

TAX REFORM FERVOR: AN OPPORTUNITY TO EXPAND TAX PREFERENCES FOR CAPITAL GAINS

Capital gains and losses historically have played an instrumental role in the United States federal income tax scheme.¹ Since 1921, the United States Congress has afforded capital gains separate and preferential treatment.² This preferential treatment has caused, in large part, the tremendous complexity in the Internal Revenue Code.³ In the recent fervor to simplify the Code, numerous legislators and administrators have proposed plans to overhaul the income tax system.⁴ The purpose of this Note is to examine the preferred status of capital gains from an economic perspective and to determine whether Congress should alter, contract, or expand the preference.

Part I of this Note discusses the history of capital gains taxation. Part II examines the micro and macroeconomic issues underlying the taxation of capital gains. In Part III, this Note introduces and evaluates the capital gains provisions in current tax proposals. Finally, Part IV evaluates the merits of reducing capital gains taxation and concludes that excessive capital gains taxation unduly restricts the flow of assets to their most valuable use. Effective capital formation and access to capital markets are necessary "ingredients" to the efficient operation of a free world economy. The Ninety-ninth Congress can provide the "leavening" by expanding capital gains preferences.

1. See generally Mayhall, *Capital Gains Taxation—The First One Hundred Years*, 41 LA. L. REV. 81 (1980). For a comprehensive presentation of arguments for and against preferential tax treatment of capital gains, see Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957).

2. See *infra* notes 13 & 14 and accompanying text.

3. See Mayhall, *supra* note 1, at 81.

Indeed, the presence of [separate and preferential treatment of capital transactions] in the income tax laws of the United States is largely responsible for the complexity of those laws. . . . [M]ost Americans do not understand how 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.

Id. See also Blum, *supra* note 1, at 247, 252, 262-63 (preferential treatment of capital gains is the primary source of complexity in the tax laws); Surrey, *Definitional Problems in Capital Gain Taxation*, 69 HARV. L. REV. 985 (1956) (preferential treatment of capital gains is the greatest barrier to tax simplification efforts).

4. See *infra* notes 50-56 and accompanying text.

I. HISTORY OF CAPITAL GAINS TREATMENT

A. *Early Supreme Court Decisions*

The treatment of capital gains taxation in the United States has varied dramatically. In *Gray v. Darlington*,⁵ the post-Civil War Supreme Court excluded capital gains from taxable income, noting that the appreciation in value of a capital asset over a number of years constituted a return of capital rather than taxable gain.⁶ Almost fifty years later, however, in *Hays v. Gauley Mountain Coal Co.*⁷ and *Merchants' Loan & Trust Co. v. Smietanka*,⁸ the Supreme Court reversed its position, holding that taxable income included capital gains realized by corporations and individuals. Although the Court based its new position on semantic differences in the Civil War and twentieth-century tax acts,⁹ commentators have stated that the Court based its decision at least in part on the belief that reaffirming *Darlington* would adversely affect tax revenues.¹⁰

Taxpayer responses to *Gauley Mountain Coal Co.* and *Merchants'*, however, reveal defects in the Supreme Court's fiscal policy. Contrary to the Supreme Court's belief, the new system did not cause tax revenues to increase. Rather, revenues decreased as taxpayers refrained from selling capital assets that had appreciated in value, but simultaneously realized a large number of capital losses.¹¹ As a result, the pre-1921 tax structure for capital gains "froze" venture capital, with taxpayers content to hold investments that had appreciated in value.

5. 82 U.S. (15 Wall.) 63 (1872).

6. *Id.* at 63-66. The Court construed income to include only "annual" income, as opposed to appreciation value over a number of years. *Id.*

7. 247 U.S. 189 (1918).

8. 255 U.S. 509 (1921).

9. See Comment, *Profits from Sale of Capital Assets as Income: Taxable Under Sixteenth Amendment*, 19 MICH. L. REV. 854 (1921) (criticizing the Court's arbitrary distinction between the language of the two acts).

10. See Recent Cases, *Income Tax—Profit on Conversion of Capital Assets is Taxable as Income*, 16 ILL. L. REV. 68 (1916) (suggesting fiscal ramifications as an underlying basis for the Court's decision). Commentators also note that the Court decided *Gauley Mountain Coal Co.* and *Merchants'* after the states ratified the sixteenth amendment, when public opinion was more receptive to income taxation. *Id.*

11. See Tremaine, *The Capital Gains Tax*, 15 TAXES 517, 567 (1937). "[T]his [capital gains] tax is holding back recovery by freezing capital, and if it were repealed . . . the Government . . . would . . . receive more revenue through taxes on increased income from the business produced by the circulation of capital thus released." *Id.* See also Hogan, *The Capital Gains Tax*, 9 TAXES 165 (1931) (the capital gains tax furnishes incentive for wealthy taxpayers to realize only capital losses and invest in tax exempt securities); Comment, *Profit on Investment as Taxable Income*, 30 YALE L.J. 396, 400 (1921) (same).

B. Legislative Change—1921 to Present

Dissatisfied with the pre-1921 tax system,¹² Congress passed the Revenue Act of 1921,¹³ providing separate and preferential tax treatment for capital gains. This Act allowed taxpayers to elect an alternative flat tax of only 12.5 percent for all realized capital gains.¹⁴

Since 1921, however, Congress has provided wildly fluctuating capital gains treatment.¹⁵ The 1934, 1942, 1969, and 1976 tax laws, for example, substantially reduced tax preferences for capital gains.¹⁶ Conversely, the 1938, 1978, and 1981 tax amendments reinstated favorable capital gains preferences.¹⁷ The current tax law enables taxpayers to exclude sixty percent of long-term capital gains.¹⁸ Combined with the current maximum ordinary income tax rate of fifty percent,¹⁹ this exclusion reduces the maximum effective long-term capital gains rate to twenty percent.²⁰

In summary, the history of capital gains taxation in the United States represents a politically volatile compromise between two polar positions. At one extreme, opponents of preferential capital gains treatment argue that taxing capital gains as ordinary income reduces the Internal Revenue Code's complexity.²¹ Proponents of preferential treatment for capital gains, on the other hand, argue that reduced capital gains rates will promote both the realization of capital gains and the economy as a whole by facilitating the transfer of venture capital.²² In light of the volatile nature of capital gains taxation, however, one must wonder what criteria Congress has employed in assessing the merits of prior legislative propos-

12. See Hogan, *supra* note 11, at 165.

13. Income Tax Act of 1921, ch. 136, 42 Stat. 227.

14. The 1921 Act allowed taxpayers to omit net realized capital gains from ordinary income by electing a flat tax of 12.5% for all realized capital gains. Individuals in high tax brackets favored the 1921 Act's capital gains election because from 1913 to 1921, Congress taxed all capital gains at ordinary rates as high as 73%. See Hogan, *supra* note 11, at 165-67.

15. See Blum, *supra* note 1, at 261 (change in capital gains taxation has been particularly frequent). See also Mayhall, *supra* note 1, at 81 (comparing the history of capital gains taxation to an anchorless dinghy awash in a turbulent sea).

16. See Mayhall, *supra* note 1, at 88, 90-92.

17. *Id.* at 89-90, 92.

18. I.R.C. § 1202 (1978).

19. I.R.C. § 1 (1982).

20. The maximum effective rate (20%) is calculated by multiplying the highest marginal tax rate (50%) by the portion of long-term capital gain to be included in ordinary income after the 60% exclusion (40%). See text accompanying *supra* notes 18 & 19. The capital gains tax, however, is progressive. Only those taxpayers in the highest tax brackets are subjected to the 20% rate.

21. See *supra* note 11 and accompanying text.

22. See *supra* note 11 and accompanying text.

als. The history of capital gains taxation is more typical of rhythmical crescendos and diminuendos of a highly political melody than sound analysis of economic fundamentals.

II. ECONOMIC CONSIDERATIONS

Recent tax reform efforts will once again bring the issue of preferential capital gains treatment to the political forefront. If the historical ebb and flow of capital gains taxation is any indication, noneconomic considerations are likely to play a significant role in its future.²³ A more prudent Ninety-ninth Congress should discard political biases and assess the treatment of capital gains taxation from an economic standpoint. Congressmen who refuse to formulate tax policies in light of economic goals necessarily view the capital gains issue in a political microcosm. This Note next examines the micro and macroeconomic issues underlying the taxation of capital gains.

A. A Microeconomic Perspective—The Lock-In Effect

Microeconomic analysis addresses the economic incentives that face individuals.²⁴ An individual investor must consider many factors when deciding to hold or sell an asset that has appreciated in value. The investor may need to improve a cash flow shortage or may want to invest in another capital asset with greater speculative value. Regardless of an individual's motivation for engaging in a capital gains transaction, current tax law has powerful ramifications on that decision.²⁵ Although the tax consequences vary with the individual's income tax bracket,²⁶ taxation of capital gains effectively reduces the proceeds from the sale, thereby discouraging the sale of capital assets that have appreciated in

23. See *supra* note 15 and accompanying text.

24. The study of economics is divided into two major areas: micro and macro.

Microeconomics is concerned mainly with the economic activities of individual[s], . . . [while] [m]acroeconomics is concerned with economic aggregates, or the economy as a whole.

. . . [M]uch of what the government does in terms of enacting laws or levying taxes directly affects individuals . . . , and these effects can be analyzed with the tools of microeconomics. By the same token, the actions of large groups of consumers or producers, such as the increased desire to save on the part of many people, are analyzed with macroeconomic tools.

W. PETERSON, PRINCIPLES OF ECONOMICS: MICRO 1 (1974).

25. Current tax law subjects realized capital gains to a maximum effective tax rate of 20%. See *supra* note 20.

26. Current marginal tax rates on ordinary income reach a maximum of 50%. See *supra* note 19 and accompanying text.

value.²⁷ This restraint, commonly referred to as the “lock-in effect,” freezes large sums of venture capital into mature investments. To overcome the tax obligation and any other transaction costs,²⁸ an alternative investment’s annual cash yield or expected future market value must sufficiently exceed that of the current investment.²⁹

By failing to tax transfers by gift or inheritance, the present tax system magnifies the lock-in effect. Property transferred by gift receives a “carryover” basis in the hands of a donee,³⁰ while property transferred by reason of death receives a “stepped-up” basis in the hands of a devisee.³¹ Because neither the donee’s nor the devisee’s increased net worth is taxable,³² the tax system further discourages the sale of appreciated capital assets.

A final aspect of the lock-in effect concerns the unique nature of capital gains.³³ Because capital gains normally accumulate over a number of years, proponents of favorable capital gains preferences claim that it is unjust to tax the gain at a *progressive* rate in the *single* year of realization.³⁴ Furthermore, proponents allege that capital gains frequently re-

27. See STAFF OF THE JOINT ECONOMIC COMMITTEE, 88TH CONG., 2D SESS., THE FEDERAL TAX SYSTEM: FACTS AND PROBLEMS 77-82 (Comm. Print 1964) [hereinafter cited as JOINT ECONOMIC COMMITTEE].

28. See Coase, *The Problem of Social Cost*, 3 J. OF L. AND ECON. 1, 15 (1960) (introducing the concept of positive transaction costs as an economic disincentive).

29. This tax consideration may be illustrated in the case of an investor with 100 shares of corporation X bought at \$50 and now selling at \$80 per share. Assume that the X stock is now yielding 6 percent on the basis of its current price and the taxpayer is considering a shift to another stock yielding 7 percent on the basis of its current price. At the present tax rate of 25 percent, the net proceeds after the tax from the sale of the X stock would be \$7,250 (\$8,000 minus 25 percent of \$3,000) which, if invested in the new stock, would yield more than the yield in the securities sold (\$507.50 compared with \$480). The switch would therefore be justified. It would also be justified if the taxpayer expected his present holdings to remain at their present price while the new stock was expected to rise in price by 10.3 percent or more. Similarly, sale of the present holdings would be justified if their price were expected to decline by \$7.50 or more per share (from \$80 to \$72.50 or less).

JOINT ECONOMIC COMMITTEE, *supra* note 27, at 77-78.

30. Code § 1015(a) provides, in pertinent part: “[i]f the property was acquired by gift . . . , the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift.” I.R.C. § 1015(a) (1985).

31. Code § 1014(a) provides, in pertinent part: “the basis of property in the hands of a person acquiring the property from a decedent . . . shall be . . . the fair market value of the property at the date of the decedent’s death.” I.R.C. § 1014(a) (1985).

32. See I.R.C. § 102 (1985): “Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.” *Id.* at § 102(a).

33. JOINT ECONOMIC COMMITTEE, *supra* note 27, at 77-82.

34. *Id.* at 80-81. See Blum, *supra* note 1, at 253 (capital gains often develop over many years—Argument 16).

sult from general increases in the aggregate price level³⁵ and thus, do not reflect an increased ability to pay taxes.³⁶ Finally, proponents argue that imposition of a capital gains tax prohibits the taxpayer from reinvesting in an asset of equal value and therefore, represents government acquisition of a potentially invaluable source of private investment capital.³⁷

From a microeconomic standpoint, the lock-in effect encourages individuals to retain capital in mature investments, and restricts the supply of venture capital available to growth-oriented enterprises.³⁸ In order to understand the cumulative impact of the lock-in effect, however, a macroeconomic analysis is necessary.

B. *A Macroeconomic Perspective*

While microeconomics addresses individual economic decisions,³⁹ the fundamental concerns of macroeconomics include inflation, unemployment, and aggregate savings and investment.

By producing a lock-in effect that reduces the net proceeds from the sale of capital assets, the taxation of capital gains provides individuals with a disincentive to save and invest.⁴⁰ When aggregated, this individual disincentive can have a detrimental effect upon a national economy.⁴¹ Economists almost universally accept the notion that increased savings and investment is necessary to maintain or stimulate economic growth.⁴²

35. Current legislation arbitrarily attempts to compensate for inflation (e.g., by allowing taxpayers a 60% deduction for capital gains). See I.R.C. § 1202 (1978). Economic studies, however, indicate that the impact of inflation on capital gains is still quite significant. See K. MALONEY, *THE IMPACT OF INFLATION ON CAPITAL FORMATION: A NEOCLASSICAL APPROACH* (1984) (approximately 42% or \$477 million of 1973 capital gains tax revenue resulted from inflation) (citation omitted).

36. *Joint Economic Committee, supra* note 27, at 80. Congress acknowledged this problem by authorizing homeowners to avoid tax liability by applying the proceeds of a sale of a personal residence to the purchase of another residence, regardless of any realized capital gain. *Id.*, citing I.R.C. § 1034 (1985). See Blum, *supra* note 1, at 255-56 (most capital gains are fictitious reflections of inflation—Argument 19).

37. *Joint Economic Committee, supra* note 27, at 80. See Blum, *supra* note 1, at 248 (tax on capital gains slows society's accumulation of capital—Argument 2).

38. See *supra* text accompanying notes 27-29.

39. See *supra* note 24.

40. See *supra* notes 11 & 26-31 and accompanying text. *But see* Blum, *supra* note 1, at 250 (favorable capital gains provisions discriminate in favor of one form of economic enhancement over another).

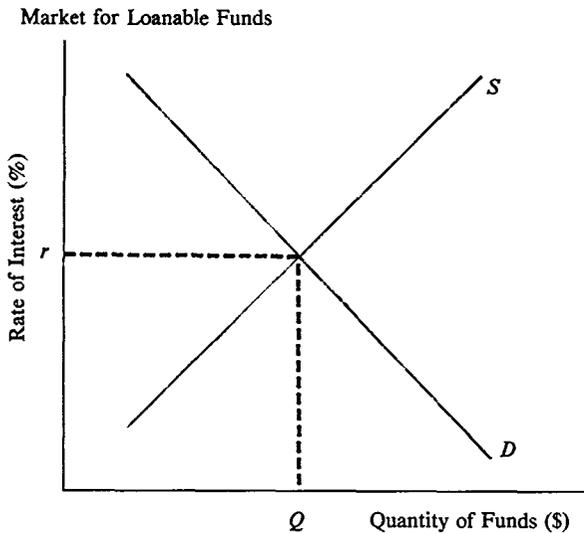
41. See M. EAKER & J. YAWITZ, *MACROECONOMICS* 284 (1984).

42. *Id.*

1. *Economic Theory—Supply Side Economics*

Some economic theorists maintain that the impact of the lock-in effect can be lessened by reducing the taxation of capital gains. These supply-side economists base their premise upon an analysis of the supply of loanable funds,⁴³ theorizing that decreasing capital gains taxes increases individual savings. As individuals increase savings, lending institutions have more money to lend. Because the aggregate supply of loanable funds increases, interest rates fall.⁴⁴ Lower interest rates, in turn, stimulate investment as businesses find additional financial opportunities economi-

43. The market for loanable funds can be described by conventional supply and demand curves. The interest rate, or "price" of loanable funds, is on the vertical axis and the quantity is on the horizontal axis. The supply of loanable funds (S) represents the aggregate quantity of funds that individuals will save at a given interest rate, while demand (D) represents the sum that individuals will borrow at a given interest rate. The intersection of the supply and demand curves indicates the equilibrium rate of interest (price) and quantity that will prevail in the market.



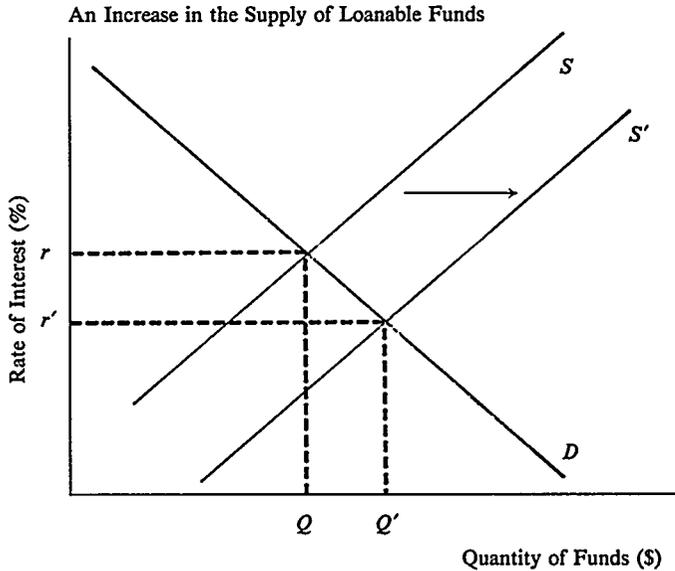
M. EAKER & J. YAWITZ, *supra* note 41, at 157 (Figure 8-1).

44. Higher savings rates result in an increase in the supply of loanable funds (S to S') and a decrease in market interest rates (r to r').

cally feasible.⁴⁵

2. Criticism of Supply Side Economics—Crowding Out

Other economic theorists, while accepting the supply side effect, criticize the theory for its failure to consider changes in the demand for loan-



M. EAKER & J. YAWITZ, *supra* note 32, at 167 (Figure 8-7).

45. Most companies use the net present value (NPV) method to evaluate investment alternatives. Under the NPV method, financial analysts project expected cash flows over the life of a project. Financial analysts then discount the projected cash flows to their present value at prevailing market interest rates. Although a specific firm's cost of capital depends on many factors, such as its debt-equity ratio and its past borrowing record, the general level of interest rates is established in the loanable funds market. See *supra* note 43. The net present value equation for an investment project with a life of t years is described below:

$$NPV = \sum_t^0 \frac{C_t}{(1+r)^t}$$

where: C_t = expected net cash flow in year t

r = interest rate (or cost of capital)

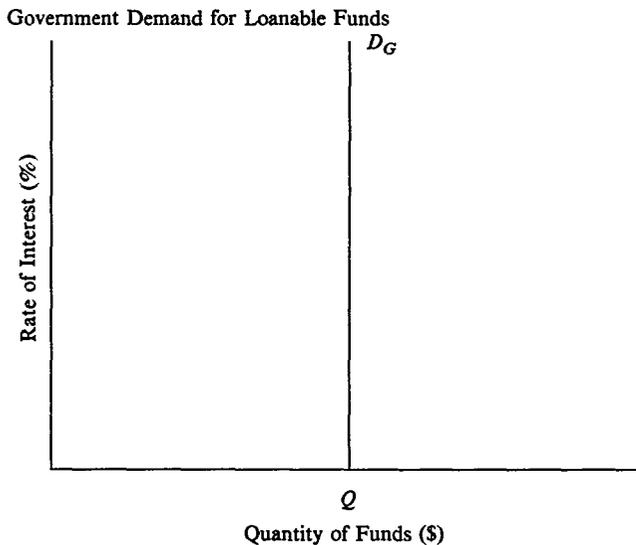
R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 26-27 (1981).

As the interest rate decreases, see *supra* note 44, the NPV increases. Businesses are more likely to make investments with higher net present values. M. EAKER & J. YAWITZ, *supra* note 32, at 56. But see Blum, *supra* note 1, at 259-60 (arguing that the capital gains exemption does not increase business investment—Argument 23) & 264-65 (preferential capital gains treatment provides incentive for corporations to retain profits—Argument 6).

able funds.⁴⁶ These theorists claim that reducing capital gains taxation reduces tax revenues and forces the government to borrow additional funds in financial markets. Unlike private industry's demand for loanable funds, however, the government's demand is inelastic.⁴⁷ The government's demand remains constant regardless of interest rate levels because the government must finance all deficits.⁴⁸ The aggregate demand for loanable funds, which encompasses government and private demand, increases. Consequently, market interest rates rise.⁴⁹ When interest rates rise, businesses find fewer financial opportunities economically feasible. As a result, the government's inelastic demand "crowds out" some of the positive influence of reduced interest rates and in-

46. See *supra* notes 43-45 and accompanying text.

47. An inelastic demand curve is characterized by a lack of responsiveness to a change in prices. In the loanable funds market, the government's demand (D_G) is equal to the amount of its budget deficit (Q) and is independent of prevailing interest rates.



M. EAKER & J. YAWITZ, *supra* note 32, at 159 (Figure 8-2).

48. *Id.*

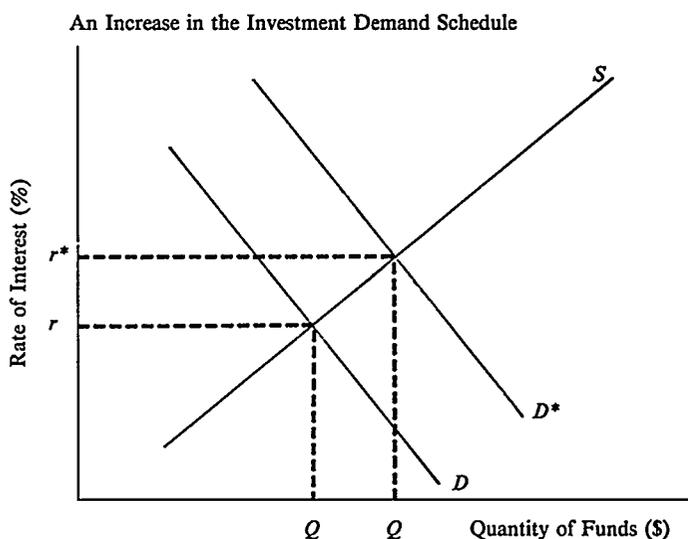
49. Greater government deficits result in an increase in the demand for loanable funds (D to D^*) and higher market interest rates (r to r^*).

creased private investment.⁵⁰

Unfortunately, econometric estimates of the crowding out effect vary across the spectrum.⁵¹ Empirical evidence, however, suggests a positive correlation between capital gains preferences and aggregate savings and investment.

3. Empirical Evidence—International Comparisons

Since World War II, the United States and the United Kingdom have



M. EAKER & J. YAWITZ, *supra* note 32, at 164 (Figure 8-5).

50. Economists describe the process as follows:

Crowding out occurs when government borrowing in the financial markets has the secondary effect of reducing private investment. Government borrowing increases the demand for funds and leads to higher interest rates. . . . Higher borrowing costs raise the discount rate that firms use in making capital-budgeting decisions, resulting in fewer investments.

Id. at 104.

51. The impact of crowding out is dependent on numerous factors. *Id.* at 104-05 (suggesting three distinct factors). Economists, however, have not accurately determined the amount of private investment displaced by crowding out. Compare Minarik, *The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains: Comment*, 99 Q.J. ECON. 93 (1984) (reduced capital gains taxes will not increase realizations sufficiently to increase federal tax revenues) with Feldstein, Slemrod, & Yitzhaki, *The Effect of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains: Reply*, 99 Q.J. ECON. 111, 117-19 (1984) (1978 increase in capital gains exclusion ratio caused increase in realization of capital gains and tax revenues). Commentators have stated that “[e]mpirical estimates of crowding out are as diverse as the theoretical arguments. They range from zero to over one.” M. EAKER & J. YAWITZ, *supra* note 41, at 105 (footnote omitted).

maintained the lowest growth rates among all industrialized nations.⁵² These two nations have also maintained correspondingly low savings⁵³ and investment⁵⁴ rates. This relationship between growth rates and

52. See J. EAKER & J. YAWITZ, *supra* note 41, at 284. Postwar growth rates can be measured in terms of both real (indexed for inflation) gross national product, per capita income and average annual growth in productivity.

Growth Rates in Real Gross National Product, 1960-81 (Percent Change)

| | 1960-73 ANNUAL AVERAGE | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|----------------|------------------------------|------|------|------|------|------|------|------|------|
| Japan | 10.5 | — .3 | 1.4 | 6.5 | 5.3 | 5.1 | 5.6 | 4.2 | 3.8 |
| Canada | 5.4 | 3.6 | 1.2 | 5.5 | 2.1 | 3.7 | 3.5 | .0 | 3.0 |
| West Germany | 4.8 | .5 | 1.8 | 5.2 | 2.8 | 3.6 | 4.5 | 1.8 | —1.0 |
| United States | 4.2 | — .6 | —1.1 | 5.4 | 5.5 | 4.8 | 3.2 | — .2 | 1.9 |
| United Kingdom | 3.2 | —1.0 | — .6 | 3.6 | 1.3 | 3.3 | 1.4 | —1.8 | —2.0 |

Id. at 275 (Table 14-2) (citing *Economic Report of the President*, 1982).

1970-79 Growth Rate in Per Capita Income

| | |
|---------------|-------|
| Japan | 17.3% |
| Germany | 13.7% |
| United States | 9.4% |
| Canada | 6.9% |

Id. at 275-76 (Table 14-3) (citing International Monetary Fund's International Financial Statistics).

Average Annual Gain in Productivity (1960-1983)

| | |
|---------------|------|
| Japan | 5.9% |
| West Germany | 3.4% |
| United States | 1.2% |

R. Alm & R. Black, *Yankee Trader*, U.S. NEWS & WORLD REP. 64, 65 (Apr. 8, 1985) (Efficiency Table).

53. See M. EAKER & J. YAWITZ, *supra* note 41, at 284. The chart below shows average annual gross saving from 1960-1980, expressed as a percentage of gross domestic product, for a selected group of industrialized nations.

| Nation | Saving Rate |
|----------------|-------------|
| Japan | 35.5% |
| West Germany | 25.9% |
| Canada | 21.6% |
| United States | 19.2% |
| United Kingdom | 18.8% |

Id. at 285 (citing the National Accounts of Organization for Economic Cooperation and Development Countries).

54. See R. Alm & R. Black, *supra* note 52, at 65.

One businessman noted that:

[A]s a matter of official policy backed up by tax structure, the other advanced industrial nations have since the 1950's been investing much more of their GNP in new plant and equipment than we have in the United States. In . . . Germany, they are proportionally investing two times as much, and in Japan three times as much, as we are in new ventures,

propensities to save and invest is more than coincidental. Japan and West Germany, two commercialized countries with more promising postwar growth rates,⁵⁵ have enjoyed extremely high savings and investment rates.⁵⁶

America's poor postwar savings rate is at least partially due to the fact that Congress has enacted tax schemes without examining their economic impact.⁵⁷ The lock-in effect is a perfect example of a tax scheme with adverse economic consequences. By taxing the realization of a capital gain, Congress effectively reduces the proceeds from the sale of a capital asset⁵⁸ and provides only disincentives to save and invest. Empirical evidence supports this proposition. Japan and West Germany, the two nations with the greatest propensity to save,⁵⁹ severely restrict taxes on capital gains.⁶⁰ The United States and the United Kingdom, on the other

new technology, and new plant and equipment. And their productivity has been increasing two or three times as fast ours.

R. JONES, TECHNOLOGICAL INNOVATION: HOW DO WE REVERSE THE DECLINE? 5 (address delivered by Chairman and Chief Executive Officer of General Electric Co. on Mar. 27, 1979 and cosponsored by Center for the Study of American Business and Washington University School of Business and Public Administration).

55. See *supra* note 52.

56. See *supra* note 54.

57. Martin Feldman has suggested that the poor saving record of the United States . . . [is the] legac[y] of John Maynard Keynes . . . Keynes's theories were largely motivated by the Depression. During the 1930s there was excess capacity, so that the econom[y] of the United States . . . [was] not supply-constrained in any way. Keynes argued that saving was not only unnecessary but in fact part of the cause of the Depression. Saving reduced the level of demand in an economic environment in which output could expand without additional investment. The crucial problem was not growth in the level of inputs [e.g., saving] but rather the full utilization of existing resources. As a result, Keynes favored policies that stimulated demand at the expense of saving. Feldstein hypothesizes that Keynes's emphasis on demand has carried over until recently, especially in the United States . . . *One consequence is that tax . . . policies have been enacted without questioning their impact on saving. Feldstein and others have now begun to analyze those effects, including that saving has been discouraged, much to the detriment of economic growth.*

M. EAKER & J. YAWITZ, *supra* note 41, at 284 (footnote omitted) (discussing Feldstein, *America's New Savings Policy*, Wall St. J., Aug. 19, 1981).

58. See *supra* notes 11 & 27 and accompanying text.

59. See *supra* notes 53 & 54 and accompanying text.

60. *Tax Rates in Other Major Industrial Countries*, Wall St. J., May 30, 1985, at 12 [hereinafter cited as *Tax Rates*]. In West Germany, capital gains are exempt from taxation, except for short-term "speculative" profits. In Japan, capital gains from securities sales are exempt. *Id.* See also SECURITIES INDUSTRY ASS'N & ARTHUR ANDERSEN & CO., COMPARISON OF INDIVIDUAL TAXATION OF LONG AND SHORT TERM CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN TEN COUNTRIES (1980) (Australia, Belgium, Italy, Japan, West Germany and other nations do not tax capital gains); NATIONAL BUREAU ON ECONOMIC SECURITIES, FOREIGN TAX POLICIES AND ECONOMIC GROWTH 57 (1966) (capital gains on securities exempt from taxation in Japan); M. KING &

hand, are modern-day havens for capital gains taxation.⁶¹ Although the lock-in effect does not completely explain the United States' low savings, investment, and growth rates,⁶² legislation reducing or eliminating capital gains taxation would at least provide an appropriate incentive for private savings and investment.

III. CAPITAL GAINS PROPOSALS

Recent tax reform efforts offer the Ninety-ninth Congress an opportunity to contract, alter or expand the preference for capital gains.⁶³ Although the thought of reducing tax preferences for capital gains alarms many economists,⁶⁴ the Bradley-Gephardt "Fair Tax Act,"⁶⁵ the Treasury Department's "Tax Reform for Fairness, Simplicity and Economic Growth" (Treasury I),⁶⁶ and two less widely acclaimed proposals⁶⁷ would completely eliminate tax preferences for capital gains.

D. FULLERTON, *THE TAXATION OF INCOME FROM CAPITAL* 154 (1984) (no individual capital gains tax in West Germany).

61. See *Tax Rates*, *supra* note 60, at 12. The United States imposes a maximum effective rate of 20% on long-term capital gains, while Great Britain taxes net gains in excess of \$7,028 at 30%. See also V. DiPALMA, *CAPITAL GAINS TAX* 1 (1972) (capital gains tax initiated in 1962); M. KING & D. FULLERTON, *supra* note 60, at 35 (1982 amendment allows 5,000 £ annual exclusion and indexation of capital gains).

62. The United States, for example, currently provides incentives to spend by permitting liberal interest expense deductions. See I.R.C. § 163 (1985). Conversely, the high savings rate among the Japanese may be due to a number of factors, including different cultural values, the lack of a social security system, and liberal exclusions for interest income. Interview with Dr. Joel Prakken, Adjunct Professor of Economics at Washington University in St. Louis (Feb. 18, 1985).

63. The six most well-known tax reform proposals are: (1) the Treasury Department proposals, (2) Bradley-Gephardt, (3) Kemp-Kasten, (4) Roth-Moore, (5) Nickles-Siljander, and (6) DeConcini-Shelby. For a summary of the key elements of the capital gains provisions under each proposal, see Appendix A.

64. Several economists at the Center for the Study of American Business have noted that: one aspect of the proposed reforms has important implications for business investment but has received little attention: curtailing the preferential treatment currently granted capital gains income. . . . The smaller the exclusion, the costlier to shareholders (in after-tax terms) is a firm's decision to retain earnings rather than pay dividends, and the higher the dividend return that the firm must offer to attract equity capital. Hence, reducing (or eliminating) the exclusion for capital gains raises the cost of capital and discourages business investment.

J. PRAKKEN, L. MEYER & C. VARVARES, *FLAT TAXES AND CAPITAL FORMATION* 3 (1984).

65. See OFFICE OF THE SECRETARY OF DEP'T OF TREASURY, *TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH* 174 (1984) [hereinafter cited as *TREASURY DEPARTMENT RECOMMENDATION*].

66. *Id.* at 76, 174.

67. Both the Roth-Moore and DeConcini-Shelby tax reform bills completely eliminate tax preferences for capital gains. *Id.*

Treasury I, however, would index capital gains to inflation, thereby eliminating that portion of appreciation derived from aggregate price level increases.⁶⁸ In contrast to these proposals, President Reagan's "Tax Proposals for Fairness, Growth and Simplicity" and the Kemp-Kasten "Fast Tax Act" would grant the taxpayer the option of accepting a percentage deduction for net realized capital gains or indexing capital gains for inflation.⁶⁹

A. *Eliminating Preferences for Capital Gains*

Tax reformers proposing to eliminate the tax preference for capital gains⁷⁰ claim that preferential treatment is the primary source of complexity in tax law.⁷¹ In addition, proponents maintain that tax administrators cannot prevent uneconomic and evasive activities designed to convert ordinary income into capital gains.⁷² Proponents, however, fail to assess accurately the economic impact of such a proposal. At all income levels, individuals who rely more heavily on capital gains as opposed to ordinary income would incur greater taxes.⁷³ Despite supporters' statements to the contrary,⁷⁴ eliminating tax preferences for

68. *Id.* at 76, 174. For example, if a taxpayer purchased a capital asset for \$100 and sold it one year later for \$110, the taxpayer would increase the asset's basis to compensate for any inflation during the holding period. Assuming a 10% inflation rate, the taxpayer would increase the asset's basis to \$110 and would pay no tax on the appreciated value.

69. *Id.* Treasury II's option to index capital gains for inflation, however, does not take effect until 1991 and only applies to individuals. Treasury II retains the current 28% capital gains rate for corporations. AMERICAN ENTERPRISE INSTITUTE, THE ADMINISTRATION'S 1985 TAX PROPOSALS 29 (1985).

70. The Bradley-Gephardt "Fair Tax Act," for example, would completely eliminate tax preferences for capital gains. S. 1421, 98th Cong., 1st Sess., 129 CONG. REC. 7836 (1983). Under Bradley-Gephardt, the maximum effective rate imposed on capital gains would increase from 20% to 30%. See Appendix A.

71. See *supra* note 3 and accompanying text.

72. See Blum, *supra* note 1, at 263-65 (elaborate rules cannot prevent efforts to turn economic benefits into capital gains).

73. S. 1421, 98th Cong., 1st Sess., 129 CONG. REC. 7850-51 (1983).

74. Senator Bradley introduced his tax reform proposal to the Senate by stating:

So what this bill says is that the most effective stimulant to investment is the *lowest possible rate of taxation* for all businesses and investments, not just for those who happen to have the best access to the political process.

I believe that most of those preferences we have put in the Tax Code over the years are not well designed to promote economic growth or create new jobs. On the contrary, they have made the tax system a hurdle that the private sector has to get over in order to be able to create those jobs and fuel economic growth or create new jobs. So what we in the Congress should do is to design a tax system that has the *lowest possible rate*, the lowest possible hurdle that the private sector can get over easily to produce jobs. That is what we have done with this bill.

capital gains would enhance the lock-in effect and would provide disincentives to save and invest.⁷⁵ Opponents allege that the proposal is a form of "capital punishment," rather than tax reform.⁷⁶

B. Indexing Capital Gains for Inflation

Some tax reformers propose to eliminate the tax preference for capital gains and to tax only that portion of gain in excess of the inflation rate.⁷⁷ Because capital gains derived from inflation do not reflect an increased ability to pay taxes, indexing would promote fairness among taxpayers. Indexing alone, however, would only partially compensate for the loss of the present law's liberal capital gains exclusion. While indexing would provide benefits for long-term investments in "blue-chip" stocks, it would penalize investments in high-risk, high-return ventures.⁷⁸

Contrary to President Reagan's statements,⁷⁹ indexing would create a bias against formation of venture capital in entrepreneurial activities.⁸⁰ As a result, the Treasury Department, in Treasury II, granted taxpayers an option either to index capital gains for inflation or to exclude a specified percentage of net realized capital gains from income.⁸¹

C. Expanding the Preference for Capital Gains

Tax reform plans proposing to expand the tax preference for capital gains fare well under a supply side analysis.⁸² By reducing the effective

S. 1421, 98th Cong., 1st Sess., 129 CONG. REC. 7837 (1983) (emphasis added).

75. See *supra* notes 24-38 and accompanying text.

76. Ruhm, *Capital Punishment—The Case Against Taxing Long-Term Gains*, Barron's 26 (Aug. 20, 1984).

77. See TREASURY DEPARTMENT RECOMMENDATION, *supra* note 65, at 76, 174. The maximum effective rate imposed on capital gains could be as high as 35% in a noninflationary economy. See Appendix A.

78. P. Blustein, *Capital Gains: Tax Plan Would Aid Some Investors But Hurt Others*, Wall St. J., Apr. 15, 1985, at 27, col. 4. See Blum, *supra* note 1, at 256-58 (capital gains taxation impairs mobility of capital—Argument 21).

79. President Reagan, in his State of the Union Address of February 6, 1985, stated: "Together, we can pass, this year, a tax bill for fairness, simplicity, and growth making this economy the engine of our dreams and America the investment capital of the world." St. Louis Post-Dispatch, Feb. 7, 1985, at 1, col. 4 (emphasis added). He further added that Treasury I's tax simplification would be "a giant step toward unleashing the tremendous pent-up power of our economy." *Id.*

80. See P. Blustein, *supra* note 78, at 27, col. 6 (low capital gains taxation stimulates entrepreneurial activities); P. Behr, *Tax Plan Scares Venture Capitalists*, Wash. Post, Nov. 29, 1984, at C1-C2 (venture capitalists fear Treasury I's impact on capital formation).

81. See TREASURY DEPARTMENT RECOMMENDATION, *supra* note 65, at 76, 174.

82. See *supra* notes 43-45 and accompanying text.

net tax rate on capital gains, individual savings would increase. As a result, the aggregate supply of loanable funds would increase, placing downward pressure on interest rates.⁸³

Such tax reform plans, however, are subject to economic and political criticisms. Economists who oppose supply side theories argue that the combination of an increased federal deficit and the federal government's inelastic demand for loanable funds would "crowd out" increased private investment by exerting upward pressure on interest rates.⁸⁴ Moreover, some politicians claim that an increased capital gains preference would favor only wealthy taxpayers.⁸⁵

An analysis of empirical data, however, suggests that these economic and political criticisms lack merit. First, the Treasury Department derives less than five percent of total income tax revenues from capital gains transactions.⁸⁶ Moreover, the Treasury Department estimates that revenues derived from capital gains taxes would increase substantially as a result of Treasury II's reduced maximum effective long-term capital gains rate.⁸⁷ In other words, Treasury II would create a *negative* crowding out effect. The government's demand for loanable funds would decrease, putting downward pressure on interest rates, thereby stimulating

83. *Id.*

84. *See supra* notes 46-51 and accompanying text.

85. The Joint Committee on Taxation estimated that the benefits of the capital gains exclusion are distributed more heavily among the highest income classes:

| <u>Income</u> | <u>Returns</u> | <u>Amount</u> |
|--------------------|----------------|---------------|
| Below \$20,000 | 1,815,000 | \$ 795 mil. |
| \$20,000-\$30,000 | 1,113,000 | \$ 890 mil. |
| \$30,000-\$50,000 | 1,589,000 | \$ 1,913 mil. |
| \$50,000-\$100,000 | 990,000 | \$ 2,918 mil. |
| Over \$100,000 | 360,000 | \$12,741 mil. |

Tax Reforms: Who'd Be Hurt if it Passes, U.S. NEWS & WORLD REP., May 6, 1985, at 80. *See also* Bartlett, *The Federal Tax Debate: Capital Gains*, BACKGROUNDERS, Dec. 27, 1984, at 2 (45% of all net long-term capital gains accrued to taxpayers with incomes above \$100,000); Feldstein, Slemrod & Yitzhaki, *supra* note 51, at 118 (wealthy taxpayers are more reactive to increased preferences for capital gains); S. Lee, *The Case for Cutting the Capital Gains Tax*, BUS. WEEK, Nov. 4, 1983, at 47 (identifying the political concern that the tax break primarily benefits the wealthy).

86. *See* Ruhm, *supra* note 76, at 26 (only \$12 billion of approximately \$300 billion in federal tax revenues are derived from the capital gains tax).

87. The Treasury Department estimates that Treasury II's proposed reduction in the maximum effective long-term capital gains rate from 20% to 17.5% would *increase* tax revenues by \$18.5 billion over the next five years. AMERICAN ENTERPRISE INSTITUTE, THE ADMINISTRATION'S 1985 TAX PROPOSALS 96 (1985) (Table A3). *But see* Blum, *supra* note 1, at 252 (aggregate tax revenues are not relevant to determining the proper tax base—Argument 13).

private investment.⁸⁸

In addition, because most of the increased capital tax revenues would be derived from wealthy taxpayers,⁸⁹ increasing the tax preference for capital gains would not result in a tax windfall for the wealthy. Rather, it would encourage all taxpayers to realize successful investments and to reinvest the proceeds in high-risk, high-return ventures.⁹⁰ After the 1978 and 1981 Revenue Acts reduced the maximum effective capital gains rate,⁹¹ new issues of common stock tripled their pre-1978 levels.⁹² Moreover, the 1978 Act's increased exclusion for capital gains led to a seventy-three percent increase in realizations of accrued net long-term gains by 1980,⁹³ evidencing the magnitude of the lock-in effect.⁹⁴

IV. CONCLUSION

Although tax preferences for capital gains may add to the complexity of the tax law, the contribution of tax preferences to economic growth more than counters any negative consequences. Capital gains preferences encourage investors to realize capital gains and to reinvest the proceeds in growth-oriented entrepreneurial ventures, thereby stimulating employment opportunities.⁹⁵

Excessive capital gains taxation hinders economic growth by restricting the flow of venture capital to its most efficient use.⁹⁶ Tax reforms should not blindly strive to simplify complex capital gains provisions without considering the economic impact on savings, investment, and employment opportunities. The Ninety-ninth Congress should grant taxpayers the option to deduct an increased percentage of capital gains or to index capital gains for inflation. Only by enhancing the preference for capital gains may Congress "unleash the tremendous pent-up power of

88. See *supra* notes 46-51 and accompanying text.

89. Capital gains provisions are progressive; only those individuals in the highest income bracket are taxed at the maximum rate. See *supra* note 20. Moreover, wealthy taxpayers realize a large percentage of long-term capital gains. See *supra* note 85. But see Blum, *supra* note 1, at 261-62 (the capital gains preference undercuts the redistributive effect of a progressive income tax—Argument 2).

90. See *supra* note 78 and accompanying text.

91. See *supra* note 17 and accompanying text.

92. See Bartlett, *supra* note 85, at 6-7 (citing ECONOMIC REPORT OF THE PRESIDENT 322 (1984)).

93. Feldstein, Slemrod & Yitzhaki, *supra* note 51, at 117-19.

94. See *supra* notes 24-38 and accompanying text.

95. See *supra* notes 43-49 and accompanying text.

96. *Id.*

our economy” and “make America the investment capital of the world.”⁹⁷

J. David Hershberger

97. *See supra* note 79 and accompanying text.

Appendix A

The following chart summarizes the key elements of capital gains taxation under the existing tax system, the Treasury Department's recommendation, and the five congressional tax reform bills.

| <u>Tax Proposal</u> | <u>Maximum Ordinary Income Tax Rate</u> | | <u>Exclusion Ratio</u> | <u>Maximum Effective Capital Gains Rate</u> | |
|-------------------------------|---|---------------------|----------------------------|---|---------------------|
| | <u>Individuals</u> | <u>Corporations</u> | | <u>Individuals</u> | <u>Corporations</u> |
| Current Internal Revenue Code | 50% | 46% | 60% ^A | 20% | 28% |
| Treasury I | 35% | 33% | 0% | 35% ^B | 33% ^B |
| Treasury II ^E | 35% | 33% | 50% | 17.5% ^C | 28% ^B |
| Bradley-Gephardt | 30% | 30% | 0% | 30% | 30% |
| Kemp-Kasten | 24% | 35% | 40% ^A | 17% ^C | 20% ^D |
| Roth-Moore | 34% | 46% | 0% | 34% | 36% |
| Nickles-Siljander | 10% | 46% | 60% ^A | 6% | 28% |
| DeConcini-Shelby | 19% | 19% | 9% | 19% | 19% |

^A Applies only to long-term capital gains; maintains the distinction between long- and short-term capital gains.

^B Capital gains to be indexed to inflation and taxed as ordinary income.

^C Taxpayer may elect (1) to have all capital gains indexed to inflation and taxed as ordinary income or (2) to exclude 50% of the capital gain and subject the remaining 50% to ordinary tax rates.

^D Corporate taxpayers may elect (1) to apply a separate 20% tax rate to capital gains or (2) to index capital gains to inflation.

^E Rates not applicable until 1991, when the proposal would be fully implemented.

