decisions of this court.

The Corporation Excise Tax Act of August 5, 1909, c. 6, 36 Stat. 11, 112, was not an income tax law, but a definition of the word "income" was so necessary in its administration that in an early case it was formulated as "the gain derived from capital, from labor, or from both combined."

This definition, frequently approved by this court, received an addition, in its latest income tax decision, which is especially significant in its application to such a case as we have here, so that it now reads: "'Income may be defined as a gain derived from capital, from labor, or from both combined,' *provided it be understood to include profit gained through sale or conversion of capital assets.*"<sup>32</sup>

The Court cited *Darlington* but simply stated that it was adequately distinguished in *Gauley Mountain Coal Co.* The Court ruled the advance to be taxable income within the meaning of the sixteenth amendment.<sup>33</sup> In fact, the Supreme Court used a definition of the word "income" that had been derived from a corporation excise tax statute<sup>34</sup> and developed in cases decided after the adoption of the sixteenth amendment. What had been so clearly a return of capital to the Supreme Court in 1897 was transformed through the alchemy of economics into taxable income. It has been pointed out that a decision in favor of the taxpayer in *Merchants' Loan and Trust Co.* would have destroyed a large source of income for a government then in dire need and could have delivered a severe blow to the finances of the country.<sup>35</sup> The historical and economic forces behind the decision now fade into obscurity. However, a clear case may be made for the proposition that in the early development of our capital gains tax structure, this country chose the wrong path, from which no return has been possible. In short, it may be argued that

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32. 255 U.S. at 517, quoting *Eisner v. Macomber*, 252 U.S. 189, 207 (emphasis in text) (citations omitted).

33. *Id.* at 521. See also *Walsh v. Brewster*, 255 U.S. 536 (1921); *Eldorado Coal & Mining Co. v. Mager*, 255 U.S. 522 (1921).

34. One commentator has classified the Court's reasoning as *ex post facto*:

Accordingly, the decision which treated those cases [under the 1909 Corporation Excise Tax Act] as precedent is in a manner of speaking, a decision based on *ex post facto* reasoning. The logic would seem to run something like this: After 1913, we, the Court, decided [under an Excise Tax Act] that income included gains from conversion of capital assets. Therefore, in 1913, the word "income" [as included in a constitutional amendment providing for an income tax] must have been intended by the legislature to carry the same meaning.

Note, *supra* note 26, at 72.

35. *Id.*

the country adopted an incorrect approach to the taxation of capital transactions, resulting in a needlessly complex taxation system.

As a result of these decisions interpreting the sixteenth amendment, the Revenue Acts, from 1913 through 1921, taxed capital gains in the same manner as any other income. Gains were included with other income and were subject to both a normal tax and a surtax at the full rates under the then-existing tax structure. Consistently, capital losses were deductible in full from gross income in arriving at net income in the years after 1917. In 1916, losses were allowed only to the extent of gains. There was general dissatisfaction with this treatment of capital transactions.<sup>36</sup> The system did not result in an increase in revenues; instead it acted merely to deter taxpayers from realizing gains and furnished an incentive to realize losses and to withdraw capital from business enterprises for the purpose of investment in exempt securities.<sup>37</sup> Thus, the impact of taxing gains from capital transactions in the same manner as other income was the "freezing in" of capital with investors simply holding and not selling assets with such gains.<sup>38</sup>

In 1921 the tax structure for capital gains was entirely revamped; a separate and preferential system for taxing these gains was installed in an effort to "unlock" the capital markets. The Revenue Act of 1921<sup>39</sup> provided that the excess of capital gains<sup>40</sup> over capital losses, or capital net gain, arising from the sale of property held for more than two years could, at the option of the taxpayer, be omitted from ordinary net income and taxed separately at a flat rate of 12-1/2%. This very substantial reduction in tax rates<sup>41</sup> relative to capital gains was favorable to those in higher tax brackets. Under the 1921 Act capital net losses were deductible in full against other income.

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36. See Hogan, *The Capital Gains Tax*, 9 TAXES 165 (1931).

37. Comment, *Profit on Investments as Taxable Income*, 30 YALE L.J. 396, 400 (1920).

38. See Tremaine, *The Capital Gains Tax*, 15 TAXES 517 (1931) (pointing out difficulties coming from those who do not trade and those who have profits but will not take them).

39. Income Tax Act of 1921, ch. 136, §§ 200-63, 42 Stat. 227.

40. "Capital assets" were defined in the Act as

property acquired and held by the taxpayer for profit or investment for more than two years [but not including] . . . property held for the personal use or consumption of the taxpayer or his family or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

*Id.* at § 206(a)(b).

41. During the period from 1913 to 1921, capital gains had been taxed at rates as high as 73%.



This system of taxation of capital gains prevailed substantially intact until 1934. However, the Revenue Act of 1924<sup>42</sup> provided that capital net losses could not be deducted from ordinary income if the result were to reduce the normal tax and the surtax by more than 12-1/2% of the amount of the net loss. In 1932, Congress modified the treatment of losses on sales of stocks and bonds held for two years or less; losses were allowed as deductions only to the extent of gains arising from the sales of stocks and bonds held for two years or less. The excess of losses over gains resulting from these short-term investments could not be charged off against the other income of the taxpayer. This limitation was primarily a reaction to the large losses in securities portfolios following the Crash of 1929; initially a provision existed for a one-year carryforward for such losses, but this was abolished in 1933.

By 1932, the preferential system of taxing capital gains instituted in 1921, and utilized through the twenties and early thirties, was under attack.<sup>43</sup> One author notes that the House Committee on Ways and Means indicated five defects in the system.<sup>44</sup> First, the system tended to produce unstable revenue—large receipts in prosperous years and low receipts in depression years. Second, evidence suggested that in many instances the capital gains tax was imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of a “real” increment in value. Third, taxpayers tended to take their losses within the two-year period and to obtain the full benefit allowed by law, while delaying the recognition of gains until the expiration of the two-year period. The use of these tactics by taxpayers substantially reduced taxes. Fourth, the relief afforded in transactions of more than two years was inequitable, effectively providing relief only to taxpayers whose net income exceeded \$16,000. Finally, in some instances, the tax hindered normal business transactions.<sup>45</sup>

Consequently, in 1934, the tax system was completely scrapped and a new graduated tax system developed.<sup>46</sup> The optional 12-1/2% maximum tax was abolished and capital gains again became subject to the same rates as ordinary income. However, the amount of the gain taxed depended upon the length of time the capital asset was held. If the asset had been held for less than one year, 100% of the gain was taxed; one to two years, 80%; two to five years, 60%; five

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42. Revenue Act of 1924, ch. 234, § 200, 43 Stat. 254.

43. Raymond, *The Capital Gains Loophole*, 10 TAXES 373 (1932).

44. Hogan, *Capital Gains Under the Revenue Act of 1934*, 12 TAXES 339 (1934).

45. *Id.* at 340.

46. Income Tax Act of 1934, ch. 277, 48 Stat. 683.

to ten years, 40%; and more than ten years, 30%. Losses from the sale of capital assets were allowed only to the extent of \$2,000, plus the amount of the capital gains.<sup>47</sup> Thus, if the losses exceeded the gains in a given year, only \$2,000 in excess could be deducted against ordinary income. It was significant that the definition of "capital asset" was changed to eliminate the two-year limitation.<sup>48</sup> The Act of 1934 is apparently the genesis of the tax structure which allows a certain portion of a capital gain as a deduction from ordinary income. This tax structure remained on the books substantially unchanged for four years.

In 1938, Congress scrapped the existing capital transaction tax system and created an entirely new one.<sup>49</sup> The 1938 Act made first mention of the terms "short term" and "long term," used to designate the two types of capital gains and losses.<sup>50</sup> Assets held less than one and one-half years fell into the first category, and those held longer were placed in the second group.<sup>51</sup> The 1938 statute provided that short-term gains were fully taxable and that short-term losses could be deducted fully from the short-term gains.<sup>52</sup> The excess of short-term losses, if any, was not currently deductible, but there was a one-year carryforward provision. Sixty-six and two-thirds percent of long-term gains and losses was recognized if the assets were held for more than eighteen months but less than two years, while 50% was considered if the assets were held longer than two years. Curiously, net long-term gains were subject to an alternate tax rate of 30% if a lower tax resulted. The practical impact of this alternative computation is interesting. The statute required that 66-<sup>2</sup>/<sub>3</sub>% of the eighteen to twenty-four-month gains and losses and 50% of the over twenty-four-month gains and losses be combined to produce a net long-term capital gain or net long-term capital loss.<sup>53</sup> The tax was then computed by one of two methods: (1) the computation of the normal tax and surtax on the net income, *inclusive* of the long-term capital items or (2) the calculation of the normal tax and surtax on the net income *exclusive* of the long-term capital items, *plus* 30% of the net long-term capital gains or *minus* 30% of the net long-term capital loss.<sup>54</sup> The result producing the lesser tax was the proper method.

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47. *Id.* at § 117.

48. *Id.* at § 117(b).

49. Income Tax Act of 1938, ch. 289, 52 Stat. 452.

50. *Id.* at § 117(a).

51. *Id.*

52. *Id.* at § 117(b).

53. *Id.*

54. *Id.* at § 117(c).

It was perfectly clear that the tax on long-term capital gains could not exceed 20% ( $66\frac{2}{3}\% \times 30\%$ ) of the eighteen to twenty-four-month gains and 15% ( $50\% \times 30\%$ ) of the more than twenty-four-month gains. This tax system thus parallels closely the 12- $\frac{1}{2}\%$  flat rate alternative tax structure prevailing in 1921-1934 for taxpayers in higher brackets. Rather than a 12- $\frac{1}{2}\%$  flat rate, the Act of 1938 embodied a 15% and 20%, respectively, flat rate. Apparently, this arrangement placated those who criticized the 1934 Act on the grounds that the tax rates were too high, especially in the case of high tax bracket taxpayers, and that assets became frozen and few transactions took place, resulting in a revenue loss.<sup>55</sup> The cycle had returned to its beginning; a close analogy existed between the effects of the pre-1921 taxation system and the 1934 Act, as well as between the 1921 amendments to remedy the effects of the prior system and the 1938<sup>56</sup> Revenue Acts, enacted to remedy the effects of the 1934 Act.

In 1942 significant changes were made in the capital gains taxing rates and structure.<sup>57</sup> The changes may be viewed as the logical wartime progression of the philosophy stated in the 1938 Act. However, the flat rate alternative tax concept was retained. During the war years, the need for revenue had caused the individual ordinary rates to be increased drastically. Essentially, the eighteen-month/twenty-four-month holding period dichotomy was replaced by a single holding period combined with a 50% deduction for long-term capital gains. The great debate in 1942 was the length of the holding period required for special long-term capital gains treatment. The Securities and Exchange Commission and legislation relating to the regulation of securities transactions set a six-month limit as the measure of a speculative turn in securities.<sup>58</sup> Congress decided that the SEC rule would work well for the Treasury,<sup>59</sup> and the Senate Finance Committee adopted the six-month provision.<sup>60</sup> Since realiza-

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55. Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 NAT'L TAX J. 12 (1949).

56. The definition of "capital assets" was also modified to add the words "to customers" in the exclusion from capital assets of property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

The purpose of this change was to make the profits and losses of a trader in securities subject to the capital gain and loss provisions to prevent tax loss through the unlimited deductibility of losses by the stock speculator trading on his own account.

57. Revenue Act of 1942, ch. 619, 56 Stat. 798.

58. See Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 NAT'L TAX J. 12, 28-32 (1949).

59. *Id.* at 32.

60. SENATE COMM. ON FINANCE, THE REVENUE BILL OF 1942, S. REP. NO. 1631, 77th Cong., 2d Sess. 50 (1942).

tion of a capital gain was entirely within the discretion of the taxpayer, the Committee believed that the shortening of the holding period would encourage the realization of capital gains and thereby direct added revenues to the Treasury.<sup>61</sup> Thus, the holding period for long-term capital gains treatment was reduced drastically in 1942 to six months. The alternative maximum rate was retained and increased to 50%; the increase yielded only a maximum effective long-term capital gains rate of 25%, since only 50% of the gains was taken into account. Both long-term and short-term capital losses were deductible only against capital gains, but \$1,000 of ordinary income could be offset by the excess of capital loss over capital gain. However, a five-year carryover for net capital losses was provided, resulting in a maximum offset of \$6,000 against ordinary income. The flexibility in terms of the scheduling of capital transactions reduced significantly the chance that a taxpayer would allow the carryover period to expire without fully using a capital loss.<sup>62</sup>

Since 1942, many changes in the details of taxation relating to capital transactions have occurred. These modifications have primarily been provisions relating to various types of abuses, the correction of particular inequities, and the closing of special loopholes. For example, in the 1950 Revenue Act,<sup>63</sup> provisions were inserted in the tax statute concerning collapsible corporations, short sales, and treatment of literary, musical, and artistic property.<sup>64</sup> These provisions were designed to stop the alchemical transmutation of ordinary income into capital gain.<sup>65</sup> However, the tax structure for capital gains remained essentially the same with a 50% exclusion of long-term capital gain from ordinary income and an alternative tax until 1969. The Tax Reform Act of 1969<sup>66</sup> provided a

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61. *Id.*

62. In addition, the capital asset definition was modified to exclude real property used in the trade or business. This was done to give consistent treatment to that given the generically similar assets, depreciable property used in the trade or business, which were excluded in 1938. This was, of course, simply legislative sleight of hand; both types of property found their way into section 117(d) of the 1942 Act. It had been contended that many of the business transactions of this wartime period contained an "involuntary" element and should receive treatment accorded involuntary conversions, which were at a high level because of war risks. See Wells, *supra* note 58, at 32.

63. Revenue Act of 1950, ch. 994, 64 Stat. 910.

64. *Id.* at § 210(a).

65. Taxpayers used corporations to develop property for sale; when the development was on the verge of producing income, the stock was sold or the corporation liquidated in hopes of realizing the gain in a capital transaction. Similarly, efforts not materially different from other types of personal labor, when cast in the form of a copyright or patent and sold, were capable of producing capital gains, under the interpretations of the law prior to 1950.

66. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

number of important changes in the law of capital transaction taxation. The alternative tax with respect to individuals was gradually phased out and was totally eliminated in 1978<sup>67</sup> for net long-term capital gains in excess of \$50,000. For net long-term capital gains of less than \$50,000, the method of deducting 50% of these gains subject to a 25% alternative tax was retained.<sup>68</sup> Net long-term capital losses could be used to offset ordinary income up to \$1,000 on a two-for-one basis, *i.e.*, two dollars of loss were needed to offset one dollar of ordinary income. The excess was not eligible for carryover.

In 1978, capital gains taxation was altered significantly by changing the exclusion from income of net long-term capital gains from 50% to 60%.<sup>69</sup> Thus, for capital transactions occurring after the effective date of the provision—October 31, 1978—only 40% of the net long-term capital gains was includible in taxable income. Further, the last vestige of the alternative capital gains maximum tax was eliminated by repeal of the alternative tax on the first \$50,000 of long-term capital gains.<sup>70</sup> The allowance of deductions of long-term and short-term capital losses only against capital gains was continued, but non-corporate taxpayers were allowed a \$3,000 maximum offset against ordinary income.<sup>71</sup>

#### RATIONALE FOR THE PREFERENCE

Since the inception of income taxation in this country during the War Between the States, only a seven-year period was devoid of preferential capital gains taxation. During this period, 1913-1920, gains from capital transactions were simply added to the rest of a taxpayer's income and taxed at the regular rates.<sup>72</sup> Apparently, extreme dissatisfaction precluded any recurrence of this simplified system of capital gains treatment. The scheme allowing the aggregation of capital gains with ordinary income was rejected mainly on the assumption that it tended to "freeze" capital; capital transactions were inhibited, resulting in losses of prosperity and revenue.<sup>73</sup> The country also experimented briefly with no taxation of capital gains under the Civil War Income Tax Acts.<sup>74</sup> Exclusion of

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67. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1786 (amending I.R.C. § 1201).

68. *Id.*

69. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2866 (amending I.R.C. § 1202).

70. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1786 (amending I.R.C. § 1201).

71. I.R.C. § 1211(b).

72. Income Tax Act of 1913, ch. 16, 38 Stat. 114.

73. Note, *supra* note 26, at 72.

74. See *Gray v. Darlington*, 82 U.S. (15 Wall.) 63 (1872). See text at note 11, *supra*.

capital gains from taxation was ultimately rejected on the ground that a large source of revenue would be lost. In effect, the United State rejected both ends of the capital taxation continuum for the same reason—each system would result in less revenue to the Treasury. Not taxing capital gains would eliminate a source of revenue and, unless compensated, would diminish total tax receipts. It was feared that the taxation of capital gains in full at the rates prevailing in 1913-1920 (and most years thereafter) would discourage taxpayers from realizing capital gains. Therefore, unless Congress or the Court was inclined to tamper with the doctrine of realization,<sup>75</sup> the result would be fewer capital transactions, fewer capital gains and losses, diminished taxes, and general rigidity in the capital market. Two diametrically opposed treatments of taxation for capital transactions were eliminated in favor of a moderate taxation scheme generating the best results.

The result has been that while a capital gain is some sort of income<sup>76</sup> and should be taxed, it is not equivalent to earned income and should receive special treatment. Writers have advocated special treatment for capital gains because capital transactions generally are not recurring.<sup>77</sup> However, many other types of income may not have a repetitive nature, such as a year-end bonus, a taxable award or prize, or a one-time contractual fee. No one suggests that such income should be excluded because it occurs only once in a person's lifetime; a conceptual difference between non-repetitive ordinary income and isolated capital gains, justifying different treatment on a "recurrence" basis, is difficult to discern.

A more appealing and more logical conclusion is that capital gains should be treated preferentially because the gains realized in the current year in reality reflect those accumulated in previous years.<sup>78</sup> The argument is that taxation of a capital gain in one year at graduated rates resulting in a higher tax seems unfair, since the gain built up over a period of years, if realized in each year, would have meant a lower total tax liability. One-time cumulative recognition of gains is not an attribute of a capital asset, but is a corollary of the realization concept as enunciated by the Supreme Court;<sup>79</sup> gains are "locked in" immutably until some event of realization

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75. See Lowndes, *The Taxation of Capital Gains and Losses Under the Federal Income Tax*, 26 TEX. L. REV. 440 (1948). See also *Eisner v. Macomber*, 252 U.S. 189 (1920).

76. See notes 33-35, *supra*, and accompanying text.

77. See, e.g., Parker, *Capital Gains and Losses*, 14 TAXES 604 (1936).

78. See Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation*, 1, 59 YALE L.J. 837 (1950).

79. *Eisner v. Macomber*, 252 U.S. 189 (1920).

mystically releases them into the mainstream of taxation. Realization and the consequential uneven taxation of capital gains are concessions to practical management of a tax system, rather than some inherent attribute of a capital gain.

Many types of "bunched" income do not, nor is it argued that they should, receive capital or special treatment.<sup>80</sup> For instance, a musician may labor a lifetime on a musical masterpiece; the copyright, if sold in a single year, results in a greater tax than if he had produced several lesser pieces over the years. The same tax outcome occurs for persons such as artists, writers, and tax lawyers who render opinions after years of research. Capital gains are not treated unfairly when compared to the many other cases of a theoretical grouping or bunching of income which occurs in a single year.<sup>81</sup>

An often-cited reason for the preferential treatment of capital gains is that really no gain exists to be taxed.<sup>82</sup> This rationale suggests that a capital gain is merely a current gauge of the value of money. Thus, a taxpayer who bought vacant land in 1970 for \$10,000 and finds that he can sell it unimproved and unchanged in 1980 for \$30,000, discovers that the dollar is worth one-third in 1980 of its 1970 value. The proposition that a capital gain simply indicates the variation in the value of money has been used for many years to justify preferential treatment.<sup>83</sup> The idea is appealing but defies empirical analysis.

Since all gains take place inside the economic system, no other context can be given to develop the "true" worth or value of the gain. Even the most thorough analysis could only conclude that if various economic factors were different, the gain would be larger or

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80. Certain types of "bunched" income may receive relief if the income averaging provisions of I.R.C. §§ 1301-05 can be met.

81. Originally, the holding period was thought to be some concession to resolution of this problem. The initial holding period in 1921 of two years was thought to separate those speculative gains occurring in the short run, when no bunching or grouping of income would be probable, from those longer term gains when real bunching was apparent and relief called for. In short, lesser tax was warranted on capital transactions when it was clear that bunching would create an unfair situation. In 1942, and lasting for the next 25 years, the holding period was reduced to six months. It has been suggested that this new period was representative of the philosophy that gain on sale of an investment is entitled to special treatment, not because it accrued over more than one fiscal period, but because "by its very nature, it represents a much lesser ability to pay." Miller, *supra* note 78, at 841. Surely, in light of this development, the bunching concept must be suspect.

82. Johnson, *The Philosophy of Specialized Treatment for Capital Gains*, 13 N.Y. UNIV. INST. FED. TAX. 1161 (1955).

83. See, e.g., Hogan, *supra* note 44.

smaller. In addition, the contention that asset prices reflect changes in the value of money has no special applicability to capital gains. The general marketplace factors operating to increase or decrease the worth of a dollar have the same effect, whether the dollars are earned by laboring in a steel mill or by selling a share of U.S. Steel stock. Conversely, if the operative factors are not affecting the economy across the board, the specific investment, not the dollar, has increased or decreased in value for particular reasons.

Another argument offered for preferential capital gains taxation is that taxation like that of other income would destroy incentive.<sup>84</sup> Thus, it is necessary for the general public to bear part of the cost of the risk-taking in the accumulation of private capital. The *quid pro quo* for this societal cost is unclear, unless the failure to underwrite a portion of this risk-taking would severely inhibit capital transfers and accumulation and cause the loss of jobs and prosperity. Again, the preferential taxation of capital gains seems rationalized by the unknown, and perhaps unknowable, conclusion. A reasonable conclusion is that the maintenance of preferential capital gains taxation results in increased rates of taxation on ordinary income to sustain the same revenue level and a resulting disincentive to work to produce more ordinary income. It may be argued that the elimination of the preferential treatment of capital gains would fragment the United States capital pool into a greater number of smaller units. Special capital gains treatment appears to be supported more by a visceral belief that such income is special and should be segregated in treatment from other types of income, rather than by hard analysis justifying the preferential aspects of the system. With few exceptions, for sixty years the United States scheme of taxation has rewarded ingenious devices for accumulating capital gains.<sup>85</sup>

One cost of this special treatment of capital gains has been a system of taxation far more complex than is necessary.<sup>86</sup> Ingenious taxpayers constantly are devising methods to attempt to bring various types of income and various transactions under the ambit of capital gains taxation. The Treasury then attempts to close the new loophole. An example is the development of real property through the use of a corporation and the subsequent sale of the stock prior to realizing the gains from the sale of the real property in the ordinary course of business; this strategy was designed to change the ordinary income from the sale of such property into capital gain.

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84. Johnson, *supra* note 82, at 1163.

85. The periods 1913-20 and 1934-38 may be cited as exceptions.

86. See Raymond, *supra* note 43, at 373.



The Treasury countered with the perversely complex collapsible corporation provisions.<sup>87</sup> History also has witnessed the incorporated pocket book and the accumulation of corporate earnings later treated as capital gains when the stock is sold. The Treasury has responded with the accumulated earnings and personal holding company statutes.<sup>88</sup>

The entire system of taxation in the United States is based upon the graduated rate—ability to pay—concept.<sup>89</sup> A common belief is that as income rises, the ability to pay a tax increases, and, therefore, a higher tax rate is justifiable. This concept finds favor throughout the tax system, particularly with graduated tax rates on incomes, gifts, and estates. The most notable exception to this idea is in the capital gains area. With the possible exceptions of the 1913-1920 period, when capital gains were taxed like any other income,<sup>90</sup> and 1934-1938, when a "graduated" deduction system was in effect,<sup>91</sup> capital gains for upper bracket taxpayers have been taxed at a maximum flat rate. From 1921 through 1934, capital gains were taxed under an alternative flat rate system subject to a maximum rate of 12-1/2%.<sup>92</sup> Any taxpayer in a bracket higher than 12-1/2% was taxed at the flat rate on his capital gains. For those taxpayers the capital gains tax was not graduated or progressive in the sense of requiring payment of a greater rate of tax as the ability to pay increased.

In 1938, the capital gains tax structure acquired a faint similarity to a graduated tax when a two-tier system was instituted for long-term capital gains.<sup>93</sup> However, until 1979, some form of alternative flat rate tax has been in effect. For example, during most of the forties and fifties, the alternative maximum tax on capital gains was 25%.<sup>94</sup> At some level the interplay between the taxpayer's marginal rate and the 50% deduction made the flat rate effective and deprived the tax of further progressiveness. Presumably, this level was somewhere above the marginal rate of 50% in the graduated scale. Thus, one may seriously question whether the capital gains tax has

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87. I.R.C. § 341.

88. *Id.* at §§ 531 & 541.

89. See Johnson, *supra* note 82, at 1162.

90. Income Tax Act of 1913, ch. 16, 38 Stat. 114.

91. Income Tax Act of 1934, ch. 277, 48 Stat. 683.

92. Income Tax Act of 1921, ch. 136, §§ 260-63, 42 Stat. 227.

93. Two-thirds of the gains on property held for more than eighteen months but less than two years and one-half of the gains on property held for more than twenty-four months were included in income and taxed at the graduated rates.

94. I.R.C. § 1201(b) (1954) (current version at I.R.C. § 1201).

been a truly graduated tax founded on the ability to pay during most of its existence in the United States.

#### THOUGHTS FOR THE FUTURE

The capital gains tax structure must again be scrapped if it is ever to be streamlined and simplified. Assuming that these attributes are desirable goals from the standpoint of revenue management and equitable and logical application of the law, the perennial finagling with the capital gains provisions will not attain these objectives. The present confusion necessitates substantial revision.

The mistakes found in the history of capital gains taxation provide certain "given" parameters to any future rectification. Seven decades of acceptance, although grudging at times, must convince even the most reluctant populist that certain capital gains will require preferential treatment. The American people seem to want at least some types of capital gains to escape the rigors of taxation of ordinary income. Conversely, the staunchest capitalist is aware that no statute exempting all capital gains from taxation will ever be passed. Further, the concept of realization remains a practical necessity if use of the annual accounting period and the avoidance of yearly appraisals of all capital assets are desired. In an intensely practical activity such as collection of revenues, the administrative difficulties of annual appraisals to measure each year's economic incremental difference cannot be advocated lightly. Finally, if simplicity is a proper objective, the incessant striving to change ordinary income into capital gains must be retarded or eliminated.<sup>95</sup>

Accomplishment of these ends may require a number of non-exclusive changes in the capital gains taxing structure. First, the holding period for so-called long-term capital gains treatment should be abolished and the terms "long-term" and "short-term" capital gain eliminated. History demonstrates that these holding periods are completely arbitrary; the dividing line between the two periods varied from two years in 1921, a maximum of ten years in 1934, and a minimum of six months in most of the 1940's and 1950's. The stated goal of these periods, the allowance of special treatment only for "long-term" investments, has been easily thwarted, repeatedly requiring complex remedial legislation.<sup>96</sup> The capital nature of a transaction must be determined by reference to the asset, rather than to the holding period.

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95. To the extent the issue encroaches upon the double taxation problem with corporations, treatment is excluded, as beyond the scope of this article.

96. See, e.g., I.R.C. § 1233.

Second, the gain or loss should receive special treatment if the asset qualifies as a capital asset and the other requirements mentioned in this article are met. All other gains and losses should be taxed at the ordinary rates. The definition of a capital asset should be revised from its present negative orientation; capital assets should not be a residual category into which every non-enumerated asset falls. Section 1221 establishes the capital asset as the norm from which a few types of property are excluded.<sup>97</sup> This definition permits imaginative taxpayers to create new "capital assets" not quite covered by the listed exceptions. Conversely, the new statute should be drafted to specify clearly-established assets given preferential tax treatment. Gains from the sale, exchange, or disposition of all other property should be ordinary gains; non-capital assets should constitute the residual category. Similarly, events of realization should include the concept of "dispositions" rather than mere "sales and exchanges."<sup>98</sup>

Importantly, a new tax structure would prohibit capital gains tax treatment in business contexts. A capital transaction should be considered identical to any other transaction when it occurs in a business setting. The Supreme Court actually recognized this equivalence in the *Corn Products*<sup>99</sup> case; the Court held that a transaction which otherwise met the definitional requirements of a capital transaction was nonetheless denied capital gains treatment because of its complete connexity with the taxpayer's business. Prohibition of capital gains treatment in business transactions would retard or eliminate many present attempts at converting ordinary income into capital gain. Business activities structured in convoluted and circumspect ways to appear like capital transactions would be deterred, since the business nature of the dealings would preclude any preferential tax benefits. Many liquidations, reincorporations, mergers, reorganizations, and other complex transactions could be avoided entirely. Nonetheless, capital treatment would still be available to those taxpayers in non-business, traditional, investor-trader roles. Unnecessary differences between the treatment of real estate dealers and securities traders would be obviated, assuming that those assets were held in a non-business context and were specifically enumerated as capital assets.

To appease businessmen for the elimination of capital gains treatment, the provisions for capital losses should undergo a bene-

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97. *Id.* at § 1221.

98. This obviates the *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), problems which introduce needless artificiality in this area of the law.

99. *Corn Prod. Ref. Co. v. Commissioner*, 350 U.S. 46 (1955).

ficial change. Uncertainty exists as to whether capital gains have warranted special treatment because capital loss deductions are limited, or whether capital loss deductions are restricted because capital gains enjoy preferential treatment. History indicates that the preferential treatment of capital gains originated in 1921, when capital losses were fully deductible. Although this situation was short-lived, no real revenue problem with capital losses arose until tax returns for the year 1929 were filed. Due to the tremendous losses sustained by securities portfolios after the Crash, a large revenue loss was foreseeable; Congress acted quickly to confine the losses roughly to the amount of the gains. This treatment of losses has stayed unchanged for fifty years, despite many repetitions, although much less severe, of the boom-bust cycle. If business capital gains are taxed like other business income, businessmen must be allowed to deduct fully losses which presently are considered capital in nature. The need for special provisions such as section 1231,<sup>100</sup> relating to business sales and exchanges of property, would be averted.

Enactment of the preceding suggestions would marshal capital gains taxation into a more manageable scheme. The distinction between gains and losses occurring within the daily operation of a taxpayer's business and those resulting from more passively-oriented capital investments is logically defensible. The historical and conceptual premises supporting the capital gains preference are more applicable to transactions not occurring in day-to-day business activities. The preference, if one is desired, should ensure access to capital investment for taxpayers at every level, rather than supply tax advantages to a limited number of businesses merely because of the ingenious structuring of an income-producing transaction.

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100. The reason for the existence of the provision was apparently the result of the abnormal circumstances of World War II, but it has been retained in the law.

