

TAX REFORM AND CAPITAL GAINS: THE WAR AGAINST UNFAIR TAXES IS FAR FROM OVER

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INTRODUCTION

In the fall of 1986, Congress completed the process of fundamentally reforming the U.S. Tax Code. The House of Representatives passed a comprehensive tax reform bill late in December 1985.¹ The bill underwent radical change in the Senate Finance Committee.² President Reagan signed the Tax Reform Act of 1986³ on October 22, 1986.

The U.S. Tax Code has grown from eighty-nine pages in 1913⁴ to thousands of pages in 1987. Additionally, the regulations and case law needed to interpret the Code require analysis of volumes of reference materials.⁵ The Deficit Reduction Act of 1984⁶ alone topped 1,300 pages. The expanded Tax Code stands as a monument to special

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1. H.R. 3838, 99th Cong., 1st Sess. (1986).

2. S. REP. NO. 313, 99th Cong., 2d Sess. (1986). The most radical changes included limiting losses and credits from passive activities in Section 501 of H.R. 3838, eliminating the capital gains exclusion in Section 301, and dramatically reducing the 50% top income tax rate. The Tax Reform Act sets out a five-bracket transitional rate structure for 1987 with a top rate of 38.5%. Beginning in 1988, the Act calls for a two-bracket rate structure with the top rate at 28% of net income. The Act imposes a 5% rate adjustment, however, to phase out the benefits of the 15% bracket and the deductions for personal exemptions. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., at II-4 and II-9, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 973.

3. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

4. The Revenue Act of 1861, ch. 45, 12 Stat. 292, included the first income tax. This portion of the Act was repealed, however, and customs receipts once again became the source of revenue for the federal fisc. This Act, as amended, was held unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895). The Supreme Court held that insofar as the Act taxed income from real estate, it was unconstitutional as an invalid direct tax.

The sixteenth amendment to the Constitution paved the way for Congress to impose the first successful income tax. Pursuant to that power, Congress passed the Tariff Act of 1913, Pub. L. No. 63-16, 38 Stat. 114. This Act established a progressive tax rate structure varying from a 17% tax on the first \$20,000 of income to a 6% tax on income over \$500,000. The Act survived a constitutional challenge. *Brushaber v. Union Pacific R.R.*, 240 U.S. 1 (1916) (plaintiffs argued the progressive tax rate structure denied them due process).

5. See generally B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* (1981); FED. INC. GIFT & EST. TAX'N (MB); Fed. Tax Coordinator 2d (Res. Inst. Am.); Fed. Tax Guide Rep. (CCH); G. ROBINSON, *FEDERAL INCOME TAXATION OF REAL ESTATE* (1984); J. MERLENS, *LAW OF FEDERAL INCOME TAXATION* (1987).

6. Pub. L. No. 98-369, 98 Stat. 494.

interests. From depletion allowances for oyster shells⁷ to deductions for investments in super dairy cows,⁸ Congress filled the Code with cures for the supposed ills of society. Left unsolved by today's Tax Code, however, is its fundamental unfairness.⁹

The capital gains tax preference¹⁰ played a pivotal role in the tax reform debate. The debate centered on how to broaden the income tax base,¹¹ thus allowing rates to be reduced to generate the same amount of revenue.¹² Capital gains tax expenditures¹³ for 1987-91 would have amounted to more than \$266 billion.¹⁴ By eliminating the capital gains preference, tax receipts during that period might increase by more than

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7. The Code provides for a 14% depletion allowance on "minerals, including, but not limited to . . . mollusk shells (including clam shells and oyster shells). . . ." I.R.C. § 613(b)(7) (1986).
 8. *Stark Proposes to End Dairy Expansion Incentives During Milk Glut*, 22 TAX NOTES 173 (1984).
 9. See generally Gephardt & Wessel, *Tax Reform: A "But-For" Test*, 29 ST. LOUIS U. L.J. 895 (1985) (discussing the unfairness of the Tax Code and the reasoning behind the development and introduction of the Fair Tax Act of 1983, S. 1421, 98th Cong., 1st Sess., 129 CONG. REC. S7838 (daily ed. June 8, 1983)). Perhaps the most truthful appraisal of U.S. tax laws was made by Wilbur Mills: "The laws have long since lost sight of the real purpose of taxation, which is simply to raise the money the government needs to pay its bills." Katsoris, *In Defense of Capital Gains*, 42 FORDHAM L. REV. 1 (1973).
 10. The capital gains tax preference generally referred to in this article is the now-repealed exclusion from income of 60% of the gain on certain assets held more than six months as found in I.R.C. Section 1202 (1982).
 11. The base is broadened when tax preferences in the Tax Code are eliminated or reduced.
 12. One of the agreed-upon political assumptions was that a comprehensive tax reform measure should not be used to raise revenue to reduce the federal deficit. See generally JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., ECONOMIC ISSUES RELATING TO THE HOUSE-PASSED TAX REFORM BILL (H.R. 3838) (Comm. Print 1986); JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., ESTIMATED REVENUE EFFECTS OF TAX REFORM PROVISIONS CONTAINED IN THE PRESIDENT'S PROPOSAL, THE HOUSE BILL (H.R. 3838) [hereinafter cited as REVENUE EFFECTS]; JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., THE FINANCE COMMITTEE CHAIRMAN'S PROPOSAL FOR FISCAL YEAR 1986 TO FISCAL YEAR 1991 (Comm. Print 1986); JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., SUMMARY OF TAX REFORM PROVISIONS IN H.R. 3838 AS ORDERED REPORTED BY THE SENATE COMMITTEE ON FINANCE (Comm. Print 1986); JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., COMPARISON OF TAX REFORM PROVISIONS OF H.R. 3838, AS PASSED BY THE HOUSE AND THE SENATE (Comm. Print 1986); JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., SUMMARY OF CONFERENCE AGREEMENT ON H.R. 3838 (Comm. Print 1986).

President Reagan also stood by his opposition to a tax increase of any kind, as he vowed during the 1984 presidential campaign. See, e.g., N.Y. Times, Aug. 14, 1984, at 1, col. 4; N.Y. Times, Aug. 8, 1984, at 1, col. 2; N.Y. Times, Aug. 7, 1984, at 14, col. 1.

13. Tax expenditures are revenue losses resulting from federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. These provisions may, in effect, be viewed as the equivalent of a simultaneous collection of revenue and a direct budget outlay of an equal amount to the beneficiary taxpayer. See STAFF OF SENATE COMM. ON THE BUDGET, 99TH CONG., 2D SESS., TAX EXPENDITURES: RELATIONSHIPS TO SPENDING PROGRAMS AND BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 1-2 (Comm. Print 1982).
14. See JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEAR 1987 TO FISCAL YEAR 1991, at table 1 (Comm. Print 1986) [hereinafter cited as JOINT COMMITTEE ESTIMATES]. This figure includes capital gains treatment for tangible and intangible items.

five percent.¹⁵ No other single item in the Tax Code has so large a revenue impact.¹⁶

This article discusses the treatment of capital gains under the present Tax Code and the role of capital gains in the tax reform process. Eliminating preferential treatment of capital gains will broaden the tax base significantly, allowing for substantial reduction in tax rates.¹⁷ The importance of the capital gains preference, however, goes far deeper than broadening the tax base and lowering tax rates. The preference motivated an incredible amount of "tax avoidance" behavior and diminished the fairness of the U.S. Tax Code. Although the preference has been curtailed, the statutory machinery necessary to reinstate the preference remains in place. As a result, those of us who oppose the capital gains preference must continue to keep watch over its grave. A study of the evolution of the capital gains tax preference exemplifies how the Tax Code has failed to meet the three objectives of taxation—equity, simplicity and promotion of economic growth.

THE QUEST FOR EQUITY

One of the principal goals behind the tax reform effort was the desire to provide equity in the tax system. Two concepts of equity must be addressed in analyzing any tax system or tax reform plan. First is horizontal equity, whereby individuals with similar amounts of income pay similar amounts of taxes.¹⁸ Second is vertical equity,¹⁹ which, in our system of taxation, is based on ability to pay.²⁰

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15. The tax expenditure for all capital income amounted to more than \$135 billion in 1983 alone. CONG. BUDGET OFF., REVISING THE INDIVIDUAL INCOME TAX 26 (1983). Estimated tax collections between 1987 and 1991 are \$2.8 trillion. See generally JOINT COMM. ON TAX'N, 99TH CONG., 1ST SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEAR 1986 TO FISCAL YEAR 1990 (Comm. Print 1985); JOINT COMMITTEE ESTIMATES, *supra* note 14.
 16. During the 1987-91 period, for example, tax expenditure for depreciation is estimated to be only \$138 billion. See JOINT COMMITTEE ESTIMATES, *supra* note 14, at 9-15.
 17. The total change in tax receipts from individuals resulting from a reduction of tax rate schedules was \$305.2 billion between 1985 and 1989 under a plan introduced by President Reagan. THE PRESIDENT'S TAX PROPOSAL TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985) [hereinafter cited as PRESIDENT'S PROPOSAL]. See REVENUE EFFECTS, *supra* note 12, at 4. The President's tax plan achieved a 30% reduction in the top marginal tax bracket from 50% to 35%. See *id.* at 3.
 18. See NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980's 13-14 (C. Walker and M. Bloomfield eds. 1984).
 19. See *id.* at 13-14.
 20. The ability-to-pay concept relates an individual's income to his or her tax burden. For example, a 10% tax on an individual making less than \$10,000 is viewed by many as more onerous than a 10% tax on a person making more than \$100,000. Although the same percentage of income is taxed in each case, the ability of the lower income individual to pay the same percentage of tax is not as great—the person simply needs his or her entire income to pay for food, shelter and other necessities.

Horizontal Equity

Roughly half of the income in the United States today goes untaxed.²¹ Achieving horizontal equity is difficult in a tax system that contains exemptions, exclusions, credits, deductions and other adjustments to income.²² The horizontal inequity in the tax system is partially a function of "high marginal tax rates, which make it lucrative to seek legal ways to reduce taxes."²³

Unless Congress adopts a tax system with no adjustments to income, perfect horizontal equity will never exist. Even in a system allowing no adjustments, different taxpayers would pay different taxes on the same income.²⁴ Substantially more horizontal equity is achieved, however, when preferential treatment of capital gains is curtailed.²⁵

Vertical Equity

Progressive rates have been a basic tenet of the United States Tax Code for more than seventy years.²⁶ Nonetheless, our present system

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21. Between 1947 and 1979, the tax base (income taxed at a positive rate) was consistently half or less of personal income. The tax base grew from 40% of personal income in 1947 to 51% in 1969. It then fell back to 46% as a result of tax exemptions, exclusions and credits. The relative importance of these items changed dramatically between 1947 and 1979. See CONG. BUDGET OFF., *REVISING THE INDIVIDUAL INCOME TAX 10* (1983) [hereinafter cited as *REVISING INDIVIDUAL TAXES*].
 22. A quick examination of the taxation of fringe benefits (as provided in I.R.C. Section 106 (1987)) will illustrate this point. Compare two wage earners: worker *A* earning \$20,000 in wages with no fringe benefits, and worker *B* earning \$18,000 per year plus a health insurance fringe benefit package worth \$2,000. Worker *A*, because he receives no fringe benefits, must pay for his health insurance in after-tax dollars; therefore, he pays a higher tax than worker *B*. I.R.C. § 106 (1987). Although the provisions affecting the exclusion from income of health insurance may arguably further the interests of health care policy, at the same time they reduce the horizontal equity of the system.
 23. See *REVISING INDIVIDUAL TAXES*, *supra* note 21, at 3.
 24. Some taxpayers modify their behavior to reduce taxes, and others qualify automatically for tax preferences, so taxpayers with equal incomes pay widely different amounts of tax. Consequently, the income tax is not as progressive as is implied by the schedule of statutory rates. Many taxpayers feel that the tax schedule is unfair; they believe that they pay more tax than the family next door with the same income and that a family with higher income does not pay as much additional tax as it should. See *REVISING INDIVIDUAL TAXES*, *supra* note 21, at 3.
 25. It would be fruitless to argue that high-income taxpayers should not have capital gains income. The economy depends, to some extent, on the willingness of these taxpayers to withhold consumption by investing, thereby stimulating economic growth. The long-term capital gains preference effectively reduces the rate of taxation on high-income taxpayers, in many cases to levels below that of low- or middle-income taxpayers. As the tax base shrinks, higher tax rates are necessary to maintain the same level of federal revenues. This results in fewer individuals who can afford to postpone consumption in favor of saving to seek out investment opportunities that will yield long-term capital gains and other tax benefits. See Lowndes, *The Taxation of Capital Gains and Losses Under the Federal Income Tax*, 26 TEX. L. REV. 440, 454-58 (1948).
 26. The Revenue Act of 1913 provided for a normal tax and a surtax. Act of Oct. 13, 1913, ch. 16, §§ II(A)(1) and (2), 38 Stat. 114, 166.

of taxation does not meet the ability-to-pay objective of vertical equity.²⁷ One 1983 tax return study found that almost eleven percent of taxpayers with total positive income²⁸ exceeding \$250,000 paid virtually no taxes.²⁹ Of the 260,275 returns analyzed, 17,000, or about seven percent, reporting total positive income exceeding \$250,000 owed less than a typical four-person family with \$45,000 income.³⁰ The same was true for taxpayers with total positive income exceeding \$1 million.³¹

Although benefits from capital gains treatment were evenly distributed among income classes in the early years of the Internal Revenue Code,³² disparity in the distribution of capital gains income has become more pronounced in favor of the wealthy.³³ Additionally, capital gains

27. Legal loopholes traditionally have created an income tax system that allows many wealthy citizens to pay little or no taxes, placing the greatest tax burden on the middle class. See N.Y. Times, June 6, 1982, § 4, at 20E, col. 1. The loopholes are too numerous to list, but they have included such items as the deduction for interest expenses (I.R.C. § 163 (1982)) and the partial exclusion of dividends received (I.R.C. § 116 (1982)). The 1986 Tax Reform Act eliminates some of these inequities. For example, Section 511 of the Tax Reform Act tightens up interest deductions, and Section 612 of the Act repeals the dividend exclusion.

28. Total positive income is defined as the sum of (1) wages and salaries, (2) interest, (3) dividends and (4) income from profitable businesses and investments. Unlike the more commonly used measures of adjusted gross income, total positive income does not take into account various exclusions or deductions that reduce adjusted gross income, such as Individual Retirement Account and Keogh contributions and the percentage of long-term capital gains excluded from taxable income. Total positive income also excludes most business and investment losses that are taken into account in computing adjusted gross income. See DEP'T OF THE TREASURY, OFF. OF TAX POLICY, TAXES PAID BY HIGH-INCOME TAXPAYERS AND THE GROWTH OF PARTNERSHIPS (1985), reprinted in *High-Income Taxpayers and Related Partnership Tax Issues: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 99th Cong., 1st Sess. 36-37 (1985) [hereinafter cited as *Hearings*].

29. Taxes paid did not amount to even five percent of their total positive income. See *Hearings*, *supra* note 28, at 26 (table), 37.

30. See *id.* at 38 (the amount of tax paid by a four-person family with \$45,000 of income is about \$6,300).

31. See *id.*

32. See H.R. 968f2, 75th Cong., 3d Sess., 83 CONG. REC. 4934 (1938) (chart: Percentage Distribution of Total Capital Gains, By Income Class).

Analysis of U.S. tax payment between 1966 and 1985 shows a consistent and marked decline in the overall effective rate of taxes in income from capital. The effective rate of such taxes in 1985 was only about half the 1966 rate. . . . At the other extreme . . . the effective rate of taxes on income from labor apparently rose sharply between 1966 and 1975 and, despite some drop in the past decade, is currently about one-sixth higher than in 1966.

Manvel, *Changes in U.S. Tax Burdens, 1966-85*, 28 TAX NOTES 1143, 1144 (1985) (interpreting J. PECHMAN, *WHO PAID THE TAXES*, 1966-85).

33. For instance, taxpayers with an adjusted gross income, or AGI, in excess of \$100,000 in 1982 accounted for only eight percent of total AGI. These same taxpayers, however, accounted for 53% of the capital gains included in AGI and 67% of the capital gains taxes. OFF. OF THE TREASURY SEC'Y, OFF. OF TAX ANALYSIS, REPORT TO CONGRESS ON THE CAPITAL GAINS TAX REDUCTIONS OF 1978, at 7 (1985) [hereinafter cited as *TAX ANALYSIS REPORT*].

In 1948, Professor Lowndes stated:

The practical effect of the present system of taxing capital gains is to ignore entirely the ability-to-pay principle, which is supposed to furnish the ethical justification for the nearly confiscatory rates of the federal income tax. The laborer, the salaried

and dividends are much more highly concentrated among upper-income groups than is taxable interest income.³⁴

THE COMPLEX PROBLEM OF TAX SIMPLICITY

Equity is the enemy of simplicity. A tax code that could account for all of the different attributes of taxpayers and the various economic transactions in today's society would be extremely complex.³⁵ The tax system already has become virtually impossible for many Americans to understand.³⁶ The complexity of the Code offers many taxpayers significant opportunities to abuse the tax system or escape taxation. Although the Tax Reform Act of 1986 simplifies the system, excessive complexity remains.³⁷

worker, and the professional man are fully taxed upon their earnings. So is the grocer or modest tradesman who makes his living selling goods which constitute part of his regular stock in trade. On the other hand, the speculator and the other parasitic elements in the economy pay little or no income tax. Because of the six months [holding period requirements], practically every capital gain will be realized in the form of a long-term gain.

Lowndes, *supra* note 25, at 443-44.

34. In 1982, taxpayers with adjusted gross income of more than \$100,000 accounted for 52.8% of capital gains and 33.8% of dividends. In contrast, taxable interest income made up only 10.9% of adjusted gross income. For those taxpayers with adjusted gross income of less than \$25,000, taxable interest income reached 45.2%, and they received 21.9% of dividends and 18% of capital gains. TAX ANALYSIS REPORT, *supra* note 33, at 4, 5 (table 1.1), 7, 12, 13 (table 1.6). By comparison, in 1973, taxpayers making the top eight percent of total adjusted gross income (those making more than \$50,000) accounted for less than 41% of capital gains in AGI. *Id.* at 6 (table 1.2), 7.
35. For instance, adjusting for family size and the type of taxpayer complicates the system. Additionally, although the system needs to account for certain types of non-cash income in order to accurately measure the taxpayer's ability to pay taxes, it can be difficult to place a value upon them. Another major source of complexity arises when deductions are allowed for expenses incurred while earning income. STAFF OF JOINT COMM. ON TAX'N, TAX REFORM PROPOSALS: RATE STRUCTURE AND OTHER INDIVIDUAL INCOME TAX ISSUES 3-4 (Comm. Print 1985).
36. The increase in the percentage of individual returns prepared by paid tax preparers is, in part, a function of the complexity of the system. *Tax Reform and Deficit Reduction: Hearings Before the House Comm. on Ways and Means*, 98th Cong., 2d Sess. 214 (1984) (prepared statement of Emil M. Sunley, Director of Tax Analysis National Affairs Office, Deloitte, Haskins & Sells).

Critics ridicule the Internal Revenue Code by pointing to lengthy, convoluted provisions and to definitions that refer readers to other definitions that in turn compel them to go farther afield. A favorite example is the 554-word sentence that makes up I.R.C. Section 341(e)(1) (1987). See Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 1 (1974).

37. For example, the rules on passive losses, contained in Section 501 of the Tax Code, have yet to be completely defined. In fact, a resolution designed to clean up technical problems in the Tax Reform Act of 1986 never passed Congress. H.R. Con. Res. 395, 99th Cong., 2d Sess., 132 CONG. REC. H11648-9 (daily ed. Oct. 18, 1986). As a result, numerous outstanding questions remain. Section 501(a) of the Tax Reform Act of 1986 does add a new section to the Tax Code (I.R.C. § 469 (1987)) that limits the use of passive losses and credits to offsetting passive income, but it does not address offsets from active sources or portfolio income.

The complexity of the Code increases the administrative difficulties facing the Internal Revenue Service. Furthermore, courts have been forced to define certain terms the Code leaves undefined. In fact, the history of capital assets is largely a story of judicial integrity in creating doctrinal limits on the scope of the capital gains preference.³⁸

Attempts to restrict the scope of transactions qualifying for capital gains treatment have added significant complexity to the Tax Code. The increasing importance of capital gains exclusions to many taxpayers in reducing their taxable income prompted restrictions that reduced the tax base.³⁹ A review of some sections of the Tax Code may be useful to illustrate the complexity injected into the Code by the capital gains preference.

Sale or Exchange Requirement

A capital asset must be sold or exchanged in order to receive capital gains treatment.⁴⁰ A statutory definition of what constitutes a sale or exchange, however, is absent from the Code.⁴¹ As a result, the definition largely has been left to the courts. Courts have held that the words "sale or exchange" are to be given their ordinary meaning,⁴² and the substance of the transaction, not its form, will guide the courts.⁴³ Whether or not a transaction qualifies as a sale or exchange must be determined on a case-by-case basis.

Treasury regulations define "sale" as a transfer of property for money or a promise to pay money and define "exchange" as a reciprocal transfer of property.⁴⁴ A number of transactions that do not fit into the commonly used definitions of what constitutes a sale or exchange are, nevertheless, given capital gains treatment by the Code.

38. See generally Chirelstein, *Fruit-Tree and the Ordinary Income Base*, 1 U. BRIDGEPORT L. REV. 1 (1980).

39. One study found that for high-income taxpayers with taxes of less than five percent of their incomes, the combination of the capital gains exclusion and losses offset almost half of the taxpayers' incomes. U.S. DEP'T OF THE TREASURY, 5 STATISTICS OF INCOME BULL. NO. 2, TAXES PAID BY HIGH-INCOME TAXPAYERS AND THE GROWTH OF PARTNERSHIPS 55 (1985).

40. I.R.C. § 1222 (1986).

41. Section 1001 of the Code stated that net long-term capital gains and net short-term capital losses were derived from the sale or exchange of capital assets, and Section 1002 indicated that the entire amount of the gain or loss on the sale or exchange of property should be recognized. No definition, however, was given of what constitutes a sale or exchange. In fact, Section 1001(c) is the only subsection of Section 1001 (which refers to the determination of the amount of and recognition of gain or loss) that even mentions "exchange." The Tax Reform Act of 1986 failed to include a definition of sale or exchange. Further, Section 1001 no longer mentions net long-term capital gains or net short-term capital loss, merely gains and losses. Additionally, the Act omits Section 1002 of the Code and incorporates its provisions into Section 1001(c).

42. *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 878 (1941).

43. *Estate of Starr v. Commissioner*, 274 F.2d 294 (9th Cir. 1959).

44. Treas. Reg. § 1.1002-1(i)(d) (1957).

Involuntary dispositions, which are not covered by Section 1033,⁴⁵ may be eligible for capital gains treatment.⁴⁶ The loss from worthless securities is deemed to result from a sale or exchange.⁴⁷ The loss from nonbusiness bad debts is deemed to result from the sale or exchange of a capital asset.⁴⁸ Amounts received for the cancellation of a lease are deemed to result from an exchange.⁴⁹ The gain on a distribution by a corporation to a shareholder is deemed to be a sale or exchange.⁵⁰ Additionally, a number of common transactions that would qualify as a sale or exchange are treated as ordinary income-producing transactions.⁵¹

Capital Asset Requirement

The question of whether the property involved is a capital asset accompanies the determination of whether there has been a sale or exchange. The starting point for this determination is Section 1221 of the Code.⁵² The definition of a capital asset is overly broad: a capital asset is defined as property held by the taxpayer subject to limited restrictions.⁵³ This definition has resulted in judicial restriction of the

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45. The Code provides that no capital gain is recognized if the property is compulsorily or involuntarily converted by its destruction, theft, seizure, requisition or condemnation and the property is converted into similar property or the money received for the conversion is reinvested for similar property. I.R.C. § 1033(a) 1, 2 (1986).
 46. I.R.C. § 1231 (1986). Capital gains treatment is generally available for the destruction, theft or seizure, or condemnation of property. Congress adopted Section 1231 subsequent to the Supreme Court's decision that receipt of insurance proceeds on the destruction of property should be treated as ordinary income because no sale or exchange was found to have occurred. *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 878, 880-81 (1941).
 47. I.R.C. § 165(g) (1986) (provides that a capital asset that becomes worthless during the year shall be treated as a loss from the sale or exchange of a capital asset).
 48. I.R.C. § 166(d) (1986).
 49. I.R.C. § 1241 (1986) ("Amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such lease or agreement").
 50. I.R.C. § 301(c)(3) (1987) (generally provides that a distribution of property by a corporation of amounts in excess of basis shall be treated as gains from the sale or exchange of property).
 51. For example, I.R.C. Sections 1276, 1277 and 1278 (1987) were enacted as part of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 543, to address certain tax shelter transactions involving market discount bonds. Under prior law, leveraged purchases of market discount bonds resulted in a deduction against current income for interest expenses, and the income generated by the bond was taxed on a deferred basis as capital gains. This resulted in a number of tax shelters' borrowing funds to purchase these market discount bonds. Section 1276(a) provides that the gain on a market discount bond, to the extent of accrued market discount, is to be treated as ordinary income.
 52. The Tax Reform Act of 1986 does not reduce the complexity of the Code in this area. In fact, although the long-term capital gains exclusion was eliminated in Section 301 of the Act, the "current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase." H.R. CONF. REP. No. 841, 99th Cong., 2d Sess., pt. II, at 106 (1986).
 53. I.R.C. § 1221 (1)-(5) (1986) (the definition of capital assets is stated in the negative; therefore, all property not excluded by these five limitations would seemingly qualify as capital assets).

scope of what constitutes a Section 1221 asset,⁵⁴ creating substantial uncertainty as to the treatment of an asset.⁵⁵

Other Requirements

Other sections have been added to the Code to distinguish ordinary income from capital gains income. For example, Sections 1245,⁵⁶ 1250⁵⁷ and 1254⁵⁸ seek to “recapture” depreciation deductions already taken from ordinary income after the sale of an asset. These recapture provisions are necessary to restrict taxpayers from taking deductions against ordinary income and recognizing any later gains as capital gains with the resulting preferential treatment. Additionally, the provisions relating to collapsible corporations,⁵⁹ the provisions governing short sales⁶⁰ and income from buying and writing options,⁶¹ and the rules for business property and involuntary conversions⁶² have been added to restrict the use of long-term capital gains treatment.⁶³

54. In interpreting Section 1221, the Supreme Court has stated:

Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic Congressional purpose. [The Supreme] Court has always construed narrowly the term “capital assets” in [Section 1221].

Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1955).

55. Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962). Plaintiff was a newspaper publisher that purchased all the securities of a paper mill company during a severe newsprint shortage. It paid no dividends to stockholders, although the company earned substantial net profits. Surplus earnings were reinvested to upgrade mill equipment. *Id.* at 919. The court characterized the acquisition as an “‘expediency’ . . . intended to continue only until an adequate supply of paper could be assured by regular suppliers.” *Id.* at 918. It concluded that because the plaintiff’s original motivation in acquiring the stock was not for investment, but to ensure a vital source of inventory, the stock was not a capital asset. The plaintiff was allowed to deduct the losses it sustained from the sale of the stock as business expenses or ordinary losses. *Id.* at 922. The court allowed this treatment because it found that the original business of the taxpayer had changed to an investment purpose prior to the disposition of the securities involved. *Id.*

The *Booth* court distinguished the Fifth Circuit’s decision in *Gulftex Drug Co. v. Commissioner*, 29 T.C. 118 (1957), *aff’d per curiam*, 261 F.2d 238 (5th Cir. 1958).

56. I.R.C. § 1245 (1987) (applies to gain from the disposition of certain depreciable property).

57. I.R.C. § 1250 (1987) (applies to gain from the disposition of certain depreciable realty).

58. I.R.C. § 1254 (1987) (applies to gain from the disposition of interests in oil, gas, geothermal or other mineral properties).

59. I.R.C. § 341 (1987) (provides that the distribution from collapsible corporations will be treated as ordinary income).

60. I.R.C. § 1233 (1987) (a short sale involves the sale of borrowed property (usually stock) and repaying the lender with substantially identical property either held on the date of sale or bought after the sale). See *Provost v. United States*, 269 U.S. 443, 450 (1925).

61. I.R.C. § 1234 (1954).

62. I.R.C. § 1231 (1954).

63. Numerous other provisions have been added to the Code regarding capital gains, such as the provisions regarding corporate reorganizations (I.R.C. § 368 (1986)) and like-kind exchanges (I.R.C. § 1031 (1986)). These provisions relate to the question of when gain has been “realized” and, therefore, remain important sources of complexity even after the preferential rate on capital gain has been repealed.

EFFICIENCY AND THE PROMOTION OF ECONOMIC GROWTH

In addition to equity and simplicity, a third criterion for evaluating the Code is its efficiency and stimulation of economic growth.⁶⁴ Because the Tax Code no longer merely raises revenue, the effect of the various provisions in the Tax Code should be measured against their effect on the economy. Economic efficiency uses as a benchmark a market economy without the burden of taxation. In a true market economy, resources are used to maximize consumer satisfaction. Taxes change the incentives to engage in different activities, such as work, investing and leisure. Any tax policy, therefore, results in some inefficiency.⁶⁵

The intrusion of the Tax Code in our daily lives is readily apparent. For many people, the decision to spend money from their savings account or to buy an item depends upon whether they itemize deductions or upon their marginal income bracket. For example, an individual in a fifty percent marginal tax bracket with \$1,000 in the bank would do much better to borrow money at a twenty percent interest rate and invest it in an Individual Retirement Account.⁶⁶ The taxpayer would receive a tax benefit of \$600 and would have sheltered \$1,000 of income from taxes. The Tax Code provides this taxpayer with the incentive to purchase an item on credit. Whether the taxpayer's decision increases economic growth by increasing saving and consumption is arguable. At any rate, the United States Treasury loses \$600, plus the loss from the deferral of taxes on the Individual Retirement Account.⁶⁷

Many provisions in the Code act as catalysts for investment in nonproductive industries. While a high-technology company may pay taxes at or near the statutory rate of forty-six percent,⁶⁸ a "rust belt" company may pay little or no taxes or may pay a negative income tax.

64. Economic growth is the increase in the productivity of a nation or area. C. AMMER, *DICTIONARY OF BUSINESS AND ECONOMICS* 186 (1977). Its basic measure is the gross national product (GNP). This figure is adjusted for price inflation and thus expressed in "constant dollars."

The GNP has been defined as the sum of the gross domestic product and the income incurred by residents as the result of economic activity and property held abroad, reduced by the corresponding income of non-residents in the country. R. PERRANT-REA, *THE POCKET ECONOMIST* 89 (1983). The Gross Domestic Product is calculated by adding the total fair market value of a country's outputs and services, including private consumption, investment, government expenditure and changes in stocks and exports, minus imports.

65. JOINT COMM. ON TAX'N, 97TH CONG., 2D SESS., *ANALYSIS OF PROPOSALS RELATING TO BROADENING THE BASE AND LOWERING THE RATES OF THE INCOME TAX* 5-6 (Comm. Print 1982).

66. Unlike many other savings instruments, the income earned on investments within an Individual Retirement Account is not taxed until distributed. The interest on a savings account, on the other hand, is taxed in the year that it is earned.

67. Although Section 1101 of the Tax Reform Act of 1986 limited the ability of certain individuals to make tax-deductible contributions to Individual Retirement Accounts, the ability to invest after-tax dollars in Individual Retirement Accounts and defer taxation on any gains remains.

68. I.R.C. § 11(b)(5) (1986).

Largely because of unrealistic depreciation deductions, investment tax credits and inflation-related distortions, the tax system distorts investment by allowing effective tax rates to vary between different types of investments. This diverts investment dollars from their most productive uses—those with the highest pre-tax return rates—into less productive uses. This retards overall economic growth.⁶⁹

The growth of tax shelters⁷⁰ exemplifies how the Tax Code distorts economic growth and efficiency. Between 1975 and 1982, the total number of partnerships increased by forty-one percent. During that same period, the increase in the number of partnerships in two major tax shelter industries, oil and gas drilling and real estate, was eighty-four percent.⁷¹ The increased number of partnerships in these two areas occurred despite an excess supply of natural gas and an overabundance of many tax-sheltered forms of real estate.⁷²

The capital gains tax provisions, however, are just some of the many tax preferences used in tax shelter transactions. Other deductions, such as those from depreciation, may in fact be more important to tax shelter transactions because of the immediate benefit available to investors.⁷³ Nevertheless, the ability to convert ordinary income into capital gains is an important component of tax-sheltered transactions.

HISTORICAL ANALYSIS OF THE TREATMENT OF CAPITAL GAINS

Provisions of the Tax Code affecting capital gains have undergone substantial changes.⁷⁴ During the early era of capital gains taxation, profit from a capital transaction was not thought to be taxable.⁷⁵ In

69. See Aaron & Galper, *Reforming the Federal Tax System*, 24 TAX NOTES 285, 285-86 (1984).

70. JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., PROPOSALS RELATING TO TAX SHELTERS AND OTHER TAX-MOTIVATED TRANSACTIONS 8 (Comm. Print 1984) [hereinafter cited as TAX COMMITTEE PROPOSALS] ("Generally speaking, a tax shelter is any investment which results in a mismatch between deductions (or credits) and income, so that the deductions (or credits) 'shelter' unrelated income from tax.").

71. U.S. DEP'T OF THE TREASURY, TAXES PAID BY HIGH-INCOME TAXPAYERS AND THE GROWTH OF PARTNERSHIPS 5 (1985).

72. See generally *id.*

73. The effect of such benefits as accelerated depreciation has not always been positive. It has been noted, for example, that by increasing the value of depreciation deductions, "the Accelerated Cost Recovery System (ACRS) . . . contributed to a construction boom which has glutted the real estate market in several southwestern cities. Post-1981 investors (often limited partnerships) can afford to lower rents or sustain high vacancy rates because of the generous ACRS deductions." TAX COMMITTEE PROPOSALS, *supra* note 70, at 13.

74. The changes in the tax treatment of capital gains discussed in this article center on changes in the exclusion for long-term capital gains and not the provisions relating to treatment of capital losses. For a discussion of the treatment of capital losses in the income tax, see generally Warren, *The Deductibility by Individuals of Capital Losses Under the Federal Income Tax*, 40 U. CHI. L. REV. 291 (1973).

75. See Mayhall, *Capital Gains Taxation—The First One Hundred Years*, 41 LA. L. REV. 81, 82-83 (1980). The operative language of the Act of 1862 provided that:
there shall be levied, collected, and paid annually, upon the annual gains, profits, or

1872, the Supreme Court held in *Gray v. Darlington*⁷⁶ that an increase of \$20,000 in the value of bonds during the four-year period in which they were held did "not constitute 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 property."⁷⁷ The Court stated that such appreciation in value "constitutes and can be treated merely as an increase of capital."⁷⁸ This holding was based on the Court's interpretation of the statutory language of the Act of 1867,⁷⁹ which mirrored the Act of 1862.⁸⁰

The *Darlington* decision, however, appears to conflict with Congress' interpretation of similar language in the Act of 1862.⁸¹ As stated during House debate: "The words 'gain' and 'income' mean the same thing. They are equivalent terms. They mean the net profits. You cannot have any gains until you pay the expenses. What it costs to produce is to be deducted, and then there will be left only the net profits."⁸² Later in the debate, an amendment to define the words gains, profits and income was defeated.⁸³

The Supreme Court later declared the Income Tax Act of 1894⁸⁴ unconstitutional because it viewed the tax imposed as a direct tax.⁸⁵ In response to this decision, Congress adopted the sixteenth amendment to eliminate constitutional restrictions upon income taxation.⁸⁶

income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment, or vocation . . . if such annual gains, profits, or income exceed the sum of six hundred dollars . . . and upon the annual gains, profits, or income, rents, and dividends accruing upon any property, securities, and stocks owned.

Act of July 1, 1862, ch. 119 § 90, 12 Stat. 432, 473.

76. 82 U.S. (15 Wall.) 63 (1872).

77. *Id.*

78. *Id.* at 66.

79. Act of Mar. 2, 1867, ch. 169, 14 Stat. 471. The following language was considered by the Supreme Court:

There shall be levied, collected, and paid annually upon the gains, profits, and income of every person . . . whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation . . . or from any other source whatever . . . a tax of five per centum on the amount so derived over \$1,000. . . . And the tax herein provided for shall be assessed, collected, and paid upon the gains, profits, and income for the year ending the 31st of December next preceding the time for levying, collecting, and paying said tax.

Id. at 477-78.

80. See *supra* note 75 and accompanying text.

81. Act of July 1, 1862, ch. 119, 12 Stat. 432, 473.

82. CONG. GLOBE, 37th Cong., 2d Sess. 1531 (1862) (statement of Rep. Stevens).

83. *Id.* at 1576.

84. Income Tax Act of 1894, ch. 349, 28 Stat. 509, 553-60.

85. 157 U.S. 429 (1895). A direct tax is one that was not apportioned among the several states in proportion to population, as required by article I of the Constitution: "No Capitation, or other direct Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. CONST. art. I, § 9, cl. 4.

86. The amendment dealt specifically with the requirement of apportionment of a direct tax among the states according to census. It provides that "the Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment

The present income tax has its roots in the Act of 1913.⁸⁷ The definition of gross income in the Act of 1913 simply restated the construction then being used in the administration of the tax laws. It was not, as many writers have indicated, the start of the treatment of capital gains as ordinary income.⁸⁸ Considerable debate occurred in the House and Senate over the meaning of "income" in the Act of 1913. Several amendments were offered to restrict the construction of the term "income" so as not to tax the increase in the value of an asset. All of these amendments, however, failed to pass.⁸⁹

The Revenue Acts from 1913 to 1921 treated capital gains as ordinary income, and capital losses were deductible in full after 1917. In 1916, losses were allowed only to the extent of gains.⁹⁰ In the Revenue Act of 1921, Congress for the first time enacted a provision allowing preferential treatment of capital gains.⁹¹ The 1921 Act allowed taxation of capital net gain at an alternative tax rate of twelve and one-half percent. The tax was paid in lieu of either the normal tax or the surtax imposed by the Act,⁹² and high-income taxpayers realized very substantial reductions in tax rates utilizing capital gains treatment.⁹³ Under the 1921 Act, capital losses were fully deductible against other income.⁹⁴

among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

87. Act of Oct. 13, 1913, ch. 16, 38 Stat. 114. The constitutionality of the Act was upheld. *LaBelle Iron Works v. United States*, 256 U.S. 377 (1921).

88. The 1913 Act stated:

[T]he net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from profession, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, *or gains or profits and income derived from any source whatever*, including the income from but not the value of property acquired by gift, bequest, devise, or descent . . .

Act of Oct. 13, 1913, ch. 16 § II(B) 38 Stat. 114, 167 (emphasis added).

89. See generally 50 CONG. REC., 63rd Cong., 1st Sess., H748-H1387 (1913).

90. See Mayhall, *supra* note 75, at 87.

91. Section 206(b) of the act read:

In the case of any taxpayer . . . who for any taxable year derives a capital net gain, there shall . . . be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided . . . and the total tax shall be this amount plus twelve and one half per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than twelve and one half per centum of the total net income.

Revenue Act of 1921, Pub. L. No. 98, § 206 (b), 42 Stat. 277.

92. Revenue Act of 1921 Section 210 provided for a normal tax of eight percent for net income in excess of the credits provided in Section 216. Section 211 provided for surtaxes in addition to the normal tax.

93. See Mayhall, *supra* note 75, at 87.

94. See *id.* at 87.

In *Burnet v. Harmel*,⁹⁵ the Supreme Court cited reasons for this change:

Before the Act of 1921, gains realized from the sale of property were taxed at the same rates as other income, with the result that capital gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provisions of the 1921 revenue act for taxing capital gains at a lower rate, reenacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.⁹⁶

Committee reports and floor debates indicate there was little opposition in 1921 to a more preferential treatment of capital gains.⁹⁷

The next major change occurred in the Revenue Act of 1934, which instituted a graduated structure for the treatment of capital gains.⁹⁸ Congress used this system for four years before instituting our present system of short- and long-term capital gains.⁹⁹ Long-term capital gains treatment was given to assets held for more than eighteen months, and short-term capital gains treatment was given to assets held for a shorter period.¹⁰⁰ If the asset was held for more than eighteen months but less than two years, sixty-six and two-thirds percent of the long-term gain was recognized.¹⁰¹ If the asset was held more than two years, fifty percent of the long-term gain was recognized.¹⁰² Long-term gains were also subject to an alternative minimum tax of thirty percent.¹⁰³ Congress distinguished between short- and long-term gains to separate speculative from investment transactions.¹⁰⁴

The Revenue Act of 1942¹⁰⁵ reduced the statutory holding period necessary to obtain long-term capital gains treatment from eighteen months to six months.¹⁰⁶ Long-term gains were recognized at fifty

95. 287 U.S. 103 (1932).

96. *Id.* at 106.

97. In the Senate minority report accompanying the passage of the bill, there is no mention of the change in the treatment of capital gains. Although the minority indicates that "[t]he reductions that have been made are of a character and were apparently intended to . . . relieve certain favored classes of taxpayers at the expense of the great body of taxpayers," no specific mention of the capital gains changes is made. S. REP. NO. 275, 67th Cong., 1st Sess., pt. 2, at 1 (1921). Only occasional comments can be found during floor debate questioning the propriety of including this provision in the 1921 Act. *See, e.g.*, 61 CONG. REC. 6575 (1921) (statement of Sen. Walsh); 61 CONG. REC. 7477-78 (1921) (statement of Sen. Lenroot).

98. Revenue Act of 1934, Pub. L. No. 73-216, § 117, 48 Stat. 680, 714-15.

99. Revenue Act of 1938, Pub. L. No. 554, § 117(a), 52 Stat. 447, 500-01.

100. Revenue Act of 1938 § 117(a).

101. Revenue Act of 1938 § 117(b).

102. Revenue Act of 1938 § 117(b).

103. Revenue Act of 1938 § 117(c).

104. H.R. 1860, 75th Cong., 3rd Sess. 7-8 (1938).

105. Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 798.

106. Revenue Act of 1942 § 150(a)(1), 53 Stat. 50 (amending I.R.C. § 117(a) (1941)).

percent,¹⁰⁷ and the alternative maximum tax on capital gains was set at twenty-five percent.¹⁰⁸

The taxation of capital gains, with some minor changes, remained virtually intact until 1969. The Tax Reform Act of 1969 gradually phased out the alternative minimum tax for net long-term capital gains in excess of \$50,000.¹⁰⁹ Congress eliminated the alternative minimum tax on long-term capital gains in the Tax Reform Act of 1976.¹¹⁰ In 1978, Congress increased the long-term capital gains exclusion from fifty percent to sixty percent.¹¹¹ Thus, forty percent of net long-term capital gains were recognized as income. In 1984, Congress reduced the long-term holding period from one year to six months for assets acquired between June 22, 1984, and January 1, 1988.¹¹²

JUSTIFICATIONS FOR CAPITAL GAINS PREFERENCE

Changes in the holding period¹¹³ necessary to obtain long-term preferential treatment have not increased U.S. Treasury revenues.¹¹⁴ Nonetheless, numerous reasons have been given to support the preferential treatment of capital gains. Originally, capital gains were given favorable treatment because of the fear of "locking-in."¹¹⁵ The 1934 Act addressed the lock-in problem more adequately than the current Code does because it reflected the appreciation in value due to inflation or other economic changes.¹¹⁶ An asset under today's holding period receives the same preferential long-term capital gains treatment if held for six months and one day or for more than ten years.¹¹⁷

107. Revenue Act of 1942 § 150(b), 53 Stat. 50-52 (amending I.R.C. § 117(a) (1941)).

108. Revenue Act of 1942 § 150(c), 53 Stat. 50-52 (amending I.R.C. § 117(b), (c), (d), and (e) (1941)).

109. Tax Reform Act of 1969, Pub. L. No. 91-172, § 1201(d)(3), 83 Stat. 487, 635.

For net long-term gains less than \$50,000, Congress retained an alternative minimum tax of 25%. Tax Reform Act of 1969 § 150(c), Pub. L. No. 91-172, 83 Stat. 487.

110. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1986 (amending I.R.C. § 1201(d) (1970)).

111. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2866 (amending I.R.C. § 1202 (1976)).

112. Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 1001(b)(14) and 1001(e), 98 Stat. 494, 1011-12 (amending I.R.C. §§ 166 and 1223 (1982)).

113. The 1976 tax bill changed the long-term holding period for a capital asset from six months to nine months. Tax Reform Act of 1976 § 1402(a) and 161 (amending I.R.C. § 1222 (1970)).

114. Treasury Department statistics "show that the lengthening of the required holding period apparently had a small overall effect on the distribution (short-term vs. long-term) of capital asset transactions for 1977 in comparison to 1973." U.S. DEP'T OF TREASURY, I.R.S. VOL. 2 NO. 1, STATISTICS OF INCOME BULLETIN 30 (1982).

115. "Locking-in" refers to a situation in which taxpayers fail to sell assets because of the high rate of tax that they would have to pay on the increase in value that had accrued on the asset over a period of years. BLACK'S LAW DICTIONARY 848 (5th ed. 1979).

116. Revenue Act of 1934, § 117(a), Pub. L. No. 216, 48 Stat. 680, 714.

117. Deficit Reduction Act of 1984, § 1001(a)(1), (2), Pub. L. No. 98-369, 98 Stat. 494. The 1984 Act enacted the present holding period of six months. This provision, however, only affects property acquired after June 22, 1984, and before January 1, 1988. Assets acquired after January 1, 1988, will again be subject to a one-year holding period for long-term capital gains treatment.

Although little correlation exists between the effect of inflation and the tax consequences of long-term capital gains treatment in today's Tax Code, the system's defenders argue taxpayers gained in ease what they lost in precision.¹¹⁸ Defenders also argue that preferential treatment of long-term capital gains counteracts what is commonly termed "bunching."¹¹⁹ Further, the capital gains preference operates as an implicit, though very rough, averaging device.¹²⁰

One of the philosophical underpinnings of the Reagan presidency has been the "supply-side" theory.¹²¹ This theory calls for substantial investments in capital assets and business to create jobs and spur economic growth. Preferential treatment of capital gains, by its nature, implies some form of incentive to spur individuals to invest in capital assets. Recent changes in the treatment of capital gains, however, appear to have had little effect on investments in capital assets.¹²²

RE-EXAMINING CAPITAL GAINS AND STRIVING TOWARD TAX EQUITY

The Fair Tax Act

The recent legislative debate allowed Congress and the public to re-examine the structure and purpose of the Tax Code to determine whether it met its objectives. In 1982, Congress first dealt with the Fair Tax Act.¹²³ In drafting the Fair Tax Act, however, Sen. Bill Bradley and I recognized that several provisions in the Code had developed substantial popular support, including home mortgage interest deduc-

118. As President Reagan has argued:

The capital gains preference serves a variety of purposes that, despite the inherent difficulties in a preferential rate, make its intention appropriate. Under current law, the capital gains preference compensates for the fact that nominal gains, unadjusted for inflation, are included in income. The inflation adjustment provided by the preference is, of course, imprecise, since it does not vary with the experienced rate of inflation or with the period of time the asset is held. On the other hand, the preference is computationally easy and is generally familiar and understandable to taxpayers.

PRESIDENT'S PROPOSAL, *supra* note 17, at 170.

119. If the entire amount of gain were subject to taxation in the year of realization, the gain would be subject to a much higher rate than if a tax had been imposed on each year that gain had accrued on the asset.

120. See PRESIDENT'S PROPOSAL, *supra* note 17, at 171.

121. See generally V. CANTO, D. JOINES & A. LAFFER, *FOUNDATIONS OF SUPPLY-SIDE ECONOMICS: THEORY AND EVIDENCE* (1983); P. ROBERTS, *THE SUPPLY-SIDE REVOLUTION: AN INSIDER'S ACCOUNT OF POLICY-MAKING IN WASHINGTON* (1984).

122. As the Secretary of Treasury reported to Congress: "The overall effects on saving and capital formation (from the 1978 Act) were necessarily modest because the tax reduction was small as a fraction of the total taxation of capital income in the United States." OFF. OF TREASURY SEC'Y AND OFF. OF TAX ANALYSIS, *REPORT TO CONGRESS ON THE CAPITAL GAINS TAX REDUCTIONS OF 1978 at v* (1985) [hereinafter cited as *CAPITAL GAINS REPORT*].

123. S. 1421, 98th Cong., 1st Sess., 129 CONG. REC. S7838 (daily ed. June 8, 1983) [hereinafter cited as *FAIR TAX ACT*]. For an analysis of the Act, see Gephardt & Bryant, *The Fair Tax Act: A Plan for a Simple, Fair and Economically Rational Tax*, 12 J. LEGIS. 129 (1985).

tions,¹²⁴ the charitable contribution deduction¹²⁵ and others.¹²⁶ As a result, we weighed the need for reform against the political forces aligned against it. The most popular and widely used deductions were retained in the Fair Tax Act to enhance the political prospects of tax reform.¹²⁷

Another self-imposed constraint was that the plan had to be revenue neutral—not only in terms of the entire income tax system, but between corporate and individual income taxes. Further, we designed the plan to be revenue neutral between income classes and not an income redistribution plan.

A key component of the Fair Tax Act was the repeal of the capital gains exclusion in an attempt to simplify the Tax Code and make it fairer.¹²⁸ Under the Fair Tax Act, capital gains would have been treated as ordinary income,¹²⁹ and all forms of investment income, interest, dividends and capital gains would have been treated the same. Although the highest rate on long-term capital gains would have increased from twenty percent to thirty percent,¹³⁰ the top tax rate on interest and dividends would have decreased from fifty percent to thirty percent.¹³¹ In addition, the distinction between short-term and long-term capital gains would have been eliminated because it no longer would have been necessary. Thus, under the Fair Tax Act all forms of investment income would have been placed on the same level.¹³² Investment decisions would

124. Congress amended the home mortgage interest deduction in the Tax Reform Act of 1986 in Section 511. The deduction is currently codified in amended form at I.R.C. Section 163(h) (1986).

125. Congress retained the charitable contribution deduction in the Tax Reform Act of 1986. The deduction is codified at I.R.C. Section 170(a) (1) (1986).

126. See Gephardt & Wessel, *supra* note 9, at 911 (1985).

127. Among the major deductions retained by the Bradley-Gephardt Fair Tax Act were home mortgage interest, other interest to the extent of investment income, the charitable contributions deduction, the deduction for medical expenses (although the percentage floor above which medical expenses could be deducted was raised from 5% to 10%), the deduction for state and local income and real property taxes, and the deductibility of contributions to Individual Retirement Accounts and Keogh plans. See *supra* note 123 and accompanying text.

128. The capital gains exclusion is found in I.R.C. Section 1202 (1986). For reference to its repeal, see S. 1421, 98th Cong., 1st Sess., § 241(a)(2), 129 CONG. REC. S7838 (daily ed. June 8, 1983).

129. FAIR TAX ACT, *supra* note 123, at § 241.

130. FAIR TAX ACT, *supra* note 123, at § 102(a). Under pre-1986 law, highest effective rate of taxation on income from capital gains was 20%. This was derived by multiplying the top individual marginal tax rate of 50% by the 40% of long-term capital gains remaining after the 60% exclusion was subtracted. Because capital gains would have been treated as ordinary income under the Fair Tax Act, the highest rate on capital gains would have been equivalent to the highest rate on ordinary income, i.e., 30%. The 1986 Act, when fully phased in, will treat capital gains as ordinary income subject generally to the regular maximum rate. Tax Reform Act of 1986 § 101 (codified as amended at I.R.C. § 1 (1986)).

131. *Id.*

132. Provisions in the Fair Tax Act would have eliminated the preferential treatment of growth over yield assets in the Tax Code. See CAPITAL GAINS REPORT, *supra* note 122, at iii-iv.

no longer have been based on tax concerns over economic consequences.¹³³

The President's Tax Reform Plan

Meanwhile, President Reagan had an agenda for tax reform that he wished to place before Congress. The President's tax reform package¹³⁴ would have retained the tax preference for capital gains, although the exclusion rate would have been reduced to the pre-1978 rate of fifty percent.¹³⁵ In proposing this change, the Reagan Administration recognized that the reduction of the maximum marginal tax rate from fifty percent to thirty-five percent meant that a reduction in the exclusion rate for net capital gains was also appropriate. This reduction would have preserved the relative tax preference currently available to investments in capital assets.¹³⁶

The President's bill would have added another layer of complexity to the Tax Code by allowing individuals to elect to index their capital assets for inflation occurring after January 1, 1991. Taxpayers would have elected this in lieu of receiving a preferential tax rate on capital gains. The election would have covered all capital assets disposed of during a particular year. Indexed capital losses would have remained subject to existing law. Corporate taxpayers would have been ineligible for this election.¹³⁷

Under the Reagan bill, a capital asset acquired before January 1, 1991, would have been indexed as if acquired on the date for an amount equal to the taxpayer's adjusted basis in the asset. The inflation adjustments would have been based on a federal government price index. The taxpayer would have had to hold the capital asset for more than twelve months in order to be eligible for indexing. The indexing proposal would not have altered realization and nonrecognition rules.¹³⁸ A major change of the President's bill, however, was that depreciable or depletable property would not have been eligible for capital gains treatment.¹³⁹ This would have had a substantial effect on taxpayers investing in real estate and many other types of limited partnerships.¹⁴⁰

133. The authors acknowledge, however, that continuing to allow capital gains to go untaxed until realized would allow individuals to defer the payment of taxes. This could substantially benefit the taxpayer in many circumstances.

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

135. PRESIDENT'S PROPOSAL, *supra* note 17, at 168.

136. *Id.* at 166.

137. *Id.* at 169.

138. *Id.*

139. *Id.* at 168.

140. A Treasury Department study highlights, among other factors, the importance of the capital gains preference to the tax-shelter industry and the effect on high-income taxpayers:

For the high-income, low-tax returns—those with taxes less than five percent of TPI [total positive income]—the combination of the capital gains exclusion and losses other than on current business activities offset forty-six percent of TPI. (The combination of this exclusion and these losses, together with current business losses, offset more

The changes made in the President's tax plan concerning capital gains were expected to increase government tax revenue by about \$18.5 billion over a five-year period.¹⁴¹ The increased revenue derived from the changes in the treatment of capital gains were to be used to fund marginal rate reductions on the corporate and individual sides of the income tax system.

The President's tax plan was most beneficial to those with incomes below \$20,000 and above \$100,000. Although all income classes under the plan would have received a reduction in income tax liability, the reductions were not uniform inside a particular income class.¹⁴² Indeed, when examined on a percentage basis, the inequitable treatment of the middle-income taxpayer was more pronounced. People with income between \$30,000 and \$40,000 would have received a net reduction of 6.6%, while those making more than \$200,000 would have received more than a fifteen percent reduction.¹⁴³

The number of taxpayers in each income class caused some of the disparity in tax liability reductions. For example, if each income class received \$5 million in tax reductions, each taxpayer's reduced amount would depend on the number of filers in each class. The reduction, however, would have had a minimal effect, because reductions by income class would have been determined by the combination of actual marginal rate reductions and the preferences retained in the Tax Code.¹⁴⁴

Combining marginal rate reductions and preferences would have provided a greater benefit under the President's bill than the marginal rate reductions and retention of preferences for the middle class. Three factors would have contributed to the reduction in tax liability for people with incomes below \$20,000—an increase in the personal exemption, an expansion in the standard deduction and an expansion of the earned income tax credit.¹⁴⁵

than one hundred percent of TPI, on average, for these returns.) Excess itemized deductions offset only eighteen percent of TPI.

Hearings, supra note 28, at 38.

141. PRESIDENT'S PROPOSAL, *supra* note 17, at 454 (relating to the capital gains exclusion rate changes).

142. STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 1ST SESS., DISTRIBUTIONAL DATA ON PRESIDENT'S PROPOSALS AND WAYS AND MEANS COMMITTEE BILL, at table 1 (Comm. Print 1985) [hereinafter cited as JOINT COMMITTEE REPORT] (chart examines the income tax liability of individuals by their income class under the present law, the Administration's proposals and other possible options).

143. *Id.*

144. Taxpayers range from those with zero adjusted gross income to those earning \$1 million or more. Thus, Congress has created 31 income classes for tax purposes. Well over 10 million returns were filed by those in the \$30,000-\$40,000 income class, compared with less than 12,000 for those individuals earning \$1 million or more. This imbalance results in some of the disparity in tax liability. U.S. DEP'T OF TREASURY, I.R.S., STATISTICS OF INCOME BULLETIN 27 (1984-85).

145. For those making less than \$10,000, the reduction amounts to 72.4%; for those making \$10,000 to \$20,000, the reduction is 18%. See JOINT COMMITTEE REPORT, *supra* note 143, at 2.

The President's bill, in terms of tax relief, would have formed an inverted bell curve. The perfect tax bill, however, would have a declining slope, providing greatest relief to people at the bottom of the income scale and least relief to those at the top. This was one of the reasons the structure of the retained deductions was designed the way it was in the Bradley-Gephardt Fair Tax Act—in general, each deduction can only be taken against the normal tax rate of fourteen percent, resulting in an equal benefit to all taxpayers.¹⁴⁶

Ways and Means Committee Bill

House Ways and Means Committee Chairman Dan Rostenkowski offered a possible compromise amendment to the President's proposal. Rostenkowski's proposal called for a forty percent exclusion for long-term capital gains, rather than the fifty percent exclusion in the President's proposal. Given the proposal's thirty-five percent maximum individual rate, the maximum individual long-term capital gains rate would have been twenty-one percent, rather than twenty percent under the existing law.¹⁴⁷ The proposal would have taxed corporate long-term capital gains at regular corporate rates of up to thirty-five percent.¹⁴⁸

In determining which assets would have been eligible for long-term capital gains treatment, Rostenkowski's proposal followed existing law, rather than the President's proposal. Rostenkowski's amendment would not have indexed the basis of depreciable assets used in a trade or business, nor would it have required ordinary income treatment of all gains or dispositions of trade or business property currently eligible for capital gains treatment. Rostenkowski's proposal, however, would have expanded existing rules requiring recapture of previously deducted items, such as depreciation, as ordinary income. All depreciation taken on real property would have been recaptured, along with depreciation taken on personal property. The proposal also would have recaptured other previously deducted items apart from research and experimental expenditures.¹⁴⁹

These changes in capital gains treatment would have improved the distribution of tax reductions for middle-income taxpayers. The income class of \$30,000 to \$40,000 would have received a reduction in income tax liability of 6.9% as opposed to 6.6% under the President's plan; the income class of \$40,000 to \$50,000 would have seen its reduction rise to 9.7% from 7.3%.¹⁵⁰

146. See Gephardt & Wessel, *supra* note 126, at 910-12.

147. STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 1ST SESS., SUMMARY OF TAX REFORM OPTIONS FOR CONSIDERATION BY COMM. ON WAYS AND MEANS 8 (Comm. Print 1985).

148. *Id.*

149. *Id.* at 8-9.

150. See JOINT COMMITTEE REPORT, *supra* note 142, at 2.

Senate Finance Committee Bill

The Senate Finance Committee eliminated the capital gains exclusion entirely from the Tax Reform Act.¹⁵¹ The Committee's action was projected to increase tax revenue over a five-year period by more than \$100 billion, compared with the existing law.¹⁵² The broadening of the base, to this degree, allowed for a dramatic reduction in marginal rates. The rates in the Senate Finance Committee proposal were fifteen percent and twenty-seven percent.¹⁵³ The provisions in the Senate bill did not "change the character of gain as ordinary or capital, or as long- or short-term capital gain."¹⁵⁴

The Tax Reform Act of 1986

The final version of the Tax Reform Act repealed the capital gains preference,¹⁵⁵ thus treating capital gains as ordinary income. For 1987, the top marginal rate on capital gains will be twenty-eight percent.¹⁵⁶ A top marginal rate of almost forty percent will apply when the rate reductions become fully effective in 1988.¹⁵⁷ Section 302 of the Act also limits the top rate on capital gains to twenty-eight percent in future years if the highest statutory tax rate exceeds twenty-eight percent on ordinary income. As previously noted, the "current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase."¹⁵⁸

CONCLUSION

Since the introduction of the Bradley-Gephardt Fair Tax Act in 1982, the debate on tax reform has progressed to the point where a comprehensive tax plan has been enacted. The final product is not perfect, but it is far better than what preceded it. Simplicity has been injected into the Code. More than 6 million Americans below the poverty line will be relieved of the burden of paying taxes. In many areas, the Tax Code will no longer be the motivating factor behind investment decisions—investments will be made based on the economics of the deal. The economy as a whole should benefit as a result of the new Code provisions.

151. See S. REP. NO. 313, 99th Cong., 2d Sess. 169 (1986). Other changes included treating passive losses differently in Section 501 of H.R. 3838. *Id.* at 718.

152. *Id.* at 14.

153. *Id.* at 3.

154. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 105 (1986).

155. The Tax Reform Act of 1986, Pub. L. No. 99-154, § 301, 100 Stat. 2085.

156. Tax Reform Act of 1986 § 302 (codified as amended at I.R.C. § 1(j)(1)(A) (1986)).

157. The rate reductions in the Tax Reform Act of 1986 are not fully effective until 1988. In 1987, Congress chose to "blend" the rates. The resulting top marginal rate is 38%. Tax Reform Act of 1986 § 101 (codified at I.R.C. § 1 (1986)).

158. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 107 (1986).

Congress took an important step to promote fairness in the Tax Code by eliminating the preferential treatment of capital gains and equating it with ordinary income. The retention of the capital gains structure, however, illustrates that the war against unfair taxes is not over.

The tax reform debate initiated a comprehensive study of hundreds of Code provisions. Members of the House Ways and Means and Senate Finance Committees reviewed the tax structure of the last seventy years to see if it reflected the nation's goals. The final product demonstrates that Congress recognized its inability to cure all of the social and economic ills of society.