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A HISTORICAL REVIEW OF THE TAX TREATMENT OF CAPITAL GAINS AND LOSSES

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A strong possibility currently exists for a reintroduction of some form of preferential treatment for capital gains. This paper examines the historically uneven treatment of capital gains versus capital losses.

The major impetus of this paper lies in the uneven treatment of individual taxpayers who enter into capital investments and whose resultant tax treatment is inequitable. For example, consider a taxpayer who invests $50,000 and subsequently divests for $100,000. That taxpayer is immediately taxed on that $50,000 gain. Another taxpayer who invests $50,000 and divests for $1,000 would be required to deduct that $49,000 loss over a period of not less than 17 years. This simplified example is given to highlight the inequity. Although, capital gains and losses may be offset without limitation, and several sections of the Internal Revenue Code (i.e., Section 1244) mitigate this inequity in specific situations, the basic inequity exists.

Few income taxation issues have received as much Congressional attention as has the issue of the tax treatment of capital gain and loss transactions. Congress has repeatedly addressed these considerations in revenue acts since the early 1920's and has attempted reconciliation in view of an apparent conflict between need for revenue and regard for equity both for and among taxpayers.

Legislative History

The definitions of capital assets, capital gain, and capital loss were first established in Section 206(a) of the Revenue Act of 1921 (Seidman, 810-11). However, the taxation of gains and the deduction of losses from assets of a capital nature took place before this statutory recognition. Within the provisions of the Revenue Act of 1913, all gains were taxed and losses were disallowed, although with the Revenue Acts of 1916 and 1917, losses were permitted to the extent of such gains. The Revenue Act of 1918 further allowed loss deductions in full against any type of income. In the Revenue Act of 1921, a maximum tax of 12½ % was permitted on gains from the sale of capital assets which were assets that had been held more than two years. In addition, gains and losses from sales of assets that were held two years or less were either taxed in full or allowed in full as a deduction against any income (Ream 100: 34-5). The situation created by these provisions was the origin of the discriminatory tax treatment that has historically been given capital losses.

In the Revenue Act of 1924, Congress attempted to plug a loophole in the situation by providing that a taxpayer would receive a tax benefit equal to only 12½ % of a capital loss. In the Revenue Act of 1932, Congress further limited the tax treatment of losses by providing that losses from the sale of stocks and bonds held for two years or less could be taken only to the extent of gains from the sales of such assets, although losses could be carried over to offset gains of the subsequent year (Ream 100:35). This action was one step closer to the harshly punitive capital loss treatment provided for in 1934. Indeed, as one speaker, Mr. Leasure, commented in a brief during hearings on the 1934 proposed capital gain and loss provisions, "perhaps this gradation of steps may have obscured the extreme and far-reaching character of the final result" (Ream 11:55). The final result that he spoke of was a provision in the 1934 Act, whereby capital losses could be offset only against capital gains and $2000 of ordinary income, with no provision for a carryover of excessive losses to future years (Seidman, 365). This was particularly punitive in view of the huge losses that were being taken in the stock market and the extreme economic conditions of the time. Congress' attempt to provide relief from this harsh treatment focused on the tax treatment of capital gains, whereby the percentage of capital gain or loss taken into account in computing net income was recognized in a sliding scale according to how long the asset had been held. For example, only 30% of a gain or loss from the sale or exchange of a capital asset which had been held for more than 10 years was taken into account in computing net income (Seidman, 306). Congress' rationale in providing this relief for a gain that had accrued over a period of years also served to penalize a loss that had accrued over a period of years. In its zeal to continue the taxation of capital gains, Congress apparently ignored this fact.

Over the years, there have been numerous changes in the capital gain and loss provisions. In the 1938 Act, the separate categories of short-term and long-term capital assets were established in Section 117(a), with long-term assets defined as those held for more than 18 months. In addition, the five brackets for the percentage of gain or loss to be taken into account in computing net income were revised to three brackets. Also, a 30% alternative tax on capital gains or tax benefit for capital losses was established (Seidman, 69-74).

In 1942, Congress made several changes in the provisions for capital assets. First of all, long-term assets were redefined as those held over six months (Seidman 1: 1772). Also, the three brackets established in 1938 were revised to two brackets with the percentage of gain or loss to be taken into account in computing net income as follows: 100 percent if the capital asset had been held for not more than 6 months and 50 percent if the capital asset had been held for more than 6 months (Seidman 1: 1780). In addition, losses from the sale or exchange of capital assets were allowed to the extent of the gains from sales or exchanges, plus the net income of the taxpayer or $1000, whichever was smaller (Seidman 1: 1787). Finally, for any taxable year beginning after December 31, 1941, if a taxpayer had a net capital loss, the amount would be considered a short-term capital loss in each of the five succeeding taxable years to the extent that such amount exceeding the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year (Seidman 1: 1791).

Further changes occurred in 1964 when the preexisting carry-over period of capital losses was changed from five years to an indefinite period, and the short-term and long-term character of capital losses was preserved on a carry-over basis (Lavelle, 882). The year 1969 brought new restrictions on the deductibility of long-term capital losses against ordinary income by individuals. For example, an individual was only permitted to deduct 50% of net long-term capital losses in excess of net short-term capital gains from ordinary income up to a maximum of $1000 each taxable year. In addition, the carry-over of unused long-term capital losses to future years was limited to 50% of the loss (Hawkins, 2730).

The Tax Reform Act of 1976 increased the amount of ordinary income against which capital losses could be deducted from $1000 to $2000 for tax years beginning in 1977 and to $3000 for tax years beginning in 1978 and thereafter. Also, the holding period for long-term assets increased to more than 9 months for taxable years beginning in 1977 and to more than one year for taxable years beginning in 1978 and thereafter (Hardee, 27). In 1978, it was provided that 60%, rather than 50%, of net long-term capital gains were to be excluded from gross income, and the capital loss rules remained unchanged (Mirsky and Protass, 322).

In the Deficit Reduction Act of 1984, the holding period for long-term capital assets was reduced from one year to six months for assets acquired after June 22, 1984 to the end of 1987 (Lagen and Oschsenschlager, 29). In 1986, Section 1202 was repealed, meaning that net capital gains were to be taxed in full. Net capital losses are still limited to the lesser of $3000 or the excess of such losses over such gains, but they are not limited to taxable income.

Analysis of Legislative Intent

Why have these continuous refinements in the tax treatment of capital transactions taken place? What has been the rationale for the differing treatments historically afforded these capital transactions? In answer, a return to the treatments' origin is necessary, for as one tax philosopher stated, "taxation is an art and a technique as well as science, and it always needs to be judged against the conditions of time and place" (Kornhauser, 870).

By the late 1920's, Congress recognized the need for an overhaul of the capital gain and loss provisions. The issue was studied by a subcommittee of the House Ways and Means Committee. In the subcommittee's report, several defects in the manner of treating capital gains and losses were noted. Primary among these were: (1) the instability of revenue, i.e., larger revenues in prosperous years and less revenues in depression or war years, (2) the potential for taxpayers to manipulate capital asset sales for tax advoidance, i.e., taking losses before the gains after the two-year period, and (3) the relief under the system was afforded to larger taxpayers with net incomes over $16,000. The British and U.S. systems were compared as to stability of tax receipts with the recognition that, for income tax purposes, the British system disregards both gains and losses of a capital nature. The British system was found to have markedly greater stability than did the U.S. system. For example, in the years 1923 to 1933, the maximum annual revenue from income tax in Britain was 35 percent above the minimum revenue, whereas in the U.S., the maximum annual revenue was 280 percent above the minimum revenue. The subcommittee also evaluated data from individual returns in 1928 (considered a good year) and in 1931 (considered a bad year) and determined that revenues in good years could be increased by 46% and revenues in bad years could be decreased by 26% under the system that was currently in place. Therefore, the conclusion of the subcommittee was that the U.S. system of capital gain and loss treatment resulted in an unstable revenue, although adopting the British system was not recommended (Ream 100: 32-37). So, in 1934 changes in the treatments of both capital gains and losses were enacted into law. These changes were intended to stabilize the nation's revenue.

Did Congress make a wise decision in retaining capital asset transactions in the nation's tax base? What were and still are the possible alternatives for the treatment of capital transactions? No one can argue that Congress' 1934 decision was a turning point that has affected and will continue to affect the nation for all time, unless the philosophy is changed at some point. Essentially, the choice that Congress made to retain the taxation of capital asset transactions has formed the basis for decades of capital asset tax legislation and has set the stage for continued punitive capital loss provisions. This choice can be evaluated not only in terms of whether it was a wise decision for that particular time, but also in terms of whether theoretically the retention of capital asset transactions in the nation's tax base is the best choice among the alternatives.

Certainly, one cannot argue with the perceived need for a relatively stable and countercyclical national revenue, rather than a procyclical revenue, particularly since at that time in history, the federal budget was balanced. One could argue with the validity of the figures in the studies, given the massive loopholes utilized during the years in which the figures were gathered. Common sense would dictate closing these loopholes that permitted improper loss recognition such as related party transactions and short sales before disallowing legitimate losses. Provisions to close these loopholes were made in the 1930's. Nevertheless, the support for the changes in capital asset treatment and particularly for the harsh capital loss provisions may rest with distorted numbers which were gathered in these earlier years. So, the question is whether the revenue would have continued to be procyclical under the system that was in place if the loopholes had been eliminated. The answer is "perhaps". So, the ultimate question is "Was this the best choice?" The answer depends upon what the choice is being judged against in the considerations of need for capital investment and business recovery, basic need for revenue, need for a stable revenue, and desire for equity. This, in turn, requires an evaluation of possible alternatives for capital asset transactions in light of these considerations, recognizing that there is no solution that can fully meet all needs.

Conclusion

Past History of U.S. Taxation has consistently shown a preferential treatment of long-term capital gains. Current law, effective December 31, 1987, treats this type of income in the same vein as other types of income. Time will tell whether this current tax viewpoint is a permanent departure from the past or merely a short-term side trip.

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DONATIONS TO ACCOUNTING HISTORY RESEARCH CENTER

Two noted accounting historians, Dr. S. Paul Garner of the University of Alabama and former SEC Chief Accountant Andrew Barr, have recently made major donations of materials to the Accounting History Research Center at Georgia State University. Professor Garner contributed what was described as "a truck load of books" to the Center. Mr. Barr donated over $600 worth of old journals, and then contributed the funds necessary to have the journals bound. Mr. Barr had made previous donations to the Center and these latest items will become a part of the Andrew Barr Collection at the Center.

Others wishing to contribute materials should contact Dr. Alfred R. Roberts at the School of Accountancy, Georgia State University, Atlanta, GA 30303.

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