

JACK DENNIS SCHROEDER

Ph. D.

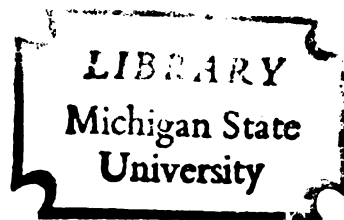


POTENTIAL SIMPLIFICATION OF THE
FEDERAL INCOME TAX LAW BY
ELIMINATING SPECIAL TREATMENT
OF CAPITAL GAINS AND LOSSES

Dissertation for the Degree of Ph. D.
MICHIGAN STATE UNIVERSITY

JACK DENNIS SCHROEDER

1975



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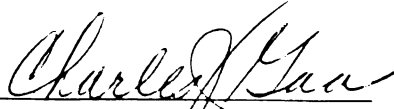
thesis entitled

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SPECIAL TREATMENT OF CAPITAL
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Jack Dennis Schroeder

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ABSTRACT

POTENTIAL SIMPLIFICATION OF THE FEDERAL INCOME TAX LAW BY ELIMINATING SPECIAL TREATMENT OF CAPITAL GAINS AND LOSSES

By

Jack Dennis Schroeder

The federal income tax law is complicated and the cost of compliance on the part of the taxpayer and administration on the part of the federal government is great. Costs of compliance from a taxpayer standpoint include recordkeeping, filing of returns, and dealing with tax audits with their attendant controversy. Also included is the cost of becoming acquainted with the law, hiring expert advisors, or in the absence of these, the cost of inadvertently overpaying one's taxes. From the standpoint of the federal government there are costs of researching, drafting, enacting, administering, and adjudicating complex tax provisions.

It is the considered opinion of many writers in the field of taxation that the federal income tax in general is too complicated, and the subject responsible for the greatest amount of complexity is the capital gain and loss provisions. Complexity is the antithesis of understanding, and understanding is an important first step in orderly compliance in a self assessment income tax system.

The sources of complexity are many and varied, some of which are unavoidable. Much complexity is the result of a \$1 trillion plus economy with its multitude of ways to frame business transactions and to earn money. Some complexity is the result of the accounting conventions of

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realization and the year as a time period for the purpose of income measurement. Another source of complexity results from the social and political decision to utilize a progressive tax rate structure in determining tax liability. The point of common ground of each of these sources of complexity is that distinctions must be made. In the case of realization there is a difference in tax consequences if an appreciated asset is held or sold. For a calendar year taxpayer there are different tax consequences for receiving an item of income on December 31 or on January 1. For taxpayers in general, there are different tax consequences between receiving the first dollar of taxable income in a year and receiving the one-millionth dollar of taxable income.

The absence of a normative concept of income for tax purposes has hindered progress in the development of a logically consistent tax statute. In too many cases statutory law reflects the result of lobbying pressures or of ad-hoc legislation designed to attain a particular objective with no thought to the statute in its entirety. A useful normative concept of income for tax purposes is the "accretion concept," long associated with the names of Robert Haig and Henry Simons. The acceptance of a normative concept of income would promote uniformity by minimizing distinctions between types of income and deductions in addition to providing a directional guide in tax policy questions. There should be no deviation from the norm except for urgent administrative reasons, and then any deviation should be recognized as such and not as an integral part of an income concept for tax purposes.

If the accretion concept of income were adopted as a directional guide, there would be no special treatment of capital gains and losses; realized capital gains and losses would be treated the same as ordinary

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gains and losses. If there were no special treatment of capital gains and losses much of the complexity would be eliminated from the various sources of federal income tax law. The objectives of this study are: (1) to examine the basic sources of tax law (legislative, administrative, and judicial) to determine the extent to which the capital gain and loss provisions are complicating factors in governmental administration of and taxpayer compliance with federal income tax law, and (2) to propose a number of changes in the law which will have the dual purpose of promoting simplicity and improving equity.

The examination and analysis of tax law include a study of the Internal Revenue Code, the published Revenue Rulings of the Internal Revenue Service, and the decisions of the federal District Courts, Tax Court, Court of Claims, Court of Appeals, and Supreme Court. The Internal Revenue Code, Court of Claims cases, and Supreme Court cases are examined on a 100% basis, while the decisions of the District Courts, Tax Court and Court of Appeals are examined on a random sample basis. A three category classification is used. The first category contains those Code sections, Revenue Rulings, or court cases which would be eliminated were there no special treatment of capital gains and losses. The second category contains those sections, rulings, or cases which have capital gain and loss implications although they could not be entirely eliminated if there were no special treatment of capital gains and losses. The third category contains those sections, rulings, and cases which would be unaffected if there were no special treatment of capital gains and losses.

The research results show that in the first category, the 100% capital gain and loss classification, the judicial source of tax law contained a greater proportion than either the legislative or administrative

sources. The legislative source had the second greatest proportion, with the administrative source a distant third. In the second category, the capital gain and loss implication category, the legislative source had the greatest proportion, followed by the judicial source, and the administrative source was again a distant third. Taken as a whole, however, it would appear that the capital gain and loss distinction plays a significant role in the overall complexity of the federal income tax.

Political considerations aside, it would appear that a great amount of complexity can be eliminated if there were no special treatment of capital gains and losses. Accompanying this change, there would have to be a redefinition of realization to include the point of time of gift and death and possibly more liberal averaging provisions. Redefining realization is necessary to alleviate the "lock-in" effect, and more liberal averaging provisions are necessary to avoid the inequity of taxing the appreciation of an asset which has occurred over a number of years, in the year of realization at progressive tax rates.

The advantages of eliminating special treatment of capital gains and losses relate not only to the advantages of a less complex tax law, but also to a more equitable tax law. The principles of horizontal and vertical equity can be more closely adhered to, and this could be an important first step in the direction of a comprehensive tax base.

POTENTIAL SIMPLIFICATION OF THE FEDERAL INCOME
TAX LAW BY ELIMINATING SPECIAL TREATMENT
OF CAPITAL GAINS AND LOSSES

By

Jack Dennis Schroeder

A DISSERTATION

Submitted to
Michigan State University
in partial fulfillment of the requirements
for the degree of

DOCTOR OF PHILOSOPHY

Department of Accounting and Financial Administration

1975

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I wish to express my sincere appreciation to Professor Charles J. Gaa for his guidance and encouragement during this study. Also, I wish to thank Professor Steven Dilley and Professor James Stapleton, members of the thesis committee, for their helpful comments and interest.

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Finally, I wish to thank my wife and family for their assistance and encouragement.

Jack D. Schroeder

LIST OF TABLES

LIST OF FIGURES

CHAPTER:

I. INTRODUCTION

Background

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II. ATTRIBUTES

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TABLE OF CONTENTS

	Page
LIST OF TABLES	vii
LIST OF FIGURES	ix
 CHAPTER:	
I. INTRODUCTION	1
Brief History of Capital Gains Taxation in the United States	4
Objectives of the Study	8
Scope of the Study	8
Methodology of the Study	9
Problem Areas	10
Footnotes for Chapter I	13
 II. ATTRIBUTES OF A GOOD TAX SYSTEM	 14
Equity	14
A Theoretical Concept of Income for Tax Purposes . . .	17
Administrative Convenience	20
Definition of Realization	28
Economic Effects	32
Arguments For Special Treatment of Capital Gains and Losses	36
Arguments Against Special Treatment of Capital Gains and Losses	42
Footnotes for Chapter II	46

CHAPTER:

III. COMPL

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IV. THE E
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TABLE OF CONTENTS
(Continued)

CHAPTER;	Page
III. COMPLEXITY IN THE FEDERAL INCOME TAX	48
Definition of Complexity	48
Sources of Complexity	49
Possibilities for Simplification	57
Suggestions for Simplification	58
The Capital Gain Distinction as a Source of Complexity	63
Indications of Complexity	65
Costs of Complexity	69
Summary	72
Footnotes for Chapter III	73
IV. THE EXAMINATION OF SELECTED SOURCES OF FEDERAL INCOME TAX LAW	76
Sources of Federal Tax Law	76
Scope of the Study	79
Research Methodology	81
The Relative Investment Advantage Attributable to Capital Gains	84
Statistical Measures	92
Sample Size	94
Sample Results	95
Research Results	97
Trends	100
Relative Importance of the Categories	108

CHAPTER:

I.

F.

V. RECON

Su

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APPENDIX:

A. COURT
AND TH

B. ANALYS
SPECIA

C. FEDERA

BIBLIOGRAPHY

TABLE OF CONTENTS
(Continued)

	Page
CHAPTER:	
Interpretation of the Research Results	111
Footnotes for Chapter IV	115
V. RECOMMENDATIONS	116
Summary	116
Primary Recommendation	122
Additional Recommendations	124
Possibilities for Future Research	126
Conclusion	126
Footnotes for Chapter V	128
APPENDIX:	
A. COURT CASES AND REVENUE RULINGS SELECTED FOR EXAMINATION, AND THE RESULTS OF THE EXAMINATION	129
B. ANALYSIS OF INTERNAL REVENUE CODE SECTIONS AFFECTED BY SPECIAL TREATMENT OF CAPITAL GAINS AND LOSSES	149
C. FEDERAL INCOME TAX EXPENDITURES CALENDAR YEAR 1972	153
BIBLIOGRAPHY	155

TABLE

1. The P
1934-
2. The A
Years
Margin
3. The Re
ciated
Reinve
4. The Nu
Intern
5. The Ac
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LIST OF TABLES

	Page
TABLE	
1. The Percentage of Capital Gains Excluded for the Period 1934-1937	6
2. The Accumulation of \$1 of Investment at the End of N Years at an Annual Rate of Appreciation of 10% and Marginal Ordinary Income Tax Rates of 30, 50, and 70%	26
3. The Relative Investment Advantage of Holding an Appre- ciated Asset as Opposed to Selling the Asset and Reinvesting the Proceeds	27
4. The Number of Revenue Rulings and Court Cases Concerning Internal Revenue Code Sections 1-1399, 1964-1973	84
5. The Accumulation of \$1 of Investment After Taxes at the End of N Years at an Annual Rate of Appreciation of 10% and Marginal Ordinary Income Tax Rates of 30, 50, and 70% . .	88
6. Investment Advantage Attributable to Capital Gains with Marginal Tax Brackets of 30, 50, and 70%	90
7. Sample Results by Year for Revenue Rulings and Court Cases .	96
8. Estimates of the Proportions of Court Cases Which Were 100% Capital Gain and Loss, Had Capital Gain and Loss Implications, or Both, for the Period 1964 Through 1973 . .	99
9. 95% Confidence Intervals About the Estimated Proportions of Court Cases Which Were 100% Capital Gain and Loss, Had Capital Gain and Loss Implications, or Both, for the Period 1964 Through 1973	100
10. Estimated Proportions of Revenue Rulings Which Were Either 100% Capital Gain and Loss, Had Capital Gain and Loss Implications, or Both, for the Periods 1964 Through 1968 and 1969 Through 1973	103
11. Estimated Proportions of All Court Cases Combined Which Were 100% Capital Gain and Loss Cases, Had Capital Gain and Loss Implications, or Both, for the Periods 1964 Through 1968 and 1969 Through 1973	107

TABLE

12. Estim.
in the
Gain a
13. Relati
and Jo
100% C
Implic
14. Propor
Cases

LIST OF TABLES

	Page
TABLE	
12. Estimated Proportions of Revenue Rulings and Court Cases in the Categories 100% Capital Gain and Loss, and Capital Gain and Loss Implications	109
13. Relative Importance of the Legislative, Administrative, and Judicial Sources of Tax Law, Within the Categories 100% Capital Gain and Loss, and Capital Gain and Loss Implications	110
14. Proportion of Code Sections, Revenue Rulings, and Court Cases in the Three Classification Categories	117

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2. Metho
3. The P
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4. Estim
100%
Impli
5. Estim
Capit
tions
Impli
6. Estim
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7. Estim
Capit
tions
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LIST OF FIGURES

	Page
FIGURE:	
1. The Methods of Taxing Appreciation as Ordinary Income . . .	26
2. Methods of Taxing Appreciation	87
3. The Percent of Investment Advantage Attributable to Capital Gains, With Marginal Tax Brackets of 30, 50, and 70%	92
4. Estimated Proportions of Revenue Rulings Which Were Either 100% Capital Gain and Loss or Had Capital Gain and Loss Implications, for the Period 1964 Through 1973	101
5. Estimated Proportions of Revenue Rulings Which Were 100% Capital Gain and Loss Rulings Plus the Estimated Propor- tions of Revenue Rulings Which Had Capital Gain and Loss Implications, for the Period 1964 Through 1973	102
6. Estimated Proportions of All Court Cases Which Were Either 100% Capital Gain and Loss Cases or Had Capital Gain and Loss Implications for the Period 1964 Through 1973	105
7. Estimated Proportions of Court Cases Which Were 100% Capital Gain and Loss Cases Plus the Estimated Propor- tions of Court Cases Which Had Capital Gain and Loss Implications for the Period 1964 Through 1973	106

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CHAPTER I

INTRODUCTION

The Federal income tax law is complicated, and the cost of compliance on the part of the taxpayer and the cost of administration on the part of the federal government are great. The costs from the standpoint of the federal government include the administrative costs of interpreting the statutes enacted by a Congress which itself is far too often woefully ill-informed as to the meaning and consequences of its own legislation. In addition, Internal Revenue Service personnel must be educated and trained in this highly complex tax law, and the law with its filing requirements must be communicated to millions of taxpayers who are expected to voluntarily comply. Communication with most taxpayers takes place through instructional booklets and through the large number of tax forms prepared and distributed by the Internal Revenue Service. These tax forms, about which taxpayers perennially complain because of their complexity, merely reflect the complex statutes upon which they are based. A simplification of income tax forms cannot be obtained without a simplification of the tax law itself. The problems associated with complicated returns do not end with their filing, however, the returns must be audited. Arithmetic must be checked, amounts must be verified, returns may have to be selected for closer scrutiny, and interviews with taxpayers and their representatives may take place. If controversy exists between the taxpayer and government, a conference may result at the district or appellate levels of the Internal Revenue Service. Finally, if agreement is not reached

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through administrative appeals, there is the process of judicial review which may be carried through the Supreme Court. As an indication of the monetary cost of administration of the internal revenue laws, the estimated budget of the Internal Revenue Service for fiscal 1975 was \$1.881 billion.¹

From the standpoint of the taxpayer, simplification means different things, including a minimization of computational complexity, the elimination or minimization of recordkeeping, and a reduced number of tax return forms which can be filled in easily without having to dig deeply into old records. Simplification also means a minimization of conflict, which is usually costly or at the very least annoying to the taxpayer.

The complexity of the income tax law is the direct result of distinctions which are made in the substantive tax law. Any time a distinction is made between types of income, classes of taxpayers, or types of expenditures, to name a few, there exists a more complex tax law. The question arises as to whether a particular kind of income, taxpayer, or expenditure falls within one classification or another. Since the answer to the questions means dollars to the taxpayer and to the government, distinctions must be drawn very carefully and delimited very sharply. Also, the taxpayer has a right to arrange his financial affairs in such a manner as to minimize his taxes. Thus, he will often attempt to seek the outer limits of a distinction, barely remaining on the favorable side. However, although proper form is necessary to obtain the desired classification, it is not sufficient. The Supreme Court has ruled in an early case that "substance" prevails over "form," and that to hold otherwise "would be to exalt artifice over reality. . . ."² Thus, a higher order of complexity results, which calls for the determination of a taxpayer's

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Much complexity emanating from the income tax is a necessary part of the revenue raising function of the tax, and therefore unavoidable. This unavoidable complexity relates primarily to the many accounting problems involved in income determination, such as, annual measurement of net income, the definition of the taxable entity, and the realization convention. In addition, the progressive tax rate structure provides another source of unavoidable complexity. The progressive tax rate structure is the product of political and social decisions designed to achieve vertical equity among taxpayers. It is a source of complexity in that there is a different tax effect on a dollar of income, depending upon where that dollar falls within the tax rate schedule. Therefore, a taxpayer benefits from moving taxable dollars from high bracket entities to low bracket entities or from high bracket years to low bracket years.

While there does exist a great deal of complexity which is unavoidable, there also exists a great deal of complexity which is the result of distinctions made which are not essential to the revenue raising function of the income tax. It is this type of distinction which could be neutralized, and if neutralized much complexity would be eliminated. Some examples of these avoidable distinctions are tax exempt interest, non-business property tax deductions, depletion deductions in excess of cost, and special treatment of capital gains and losses.

The capital gain distinction presents a particularly bountiful source of complexity because of it's advantageous tax position and the breadth of it's scope. Mr. Jerome Hellerstein in his book Taxes, Loopholes, and Morals, in describing the difficulties involved in drawing a line between assets that qualify for capital gains treatment and those that do not

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said that "[i]t is one of the most vexatious and slippery problems in the income tax field. While plausible explanations can be offered for virtually every nice distinction drawn, as a matter of equality between taxpayers, the whole complicated structure is indefensible."³ Another writer cited the capital gains area as "the most significant single cause of tax complexity."⁴ And Mr. Stanely S. Surrey, top tax advisor to the Kennedy Administration and former Harvard law professor has stated that the capital gain is "the subject singly responsible for the largest amount of complexity in the American tax laws."⁵

Brief History of Capital Gains Taxation in the United States

The history of capital gains taxation in the United States corresponds to the history of the Revenue Acts enacted subsequent to ratification of the 16th Amendment to the Constitution on February 25, 1913. The present day series of income tax laws originated with the Revenue Act approved on October 3, 1913 effective retroactively to March 1, 1913. In this first act, net income was defined as in the following paragraph and this definition has been continued in substance in subsequent acts.

That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages or compensation, or personal service of whatever kind and in whatever form paid, or from professions, 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 transactions of any lawful business carried on for gain or profit, or gains or profits, and income derived from any source whatever.⁶

This first act included an income tax section assessing a basic income tax at the rate of one percent, with an additional income tax imposed on annual income in excess of \$20,000 graduated from one percent to the rate of six percent on annual income in excess of \$500,000.⁷ This

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section originally less than fifteen pages in length, was the modest beginning of a statute that has grown to become the Internal Revenue Code. This Code is today lengthy, incredibly complex, and affects virtually every individual, business, transaction, and because of its profound economic impact, virtually every social and economic policy issue.

Once Congress had enacted the income tax section of the Tariff Act of 1913, the stage was set for the court decisions which provided the legal interpretation for the word "income" to include capital gains. In the much quoted case of Eisner v. Macomber the Supreme Court majority expanded upon a judicial definition of income which had been formulated in earlier cases: "'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets. . . ." ⁸ The following year in the case of Merchants Loan Company v. Smietanka the Supreme Court held that the word "income" included a gain from a single isolated sale as well as profits from sales by one engaged in buying and selling as a business. ⁹

Capital gains and losses have been subject to varying rules since 1913. Ray Sommerfeld, Professor of Accounting at the University of Texas, has identified six distinct historical periods in the development of the tax treatment of capital gains and losses. ¹⁰ During the first period, 1913 to 1922, capital gains and losses were taxed the same as any other gains and losses, there was no special treatment. The second period, 1922 through 1933, saw capital gains subject to an alternate tax of a flat 12 1/2% while all other taxable income was subject to the normal surtax rates.

In the relatively short period 1934 through 1937 a proportion of

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the capital gain could be excluded from taxable income, depending upon the length of time of the holding period (Table 1). This method of excluding a portion of the gain resurfaced briefly when former Chairman of the House Ways and Means Committee Wilbur Mills suggested that he favors a sliding scale for the exclusion of capital gains from taxable income.¹¹ The fourth distinct period, 1938 through 1949, saw capital gains divided into three groups for tax purposes: the long-long-term capital gain, the long-term capital gain, and the short-term capital gain. To qualify for the long-long-term capital gain a capital asset had to be held for 24 months. The long-term capital gain holding period was 18 months. Short term capital gains were 100% included in income, long-term capital gains were 66 2/3% included, and long-long-term capital gains were 50% included. Professor Sommerfeld implied that the final two identifiable periods were actually the result of several minor changes, the most important change occurring with the passage of the Tax Reform Act of 1969.

TABLE 1

THE PERCENTAGE OF CAPITAL GAINS EXCLUDED FOR THE PERIOD 1934-1937

Holding Period	Percentage Exclusion
One year or less	0
One to two years	20
Two to five years	40
Five to ten years	60
Over ten years	80

Perhaps we are on the threshold of a new period in the history of capital gains. With the economy at the bottom of a recession and the stock market none too healthy, there are pressures being exerted to

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liberalize the tax treatment of capital gains. Representative Mills has been quoted as stating that he would "push for lower capital-gains taxes to bolster the economy so that 'every American can get back into the stock market.'"12

On the other hand other tax experts including former Internal Revenue Commissioner Sheldon S. Cohen have urged Congress to simplify the tax law. Mr. Cohen in testimony before the House Ways and Means Committee has said that those who write the law and the officials administering it may understand what it means, "but God help millions of people out there who have to live with it."13 With these countervailing pressures for more liberal benefits for capital gains, for simpler tax laws, and in addition for the closing of tax "loopholes," the direction of the next change in the tax treatment of capital gains is far from certain.

While the direction of the next change is not certain, there are factors which exist today which would make the elimination of special treatment of capital gains appear to be more possible than any time since the preference was first allowed. The basic factor is the relatively small tax differential between the maximum tax on earned income and the maximum tax on capital gains. The maximum tax on earned income is currently 50%, which is not a great deal higher than the maximum tax on long-term capital gains which is 36.5%, if the minimum tax on tax preference items is considered. The smaller the differential, the less pressure by taxpayers to seek capital gains. Reduced pressure by taxpayers to seek capital gains would, presumably, result in less political pressure to maintain the preference.

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Objectives of the Study

The objectives of this study are twofold. First, to examine the three prime sources of tax law (legislative, administrative, and judicial) to determine the extent to which the capital gain and loss provisions are complicating factors in the governmental administration of and taxpayer compliance to federal income tax law. Second, to propose a number of changes in the federal income tax law which will have the dual purpose of promoting simplicity and improving equity. The proposed changes include: (1) elimination of special treatment of capital gains and losses, (2) presumed realization of gain or loss at time of gift or at death in addition to realization upon sale or exchange, and (3) a comprehensive program of income averaging to alleviate the problem of taxing a gain which has accrued over a number of years at high marginal brackets in the year of presumed or actual realization.

Scope of the Study

The examination and analysis of the legislative source of tax law is comprised of the income tax provisions of the Internal Revenue Code. Specifically, this entails an examination of Subtitle A, Chapter 1, sections 1-1399 of the Internal Revenue Code of 1954. The examination of the administrative source of tax law is confined to the published Revenue Rulings of the Internal Revenue Service dealing with issues arising from Code sections 1-1399 and for the ten year period 1964-1973. Only the published Revenue Rulings of the Internal Revenue Service are examined. Private or "letter" rulings are not examined since in general they are not available for public inspection. The Code of Federal Regulations, which is a major administrative source of tax law, are not

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examined because the Regulations follow section by section the Internal Revenue Code, and an analysis of the Regulations would correspond very closely to an analysis of the Code. For the judicial source of tax law, court cases dealing with issues arising under Code sections 1-1399 and for the period 1964-1973 are examined. The court cases examined include memorandum and regular Tax Court decisions, District Court decisions, Court of Claims decisions, Court of Appeals decisions, and Supreme Court decisions.

Methodology of the Study

Sections 1-1399 of the Internal Revenue Code are examined to determine: (1) the proportion of Code sections which would be completely eliminated if there were no special treatment of capital gains and losses, (2) the proportion of Code sections which have capital gain and loss implications, even though for other reasons they probably could not be completely eliminated, and (3) the proportion of Code sections that would be unaffected by a repeal of special treatment of capital gains and losses. An example of category (1) is section 1245 which deals with the recapture of depreciation as ordinary income upon the sale of personal property at a gain. An example of category (2) is the Code sections dealing with the penalty tax on an excess accumulation of earnings. An example of category (3) is the Code section setting forth the tax rate schedules. The Internal Revenue Code is examined on a 100% sample basis, that is, all sections from section 1-1399 are examined.

The published Revenue Rulings of the Internal Revenue Service are analyzed to determine the proportion falling into the above named categories. Because of the volume of Revenue Rulings for the period 1964-1973, they are examined on a stratified random sample basis rather than on

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Court cases for the various federal courts are examined and analyzed in order to determine the proportion falling into the above three categories. Memorandum and regular Tax Court decisions, District Court decisions, and Court of Appeals decisions are examined on a stratified random sample basis because of the large number of cases for the period 1964-1973. Court of Claims and Supreme Court decisions are examined on a 100% basis because of the relatively few cases involved.

Problem Areas

Taxpayers in general dislike paying taxes. Consequently, they are always looking for methods of reducing their taxes. The higher the tax bracket the stronger the motivation to utilize the available tax savings methods. There are basically three ways to reduce a tax bill.

- (1) Pay taxes later rather than sooner. The advantage here results from the concept of the present value of money. The later a tax bill is paid the smaller is the present value of the eventual tax payment. An example would be taking a deduction in the current year rather than waiting till a later year, or deferring income to a later year rather than having it taxed in the current year.
- (2) Have income taxed in a lower bracket rather than a higher bracket. Since the federal income tax is progressive, a person with a stable income stream will pay less tax than a person with a widely fluctuating income stream, given the same total income. This second method of reducing taxes results in such tax saving devices as splitting income among family members through outright gifts or gifts in trust or through family partnerships or through arranging to have income taxed in a low bracket year as opposed to a high bracket year.
- (3) Have income taxed at less than the full rates provided in the tax

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rate schedules. Examples of this tax saving device would be the capital gains tax, income averaging, and the maximum tax on earned income. A problem arises in that these three tax saving methods are not always separate and distinct but often interrelate with one another,

The capital gain and loss provisions of the Internal Revenue Code permeate federal income tax law at every level. However, the influence of these provisions is often very subtle and not always readily apparent. Consequently, it may not be possible to say with certainty that a particular section of the Code with its attendant complications would be unnecessary if there were no special treatment of capital gains and losses. This is the primary reason that the second category is necessary. It is to accomodate those Code sections, Revenue Rulings, and Court Cases that have capital gain implications, though for other reasons would not be able to be eliminated. However, if there were no special treatment of capital gains and losses, the pressure to utilize these provisions would be reduced, and the complexity of the tax law would be correspondingly reduced.

Much has been written concerning the complexity of the federal income tax and also its equity, or rather lack thereof. Oftentimes, the two attributes are thought to be diametrically opposed, in that less complexity implies less equity. This viewpoint would be reinforced if one were to read the Congressional hearings reports concerning any tax proposal which bestows tax benefits on a specially situated group of taxpayers. However, whenever any group of taxpayers is taxed in a preferential manner when compared to all other taxpayers, the principle of horizontal equity is being violated. In addition, in the case of the capital gain and loss provisions, the cost in terms of increased comple-

xity is enormous. This study will provide a measure of the additional complexity which results from bestowing special treatment on capital gains and losses. Chapter II reviews the literature concerning the attributes of a good tax system as well as the arguments for and against special treatment of capital gains and losses. Chapter III analyzes the definition of complexity and the sources of complexity in the tax law in general, and cites some specific examples of complexity emanating from the capital gain distinction. Chapter IV presents the research results. Chapter V contains the summary, conclusions, and recommendations.

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FOOTNOTES CHAPTER I

¹The Budget of the United States Government, Fiscal Year 1975, U.S. Government Printing Office, p. 233.

²Gregory v. Helvering, 55 S. Ct. 226, 268 (1935).

³Jerome R. Hellerstein, Taxes, Loopholes, and Morals (New York: McGraw-Hill Book Co., Inc., 1963), p. 42.

⁴Philip M. Stern, The Great Treasury Raid (New York: Random House, Inc., 1964), p. 82.

⁵Stanley S. Surrey, Tax Revision Compendium of Papers on Broadening the Tax Base, Vol. 2, p. 1203.

⁶Lawrence H. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (New York: National Bureau of Economic Research, Inc., 1951), pp. 35-36.

⁷Willard H. Pedrick and Vance N. Kirby (coordinating editors), The Study of Federal Tax Law (Chicago: Commerce Clearing House, Inc., 1972), p. 18.

⁸Eisner v. Macomber, 40 S. Ct. 189, 193 (1920).

⁹Merchants' Loan and Trust Co. v. Smietanka, 41 S. Ct. 386 (1921).

¹⁰Ray Sommerfeld, Hershel M. Anderson, and Horace R. Brock, Introduction to Taxation (New York: Harcourt-Brace-Jovanovich, Inc., 1972), pp. 208-215.

¹¹"Mills to Push for Capital-Gains Tax Cuts to Bolster Economy, 'Free Up' Securities," Wall Street Journal, 22 May 1974, p. 2.

¹²Ibid.

¹³"A Tax Law Easy to Understand is Urged by Experts," Detroit News, 25 June 1975, sec. C, p. 4.

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CHAPTER II

ATTRIBUTES OF A GOOD TAX SYSTEM

From the beginning of systematic economic thought, men have sought to identify the attributes of a good tax system. Adam Smith, himself a one-time tax collector, has stated four maxims applicable to tax systems in general:

1. Taxes on individuals should be in proportion to their ability to pay.
2. The tax each individual should pay should be certain, not arbitrary.
3. Every tax should be levied at a time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.
4. Every tax should be so contrived as to both take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.¹

This last principle Smith interpreted to mean that a tax should be capable of economic administration, should not obstruct the industry of the people, should not offer undue opportunities for evasion, and should not impose "unnecessary trouble, vexation, and oppression" on the public. In addition to Smith's criterion of equity, certainty, convenience, and economy of administration, a tax system should also be simple and have a minimum of negative economic effects.

Equity

The first principle, that taxes should be proportional, has been replaced by the principle of progressive taxation whereby tax rates increase as income increases. The principle of progressive taxation, in

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turn, is based on the concept of vertical equity. Stated in its simplest form, vertical equity calls for different tax treatment for those taxpayers in different economic circumstances, with those who have greater income, paying an increasing proportion of that income as taxes. Since individuals in a society receive all income generated by an economy and ultimately bear all of the taxes, the distribution of the tax burden is at the heart of the problem of vertical equity. Advocates of progressive taxation make the implicit assumption that income is not equitably distributed, thus, income should be redistributed through the use of progressive taxation. The question of the propriety or impropriety of the distribution of income is a political and social question which necessitates subjective judgement and which is not amenable to objective analysis.

In general, the concept of vertical equity is couched in terms of the phrase "ability to pay." Advocates of this concept believe that as a person's income increases, his ability to pay taxes increases more than proportionately. This belief is based on three propositions: (1) to obtain equality in taxation it is necessary that all taxpayers sacrifice equally, (2) sacrifice in taxation is based upon satisfaction foregone by the taxpayer, and (3) as income increases utility or satisfaction decreases at the margin. Taken together, these three propositions imply a progressive tax rate system which equalizes sacrifice at the margin among taxpayers. Very few people, however, would carry this sacrifice theory to its logical conclusion, that is, through the tax system a redistribution of income would take place which would result in equal incomes for all persons in an economy. Attempts to combine these propositions and others into a rigorous analysis have been unsuccessful, primarily because of the difficulty in making interpersonal comparisons

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In addition to the principle of vertical equity, there is the principle of horizontal equity. This principle calls for the taxation of those in similar economic circumstances similarly. Ironically, the concept of horizontal equity has been used in attempts to broaden the scope of capital gains treatment. Used in this context, taxpayers have argued before Congress that their particular type of income is similar to a type of income already being afforded the favorable capital gains treatment. Therefore, in order to achieve the similar taxation of those similarly situated, their income should also be taxed as capital gain. This view of equity has been stated as being the "privilege of paying as little as somebody else."³ What should be argued, of course, is that since a dollar of capital gain is no different than a dollar of ordinary income, special treatment of capital gains should be eliminated, not expanded.

A point which the concepts of horizontal and vertical equity have in common is the requirement that changes in economic position be measured. This is absolutely necessary if those in similar economic circumstances are to be taxed similarly for purposes of horizontal equity, and those in different economic circumstances are to be taxed differently for purposes of vertical equity. The inability to agree upon a sound theoretical method for measuring economic position and changes in economic position has caused tax theory and practice to suffer. It is impossible to evaluate a tax system in terms of either horizontal or vertical equity in the absence of a normative concept of income for tax purposes. An additional benefit that a sound theoretical income concept can provide is that it can act as a touchstone for legislators when considering

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legislation in the tax area. It would give legislators a guide when considering tax legislation, and theoretical backing for refusing the requests of special interest groups for preferential tax treatment, if these requests conflict with the normative income concept.

A Theoretical Concept of Income for Tax Purposes

A theoretical income concept which has received much academic support is the accretion concept of income. The accretion concept of income, long associated with the names of Robert Murray Haig and Henry C. Simons, may be defined as the algebraic sum of consumption expenditures plus or minus the change in a person's net worth over a specified period of time.⁴ Under the accretion concept, income can be either positive or negative, and it would be recognized for tax purposes whether or not realized from an accounting standpoint. If the accretion concept of income were accepted in its purest form, the absence of a realization requirement would necessitate a periodic revaluation of assets and liabilities in order to determine the change in a person's net worth.

The primary advantage of the accretion concept of income is that it treats all dollars in the same manner in spite of the way in which they were earned, saved, or spent on consumption. This consideration of the dollar as a common denominator is in noticeable contrast to the manner in which current income tax provisions treat the dollar. To illustrate, under current tax law a dollar of wages is treated differently than a dollar of capital gain; a dollar spent on food is treated differently than a dollar spent on medical services; and a dollar saved in a bank has different tax consequences if it is a part of a self-employed retirement plan as opposed to not being part of such a plan.

For the purpose of determining either horizontal or vertical

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equity, the prime requisite is to be able to measure the relative economic position of different persons. For this purpose a common denominator is necessary. In its purest form the accretion concept of income provides this common denominator by treating a person's income as the dollar value of his consumption expenditures plus or minus the dollar value of the change in his net worth between the beginning and the end of his reporting period. From the standpoint of the accretion concept of income it is vital to treat every dollar of economic enhancement the same as every other dollar. If, as is the case with capital gains, this is not so, the common denominator is destroyed and the principles of horizontal and vertical equity are made meaningless. A dollar of capital gain commands exactly the same amount of goods and services in the market place as a dollar of ordinary income. Therefore, a dollar of capital gain has an equal amount of taxpaying capacity as a dollar of ordinary income.

Two disadvantages of the accretion concept of income as a normative concept of income for tax purposes, are (1) it violates Adam Smith's maxim of taxpayer convenience, and (2) it violates his maxim of economy of administration. The taxpayer convenience maxim is violated by the requirement that income be recognized annually, whether or not realization takes place. In the absence of realization, the accretion concept of income places a tax burden on the taxpayer at a time when he may not have sufficient liquid assets to satisfy the tax assessment. In addition, this same requirement violates Adam Smith's maxim of economy of administration. By requiring recognition prior to realization, a tremendous administrative burden is placed upon the government and the taxpayer. It is very difficult to determine a taxpayer's liability in the absence of an objective market transaction, and much controversy is bound to

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arise. The solution to these two problems, of course, is to retain the realization convention. However, if the realization convention is retained, it should be recognized as a departure from the theoretically ideal concept of income, and not as a part of the income concept itself. The administrative aspects of the realization convention are discussed more fully below.

Tax literature abounds with statements that attempt to rationalize the distinction between capital gains and ordinary income on grounds of improved equity or more generally with statements to the effect that equity requires that distinctions be made between sources of income, types of deductions, categories of taxpayers, etc. This viewpoint, of course, is redundant if each distinction drawn is assumed to be a refinement made necessary because taxpayers are differently situated. Taken to its logical conclusion, there would have to be a different tax law for every taxpaying entity, because there are no two persons whose economic situations are identical. Therefore, in order to consider their different circumstances, they would have to be taxed differently. This conclusion results from the fact that a common denominator is not used to measure economic circumstances for purposes of determining horizontal and vertical equity.

While it is true that differentiating between sources of income, types of deduction, or the personal situation of taxpayers creates a more intricate measure of ability to pay and a more complex law, it is by no means certain that this more intricate measure results in a more equitable law. In fact, by destroying the dollar as a common denominator, the relative positions of taxpayers become uncertain and the concepts of horizontal and vertical equity are rendered meaningless.

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Administrative Convenience

The accretion concept of income as expressed above does not represent a tax formula which can be precisely followed in all situations, but should be viewed as a theoretical ideal or guide with exceptions being made only for urgent administrative reasons. For example, the accretion concept of income would tax the net rental value of owner occupied homes. Because of difficulties in measurement, this type of economic enhancement may be excluded even though it should be recognized that the exclusion is a departure from the ideal. Another area, mentioned above, which may require a deviation from the ideal, is the problem of when to recognize income for tax purposes. The accretion concept of income calls for a periodic revaluation of assets with an increase in value included in income and a decrease in value deducted from income.

Two problems exist with respect to the recognition of income for tax purposes before realization in the accounting sense. The first relates to the difficulty of obtaining an asset valuation prior to the point of a market transaction. This problem is particularly troublesome in the case of assets which do not have a readily available market, such as a stock investment in a closely held company as opposed to a stock investment in a publicly traded corporation. Taxpayers, their advisors, and the Internal Revenue Service are keenly aware of the problem of valuing assets which have no immediate market because of the requirement that assets be valued for estate and gift tax purposes in the absence of a market transaction. A second problem, which from the standpoint of the taxpayer is probably more important than the valuation issue, is the question of how to pay the additional tax assessment attributable to the appreciation in assets if the assets are not actually sold. This

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difficulty relates to Adam Smith's third maxim applicable to tax systems in general that "every tax should be levied at a time, or in a manner, in which it is most likely to be convenient for the contributor to pay it."⁵ In a number of instances, current tax law recognizes the difficulty of paying a tax assessment when liquid assets may not be available. For example, the estate tax may be spread out over a ten year period if stock in a closely held corporation represents a significant portion of the estate. In addition, tax free exchanges and the installment method of reporting income are allowed under certain carefully defined circumstances. These special provisions are designed to enable the taxpayer to satisfy his tax liability at a time when he is most likely to have the necessary funds available. Again, however, these departures from the ideal should not be viewed as an integral part of an income concept for tax purposes, but as a divergence from the norm made necessary because of administrative convenience.

If the accretion concept of income is accepted for income tax purposes, but for administrative reasons the realization convention is maintained, a serious tax loophole would exist which would be intensified if a dollar of capital gain were taxed the same as a dollar of ordinary income. To illustrate this problem, consider the taxpayer who is in a marginal tax bracket of 70% and is holding two assets, one which has appreciated \$10,000 and the other which has depreciated \$10,000. The taxpayer can sell or hold either or both assets. If he sells the appreciated asset his \$10,000 gain will net him \$3,000, the remainder going to the government in settlement of his increased tax liability. If the taxpayer sells the asset which has declined in value, he will offset a portion of his other income resulting in a tax saving of \$7,000. Given the

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taxpayer's awareness of the present value of a dollar and other things being equal, an obvious investment strategy in this case would be to recognize all losses and to let gains accumulate. Current tax law attempts to deal with this problem by limiting the deduction of capital losses from ordinary income to \$1,000 per year for individuals, and by requiring that capital losses be deducted only from capital gains in the case of corporations. However, let us assume for the moment that the accretion concept of income is adopted for tax purposes, modified only by the realization convention. If this situation were to exist, the above investment strategy would be available to the taxpayer, and because of the increased tax rates on capital gains, it would become more important.

If this strategy is followed, the problem then faced by the taxpayer is how to realize on his investment in the appreciated asset in a manner which will minimize his taxes. Under current tax law a number of options are available to him: (1) he can hold the asset until he is in a lower marginal tax bracket at which time he can sell it and pay the reduced income tax assessment, (2) he can give the asset away either directly or in trust, thus, avoiding the income tax himself, or (3) he can hold the asset until he dies, with the asset passing to his beneficiaries at its fair market value at the time of his death.

Under the first method of avoiding the 70% marginal tax bracket, the taxpayer is ultimately taxed on the appreciation, even though through judicious timing his tax payment is less because he is in a lower tax bracket. If the taxpayer utilizes the second method of avoiding the 70% bracket, that is, he gives the appreciated property away, he will avoid all income taxes himself, though he may be subject to gift taxes. From

the standpoint of the income tax, the asset appreciation will be taxable to the donee upon realization by the donee. Presumably though, the donee will be in a lower tax bracket than the donor. The third method of avoiding the 70% tax bracket is the most appealing from a tax viewpoint. Under this method, the asset appreciation is never subject to the income tax, since the tax basis of the asset to the heirs is the fair market value of the asset at the time of death. The fair market value of the asset, however, does enter into the decedent's estate for purposes of the estate tax.

This taxpayer's difficulty and the suggested solutions point up a number of interesting problems. First is the so called lock-in effect. The taxpayer faced with a potential 70% tax on the appreciation of the asset is effectively locked into his investment. The potential \$7,000 tax assessment is a transaction cost of switching investments. The lock-in argument is used to defend preferential treatment of capital gains and is stated thusly: a tax on capital gains interferes with an investor's decision making process by adding a transaction cost to selling an existing investment without adding a comparable cost to holding that investment. The preferential treatment of capital gains, it is argued, somewhat alleviates this problem, but given the current relatively high ordinary income tax rates, if capital gains were taxed as ordinary income the lock-in effect would be intolerable.

The immediate cause of the lock-in effect is the tax differential between holding an appreciated asset and selling that asset, with the intensity of the lock-in varying in direct proportion to the size of the differential. Since the cause of the lock-in effect is the tax differential between holding and selling the asset, the lock-in effect would

evaporate if the differential would disappear. The lock-in effect, therefore, is the consequence of not being able to tax asset appreciation on an annual basis in the absence of realization. If it is believed necessary, for urgent administrative reasons, to maintain the concept of realization for tax purposes, the problem would appear to be insoluble. However, even though the current tax differential is the immediate cause of the lock-in effect, there are other determining factors which aggravate the problem and which are perhaps even more important.

The first of these other determining factors is the progressive tax rate structure. Not only is the current tax differential important, but the possibility of a reduced tax differential in the future would also tend to intensify the lock-in effect. This can be illustrated by the first suggested solution to the taxpayer's problem: hold the asset until the taxpayer is in a lower marginal tax bracket. If all income were taxed at a flat rate, there would be no point in holding an asset until a lower rate could be obtained, and thus, there would be a lessening of the lock-in effect.

Related to the first solution, that is, waiting for a future lower rate, is the second suggested solution to the taxpayer's predicament: give the asset away and avoid the income tax altogether. The income tax cost to the donor is zero, but there is a potential gift tax cost which must be considered. If, however, the donor and donee are viewed as a unit, as is the usual case with gifts between relatives, the donee must recognize the appreciation upon the sale or exchange of the donated asset. The tax advantage, similar to the first suggested solution, lies in the fact that the donee is usually in a lower income tax bracket than the donor. Again, this advantage would not exist if it

were not for the progressive tax rate structure.

Another determining factor intensifying the lock-in effect which is also related to the problem of the tax differential is the fact that an asset held until the death of the taxpayer takes as a basis for income tax purposes its fair market value at the date of death. This income tax provision provides tremendous incentive to hold appreciated assets as opposed to selling them, because the tax effect of holding an appreciated asset is so much superior to the tax effect of selling. To illustrate the advantage of holding an appreciated asset until death as opposed to selling it, assume a taxpayer who is in a 70% income tax bracket and a 70% estate tax bracket is holding an asset with a zero tax basis which has a market value of \$10,000. If he sells the asset before death, income taxes of \$7,000 will have to be paid leaving \$3,000 which will be added to the estate. After the estate tax is paid, \$900 will be left for the heirs. Alternatively, if the taxpayer holds the asset until death, no income tax would be due, but an estate tax of \$7,000 would have to be paid. It is obvious that the step-up in tax basis at death is a tremendous incentive to hold appreciated assets, and this has the effect of intensifying the lock-in effect.

In addition to all of the above factors, there is an investment advantage to holding an asset thus allowing it to appreciate tax free, rather than realizing annual appreciation, paying the tax due, and then reinvesting the proceeds net of tax. This investment advantage, of course, is also the consequence of not being able to tax appreciation annually because of the assumed realization requirement. The two methods of taxing appreciation as ordinary income are illustrated in Figure 1. Cell a₁₁ is the ideal method of taxing appreciated assets according to

FIGURE 1

THE METHODS OF TAXING APPRECIATION AS ORDINARY INCOME

a_{11} Ordinary Income Taxed Annually
a_{21} Ordinary Income Taxed Upon Realization

the Haig-Simons accretion concept of income. It corresponds to the way most income is taxed, such as wages, interest, dividends, rents, royalties, profits, etc. Cell a_{21} represents the method of taxing appreciated assets if there were no special treatment of capital gains and losses, but because of administrative convenience the realization convention was maintained.

TABLE 2

THE ACCUMULATION OF \$1 OF INVESTMENT AT THE END OF N YEARS AT AN ANNUAL RATE OF APPRECIATION OF 10% AND MARGINAL ORDINARY INCOME TAX RATES OF 30, 50, AND 70%

	Ordinary Income Taxed Annually (a_{11})			Ordinary Income Taxed Upon Realization (a_{21})		
	30%	50%	70%	30%	50%	70%
Tax						
Years						
1	1.0700	1.0500	1.0300	1.0700	1.0500	1.0300
5	1.4026	1.2763	1.1593	1.4274	1.3053	1.1832
10	1.9672	1.6289	1.3439	2.1156	1.7969	1.4781
15	2.7590	2.0789	1.5580	3.2240	2.5886	1.9532
20	3.8697	2.6533	1.8061	5.0093	3.8638	2.7183
25	5.4274	3.3864	2.0938	7.8843	5.9174	3.9504
30	7.6123	4.3219	2.4273	12.5146	9.2247	5.9348
35	10.6766	5.5160	2.8139	19.9717	14.5512	9.1307
40	14.9745	7.0400	3.2620	31.9815	23.1297	14.2778

Table 2 represents the accumulation of an original investment of \$1 which is appreciating at an annual rate of 10%, and is taxed either annually or upon realization at marginal ordinary income tax rates of 30, 50, and 70%. As indicated by Table 2, the investment advantage of deferring the income tax becomes more important the longer the asset is held. This is a consequence of the fact that the effective compounding rate of the classification "ordinary income taxed upon realization" is greater than the effective compounding rate of the classification "ordinary income taxed annually." The relative investment advantage of holding an appreciated asset as opposed to selling the asset and reinvesting the proceeds net of tax is shown in Table 3. As indicated by Table 3, the relative investment advantage of deferring the income tax becomes more important the longer an asset is held and the higher the marginal tax bracket.

TABLE 3

THE RELATIVE INVESTMENT ADVANTAGE OF HOLDING AN APPRECIATED ASSET
AS OPPOSED TO SELLING THE ASSET AND REINVESTING THE PROCEEDS

	(Ordinary Income Taxed Upon Realization - Ordinary Income Taxed Annually) Ordinary Income Taxed Annually $(a_{21} - a_{11}/a_{11})$		
Tax	30%	50%	70%
Years			
1	0.0000	0.0000	0.0000
5	0.0177	0.0227	0.0206
10	0.0754	0.1031	0.0999
15	0.1685	0.2452	0.2537
20	0.2945	0.4562	0.5051
25	0.4527	0.7474	0.8867
30	0.6440	1.1344	1.4450
35	0.8706	1.6380	2.2449
40	1.1357	2.2855	3.3770

The investment advantage of holding v. selling an appreciated asset is another factor which intensifies the lock-in effect, and as stated earlier, the higher the tax bracket and the longer an investment is held the more important is the deferral of tax advantage.

Definition of Realization

There are a number of possible methods of diminishing the intensity of the lock-in effect, each of which strives toward lessening the tax advantage of holding an appreciated asset as opposed to selling it. The first of these methods would be to redefine realization. Under current tax law realization takes place, in general, at the point of time of sale or exchange. As noted above, two methods that an individual may employ to avoid the tax on appreciated property are to avoid realization by giving the property away, or to hold the property until death. The latter method which a taxpayer may use to avoid the income tax is particularly important because a taxpayer's heirs receive property at a stepped-up tax basis, which means that the income tax is avoided on all appreciation prior to the death of the taxpayer. Investments in the hands of the elderly taxpayer are particularly sensitive to the "lock-in" effect, since the intensity of the lock-in varies directly with age. To reduce the lock-in effect occasioned by a definition of realization which excludes gifts or inheritances, realization could be redefined to include realization at the time of gift or death. With this new definition of realization, the appreciation of property would always be taxed to the individual who held the property as it appreciated. The lock-in effect would be greatly diminished if a taxpayer was certain that eventually all appreciation would be charged to his account for the purpose of the income tax. The only advantage to the taxpayer under these circumstances would

be the advantage of an "interest free" loan on the amount of the deferred tax. The tax advantage of this interest free loan would vary directly with the life expectancy of the taxpayer. Because at the latest the loan would become due at the death of the taxpayer.

The primary reason for not taxing appreciation on an annual basis is that the increased administrative and compliance burden would be the antithesis of simplification and thus unacceptable. The additional administrative and compliance burden resulting from a redefinition of realization to include gifts and inheritances, however, would be minimal because asset valuations must currently be made for the purpose of gift and estate taxation.

As mentioned above, the current tax differential is the immediate cause of the lock-in effect. If there was constructive realization at the time of gift or death, much of this lock-in pressure would be reduced. However, there would still remain two factors which would contribute to the lock-in effect. The first is the option that the taxpayer has to time his asset sales to take advantage of possible future lower tax rates. The root of this problem lies in the progressive tax rate structure of the federal income tax, and the inability to tax appreciation on an annual basis. If because of vertical equity, a progressive tax rate structure is desirable, and if for administrative reasons the annual taxation of appreciation is not possible, the problem would appear to be insoluble. However, the taxpayer with widely fluctuating tax rates is probably the exception rather than the rule, particularly in light of the fairly liberal income averaging provisions of the current law. Therefore, for the vast majority of taxpayers there is not a great deal of advantage to manipulating realization to take advantage of fluctuating tax rates.

A second factor which must be considered when appraising the lock-in effect is the tax deferral advantage attributable to the inability to tax asset appreciation as it occurs in the absence of realization. As Table 3 indicates, this is a real tax advantage which increases the longer an asset is held, and/or the higher is an individual's tax bracket. This tax advantage could be neutralized if upon realization the taxpayer was subject to an interest charge to compensate the government for taxes which were deferred in the past. Correspondingly, if consistency is to be maintained, the government should rebate to the taxpayer interest on deferred losses which were not realized in the past. This suggestion, of course, would add a certain amount of complexity to the tax law, which may or may not be worth the trouble, depending upon one's view of the importance of the contribution of the deferral advantage to the lock-in problem. If it was decided that an interest charge should be made, certain simplifying assumptions would be necessary in order to implement the charge. A basic assumption which would probably have to be made would be the manner in which appreciation took place over time; a straight line assumption being the simplest.

If capital gains were taxed as ordinary income, the lock-in effect would be intensified because of the increased current tax differential between selling and holding an appreciated asset. The two proposals suggested to alleviate this lock-in effect are: (1) redefine realization to include gift and death, and (2) charge taxpayers interest on tax deferral. Of the two, the first is critical, particularly realization at the time of death. In the opinion of the author, the second proposal is much less important. The reason for this is that the older taxpayer is more likely to hold appreciated assets, and as stated above, the

intensity of the lock-in effect attributable to the step-up in tax basis at death varies directly with the age of the taxpayer, and the intensity of the lock-in effect attributable to the deferral advantage varies inversely with age. However, if the lock-in effect is still considered to be serious even with constructive realization at the time of gift or death, the second proposal is available.

It is interesting to note that some writers in the field of public finance believe that the strength of the lock-in effect is greatly overemphasized.⁶ They base their argument on the fact that most investments can be used as collateral for the raising of capital and thus funds are not locked into a particular investment. In addition, the purchase of an outstanding security is not an investment from the social point of view, it is merely a switching of investments by investors with total investment remaining the same. A distinction must be made between the purchase of a capital good which from a social viewpoint is true investment, and the purchase of an outstanding security which is merely a portfolio change.

One difficulty which must be considered if capital gains were to be taxed as ordinary income in conjunction with constructive realization at death, is the potential liquidity problem of estates containing the bulk of their assets in closely held corporations or other family type businesses. Upon death, an income tax would accrue on the unrealized appreciation of assets being held in addition to the estate tax which would also be due. For closely held business organizations sufficient cash may be unavailable to settle these liabilities, thus forcing a sale of all or part of the business with the resultant loss of family control of the business. Current estate tax law recognizes the liquidity

problems of certain estates by allowing these estates to pay the tax due over an extended period of time. In addition, closely held corporations can distribute cash without the distribution being considered essentially equivalent to a dividend, if the cash is used for the purpose of paying the estate tax. These provisions are intended to alleviate the liquidity problem of certain estates and these types of relief provisions could be extended if necessary to assure the availability of cash to settle income and estate taxes. While it is probably true that the most important economic consequence of taxing capital gains as ordinary income, coupled with maintaining the realization convention for purposes of administrative convenience, is the lock-in phenomenon, other economic effects must also be considered,

Economic Effects

If there were no special treatment of capital gains and losses, would there be adverse economic effects that would offset the improvements in equity, certainty, and simplicity? This is the question that must be considered. Some of the general economic considerations have already been reviewed (the lock-in effect and the need for a clear and comprehensive concept of income), and others will be examined in the sections of this chapter concerning arguments for and against the full taxation of capital gains. In addition to the lock-in effect, a second major objection from an economic point of view against the full taxation of capital gains is that it would reduce the amount of risk capital available. The effect on saving and investment of full taxation of capital gains has two aspects, (1) the effect on the total amount of savings, and (2) the effect on the allocation of funds.

Taxes which impinge heavily upon savings slow the rate at which

capital is accumulated. However, society's present stock of capital will not be reduced or depleted unless savings are reduced to the point at which in total they are not sufficient to replace the existing stock of capital assets. There can be little doubt that the burden of a full taxation of capital gains would fall partially upon savings. The same is true, however, of the burden of the full taxation of wages, interest, dividends and other forms of income. Assuming that the encouragement of savings is an appropriate economic goal of government, whether the preferential taxation of capital gains is a desirable means of attaining that goal is open to question. It should be pointed out, however, that this incentive is not available to all taxpayers, nor is it even available to the same extent to all taxpayers with the same economic income. It is an inequitable incentive in that it is available only to a small proportion of the population. It is unjust not to allow the incentive to invest to the wage earner, the person with business income, or the professional person while the person with capital gains is allowed a generous incentive. If an incentive to save is to exist, for equity reasons it should be broadly based and available to as many persons as possible, rather than the few.

The second aspect of the effect on savings and investment, concerns the assertion that a full taxation of capital gains would diminish the attractiveness of risky ventures by reducing the after tax return of these investments. While this assertion is probably valid, the same argument is probably true of a tax on any source of income. A particular venture is always less attractive if a tax is imposed than it would be if there were no tax imposed. However, there are a number of counterbalancing factors which must be considered. First is the effect of the

tax treatment of losses. If there were full deductibility of capital losses, the potential net loss on a risky venture would be reduced. While it is true that investors do not invest with the idea that losses will be incurred, it is also true that the possibility of loss does exist, particularly in the case of a risky investment. In addition to the full deductibility of capital losses, taxpayers have control of the moment to recognize gains and losses for tax purposes, and this itself is an investment advantage. If the accounting concept of realization is to be maintained (see the earlier discussion of administrative convenience), the investor can get a current tax deduction for realized losses, yet defer gains indefinitely. Another factor to consider is that investors contemplate what they consider to be a satisfactory after tax rate of return. If the tax rate increases, the before tax rate of return would have to increase in order to maintain a constant after tax rate of return. Since this is true, it would indicate that the full taxation of capital gains would result in a bias in favor of the riskier investment which promises a greater return, as opposed to an investment bias against this type of investment. As pointed out above, there are many tax factors to consider which may have opposite effects on different investors in their choice of investment alternatives. Thus, the whole question of the effect of tax factors on investment decisions is open to dispute.

In addition to tax factors, there are non-tax factors which play a major role in an individual's investment decisions. In a comprehensive attempt to assess the importance of tax and non-tax factors on the investment decisions of investors, Butters, Thompson, and Bollinger (after interviewing a carefully selected sample of over 700 investors) stated:

Income-minded and security-minded investors . . ., in deciding on an investment policy, tend to balance the current income yield

of their investments against the risk of capital loss, and to give very little weight in their investment decisions to the possibility of capital gains usually present in investments which also present high risks of capital loss. The high rates of the individual income tax exert by far the most important tax influence on the investment decisions of these groups of individuals, and their predominant effect is to drive these individuals into lower yield, less risky investments than they would otherwise make.⁷

and that:

The tax effects on investors interested mainly in capital appreciation are quite different from those just summarized for the income minded and security minded investors. Our field surveys point overwhelmingly to the conclusion that, for appreciation-minded investors, the single most important feature of the tax structure is the differentially low rate at which long-term capital gains are taxed in comparison with the much higher rates on ordinary income, especially for incomes in the upper income tax brackets. This differential has stimulated inherently venturesome individuals to seek out investments which offered prospects of capital gains rather than the receipt of ordinary income. . . . Similarly, the absolute level of the capital gains rate and the length of the six-month holding period were cited as investment deferments only in a very small number of instances.⁸

Thus, income minded investors "give very little weight in their investment decisions to the possibility of capital gains" and for investors interested mainly in capital appreciation, it was the existence of a differential rate of tax and not the absolute level of the tax which was the most important factor. Non-tax factors that affect an individual's investment decisions which were emphasized by the authors include the personal circumstances of the individual, and his expectations of inflation, general business conditions, etc.

In addition to the economic issues regarding the lock-in effect and the effect on saving and investment, arguments both pro and con concerning the appropriate taxation of capital gains and losses abound. Walter J. Blum, Professor of Law at the University of Chicago, has listed twenty-five arguments "for" and eight arguments "against" special treatment of capital gains and losses.⁹ As Professor Blum has pointed out,

many of the arguments for special treatment of capital gains and losses are either irrelevant or redundant. A few of these arguments, however, form the cornerstone for the divergent positions and thus merit discussion.

Arguments For Special Treatment of Capital Gains and Losses

At the crux of the controversy of whether or not to afford special treatment to capital gains and losses lies the question of whether capital gains are, or are not income. If capital gains are not income, they should not come under the income tax provisions of the law. Conversely, if capital gains are income, they should be subject to the federal income tax. Henry C. Wallich, Professor of Economics at Yale University and Assistant Secretary of the Treasury, 1958-1959, contends that capital gains are not income.¹⁰ He bases his conclusions on national income accounting concepts whereby capital gains represent the capitalization of improved growth prospects. He contends that if this future capitalized income is recognized in the present and then a second time when this income eventually materializes, it will appear in the national income accounts twice, and would therefore be double counting.¹¹ The realization concept of accounting is a crucial part of this argument. It is contended that unrealized gains are taxed first as increases in capital, when in fact they represent an expected increase in future cash flows, and since these future flows will be taxed at normal tax rates upon realization, the result is double taxation. However, under the proposed full taxation of capital gains, there would be no taxation of unrealized appreciation. A capital gain would be taxed as an improvement in the economic position of a taxpayer only upon realization, and the increased flow would be taxed at a later time to a second taxpayer as the

flow is realized. Both the increased capital and the increased flow represent economic enhancement and thus taxpaying capacity. If there were appropriate provisions to allow for capital recovery, there would be no double counting.

Another aspect of this argument against treating capital gains as income, relates to trust and property law. The point is made that an asset held in trust can be divided into corpus and income interests. Generally, a capital gain inures to the benefit of the corpus interest unless specifically indicated otherwise by the originator of the trust. Thus in the typical case where property is divided into a life estate and a remainder interest, unless otherwise specified by the originator, appreciation will inure as accretion to the remainder interest, and not be available to the income interest.¹² This argument is developed quite extensively by Seltzer who points out that this concept of income is based primarily on the nature of an agricultural economy.¹³ It is a carryover from that period in England where an asset was a physical thing, such as a piece of land, and the land was kept in a particular family by passing to succeeding generations only the income interest and not the corpus interest. Today intangible forms of wealth predominate in our society and the distinction between the asset and the income from the asset has been blurred.

Both aspects of this argument merely cloud the issue of whether or not capital gains and losses should be afforded special treatment. The critical question is still whether or not for income tax purposes we should provide special treatment for capital gains and losses. The fact that economists do not consider capital gains to be income for purposes of national income accounting or that they are not considered as income

for purposes of property law is irrelevant. As Seltzer has pointed out:

Although different concepts of income may well be valid for other purposes, the proper measure of income for tax purposes is to be found in the actual ex post results of economic activity, not in subjective expectations or presumptions. Taxable income, it is urged, should measure the relative capacity of individuals to pay taxes, as indicated by the net annual additions to their wealth from economic activity plus their consumption. Capital gains supply an individual with the same additions as any other kind of personal income to his power to buy consumption goods or investments. . . .¹⁴

The existing controversy as to whether capital gains should be subject to the income tax would be settled if the accretion concept of income was accepted for tax purposes. Under this concept, no distinction is made with regard to the source of economic enhancement, all accretions to economic power being subject to the income tax.

A second argument against taxing capital gains in full is that the revenues obtained would be less than the costs of administering the tax.¹⁵ While no estimates of dollar costs of administration are available, much of the cost of administration is undoubtedly due to the distinction between capital gains and losses and ordinary gains and losses. The present special treatment of capital gains and losses creates major definitional problems which would not exist in the absence of the distinction between capital and ordinary gains and losses. The greater the tax advantage of capital gain over ordinary income, the greater the pressure by taxpayers and their advisors to utilize the capital gains provisions. In fact, one of the purposes of the 50 percent maximum tax on earned income was to induce taxpayers to concentrate more on earning income and less on employing tax gimmicks to shelter income from high marginal tax rates.¹⁶ As will be discussed in greater detail in Chapter III, the root causes of complexity in the federal income tax law are the distinctions which are drawn between taxpayers, sources of income,

taxable years, types of expenditures, etc. If there were no special treatment of capital gains and losses, one major distinction would be neutralized, with a resulting decrease in complexity. A less complex tax law would certainly be no more costly to administer than a more complex tax law.

A third argument against the full taxation of capital gains is that they are fictitious in that they merely reflect inflated asset prices.¹⁷ In an economy such as our own, with an obvious built in inflationary bias, this argument would appear to have some merit. A decline in the purchasing power of money will generally be accompanied by a rise in asset values, since the supply of such assets remains constant, while the supply of dollars is increasing.

Looking from the other side, however, not all capital gains are the result of inflation. Some may reflect increased retained earnings, while others may reflect an increased future stream of income or a change in the capitalization rate of a given future income stream. There have been many proposals made to counter the effects of inflation on taxation. One of the more recent proposals considered by Congress was the Corman Bill, which would have provided for monthly inflationary adjustments at an annual rate of 4 percent.¹⁸ This bill would have benefited the holders of capital assets, but it would have been discriminatory against dividends and interest-bearing securities that did not enjoy the exemption. It is a well known fact that most taxpayers are affected by inflation, from the wage earner who finds himself in a higher tax bracket when his wages keep pace with inflation but his real income before taxes remains constant, to the investor in fixed income securities who obtains a higher before tax yield to compensate for anticipated increases in the general price level.

To ignore these individuals who are affected by inflation, while providing relief to the capital asset holder would be unjust. However, to tax everyone on a constant dollar basis would be difficult if not impossible. Finally, the government needs a specified number of dollars to operate. Given the budgetary position, either a deficit or surplus position, a specified number of dollars must be raised through the income tax. If the tax base is reduced in order to account for inflation, it is axiomatic that the average tax rate would have to be increased to compensate for the reduced tax rate. Thus, the net effect on all taxpayers taken together will be zero. This is not to say that the tax burden of each individual would be the same after allowing for inflation as before. However, since most individuals are aware of the problem of inflation it is probable that they implicitly adjust for it in making economic decisions.

A fourth argument against the full taxation of capital gains is that it would be unfair to tax gains which have accrued over a number of years in the year of realization at high progressive tax rates. The "bunching" argument was probably the original rationalization for preferential treatment of capital gains. There are two aspects of this problem, both relating to the issue of realization, which have opposite effects. The first concerns the taxpayer who holds an appreciating asset for a number of years while he is in a constant relatively low marginal tax bracket. If he sells the asset, it is possible that he would be pushed to a much higher tax bracket, thus paying more taxes than he would have paid if he had been taxed annually on the appreciation. Current tax law contains provisions for income averaging which allows the taxpayer to pay tax at the rate of five times the marginal tax on one-fifth of the "averageable income." Possibly a better method of income averaging was

suggested by Emory who said: "perhaps [the bunching problem can be] best solved by an averaging approach allowing the taxpayer to average the gain over the number of years the asset is held."¹⁹ The primary advantage of this type of averaging system is that it would provide a greater benefit to those taxpayers holding assets for relatively long periods of time, and less benefit to taxpayers holding assets for lesser periods of time. This method of averaging would automatically grant the greatest tax benefit to the long-term investor, and the least tax benefit to the short-term speculator, without having to delve into the motives of the various taxpayers.

The second aspect of the bunching problem deals with what one writer has referred to as the "overlooked preference."²⁰ This overlooked preference refers to the tax deferral benefit available to the taxpayer who holds an appreciating asset for a number of years without realization. Even if capital gain were taxed as ordinary income at progressive tax rates the taxpayer has still enjoyed the tax deferral benefit available to most types of income. In the Report of the Royal Commission on Taxation, the point was made that in principle the Commission felt that appreciation of assets should be brought into income annually.²¹ The Commission backed off from this position for practical reasons, yet not in principle. Tax liability deferral has two effects on the taxpayer, (1) it results in a "bunching" problem in that appreciation which has accrued over the holding period of the asset is taxed in the year of realization, and (2) by not being taxed annually on the appreciation, the taxpayer obtains the advantage of an "interest free" loan on the deferred tax. For the taxpayer, the first effect is undesirable and the second effect is desirable. Whether or not the taxpayer is at an overall

advantage or disadvantage, depends upon his marginal tax bracket during the holding period of the asset and the rate of appreciation of the asset. Perhaps a rough justice would be served by not allowing taxpayers to income average capital gains, in order to offset the investment advantage gained through tax deferral.

Arguments Against Special Treatment of Capital Gains and Losses

Perhaps the decisive argument against special treatment of capital gains and losses rests with Professor Blum's comment that "a dollar is a dollar."²² One dollar, irrespective the source, commands the same amount of purchasing power in the market place or can be saved in the same manner as any other dollar. To distinguish dollars on the basis of source is to undermine the common unit of measure, and to make meaningless any comparisons of relative economic position. In order to develop an equitable tax system, a common unit of measure is a necessity, and the dollar should be that common denominator.

A second argument against special treatment of capital gains and losses is that a full taxation of gains would provide much needed additional revenue, or alternatively allow tax rates to be reduced. Robert Eisner, Professor of Economics at Northwestern University, has stated: "[The] exclusion of half of 'realized' capital gains from adjusted gross income and exclusion of all of capital gains in estates or in gifts amounts to some ten to twelve billion dollars per year in lost revenues to the United States Treasury."²³ This amount is equal to approximately 10% of the tax revenues from the individual income tax. If there were no special treatment of capital gains and losses, a substantial reduction in the ordinary income tax brackets could be effected with no loss of revenue. This would have the effect of further softening the impact of a

taxation of capital gains.

A third argument against preferential treatment of capital gains and losses is that the distinction is a major source of tax law complexity. In fact some writers in the area of federal income taxation have stated that the separation of ordinary income from capital gain for tax purposes "adds more complexity to our tax laws than any other single notion."²⁴ And concerning the cost of compliance another writer has stated:

The cost of compliance is significantly greater under the capital gains tax system, since the taxpayer may buy additional after-tax income by purchasing legal and accounting services in order to minimize taxes. While the additional costs may not be large relative to the gross national product, they do represent the time and effort of able managerial and professional talent that could otherwise be used to enhance the productivity of the economy.²⁵

The questions that must be answered by the Internal Revenue Service and taxpayer alike include:

- a. What should be included in the class of eligible transactions?
- b. What should be the holding period criteria?
- c. How should the value of gains and losses be defined?
- d. When should taxes be paid?
- e. What rate should be paid on capital losses?
- f. At what rate should capital losses benefit the taxpayer?

These and other questions must be answered by reference to the various sources of tax law which include the Internal Revenue Code, the various Congressional committee reports, the Code of Federal Regulations, the published Revenue Rulings of the Internal Revenue Service, and the results of court cases dealing with federal income tax matters.

The provisions in the Code specifically related to capital gains and losses are contained in Subchapter P sections 1201-1253. In terms of

volume these sections represent a relatively minor part of the law concerning the federal income tax which is contained in sections 1-1399 of the Code. The specific capital gain and loss Code provisions, however, only scratch the surface of their actual impact on the law. Much of the law is concerned with closing "loopholes" created by capital gains and losses, that is, restricting the benefits of capital gains or applying the penalties of capital losses, or extending the benefits to another class of property or type of transaction. Economist Carl Shoup has estimated that over half the verbiage in the Internal Revenue Code relates in one way or another to the special treatment of capital gains and losses.²⁶

The New York Bar Association's Committee on Tax policy issued a report on complexity in the federal income tax law which contained a strongly worded statement about one consequence of complicated tax laws. The committee stated: "This committee is unanimously of the view that the present course of development of the tax law, if not reversed may well result in a breakdown of the self assessment system. Indeed some members believe that the breakdown has to some extent already occurred."²⁷ This consequence relates to the whole problem of taxpayer morale. The Tax Reform Act of 1969 was in large part a result of published statistics showing that a surprising number of taxpayers with large incomes paid little or no tax. While the capital gains preference is not the only reason for these statistics, it certainly plays a substantial part. As implied earlier, taxpayer cooperation is at the heart of a tax system, particularly a self assessment system. In turn taxpayer cooperation depends upon his faith in the fairness of the system.

In summary, the preferential treatment of capital gains and losses

makes it impossible to determine the fairness of our tax system in terms of either horizontal or vertical equity. Both of these concepts require a measurement of economic position, which in turn necessitates the acceptance of a normative concept of income for tax purposes. The accretion concept of income, which does not distinguish among sources of accretion to economic power, provides a useful concept of income for tax purposes. In its purest form this concept of income requires a periodic valuation of assets, which would probably not be feasible for administrative reasons. In order to ease the burden of administration, the realization convention would have to remain. However, if the realization convention was maintained, there would be an intolerable lock-in effect. The intensity of the lock-in effect would be substantially reduced if realization was redefined to include the point of time of a gift or the death of the taxpayer. Not only would there be an improvement in the equity of the tax system, but there would also be a less complex tax system, because a major distinction in the tax law would be neutralized. An analysis of the causes of complexity in the tax law is undertaken in Chapter III, and the effect of the capital gain and loss distinction on the scope and complexity of the tax law is examined in Chapter IV.

FOOTNOTES CHAPTER II

¹Adam Smith, The Wealth of Nations, ed., Edwin Cannon (New York: The Modern Library), book V, chapter II, part II, pp. 777-778.

²For an analysis of sacrifice theories of taxation, see: Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill Book Company, Inc., 1959), chapter 5.

³Louis Eisenstein, The Ideologies of Taxation (New York: The Ronald Press Company, 1961), p. 176.

⁴See: Robert Murray Haig, "The Concept of Income: Economic and Legal Aspects," in The Federal Income Tax, ed. R. M. Haig (New York: Columbia University Press, 1921), chap. 1. Also see: Henry Simons, Personal Income Taxation (Chicago: The University of Chicago Press, 1938).

⁵Smith, The Wealth of Nations, book V, chapter II, part II, p. 778.

⁶Raymond L. Richmond, "Reconsideration of the Capital Gains Tax-- A Comment," National Tax Journal 14 (1961): 403.

⁷J. K. Butters, L. E. Thompson, and L. L. Bolinger, Effects of Taxation on Investments by Individuals (Harvard University Press, 1955), p. 36.

⁸Ibid., pp. 41-42.

⁹Walter J. Blum, "A Handy Summary of the Capital Gains Arguments," Taxes--The Tax Magazine 35 (1957) : 247-266.

¹⁰Henry C. Wallich, "Taxation of Capital Gains in the Light of Recent Economic Developments," National Tax Journal 18 (1965): 139-140.

¹¹Ibid.

¹²Blum, "A Handy Summary of the Capital Gains Arguments," p. 248.

¹³Seltzer, The Nature and Tax Treatment of Capital Gains and Losses, p. 25.

¹⁴Ibid., p. 285.

¹⁵Blum, "A Handy Summary of the Capital Gains Arguments," p. 252.

- ¹⁶Internal Revenue Code of 1954, sec. 1348,
- ¹⁷Blum, "A Handy Summary of the Capital Gains Arguments," p. 255.
- ¹⁸Meade Emory, "The Corman and Mills-Mansfield Bills: A Look at Some Major Tax Reform Issues," Tax Law Review 29 (1973): 96.
- ¹⁹Ibid., p. 95.
- ²⁰Richard Armstrong, "The Right Kind of Tax Reform," Fortune, December 1972, p. 180.
- ²¹Report of the Royal Commission on Taxation (Canada), in Readings in Federal Taxation, eds. Frank E. A. Sander and David Westfall (Mineola, New York: The Foundation Press, Inc., 1970), p. 89.
- ²²Blum, "A Handy Summary of the Capital Gains Arguments," p. 265.
- ²³Robert Eisner, "Tax Incentives for Investment," National Tax Journal 26 (1973) : 397.
- ²⁴Sommerfeld, Anderson, and Brock, An Introduction to Taxation, p. 180.
- ²⁵Martin David, Alternative Approaches to Capital Gains Taxation (Washington: Brookings Institution, 1968), p. 4.
- ²⁶Armstrong, "The Right Kind of Tax Reform," p. 180.
- ²⁷Martin D. Ginsburg, "Tax Simplification--A Practitioner's View," National Tax Journal 26 (1973): 317.

CHAPTER III
COMPLEXITY IN THE FEDERAL INCOME TAX

Definition of Complexity

The word complexity connotes a difficulty of understanding. Webster's Third New International Dictionary defines complexity as anything which is "marked by an involvement of many parts, aspects, details, notions, and necessitating earnest study and examination to understand or cope with."¹ Complexity within the context of the federal income tax means different things to different people, but in general, it refers to the complex technical structure of the federal income tax. This complex technical structure in turn refers to the complex substantive tax rules with their complex interrelationships all of which is stated in complex statutory terminology.

The search for simplicity in the federal income tax is practically as old as the modern day income tax. In discussing the income tax Act of 1913, Mr. Justice McKenna referred to the Act as one "which concerns the activities of men and intended, it might be supposed, to be without perplexities and readily solvable by the off-hand conceptions of those to whom it was addressed."² In referring to the 1918 Act, Treasury expert Dr. T. S. Adams said:

There is an imperative need for immediate simplification in the systems of internal revenue taxes. The unvarnished truth is that the income and profits taxes are so heavy and so intricate that a sufficient number of auditors and experts cannot be secured by the government to audit, assess, and settle old claims as fast as new claims are created.³

This statement was made at a time when our revenue laws consisted of 106 pages. And as recently as June 24, 1975 in a panel discussion before the House Ways and Means Committee, former Treasury official John S. Nolan strongly recommended "simplification before misunderstandings caused by complexity in the law causes the public to lose confidence in the excellent tax system."⁴

To the taxpayer, complexity can mean a difficulty in determining his tax liability because of an inability to understand the tax forms or his obligations under our voluntary self-assessment tax system. In addition, it can mean the possibility of an undesirable tax consequence because of the structuring of a transaction in a particular manner instead of in some other manner. This, of course, is the result of the complex variation in tax treatment of transactions that are often not materially different in form or substance. To other taxpayers, complexity can merely mean the existence of complex arithmetic computations or the volume of record keeping which is required.

To the tax practitioner, complexity relates primarily to the regulations, rulings, and to some extent the statute itself. Their judgment of complexity relates to their difficulty in understanding the regulations, rulings, and statutes, and in making the determinations and computations required by them. Much the same standards for judging complexity are used by those charged with the responsibility of administering the tax law, the Internal Revenue Service.

Sources of Complexity

The sources of complexity in federal income tax law can be divided into three categories: (1) complexity arising from a vast and intricate

economic system itself, (2) complexity arising from the revenue raising function of any income tax, and (3) complexity arising outside of the revenue raising function of an income tax. Of these three sources, there is little hope for a lessening of complexity in the first two categories without a radical change in the economic system, or a reduction in the dependence on the income tax as the prime revenue source of the federal government. The hope for a lessening of complexity, therefore, lies in the third category.

With respect to the first category, the fact that the income tax at the federal level carries such a tremendous burden is one basic reason for its complexity. The income tax for the fiscal year 1974 accounted for over 68% of all receipts at the federal level out of total receipts of over \$237 billion.⁵ In addition, the income tax is a mass tax--a requirement of the tremendous load it must bear. With its relatively low exemptions, the population coverage is great. The tax system of the United States, with an economy generating an annual GNP close to \$1.5 trillion, together with the many types of businesses and ways people have of earning money and arranging their financial affairs is bound to create much complexity merely from its scope alone. Thus, the scope of a tax system which is required to measure net income annually for millions of taxpaying entities, earning income in a multitude of different ways, is bound to result in a tax system with a great deal of complexity.

Regarding the second category, there is a great deal of complexity which is inherent in the revenue raising function of any income tax, and thus, is unavoidable. For example, not only must net income be measured for millions of taxpaying entities, but it must be measured annually. This results in two problems. First, the year is not usually the ideal

time period for measuring income. Much complexity is the result of cutting off the tax period at the end of a calendar or fiscal year. Basic difficulties exist because of this artificial cut-off, such as, the determination of the proper period in which to recognize an item of income or deduction for tax purposes. This issue encompasses all of the difficult problems the accountant faces in making the appropriate revenue and expense accruals, and in general, involves all of the problems of properly matching expenses with revenues. Since the taxpayer and the government are well aware of the present value of a tax dollar to be paid in the future compared with the present value of a tax dollar to be paid currently, it is inevitable that the taxpayer and the government would have many disagreements on audit regarding the timing of income and deductions. A second problem resulting from the necessity for an annual measurement of taxable income is the rather obvious fact that measurements must be made repeatedly, once a year. If, for example, returns were required every 10th year instead of on an annual basis, as a minimum, many of the difficult decisions involved in income determination would have to be made only one-tenth as often. In addition, other difficult determinations would not have to be made at all. From the standpoint of the government, fewer returns would permit a closer scrutiny with the concomitant benefit of better enforcement. This, of course, is not to advocate that returns be filed only once every 10 years. For many valid reasons the annual filing of a return and settlement of the income tax assessment is necessary. Also, the annual filing requirement promotes simplicity in many ways, since it is much easier to collect data necessary for the preparation of the return if it is only one year old as opposed to 10 years old.

Another source of complexity inherent in the revenue raising function of any income tax is that it is based on the net income of particular taxpaying units which must be precisely defined. With regard to net income, it is necessary to determine not only how much is to be taxed but to whom it is to be taxed. To illustrate, since corporations are taxed differently than trusts, which are taxed differently than partnerships, which are taxed differently than individuals, a precise articulation of the definition of each is necessary. Even within the definition of a corporation, life insurance companies are taxed differently than mutual funds, which are taxed differently than utilities, which are taxed differently than the ordinary corporation. Individuals are also not taxed alike. A husband and wife are treated as one taxpaying unit, but the children of the family are not included in the taxpaying unit. In addition, there are several classes of "single" individuals--the single person, the single person who is head of a household, the surviving spouse who maintains a household, and others. This is not an exhaustive list of taxpaying entities, but it does serve to point up the fact that if we are going to tax different taxpaying units differently it is necessary to precisely define these units and to determine the income to be allocated to each if more than one has come into contact with the income.

Another important source of complexity results from the fact that the income tax is applied at significantly progressive rates.⁶ The progressive attribute of the federal income tax is the root cause of the complexity, mentioned above, resulting from the need to precisely define each of a multitude of taxpaying entities. If income was taxed at a flat rate, which was the same for all taxpaying entities, there would be no need to distinguish between a married person and a single person, or

between a single person who is a "head of the household" and one who is not, or between a single person who is a "surviving spouse" and a married person who is an "abandoned spouse." In addition, problems associated with the question of who earned the income would be solved. For example, families would derive no tax benefit from shifting income among themselves, thus attempts to assign income from one family member who is in a relatively high bracket to another who is in a lower bracket and the whole complex tax pattern of family trusts would be eliminated.

If income was taxed at a flat rate, complexities resulting from attempts by taxpayers to shift income from high tax bracket years to low tax bracket years would also be eliminated. A stable pattern of taxable income would not be of critical importance, thus, a taxpayer would not feel compelled to artificially create this pattern. In addition, the income averaging provisions, which are designed to benefit those with rapidly rising incomes, would be unnecessary. Therefore, without a progressive income tax rate schedule, taxpayers would have no tax motive for trying to shift income between taxpaying entities or for trying to recognize income for tax purposes in a low bracket as opposed to a high bracket year to avoid high tax rates.

Another problem resulting from the progressive income tax, aggravated when rates are high, is the need to give hardship relief in special cases.⁷ Once the political decision is made concerning which taxpayer or group of taxpayers is to benefit from a particular relief provision, in order to prevent undue tax avoidance, the statute must be precisely drafted with a view toward benefiting those who are deemed deserving and excluding those who are not so deemed. Since it is the nature of taxpayers and their advisors to minimize their taxes, relief provisions

must be precise instruments which prevent avoidance but do not injure innocent taxpayers. As Randolph Paul has said, "It is not enough to attain a degree of precision which a person reading in good faith can understand; it is necessary to attain a degree of precision which a person reading in bad faith cannot misunderstand."⁸

An illustration of this source of complexity is the historical development of section 341 of the Internal Revenue Code. This section of the Code was originally designed to prevent the conversion by taxpayers of what would be ordinary income into capital gain through the use of a "collapsible corporation." As originally enacted in 1950 as section 117(m) of the Internal Revenue Code of 1939, a collapsible corporation was defined as one which was "formed or availed of principally for the manufacture, construction or production of property." When the 1954 Code was enacted, it was decided that section 117(m) was not strong enough so further restrictions were added to the collapsible corporation rules to increase their effectiveness. Thus section 341 of the 1954 Code came into existence. It was soon obvious that section 341 was too broad, so to provide relief in certain circumstances, section 341(e) was added to the 1954 Code. Section 341(e) provides numerous exceptions to the application of section 341 if certain complex tests are met. It is approximately four and one half pages long containing one sentence which is almost a page long. The entire subsection (e) is virtually unintelligible. In 1964 more relief was provided through the enactment of section 341(f), which further complicated section 341.

Another source of complexity related to the revenue raising function of any income tax is the fact that the tax is a net income tax. There are two basic elements in the measurement of net income, the first

being gross income and the second being deductions. In the United States the application of the first element is quite broad--"all income from whatever source derived."⁹ Thus, certain complexities result from the determination of what to include in gross income. The second complicating element is the determination of what is to be allowed as a reduction of gross income in determining net income. In the United States, for individuals, the process is further complicated by the distinction between deductions allowable from gross income, which are primarily of a business nature, resulting in an intermediate computation of adjusted gross income, and deductions allowable from adjusted gross income, which are primarily of a non-business nature, to determine taxable income. Much controversy between taxpayer and government results from questions of whether or not an expenditure is deductible in determining taxable income, and then if deductible, whether from gross income or adjusted gross income. The problem is further aggravated when a taxpayer has expenditures which are part business and part personal in nature. In this situation, somewhat arbitrary allocations must often be made which inevitably lead to conflict between the taxpayer and the tax collector. This allocation problem is an unavoidable source of complexity.

Concerning the deductions allowable from gross income, only those deductions which are of a business nature are a necessary element in the concept of a net income tax. All of the deductions which are allowed, but are not of a business nature, are sources of complexity not essential to the revenue raising function of a net income tax. It is this area that holds the greatest possibilities for simplification. Through tax benefits in the form of special deductions, exclusions, deferrals, exemptions, credits, and methods of computing the income tax, Congress

provides financial assistance to a variety of business and social activities. For the most part, these tax expenditures are designed to stimulate or assist action which Congress deems appropriate. The common ground shared by all of these special deductions, etc., is that each is not essential to the revenue raising function of the income tax, but is designed to provide tax relief to certain groups of taxpayers. These special tax provisions result in a superstructure which is added to the basic structure of a net income tax. Professor Stanley S. Surrey has called these special provisions a "tax expenditure apparatus."¹⁰ It is a way to distribute dollars to taxpayers indirectly through the tax system, instead of directly through the budgetary process.

The amount and variety of these tax expenditures is very large. Recent estimates indicate that the overall magnitude is equal to about one-fourth of the federal budget.¹¹ In addition, the scope of these tax expenditures includes almost every relevant budget classification including: natural resources (percentage depletion, intangible drilling expenses); construction (accelerated depreciation); housing (accelerated depreciation, deduction for mortgage interest and real property taxes, tax credit for new housing); farming (cash method of accounting, expensing of capital expenditures, capital gain treatment for certain assets held for sale); investment (dividend exclusion, capital gain); and so on. A tax expenditure apparatus of this magnitude and scope is bound to be complex because in each situation an exception is made to the general rule. However, the potential for complexity does not stop with the current set of tax expenditure items. Exceptions have a tendency to breed exceptions, and these exceptions other exceptions which are of a higher order of complexity. When preferential treatment is granted to

one group, it is not long before others can demonstrate that they are equally deserving of special consideration. Each additional exception is strongly defended by its supporters usually on the basis of improved equity.¹²

Possibilities for Simplification

It is the view of some tax experts that nothing can be done about the complexity of the income tax system, because a complex society with a complex economic system cannot avoid a complex tax system.¹³ This statement is partially true. However, much complexity in the tax law is not the result of either a complex society or a complex economic system. There is a great deal of complexity which is the result of distinctions which are made among sources of income, types of deductions, types of taxpaying entities, etc., which are not essential to the revenue raising function of an income tax. The capital gains distinction is a prime example of this type of unnecessary distinction which results in complexity. In general, the greatest possibilities for a lessening of complexity lie in neutralizing the distinctions created by the above mentioned tax expenditure apparatus.

It has also been suggested that simplification cannot be obtained without the sacrifice of equity.¹⁴ The argument is that complexity results from an attempt by Congress to respond to the needs of taxpayers who merit special treatment. Even conceding the equity argument, however, the question must be asked, is the additional complexity worth it? As Justice Jackson said in the Dobson case: "No other branch of the law touches human activities at so many points. It can never be made simple, but we can try to avoid making it needlessly complex."¹⁵ Also, as was stated earlier, equity is dependent upon the ability to measure the

income of taxpayers. The effect of the tax expenditure apparatus is to make meaningless any comparison of the taxable incomes of taxpayers. Thus, the relative taxpaying capacity of individuals cannot be measured, which destroys the concepts of both horizontal and vertical equity.

Suggestions for Simplification

One suggestion for simplification is that all sources of tax law be located in a single place.¹⁶ This would involve the codification of all substantive regulations of the Internal Revenue Service and also all court decisions. While the existence of all tax law in a single place may be of some help, especially if one must determine the relative weight to be granted to a particular authority, it is doubtful that much less complexity would be obtained. This is particularly so because a comprehensive code would itself be quite voluminous, and tax reporting services are already quite effective in gathering together the various sources of tax law. In addition, even if all tax laws were codified, it would still be necessary to examine the legislative history of the comprehensive code. In the case of judicially initiated code sections, this would require an examination of the court cases which gave rise to a particular code section, thus, partially defeating the purpose of a comprehensive code.

A second suggestion for simplification is the opposite of comprehensive codification; redraft the tax statutes in broad outline form.¹⁷ A common complaint concerning existing statutes is that too often they attempt to deal with specific, relatively unimportant situations, thus, resulting in a cluttering up of the statutes with a multitude of minor exceptions. The ideal statute under this conception would be one which states the rules of law in general terms with the Internal Revenue Service or courts treating exceptions on a case by case basis. The argument is

further stated that if the law were drafted in broad outline form, tax experts could more easily understand the basic structure of the statute, and less controversy concerning the proper application of the rules to specific circumstances would result. However, this probably represents wishful thinking in that it is the nature of taxpayers and their advisors to seek the limits of tax statutes. It is doubtful, to say the least, whether the application of a general rule to a specific case will result in less controversy than the application of a specific rule to a specific case. The effect of the general rule would probably be to give the taxpayer more room for maneuvering.

A third possibility for simplification lies in the draftsmanship of the statute itself. As Louis Eisenstein has stated; "The statutes are enveloped in a peculiar verbal fog of their own. The Internal Revenue Code, indeed, is a remarkable essay in sustained obscurity. It has all the earmarks of a conspiracy in restraint of understanding."¹⁸ The means of simplification lie here not in the substance of the statute but in the means of communicating that substance. It includes logical arrangement of Code sections, appropriate typographical changes, such as better use of bold face type to set out descriptive headings and sub-headings, better cross-referencing, shorter sentences, and possibly less legal terminology. The prospects for simplification in this area, however, are quite limited. First, it is too much to expect that a tax statute which reflects exceedingly complex substantive provisions can be simply stated in nonlegal terminology. Second, the change in language to a simpler form without changing the substance of the statute is an exceedingly delicate operation. The fact that a particular provision was poorly worded may have resulted in litigation to clarify the poor

wording, and a change in the language to a simpler form could well result in another round of litigation.

Each of the first three possibilities for increased simplicity have in common the fact that there is no change in the substance of the statute, but merely a change in the method of presenting the tax law. Real prospects for increased simplicity lie in substantive changes in the income tax provisions themselves.

Since every rule in substantive tax law is an attempt to draw a distinction, the volume of rules and decisions necessary to define the limits of a distinction can be reduced only if the number of distinctions attempted to be drawn are reduced. Much simplification could result without radical change in the prevailing concept of taxable income. For example, the elimination of the deduction for extraordinary medical expenses or casualty losses in excess of \$100 would remove small parts of the tax law which have become increasingly complex. The same could be said for the elimination of most itemized deductions and exemptions, and their elimination would not affect the prevailing concept of net income.

There is, however, a limit to the extent which the tax law can be simplified by the above method unless there is a willingness to eliminate certain basic distinctions which hold key positions in the structure of the tax law. As Henry Simons has said in his pioneer work Federal Tax Reform:

Simplicity in modern taxation is a problem of basic architectural design. Present legislation is insufferably complicated and nearly unintelligible. If it is not simplified, half of the population may have to become tax lawyers and tax accountants. Present laws are marvelously well built. But they are abominable structurally. They lack structure or sound foundational plan. . . .

As regards personal income taxation, which mainly concerns us here, it is easier to promise simplification than to deliver it.

It can, we believe, be delivered in large measure. . . .

Four general prescriptions may be offered in passing;

1. We should greatly reduce present emphasis on the year as an accounting period. . . .

2. We should avoid arbitrary special treatment for any particular kind of income or deduction. There should be no special-interest dispensations in the prescribed methods of income determination. . . .

3. We should stop tax avoidance by simple fundamental measures, instead of constantly diverting the avoidance stream from particular channels by legislative gadgets. . . .

4. We should not perpetuate or multiply temporal categories in the law. . . .¹⁹

Thus, there should be an elimination of the tax difference between ordinary income and capital gain and between tax exempt income and other income. There should be no difference between realized and unrealized gains. And there should be no difference in tax whether an item was accounted for in one year or another. Neutralization of these basic distinctions requires a definition of net income in terms of net change in economic position over a relatively long period of time. In theory all economic enhancement would be brought into the tax computation over time; and if an appropriate averaging device were utilized, timing differences could also be almost perfectly neutralized. This would result in a tax statute which is the ultimate in simplicity from a structural standpoint.

These changes, of course, would require radical changes in the concept of net income. In addition, a de-emphasis of the year as an accounting period and the elimination of the realization concept would result in great administrative burdens, which are the antithesis of simplification. However, the elimination of arbitrary special treatment of particular kinds of income or deduction would neutralize some of the distinctions which are the source of much complexity in our federal income tax laws; and this could be accomplished without radical change

in the traditional concept of income.

Some tentative conclusions can be drawn from this analysis of simplification of federal income tax provisions. There can be no great reduction in the complexity of the law through formal changes in its structure, while the substance of the law is left unchanged. The prospects for simplicity are somewhat brighter, however, when certain distinctions relating primarily to itemized deductions are blunted. The neutralization of these distinctions, which would leave the substance of the net income tax unchanged, provides important though only limited possibilities for simplification. The real possibilities for simplification lie in the elimination of the germinal distinctions which underlie the substance of federal income tax law. However, if for administrative reasons the year is maintained as the time period for tax measurement, and the concepts of realization and a progressive income tax are also maintained, real simplification would appear to lie in the area of neutralizing distinctions between types of income and deductions.

This would imply the elimination of special treatment of capital gains and losses, the elimination of any tax exempt income, such as, interest on municipal bonds, and the elimination of types of deductions which are treated differently from other types of deductions, such as, percentage depletion. A list of tax provisions that could be eliminated by neutralizing tax distinctions which are not essential to the concept of an annual net income tax can be obtained from a listing of the tax expenditures published by the House Ways and Means Committee in June 1973, and prepared by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation. This list, segregated by budget function is reproduced as appendix C.

The Capital Gain Distinction as a Source of Complexity

The basic difficulty which arises when one tries to distinguish between capital gain and ordinary income is that in terms of the common denominator, dollars of taxpaying capacity, there is no difference. In fact, it is this absence of distinction which causes a rather unusual coalition of taxpayers to call for an elimination of special treatment for capital gains and losses. On the one hand, there are individuals with large incomes but little or no capital gains who would like to see preferential treatment of capital gains eliminated, usually accompanied by a lowering of the top tax brackets. They are primarily concerned with horizontal equity. On the other hand, taxpayers in the lower tax brackets want preferential treatment of capital gains to be eliminated because it is a strongly regressive element in a nominally progressive income tax. Their concern, of course, is with vertical equity. The definitional problems resulting from the capital gains distinction have been called insoluble by one writer who likened the capital gains problems to those which would exist if "for some reason or another, [it was decided] to tax wages at half the rate of salaries."²⁰

The term "capital gain" has been used for such a long time by so many people, that it has become quite familiar to most individuals. This familiarity oftentimes leads to the mistaken impression that a capital gain can be readily distinguished from something called ordinary income. Nothing could be further from the truth. The capital gain distinction is a creature of the law, and as such, depends upon legal definition and interpretation for its existence. Furthermore, the legislative definition is confined to a few relatively short sections. It is only when the definition must be interpreted and applied to a particular

fact situation that the enormity of the definitional problems begins to surface. Since the legislative definition of capital gain is stated in quite broad terms, the responsibility for delimiting the boundaries of the definition has been left to the administrative and judicial branches of government, primarily the courts. With the obviously beneficial tax differential between capital gains and ordinary income, taxpayers have sought to have as much income as possible taxed as capital gain, which places tremendous pressure on a loosely drawn capital gains definition. With the Treasury Department cast in the role of "protector of the revenue," controversy was, and is inevitable. The responsibility for arbitrating disputes between the taxpayer and government rests with the judiciary. The judicial system responded to their responsibility by issuing conflicting opinions regarding many fact situations which were essentially identical. In other cases, the judiciary attempted to make more specific the boundaries of the capital gain definition which was loosely drawn by Congress.

The net result is that the difficulties resulting from the definitional approach to capital gains are quite formidable. Not only are the difficulties formidable, but they are also insoluble as long as a distinction remains between a dollar of income called capital gain, and a dollar of income called ordinary income. The approach used in the past to reduce the pressure exerted by taxpayers on the capital gain definition, has been to reduce the tax differential between capital gain and ordinary income. By reducing the differential, the advantage is lessened. It is presumed that since the tax advantage is smaller, the pressure to utilize the capital gain advantage will be lessened. The current tax differential for individuals between the maximum tax on capital gain and

and the maximum tax on earned income is 13.5% (50% - 36.5%). However, the current tax differential between unearned income and capital gain is 33.5% (70% - 36.5%), which is not an insignificant amount. The only way to entirely eliminate the pressure on the capital asset definition, along with the resulting complexity, is to neutralize the distinction between capital gain and ordinary income. Unless this is done, the capital gain area will remain a jungle of complexity, through which the taxpayer, his advisors, and the government will continue to wander.

Indications of Complexity

To most taxpayers, contact with federal income tax laws is limited to tax forms which must be completed annually. From the standpoint of these taxpayers, simplicity probably means a number of things. The minimization of arithmetic. The elimination or minimization of record-keeping requirements. And the reduction of tax return forms to a few which can be filled in rapidly without having to dig into old records. The tax forms themselves which daily face taxpayers and their advisors, however, are merely reflective of the underlying statutory provisions which they attempt to administer. A complex statute can only result in complex forms. These forms include forms for returns, elections, supporting statements, aids in computation, worksheets, applications for exemption, and many others. Just choosing the correct form for a business transaction can be a difficult problem. An enumeration of so called "public use" forms or, to use the words of Internal Revenue Service Publication 481 (Description of Principal Federal Tax Returns, Related Forms and Publications), "those forms which the taxpayer may need to originate action on a tax matter," results in a list of 344 separate forms.²¹ The list would include everything from Form 1040A (Short Form,

U.S. Individual Income Tax Return) to Form 7018 (Employer's Order Blank for Forms) which is used to order more forms,

Selecting the proper form, however, is only the beginning of the taxpayer's difficulties; the forms must be completed and filed. Due to the complexity of the income tax provisions, approximately one-half of all taxpayers (over 35 million in 1973), sought paid advice in filing their tax returns.²² This excludes those who sought the free advice and assistance from the Internal Revenue Service. Even with this assistance, the number of errors in returns is alarmingly high. Former acting Commissioner of the Internal Revenue Service, Mr. Raymond F. Harless, has stated in testimony before the House subcommittee of the committee on government operations:

As of April 30, 1973, 4,977 tax returns were prepared by tax practitioners "shopped" by IRS. Of the 4,977 returns obtained, 3,031 (61%) were correctly or substantially correctly prepared; 834 (17%) incorrectly prepared but non-fraudulent and 1,112 (22%) were potentially fraudulent. In one checkup of IRS employees, a sample of 603 returns were examined, of which 447 (74%) contained some type of technical or mathematical error or omission.²³ (318 in favor of the taxpayer, 129 in favor of the government).

In order to reduce the number of errors the Internal Revenue Service administers a comprehensive program of taxpayer assistance and education. The Taxpayer Service Division of the Internal Revenue Service responded to approximately 34.5 million taxpayer inquiries in 1974.²⁴ In addition, mini-computers were used to automatically prepare individual income tax returns on Form 1040A, and an Integrated Data Retrieval System was installed in all 58 district offices and 169 other offices in the United States and Puerto Rico.²⁵ Also, the Internal Revenue Service administers a Spanish-speaking taxpayer assistance program, and a volunteer income tax assistance program to assist Spanish-speaking taxpayers and low-income people, retired persons, and others who cannot afford to

have their returns prepared by tax practitioners.²⁶ The Internal Revenue Service recognizes the complexity of the income tax laws and the difficulty taxpayers have in complying with them, therefore, as much assistance as possible is offered to taxpayers.

Another indication of complexity in the tax laws, is the number of taxpayer and Revenue Agent requests for "technical advice" from the Office of the Assistant Commissioner (Technical) in the National Office concerning the proper application of the tax laws to a particular set of facts. For the fiscal year ending June 30, 1974 there were 14,017 taxpayer requests and 1,602 revenue agent requests.²⁷ In addition to "technical advice" which is furnished in connection with the audit of a taxpayer's return, the Internal Revenue Service published in the Internal Revenue Bulletin for 1974, "636 Revenue Rulings, 44 Revenue Procedures, 13 Public Laws relating to Internal Revenue Matters, 5 Committee Reports, 7 Executive Orders, 37 Treasury Decisions containing new or amended regulations, 10 Delegation Orders, 3 Treasury Department Orders, 5 Court Decisions, 7 Notices of Suspension and Disbarment from Practice before the Service, and 150 Announcements of general interest."²⁸ All for the guidance of taxpayers, tax practitioners, and Internal Revenue Service personnel.

The problems with complicated returns do not end with their filing; they must be audited. Arithmetic must be checked, amounts must be verified, returns may have to be selected for closer scrutiny and interviews with taxpayers and their representatives may take place. For the fiscal year ending June 30, 1974, a total of 121.6 million returns of all kinds were filed,²⁹ Of these, 95.0 million were income tax returns and the remainder employment, estate, gift, or excise tax returns.³⁰

The arithmetic was checked on 84.5 million returns and found to be in error on 5.1 million returns.³¹ Also, for the fiscal year ending June 30, 1974, 2.2 million returns were selected for audit including 2.0 million income tax returns.³²

After the returns have been audited, if controversy exists between the taxpayer and government, a conference at the district or appellate levels of the Internal Revenue Service may result. For the fiscal year 1974, the appeals function within the Internal Revenue Service disposed of 47,602 cases by agreement which is about 97% of all disputed cases.³³ Of the 3% disputed cases not settled by the administrative appeals system, the Tax Court tried 997 cases; and the United States District Courts and Court of Claims tried 369 cases.³⁴ Each of these sources of tax information add complexity to the income tax law in that taxpayers or their advisors must be aware of them in order to properly determine their tax liability and/or to avoid undesirable tax consequences when planning economic transactions.

Complexity, as it relates to federal income taxes, is not solely the result of the number of different sources of tax law or the volume of the provisions emanating from these sources. Complexity also results from the interaction of various provisions which are joined to form intricate patterns, difficult to understand. It is the intricate interrelationships of these provisions that provide much of the uncertainty for taxpayers and their advisors when planning economic transactions. By way of illustration, section 483 of the Code calls for the imputation of interest on deferred payment contracts if the stated interest rate is less than 4%. The sole purpose of this section is to deter taxpayers who are selling assets which would result in a capital gain from

overstating the selling price in exchange for a lower interest rate. From an economic standpoint, of course, interest is included through the higher than market selling price. From a compliance and administrative standpoint, preventing the conversion of ordinary income into capital gain is not the only effect of section 483. As described in the 1974 Ernst and Ernst National Tax Training Program manual section 483 could possible:

. . . create personal holding company problems; terminate a valid election to be an electing Sub-chapter S corporation; create a non-deductible loss under section 267; affect the qualification of a stock option; disqualify installment reporting; and affect the status of an otherwise tax free reorganization.³⁵

Consequently, the effort to restrict taxpayers' use of the capital gain provisions resulted in ripple effects some of which were probably undreamed of when the statute was drafted. In discussing the complexity of tax laws and the ignorance of the Members of Congress who vote on them, Representative Wright Patman stated, "the tax laws are passed with the Members not knowing exactly what they mean."³⁶

Costs of Complexity

The cost of administration and compliance is without a doubt greatly increased because of complex income tax laws. These costs are both monetary and non-monetary in nature. As an indication of the monetary cost of administration of the internal revenue laws, the estimated budget for the Internal Revenue Service for fiscal year 1975 is \$1.881 billion.³⁷ While no dollar estimate of compliance costs have been made, it would seem reasonable to expect that annual compliance costs are at least this great; especially considering the fact that there are an estimated 250,000 attorneys, accountants, and trained commercial tax return preparers, preparing more than 35 million tax returns.³⁸

In addition to the direct costs of administration and compliance, there are many important indirect costs. Included among these indirect costs are the costs of training and education. Most tax advisors have a substantial investment in their knowledge and understanding of the tax laws. This investment is both monetary and non-monetary; monetary from the standpoint of an investment in formal educational programs and in the tools of his trade necessary to remain abreast of the most recent changes in the tax law, and non-monetary from the standpoint of the time and effort necessary to master the tax law. It is interesting to note that for the tax expert there are substantial real costs involved in any significant changes in the tax law; whether these changes are designed to simplify the law or whether they are made for other reasons. However, one must take a long view when considering a move to an admittedly better tax system and not be overly concerned with short term costs and inconvenience. Without this long view, the status quo would always be maintained and change would never take place.

Additional monetary costs include the legislative costs of researching, drafting, and enacting the statutes; and the judicial costs of adjudicating controversy which results from complex provisions. Finally, there is the inestimable cost to taxpayers who inadvertantly overpay their taxes because of a lack of knowledge of the intricacy of the tax laws and an inability to afford or obtain competent tax advice.

As important and substantial as the monetary costs of complexity are, perhaps of even greater importance are the non-monetary costs of complexity. The income tax system in the United States is based on the principle of self-assessment. In turn, this principle is based upon taxpayer goodwill without which the system would cease to function.

Complicated tax provisions which the taxpayer cannot understand may cause some taxpayers to become annoyed or even hostile--a potentially dangerous attitude in a system which depends to a great extent on voluntary cooperation on the part of the public. This annoyance or hostility may be evidenced in a number of ways. A taxpayer might react against having to turn to a professional to prepare his return, or he might object to find that he overpaid his taxes at some time in the past because he did not understand the complexities of a particular tax provision, or he might rebel at finding that he just misses a preferential provision even though his situation is seemingly identical to the preferred case. Given this annoyance, a taxpayer may convince himself that he is justified in ignoring complex tax laws which are difficult to understand and more importantly may be difficult for the government to effectively police. As Randolph E. Paul has said, ". . . laws are made for men. Men must live by them. They must understand them, for understanding is the first step in orderly compliance."³⁹

Another important cost of complexity is the opportunity cost of those involved in tax work. Tax work is essentially non-productive. Much time and talent is devoted to tax planning designed to maximize tax benefits and this effort produces nothing for society as a whole. As one writer in the field of taxation has stated, ". . . the golden opportunity of this decade could be lost to us because our top talent was consecrating itself to the invention of new and better capital gains."⁴⁰ Complexity within the tax laws, therefore, is manifested in many different ways, some avoidable others unavoidable. The common denominator among all manifestations of complexity is that they are all costly. Complexity is costly in monetary terms, and perhaps even more importantly when taxpayer morale is affected, in non-monetary terms.

Summary

The causes of complexity can be divided into three categories:

(1) complexity resulting from the scope of the economic system itself, (2) complexity inherent to a net income tax, and (3) complexity resulting from provisions grafted onto the basic structure of the income tax which bear no basic relation to that basic structure and which are not a necessary part of its operation. Of the three sources of complexity, the first two offer no hope for simplification. Hope for simplification lies in the third category. Within the third category, many knowledgeable writers believe that the capital gain and loss provisions result in a greater amount of complexity than any other single notion. The effect of the capital gain and loss provisions on the scope and complexity of the federal income tax law is examined in Chapter IV.

FOOTNOTES CHAPTER III

¹Webster's Third New International Dictionary of the English Language, Unabridged (Springfield, Mass.: G. and C. Merriam Company, 1961).

²Lynch v. Turrish, 247 U.S. 224 (1918).

³Dr. T. S. Adams, cited by Randolph E. Paul, Taxation for Prosperity (New York: Bobbs-Merrill, Co., 1947), p. 28.

⁴Standard Federal Tax Reports--Taxes on Parade (Chicago: Commerce Clearing House, Inc., June 25, 1975), p. 2.

⁵Annual Report 1974 Commissioner of Internal Revenue (Washington, D.C.: U.S. Government Printing Office), pp. 10-11.

⁶For a comprehensive theoretical discussion of progressive taxation, see Harry Kalven and Walter J. Blum, The Uneasy Case for Progressive Taxation (Chicago: Phoenix Books, 1953).

⁷See Note, "Tax Equity and Ad Hoc Legislation," Harvard Law Review 84 (1971): 640-663.

⁸Paul, Taxation for Prosperity, p. 707.

⁹Internal Revenue Code, sec. 61.

¹⁰Stanley S. Surrey, Pathways to Tax Reform (Cambridge: Harvard University Press, 1973).

¹¹Stanley S. Surrey, "Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail," Law and Contemporary Problems 34 (1969): 684.

¹²For a discussion of equity as it applies to the taxing process, see Louis Eisenstein, The Ideologies of Taxation (New York: The Ronald Press Company, 1961), chapter 7 and Philip Stern, The Great Treasury Raid (New York: Random House, Inc., 1964), chapter 15.

¹³See the remarks by Edwin S. Cohen before the American Bar Association National Institute on Tax Reform, Tax Lawyer 23 (1970): 424.

¹⁴Paul, Taxation for Prosperity, p. 411.

- ¹⁵ Dobson v. Commissioner, 64 S. Ct. 239, 243 (1943).
- ¹⁶ Walter J. Blum, "Simplification of the Federal Income Tax Law," Tax Law Review 10 (1954) : 240.
- ¹⁷ Ibid., pp. 241-242.
- ¹⁸ Eisenstein, The Ideologies of Taxation, p. 215.
- ¹⁹ Henry C. Simons, Federal Tax Reform (Chicago: The University of Chicago Press, 1950), pp. 28-30.
- ²⁰ Carl S. Shoup, testimony before the Joint Committee on the Economic Report on Federal Tax Policy for Economic Growth and Stability, 84th Cong., 1st sess. (1955), p. 345.
- ²¹ Federal Tax Forms (Chicago: Commerce Clearing House, 1975), pp. 51-71.
- ²² Tax Return Preparation--Internal Revenue Service and the Commercial Return Preparer, Hearing Before a Subcommittee of the Committee on Government Operations, House of Representatives, 93rd Cong., 1st Sess. (1973), p. 16.
- ²³ Ibid., p. 14.
- ²⁴ Annual Report 1974 Commissioner of Internal Revenue, p. 2.
- ²⁵ Ibid., p. 3.
- ²⁶ Ibid., p. 5.
- ²⁷ Ibid., p. 31.
- ²⁸ Ibid., p. 31.
- ²⁹ Ibid., p. 9.
- ³⁰ Ibid.
- ³¹ Ibid., p. 14.
- ³² Ibid., p. 19.

³³Ibid., p. 23.

³⁴Ibid.

³⁵Ernst and Ernst, 1974 National Tax Training Program, level I, chapter 15, p. 10.

³⁶103 Congressional Record 6356 (1957).

³⁷The Budget of the United States Government, Fiscal Year 1975, p. 233.

³⁸Tax Return Preparation--Internal Revenue Service and the Commercial Return Preparer, p. 16.

³⁹Paul, Taxation for Prosperity, p. 409.

⁴⁰Walter J. Blum, "How the Growth of Favored Tax Treatment Affects Taxpayers and Practitioners, Journal of Taxation 4 (1956): 29.

CHAPTER IV

THE EXAMINATION OF SELECTED SOURCES OF FEDERAL INCOME TAX LAW

Sources of Federal Tax Law

The sources of federal income tax law are many and varied. The three primary sources, however, are: (1) legislative, (2) administrative, and (3) judicial.

Within the legislative area we have the statute itself, which currently is the Internal Revenue Code of 1954. The Internal Revenue Code is incorporated into the United States Code as Title 26. It is divided into Subtitles which are subdivided into Chapters, Subchapters, Parts, Sections, Subsections, Paragraphs, and Subparagraphs. When speaking of the legislative sources of tax law, it is not enough to consider only the statute. In addition, the committee reports of the House Ways and Means Committee, the Senate Finance Committee, and the Conference Committee must be considered in order to determine the oftentimes elusive "intent of Congress."

The administrative sources of federal tax law consist primarily of regulations and rulings. In general, regulations have been classified into two categories--legislative and interpretive.¹ Legislative regulations result from the authority which Congress has delegated to the Secretary of the Treasury to prescribe detailed rules for certain Code sections. Interpretive regulations are designed to interpret the various sections of the Code and to serve as a guide for the Internal Revenue

Service and the taxpaying public.² The second major source of tax law within the administrative area results from the rulings program of the Internal Revenue Service. The program consists of two types of rulings--letter rulings and Revenue Rulings. As stated by Mr. Mitchell Rogovin, former chief counsel of the Internal Revenue Service:

A letter "ruling" is a written statement issued to a taxpayer by the Office of Assistant Commissioner (Technical) in the National Office which interprets and applies the tax laws to a specific set of facts. Rulings are issued only by the National Office and are generally issued in respect to transactions that have not been consummated. A "Revenue Ruling" is an interpretation by the Service, issued only by the National Office and published in the Internal Revenue Bulletin for the information and guidance of taxpayers, Service personnel, and others concerned.³

Letter rulings are designed to provide the taxpayer with certainty regarding the tax consequences of a particular transaction. These letter rulings may only be relied upon by the taxpayer to whom issued, and then only if all the resulting facts of the transaction are as stated in the initial request for ruling. Published Revenue Rulings, on the other hand, are designed to promote uniformity of interpretation among the public and among Internal Revenue Service personnel, and to inform all interested parties as to the position of the Commissioner of the Internal Revenue Service with respect to particular issues. In addition to regulations and rulings, administrative sources of tax law include Revenue Procedures, Technical Information Releases, Opinions of the Attorney General, and many others. Published Revenue Procedures usually result from internal management documents of the Internal Revenue Service. Their function is to make public, procedural statements issued primarily for internal use which affect the rights and duties of taxpayers. In addition, Revenue Procedures are used to communicate to taxpayers instructions which are given to Internal Revenue Service personnel for the

purpose of simplifying audits. The Technical Information Release is designed to communicate quickly with tax specialists and technical publications important technical developments which are not of interest to the layman or the general news media. It would be used for example, to inform tax technicians of a new election which has to be made within a relatively short period of time. Of the administrative sources of tax law, the Code of Federal Regulations is the most important, followed closely by published Revenue Rulings. All other sources are of relatively less importance.

The third basic source of tax law is the judiciary. Regardless of how articulate a statute may be, and how detailed and clear the interpretive regulations and the many informal administrative rulings may be, there is usually room for interpretation and controversy. Taxpayers and their advisors are always on the hunt, and rightly so, for methods of minimizing their taxes. The Supreme Court has recognized the principle that "when the law draws a line, a case is on one side of it or the other," and if the case is on the safe side, it is "none the worse legally that a party has availed himself to the full of what the law permits."⁴

The federal judiciary consists of the Tax Court, District Courts, Court of Claims, Court of Appeals, and the Supreme Court. The Tax Court decisions, in turn, can be divided into "officially reported" decisions and "memorandum" decisions. The officially reported or regular Tax Court decisions are usually those decisions which involve an interpretation of law. Memorandum decisions, on the other hand, generally require the determination of a fact situation to be applied within previously settled legal principles.

Scope of the Study

The purpose of this study was to determine the effect of the capital gain and loss provisions on the scope and complexity of the sources of federal income tax law by examining elements from each of the sources of tax law; legislative, administrative, and judicial. Only the areas of federal tax law dealing with income tax provisions were considered. This restriction had the effect of limiting the study within the legislative area to those provisions arising under sections 1-1399 of the Internal Revenue Code of 1954. Within the administrative and judicial areas, the study was limited to administrative rulings and court decisions resulting from problems and controversy created by the income tax provisions (sections 1-1399) of the Internal Revenue Code. Specifically excluded from examination were the statutory provisions dealing with the federal gift tax, estate tax, excise taxes, and social security taxes, as well as any administrative rulings or court decisions arising thereunder.

Within the legislative area, the research was limited to the Internal Revenue Code of 1954. The legislative reports of the House Ways and Means, Senate Finance, and Conference Committees were not examined since they are reflective of the content of the Code.

Within the administrative area, the research was limited to an examination of the published Revenue Rulings of the Internal Revenue Service. Private or "letter" rulings, technical advice memoranda, and other such information are not currently available for public inspection. The current position of the Internal Revenue Service is that this type of information is exempt from the disclosure requirements of the Freedom of Information Act.⁵ The availability of letter rulings, technical

advice memoranda, etc., is currently at issue in a suit pending before the United States Court of Appeals for the Sixth Circuit in Fruehauf Corp. v. Internal Revenue Service. The Revenue Rulings examined were limited to the Rulings issued in the 10 year period 1964 through 1973. The 10 year period 1964 through 1973 was selected because it was long enough to provide a reasonable estimate of the characteristics being examined, yet short enough to allow a relatively large sample to be selected from each year in order to gain the desired precision.

Also excluded from examination was the Code of Federal Regulations, which is the official interpretation of the Internal Revenue Code by the Treasury Department. The Code of Federal Regulations was excluded because the sections of the Regulations affected by special treatment of capital gains and losses are the same sections of the Internal Revenue Code which are affected by special treatment of capital gains and losses. Consequently, the proportion of Regulations dealing with capital gains and losses should be approximately the same as the proportion of Code sections dealing with capital gains and losses.

Within the judicial area, cases arising in each jurisdiction of the federal courts were examined with a view to determining the effect that the capital gain and loss provisions have on the issues involved in the cases studied. The cases examined included cases from the United States Tax Court, both memorandum and regular decisions, the District Courts, Court of Claims, Court of Appeals, and Supreme Court. Only cases concerning issues arising from sections 1-1399 of the Internal Revenue Code were examined, and these for the 10 year period 1964 through 1973.

Research Methodology

Sections 1-1399 of the Internal Revenue Code have been analyzed in order to determine; (1) the proportion of Code sections which would be completely eliminated if there were no special treatment of capital gains and losses, (2) the proportion of Code sections which have capital gain and loss implications and would be affected by elimination of special treatment of capital gains and losses, but for other reasons could not be entirely eliminated, and (3) the proportion of Code sections which would be unaffected by the absence of special treatment of capital gains and losses.

An example of the first classification is section 1245 which calls for the recapture of depreciation as ordinary income upon the sale of depreciable personal property at a gain. The purpose of this provision is to prevent a taxpayer from taking a depreciation deduction from ordinary income, especially at an accelerated rate, and then selling the asset for an amount in excess of its book value and recognizing capital gain through the operation of section 1231, thus effectively turning ordinary income into capital gain.

Examples of the second classification are Code sections 531 through 537 dealing with the penalty tax on an excess accumulation of earnings. The purpose of these sections is to force corporations to pay dividends currently rather than retaining earnings beyond the reasonable needs of the business. Although these sections are related to capital gains, they are not entirely capital gain sections. There are basically three reasons that a taxpayer may not want his closely held corporation to pay current dividends; (1) a deferral of a dividend results in a deferral of the tax on that dividend, and other things being equal it is

always better to make a tax payment later rather than sooner, (2) the taxpayer may want to shift income from a current high tax bracket year to a future low bracket year with obvious tax benefits, and (3) the taxpayer may want his corporation to accumulate earnings with a view towards selling his stock at the appreciated value and realizing capital gain instead of ordinary dividend income. If special treatment of capital gains and losses were eliminated, the third tax saving motivation would be absent but the other two would remain. Consequently, sections 531 through 537 would have to remain because of the first two tax saving motivations, the pressure to utilize a closely held corporation for strictly tax saving reasons would be diminished, since the third tax saving motivation would be absent. In addition, it is probable that if a taxpayer expected to be taxed at ordinary income rates on the appreciation of his stock in his closely held corporation, he would be more inclined to pay current dividends rather than to accumulate liquid assets. This is particularly true given a progressive tax rate structure whereby the recognition of ordinary income in the year of realization may result in the taxpayer being in a much higher tax bracket than he would have been in had he realized periodic dividends over a number of years.

An example of the third classification is the definition of a dependent. Even if there were no special treatment of capital gains and losses, the complexity in the federal income tax law resulting from the existence of a dependency exemption would still remain. This threefold analysis of the Internal Revenue Code gives a quantitative indication of the effect of the capital gain and loss provisions on the scope and complexity of this source of federal income tax law.

The second major source of tax law originates in the administrative area. The published Revenue Rulings of the Internal Revenue Service were examined on a stratified random sample basis to determine: (1) the proportion of Revenue Rulings which would have been completely eliminated if there were no special treatment of capital gains and losses, (2) the proportion of Revenue Rulings which, while not dealing strictly with capital gains and losses, have capital gain and loss implications, and (3) the proportion of Revenue Rulings which have no capital gain and loss implications. It was necessary to randomly sample the Revenue Rulings rather than to analyze all of them because of the sheer volume issued during the 10 year period 1964 through 1973 (see table 4).

The third major source of tax law which was examined was in the judicial area and included memorandum Tax Court, regular Tax Court, District Court, Court of Claims, Court of Appeals, and Supreme Court decisions. Because of the large number of memorandum Tax Court, regular Tax Court, District Court and Court of Appeals decisions for the period 1964 through 1973 (see table 4), they were examined on a stratified random sample basis to determine the proportion of cases in each of the three classifications. However, since the number of Court of Claims and Supreme Court cases for the period 1964 through 1973 was relatively small (see table 4), they were examined on a 100% basis to determine the proportion of cases falling into the above listed categories.

The analysis of court decisions presented a special problem because of the possibility of multiple issues being involved in a single court case. The second classification category was stated as containing Code sections or Revenue Rulings which had capital gain and loss implications though not exclusively so, that is, there may be other reasons

TABLE 4

THE NUMBER OF REVENUE RULINGS AND COURT CASES CONCERNING INTERNAL
REVENUE CODE SECTIONS 1-1399, 1964 THROUGH 1973

	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Total
Revenue Rulings	152	166	249	330	432	449	459	421	378	436	3,462
Memorandum Tax											
Court	298	294	245	243	269	266	331	314	229	252	2,741
Regular Tax Court	143	126	125	125	168	172	192	171	147	146	1,515
District Court	187	172	186	200	154	182	150	169	144	136	1,680
Court of Claims	27	22	25	33	33	28	29	15	19	24	255
Court of Appeals	241	171	201	171	164	183	198	196	186	187	1,898
Supreme Court	-	8	5	3	3	4	3	1	4	5	36

that would prevent a Code section or Revenue Ruling from being eliminated even if there were no special treatment of capital gains and losses.

This also held true for court cases, but in addition, the second classification for court cases includes those cases in which there were multiple issues one of which was wholly or partly a capital gain issue.

The multiple issue problem did not exist with respect to the analysis of the Internal Revenue Code or the published Revenue Rulings of the Internal Revenue Service.

The Relative Investment Advantage Attributable to Capital Gains

With few exceptions, there are only three methods that a taxpayer may utilize to reduce his income tax assessment. First, a taxpayer may utilize devices to defer the payment of taxes, assuming a constant marginal tax bracket. The advantage in this method lies not in reducing the total number of tax dollars paid, but in the timing of the tax payment. Given the choice between the payment of a dollar of income tax today and a dollar of income tax a year from today, the knowledgeable taxpayer will choose the latter because the present value of the dollar to be paid in

the future is less than the present value of the dollar to be paid today. The deferred tax is equivalent to an interest free loan from the government to the taxpayer and over time can become quite valuable because of the mechanics of compound interest. There are many provisions in the Internal Revenue Code which benefit the taxpayer by allowing him to defer the payment of income taxes beyond the time that an economic gain has arisen. Examples include the installment method of reporting gain on deferred payment sales, tax free exchanges, and tax free reorganizations. However, in addition to these rather obvious methods of deferring the payment of income taxes is the not so obvious method resulting from the accounting convention of realization, whereby taxable income is not recognized until a taxable sale or exchange occurs.

The second method a taxpayer may use to reduce his income tax assessment is to have economic enhancement taxed at less than the full statutory rates. Examples include preferential treatment of capital gains, the maximum tax on earned income, tax exempt income, and income averaging. Each of these methods have in common the fact that income is removed from the progressive tax rate schedule and taxed in a preferential manner.

The third method to reduce income taxes is also aimed at escaping from the full effect of the progressive income tax rate schedule. Devices used by taxpayers to obtain this goal include shifting income from high tax bracket to low tax bracket years by controlling realization, or moving income from high tax bracket entities to low tax bracket entities through the use of family partnerships, gifts in trust, and closely held corporations, among others.

A problem, mentioned earlier, existed in the classification of

Code sections, Revenue Rulings, and court cases, because it was not always possible to state that a particular section or ruling or court case would have been unnecessary if there were no special treatment of capital gains and losses. The possibility existed that a particular provision was necessary in order to curtail all three of the general methods a taxpayer uses to reduce his income taxes. However, by eliminating special treatment of capital gains and losses, the pressure to utilize a particular tax saving device would be reduced but not eliminated. An example of this mentioned earlier is the penalty tax on the excess accumulation of earnings. From a conceptual standpoint, it would be ideal to be able to quantify the reduced pressure to use a particular tax saving device if there were no special treatment of capital gains and losses. Since this is not possible, the second classification used in this study, capital gain and loss implications, but not 100% capital gain and loss, was necessary.

Even though it is not possible to quantify the reduced pressure to utilize a particular tax savings device, it is possible to measure the relative importance, from a dollar standpoint, of the capital gains advantage as opposed to the tax deferral advantage, holding a taxpayer's marginal tax bracket constant. If a taxpayer acquires an investment at the beginning of year 1, the following matrix (figure 2) indicates the possible methods of taxing the appreciation of that investment. Cell a_{11} is the ideal method of taxing income according to the Haig-Simons definition of income, that is, appreciation would be taxed annually as ordinary income. Cell a_{22} is the method currently being used to tax appreciation, that is, it is taxed only upon realization in a taxable transaction as capital gain. If there were no special treatment of capital gains and

FIGURE 2

METHODS OF TAXING APPRECIATION

a_{11} Ordinary income taxed annually	a_{12} Capital gain taxed annually
a_{21} Ordinary income taxed upon realization	a_{22} Capital gain taxed upon realization

losses, but the realization convention remained, appreciation would be taxed upon realization in a taxable transaction as ordinary income, cell a_{21} . The accumulation of \$1 of investment after taxes at an annual rate of appreciation of 10%, marginal ordinary income tax rates of 30, 50, and 70%, and tax methods as indicated in cells a_{11} , a_{21} , and a_{22} of figure 2, is shown in table 5.

For example, at a marginal ordinary income tax rate of 50%, the original \$1 investment would accumulate to \$34.1945 after taxes if realized at the end of 40 years and the appreciation was taxed as long term capital gain. If the appreciation was taxed as ordinary income when realized at the end of the 40th year, the original \$1 investment would accumulate to \$23.1297, If the appreciation was taxed annually as ordinary income at a marginal tax rate of 50%, and the net of tax proceeds reinvested, the original \$1 investment would accumulate to \$7.0400 at the end of 40 years.

Total investment advantage is defined as $(a_{21} - a_{11})$. Using the

TABLE 5

THE ACCUMULATION OF \$1 OF INVESTMENT AFTER TAXES AT THE END OF N YEARS AT AN ANNUAL RATE OF APPRECIATION OF 10% AND MARGINAL ORDINARY INCOME TAX RATES OF 30, 50, AND 70%*

Tax Years	Ordinary income taxed annually (a_{11})			Ordinary income taxed upon realization (a_{21})			Capital gain taxed upon realization** (a_{22})		
	30%	50%	70%	30%	50%	70%	30%	50%	70%
1	1.0700	1.0500	1.0300	1.0700	1.0500	1.0300	1.0850	1.0750	1.0650
5	1.4026	1.2763	1.1593	1.4274	1.3053	1.1832	1.5189	1.4579	1.3968
10	1.9672	1.6289	1.3439	2.1156	1.7969	1.4781	2.3546	2.1953	2.0359
15	2.7590	2.0789	1.5580	3.2240	2.5886	1.9532	3.7006	3.3829	3.0652
20	3.8697	2.6533	1.8061	5.0093	3.8638	2.7183	5.8684	5.2596	4.7229
25	5.4274	3.3864	2.0938	7.8843	5.9174	3.9504	9.3595	8.3760	7.3926
30	7.6123	4.3219	2.4273	12.5146	9.2247	5.9348	14.9820	13.3371	11.6921
35	10.6766	5.5160	2.8139	19.9717	14.5512	9.1307	24.0370	21.3268	18.6166
40	14.9745	7.0400	3.2620	31.9815	23.1297	14.2778	38.6204	34.1945	29.7685

*All amounts rounded to nearest .0001.

**The effective rates of taxation for cell (a_{22}) are 15, 25, and 35% which reflect the fact that they are long term capital gain rates.

above figures, total investment advantage is $(34.1945 - 7.0400)$. It is the difference between the amount of dollars that would accumulate by the end of the 40th year if the investment was realized at the end of the 40th year and the appreciation was taxed as long term capital gain, and the amount of dollars that would accumulate by the end of the 40th year if the 10% annual appreciation was taxed annually as ordinary income and the proceeds, net of tax, reinvested. The investment advantage attributable to the capital gain element is $(a_{22} - a_{21})$. Using the above figures, the investment advantage attributable to the capital gain element is $(34.1945 - 23.1297)$. It is the difference between the amount of dollars that would accumulate by the end of the 40th year if the appreciation was taxed as capital gain and the amount of dollars that would accumulate by the end of the 40th year if the appreciation was taxed as ordinary income. The investment advantage attributable to the deferral element is defined as $(a_{21} - a_{11})$. Again, using the above figures, the investment advantage attributable to the deferral element is $(23.1297 - 7.0400)$. It is the difference between the amount of dollars that would accumulate at the end of 40 years if the appreciation was realized and taxed as ordinary income at the end of the 40th year, and the accumulated dollars at the end of 40 years if the appreciation was taxed annually as ordinary income and the proceeds, net of taxes, reinvested.

The percentage of investment advantage attributable to capital gains is $(a_{22} - a_{21}) / (a_{22} - a_{11})$, which is the investment advantage attributable to capital gains divided by the total investment advantage (see table 6). The percent of investment advantage attributable to deferral is $(a_{21} - a_{11}) / (a_{22} - a_{11})$, which is the investment advantage

TABLE 6
INVESTMENT ADVANTAGE ATTRIBUTABLE TO CAPITAL GAINS WITH
MARGINAL TAX BRACKETS OF 30, 50, AND 70%

	Total investment advantage ($a_{22} - a_{11}$)			Investment advantage attributable to capital gains ($a_{22} - a_{21}$)			Percent of investment advantage attributable to capital gains ($a_{22} - a_{21}$)/($a_{22} - a_{11}$)		
	30%	50%	70%	30%	50%	70%	30%	50%	70%
Tax									
Years									
1	.0150	.0250	.0350	.0150	.0250	.0350	100.00	100.00	100.00
5	.1163	.1816	.2375	.0915	.1526	.2136	78.68	84.03	89.94
10	.3874	.5664	.6920	.2390	.3984	.5578	61.69	70.34	80.61
15	.9416	1.3040	1.5072	.4766	.7943	1.1120	50.62	60.91	73.78
20	1.9987	2.6063	2.9168	.8591	1.3958	2.0046	42.98	53.55	68.73
25	3.9321	4.9896	5.2988	1.4752	2.4586	3.4422	37.52	49.27	64.96
30	7.3697	9.0152	9.2648	2.4674	4.1124	5.7573	33.48	45.62	62.14
35	13.3604	15.8108	15.8027	4.0653	7.7756	9.4859	30.43	42.85	60.03
40	23.6459	27.1545	26.5065	6.6389	11.0648	15.4907	28.08	40.75	58.44

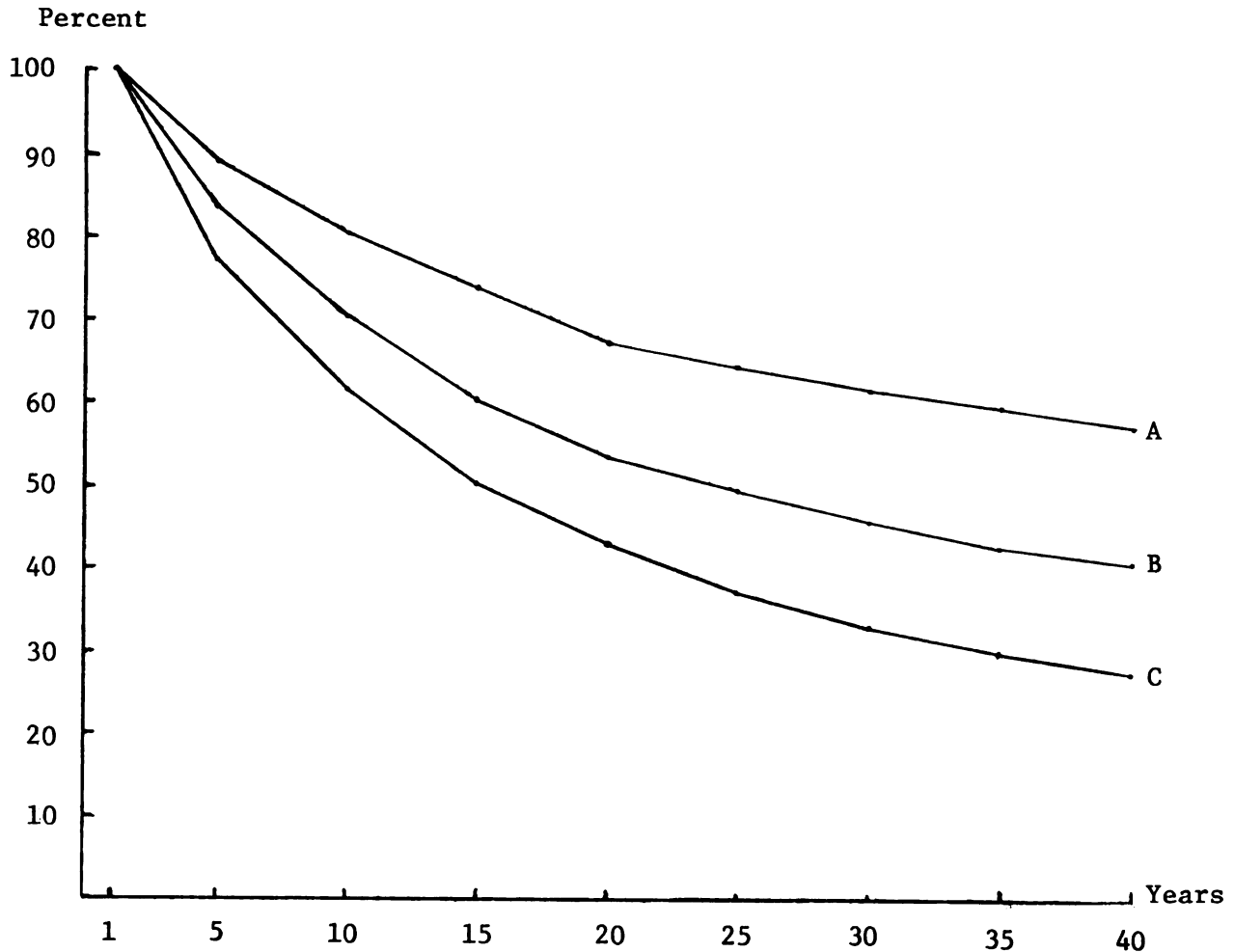
attributable to deferral divided by total investment advantage.

As table 6 indicates, the relative investment advantage attributable to capital gains increases as an individual's marginal tax bracket increases. Consequently, it is the higher bracket taxpayer who exerts the greatest amount of pressure on those provisions of the tax law which allow him to realize capital gain instead of ordinary income. As table 6 also indicates, the relative investment advantage attributable to capital gains decreases the longer the asset is held, because the longer it is held the more important the deferral advantage becomes. If there were no special treatment of capital gains, the pressure by the high bracket, short term investor to utilize those provisions which allow him to recognize capital gains instead of ordinary income would disappear completely. However, since the deferral advantage still remains, those provisions in the tax law which have multiple objectives, such as the penalty tax on an excess accumulation of earnings would have to remain. However, since the capital gain advantage would no longer exist, taxpayer pressure to utilize these provisions as a means of reducing their income taxes would be diminished, and there would be less controversy with resulting litigation and thus in one sense less complexity.

The percent of investment advantage attributable to capital gains is illustrated in figure 3. The assumptions of figure 3 are identical to those in table 6. Curve A represents a marginal ordinary income tax bracket of 70%, curve B a marginal ordinary income tax bracket of 50%, and curve C a marginal ordinary income tax bracket of 30%. It is important to notice that although all three curves start out with an investment advantage attributable to capital gains of 100%, at the end of the first year, curve A which represents a marginal ordinary income

FIGURE 3

THE PERCENT OF INVESTMENT ADVANTAGE ATTRIBUTABLE TO CAPITAL GAINS,
WITH MARGINAL TAX BRACKETS OF 30, 50, AND 70%



tax bracket of 70%, maintains a much higher proportion of investment advantage attributable to capital gains by the end of the 40th year. This indicates that there would be exerted much more pressure by those in relatively high tax brackets to utilize those provisions which permit the recognition of capital gains.

Statistical Measures

Since statistical sampling techniques were employed in this study, it was first necessary to make certain decisions with respect to sample precision and the desired level of confidence. These decisions

were particularly important because the size of the sample is directly dependent on them; the narrower the required precision and the higher the level of confidence, the larger must be the sample size. For example, it would be meaningless to speak of an error range of sample results which is as wide as $\pm 30\%$ or a confidence level of 80%. On the other hand, in order to obtain a sample precision as narrow as $\pm .5\%$ and a confidence level of 99%, the size of the necessary sample would be prohibitive. With these constraints in mind a sample precision of $\pm 5\%$ and a confidence level of 95% were chosen.

In addition to the required precision and confidence level, in order to determine the necessary sample size, it was necessary to know the population size and to estimate the maximum rate of occurrence of the characteristic of the population being measured. With regard to the latter, the use of an estimated rate of occurrence of 50% would be the most conservative estimate possible, which would result in choosing the largest sample necessary to obtain the desired precision at the required confidence level. If the estimated rate of occurrence is less than 50%, the necessary sample size to obtain the desired precision and confidence level would likewise be smaller.

Within the legislative area, the income tax provisions of the Internal Revenue Code sections 1-1399, were surveyed on a 100% basis. Within the administrative area, the published Revenue Rulings of the Internal Revenue Service covering sections 1-1399 of the Internal Revenue Code were examined on a random sample basis for the years 1964 through 1973. Within the judicial area, court cases involving issues arising under Code sections 1-1399 were examined for the period 1964 through 1973. Memorandum Tax Court, regular Tax Court, District Court, and Court of

Appeals decisions were examined on a random sample basis. Court of Claims and Supreme Court decisions were surveyed on a 100% basis. Table 4 contains the population size, by years, of the administrative and judicial sources of tax law. Table 4 contains only those Revenue Rulings and court decisions which deal with problems arising from Code sections 1-1399.

Sample Size

Using the statistical formulas (1) $E = z\hat{\sigma}_{\hat{p}}$ and
 (2) $\hat{\sigma}_{\hat{p}} = \frac{\hat{p}(1-\hat{p})}{n} \frac{N-n}{N-1}$ the sample size was determined. The factor $\frac{N-n}{N-1}$ is called the finite correction factor, needed for the case that sampling is without replacement.

E = the maximum allowable error or the difference between the population proportion and the sample proportion; $\pm .05$.

z = the normal deviate for a 95% confidence level; 1.96.

$\hat{\sigma}_{\hat{p}}$ = the estimated standard error of a proportion.

$\hat{p}$ = the sample proportion.

N = the population size.

n = the sample size.

As stated above, the sample size is dependent upon the estimated population proportion of the characteristic being examined, with the most conservative estimate being .5 which would result in the largest sample. Since there was no prior information available as to the estimated proportion of the characteristics of the population being examined, a pilot study was made to determine this proportion. For the pilot study, twenty Revenue Rulings and twenty court cases from each court category were selected on a random sample basis for each year 1964 through 1973. The rulings and cases were analyzed to determine the proportion in each

of the three classification categories. With the information obtained from the pilot study, it was determined that the maximum estimated proportion of the characteristics being examined for purposes of determining the ultimate sample size was .30 for Revenue Rulings and memorandum Tax Court decisions, and .40 for regular Tax Court, District Court, and Court of Appeals decisions. Using .30 and .40 respectively, an ultimate sample size of thirty per year or three-hundred was determined for Revenue Rulings, memorandum Tax Court decisions, and regular Tax Court decisions, and an ultimate sample size of thirty-one per year or three-hundred ten was determined for District Court and Court of Appeals decisions.

Sample Results

The three categories used to classify the Code sections, Revenue Rulings, and court cases were: (1) 100% capital gain and loss, (2) capital gain and loss implications but not entirely capital gain and loss, and (3) no capital gain and loss implications. As stated earlier, the first category contains those sections, rulings, and cases that would not exist were there no special treatment of capital gains and losses. The second category contains those sections, rulings, and cases that have capital gain and loss implications but may not be entirely eliminated because of noncapital gain and loss considerations. In addition, for court cases, the second classification contains those cases in which there exist multiple issues, one or more of which are wholly or partially capital gain and loss issues, and one or more of the others, which are not capital gain and loss issues. The third category contains those sections, rulings, or cases that would have been unaffected were there no special treatment of capital gains and losses.

The sample results for Revenue Rulings and court cases are presented in Table 7, and for convenience, the first category is designated "all", the second category "some", and the third category "none". The sample results for Court of Claims and Supreme Court decisions are based on a 100% sample, that is, all cases were examined. The cases and rulings selected for examination and the results of the analysis are contained in appendix A.

TABLE 7

SAMPLE RESULTS BY YEAR FOR REVENUE RULINGS AND COURT CASES

Revenue Rulings:											
	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Total
All	0	0	1	1	2	2	2	0	3	3	14
Some	1	5	1	3	3	2	0	3	1	1	20
None	29	25	28	26	25	26	28	27	26	26	266
Memorandum Tax Court:											
	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Total
All	1	3	2	1	3	1	1	2	0	3	17
Some	7	3	6	7	6	2	4	1	6	8	50
None	22	24	22	22	21	27	25	27	24	19	233
Regular Tax Court:											
	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Total
All	3	7	5	2	2	5	3	0	5	4	36
Some	5	3	6	4	8	7	2	5	8	4	52
None	22	20	19	24	20	18	25	25	17	22	212
District Court:											
	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Total
All	5	4	6	7	6	1	3	3	4	3	42
Some	3	8	5	5	4	7	7	6	7	6	58
None	23	19	20	19	21	23	21	22	20	22	210

TABLE 7 (Continued)

Court of Claims:											
	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Total
All	5	2	6	5	6	3	5	2	1	3	38
Some	1	2	1	11	7	6	4	2	3	3	40
None	21	18	18	17	20	19	20	11	15	18	177
Court of Appeals:											
	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Total
All	6	4	7	6	2	4	6	3	5	3	46
Some	5	3	6	5	6	7	3	2	5	4	46
None	20	24	18	20	23	20	22	26	21	24	218
Supreme Court:											
	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	Total
All	0	3	3	0	1	0	1	0	0	0	8
Some	0	0	0	1	1	2	0	0	2	0	6
None	0	5	2	2	1	2	2	1	2	5	22

Research Results

The analysis of Code sections 1-1399 resulted in the examination of 537 sections. Of these 537 sections, 44 or 8.19% would be completely eliminated if there were no special treatment of capital gains and losses, 174 or 32.59% have capital gain or loss implications although they could not be completely eliminated, and 218 or 59.22% would be unaffected by the elimination of special treatment of capital gains and losses. The Code sections examined and the results of the examination are listed in appendix B.

Within the administrative area of the tax law, Revenue Rulings were examined on a stratified random sample basis. Therefore, it was necessary to combine the sample results to obtain an unbiased estimate of the population proportion. To accomplish this, the statistical

formula (3) $\hat{p} = \frac{\sum_{h=1}^{10} \hat{p}_h N_h}{\sum_{h=1}^{10} N_h}$ was used.

$\hat{p}$ = an unbiased estimate of the population proportion.

$\hat{p}_h$ = the sample proportion of the characteristic being examined for the hth strata, h being from one to ten years.

N_h = the population size for the hth strata.

The unbiased estimate of the proportion of Revenue Rulings which would have been unnecessary if there were no special treatment of capital gains and losses was .0546 or 5.46%. The unbiased estimate of the proportion of Revenue Rulings which had capital gain and loss implications was .0624 or 6.24%.

Since a confidence level of 95% was specified, it was possible to determine the estimated proportion of the characteristic being examined, and the 95% confidence interval. To accomplish this it was necessary to compute an estimate of the standard error of a sample proportion using the statistical formula:

$$(4) \quad \hat{\sigma}_{\hat{p}} = \frac{1}{\sum_{h=1}^{10} N_h} \sum_{h=1}^{10} \frac{\hat{p}_h (1 - \hat{p}_h)}{n_h} \frac{N_h - n_h}{N_h - 1} N_h^2$$

Where $\hat{\sigma}_{\hat{p}}$ is an estimate of the standard error of a sample proportion, and all other terms are as defined earlier.

The 95% confidence interval computed for the first category, which contained those Revenue Rulings which would have been unnecessary were there no special treatment of capital gains and losses, was .0546 $\pm$.0267. Thus the precision actually obtained was much greater (the error is smaller) than the originally required $\pm$.05. The 95% confidence interval computed for the second category, which contained those Revenue Rulings having capital gain and loss implications, was .0624 $\pm$.0267. If

the two categories were combined, that is, the combined category consisted of Revenue Rulings that were either 100% capital gain and loss, or had capital gain and loss implications, the 95% confidence interval for this new category would be $.1170 \pm .0368$.

Within the judicial area of the tax law, court cases were also examined on a stratified random sample basis, so it was necessary to use formula (3) in order to combine the sample results to obtain an unbiased estimate of the population proportion. The results of these estimates are presented in Table 8. As in the case of Revenue Rulings, the 95% confidence interval was computed for the court cases using formula (4).

TABLE 8

ESTIMATES OF THE PROPORTIONS OF COURT CASES WHICH WERE 100% CAPITAL GAIN AND LOSS, HAD CAPITAL GAIN AND LOSS IMPLICATIONS, OR BOTH, FOR THE PERIOD 1964 THROUGH 1973

	All	Some	All + Some
Memorandum Tax Court	.0572	.1619	.2191
Regular Tax Court	.1161	.1736	.2897
District Court	.1380	.1852	.3232
Court of Claims	.1490	.1569	.3059
Court of Appeals	.1511	.1480	.2991
Supreme Court	.2222	.1667	.3889
All Court Cases Combined	.1104	.1655	.2759

The results of this computation are shown in Table 9. It should be noticed that in Table 9, there is no confidence interval around the proportion for Court of Claims cases or Supreme Court cases. The reason for this is that these proportions are the result of a 100% sample, therefore, there will be no sampling error.

TABLE 9

95% CONFIDENCE INTERVALS ABOUT THE ESTIMATED PROPORTIONS OF COURT CASES WHICH WERE 100% CAPITAL GAIN AND LOSS, HAD CAPITAL GAIN AND LOSS IMPLICATIONS, OR BOTH FOR THE PERIOD 1964 THROUGH 1973

	All	Some	All + Some
Memorandum Tax Court	.0572 ± .0251	.1619 ± .0384	.2191 ± .0435
Regular Tax Court	.1161 ± .1318	.1736 ± .0382	.2897 ± .0455
District Court	.1380 ± .0349	.1852 ± .0390	.3232 ± .0472
Court of Claims	.1490 ± .0000	.1569 ± .0000	.3059 ± .0000
Court of Appeals	.1511 ± .0368	.1480 ± .0361	.2991 ± .0466
Supreme Court	.2222 ± .0000	.1667 ± .0000	.3889 ± .0000
All Court Cases Combined	.1104 ± .0153	.1655 ± .0188	.2759 ± .0223

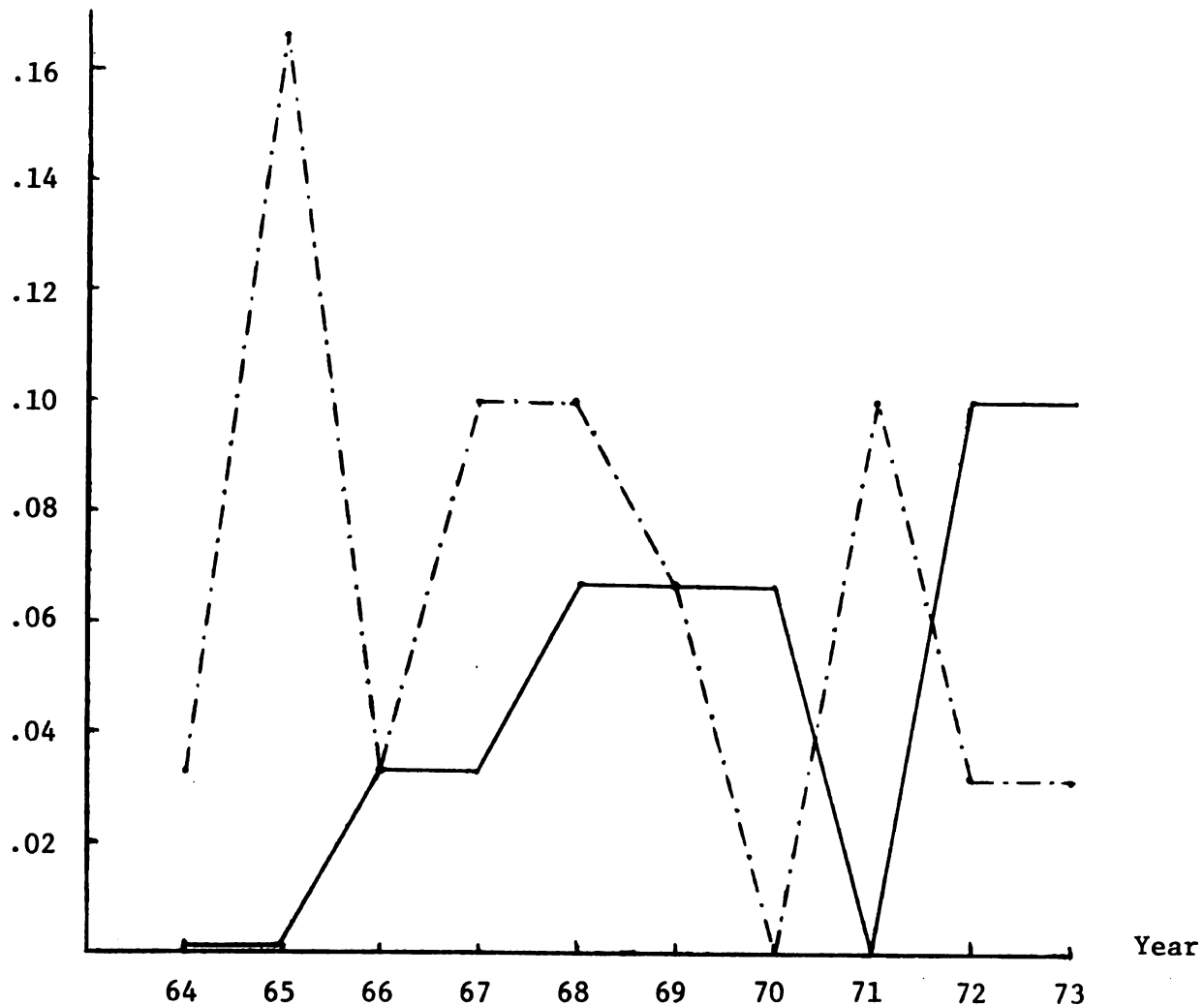
Trends

In examining the various proportions resulting from the research, the question naturally arises as to whether or not there was a discernable trend over the ten year period for Revenue Rulings and court cases. In the case of Revenue Rulings, the following graph (figure 4) shows the proportion of Revenue Rulings for each year which either would have been unnecessary were there no special treatment of capital gains and losses, or though necessary for other reasons, did have capital gain and loss implications.

FIGURE 4

ESTIMATED PROPORTIONS OF REVENUE RULINGS WHICH WERE EITHER 100%
CAPITAL GAIN AND LOSS OR HAD CAPITAL GAIN AND LOSS
IMPLICATIONS, FOR THE PERIOD 1964 THROUGH 1973

Proportion

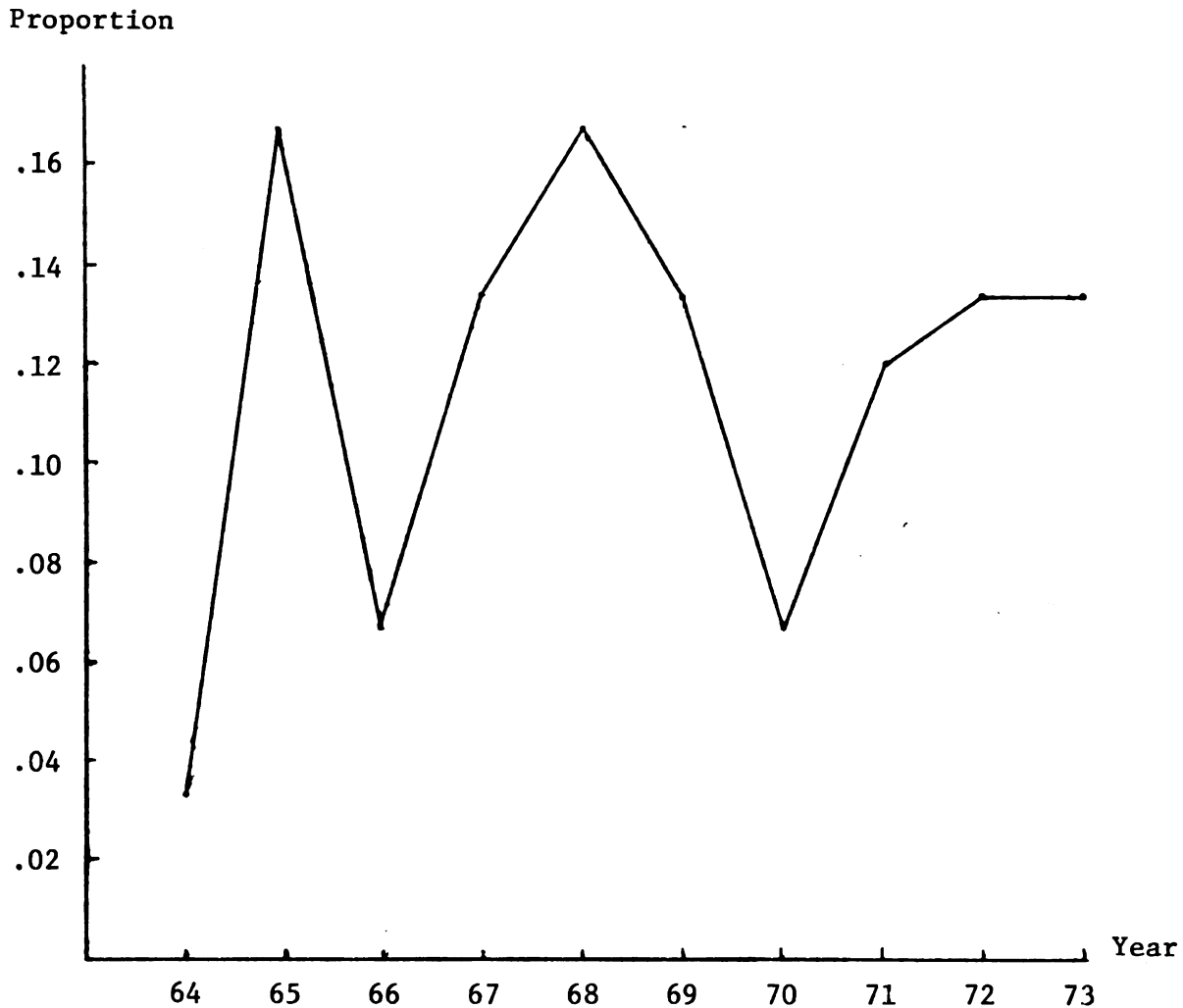


———— 100% capital gain and loss.
----- capital gain and loss implications.

Figure 5 represents the two categories in figure 4 combined, that is, it shows the estimated proportions of Revenue Rulings which were 100% capital gain and loss plus the estimated proportions of cases which had capital gain and loss implications, even though for other reasons they would not have been eliminated.

FIGURE 5

ESTIMATED PROPORTIONS OF REVENUE RULINGS WHICH WERE 100% CAPITAL GAIN AND LOSS RULINGS PLUS THE ESTIMATED PROPORTIONS OF REVENUE RULINGS WHICH HAD CAPITAL GAIN AND LOSS IMPLICATIONS, FOR THE PERIOD 1964 THROUGH 1973



In order to determine if there was a trend involved for the three categories, the proportions were combined into two periods, 1964 through 1968 and 1969 through 1973. The estimated proportions of cases in the three categories, that is, the 100% capital gain and loss category, the capital gain and loss implications category, and the combination of 100% capital gain and loss and capital gain and loss implications category, are presented in Table 10.

TABLE 10

ESTIMATED PROPORTIONS OF REVENUE RULINGS WHICH WERE EITHER 100% CAPITAL GAIN AND LOSS, HAD CAPITAL GAIN AND LOSS IMPLICATIONS, OR BOTH, FOR THE PERIODS 1964 THROUGH 1968 AND 1969 THROUGH 1973

	1964-1968	1969-1973
100% Capital Gain and Loss	.0362	.0661
Capital Gain and Loss Implications	.0881	.0463
100% Capital Gain and Loss Plus Capital Gain and Loss Implications	.1243	.1124

From Table 10 it appears that the trend for Revenue Rulings that were 100% gain or loss was upwards; the proportion for the second five year period being almost double that of the proportion for the first five year period. The trend for the proportion of Revenue Rulings with capital gain and loss implications, however, was just the opposite; the proportion for the first five year period being almost double that of the proportion for the second five year period. For the two categories combined, only a slight downward trend existed, reflecting the opposite trends of the components of the third category.

In order to statistically test the existence of a trend, the following three sets of hypotheses for the three categories of Revenue Rulings are proposed:

- (a) H_0 : The proportion of Revenue Rulings for the period 1964 through 1968 which were 100% capital gain and loss was the same as the proportion of Revenue Rulings for the period 1969 through 1973 which were 100% capital gain and loss. $p_1 = p_2$.
- H_1 : The proportion of Revenue Rulings for the period 1964 through 1968 which were 100% capital gain and loss was less than the proportion of Revenue Rulings for the period 1969 through 1973 which were 100% capital gain and loss; there was an upward trend, $p_1 < p_2$.

At the 5% level of significance, the decision criteria are: reject H_0 if $z < -1.64$; accept H_0 if $z \geq -1.64$ where

$$(5) \quad z = \frac{\hat{p}_1 - \hat{p}_2}{\hat{\sigma}_{\hat{p}_1 - \hat{p}_2}}.$$

$\hat{p}_1$ = the estimated proportion of Revenue Rulings for the period 1964 through 1968.

$\hat{p}_2$ = the estimated proportion of Revenue Rulings for the period 1969 through 1973.

$\hat{\sigma}_{\hat{p}_1 - \hat{p}_2}$ = the estimated standard error of the difference of sample proportions.

Since $\hat{p}_1 = .0362$, $\hat{p}_2 = .0661$, and $\hat{\sigma}_{\hat{p}_1 - \hat{p}_2} = .0260$, then $z = -1.15$. Since $z (-1.15)$ is not less than $z_\alpha (-1.64)$, accept H_0 . The test does not show that the proportion of Revenue Rulings which were 100% capital gain and loss rulings for the period 1964 through 1968 was significantly less than the proportion of Revenue Rulings which were 100% capital gain and loss rulings for the period 1969 through 1973.

(b) $H_0: p_1 = p_2$ for Revenue Rulings which had capital gain and loss implications, but were not 100% capital gain and loss rulings.

$$H_1: p_1 > p_2.$$

At the 5% level of significance, the decision criteria are: reject H_0 if $z > 1.64$; accept H_0 if $z \leq 1.64$. Since $\hat{p}_1 = .0881$, $\hat{p}_2 = .0463$, and $\hat{\sigma}_{\hat{p}_1 - \hat{p}_2} = .0288$, then $z = 1.45$. Since $z (1.45)$ is not greater than $z_\alpha (1.64)$, accept H_0 . The test does not show that the proportion of Revenue Rulings which had capital gain and loss implications for the period 1964 through 1968 was significantly greater than the proportion of Revenue Rulings for the period 1969 through 1973.

(c) $H_0: p_1 = p_2$ for Revenue Rulings which were 100% capital gain and loss rulings, plus those which had capital gain and loss implications.

$$H_1: p_1 > p_2.$$

At the 5% level of significance, the decision criteria are: reject H_0 if $z > 1.64$; accept H_0 if $z \leq 1.64$. Since $\hat{p}_1 = .1243$, $\hat{p}_2 = .1124$, and

$\hat{\sigma}_{\hat{p}_1 - \hat{p}_2} = .0377$, then $z = .3156$. Since $z (.3156)$ is not greater than $z_\alpha (1.64)$, accept H_0 . The test does not show that the two proportions were significantly different. In the three categories, therefore, there was no statistically significant trend either upward or downward at the 5% level of significance,

For all court cases combined, diagrams similar to figures 4 and 5 show the proportion of court cases in the three categories for the ten year period examined.

FIGURE 6

ESTIMATED PROPORTIONS OF ALL COURT CASES WHICH WERE EITHER 100% CAPITAL GAIN AND LOSS CASES OR HAD CAPITAL GAIN AND LOSS IMPLICATIONS FOR THE PERIOD 1964-1973

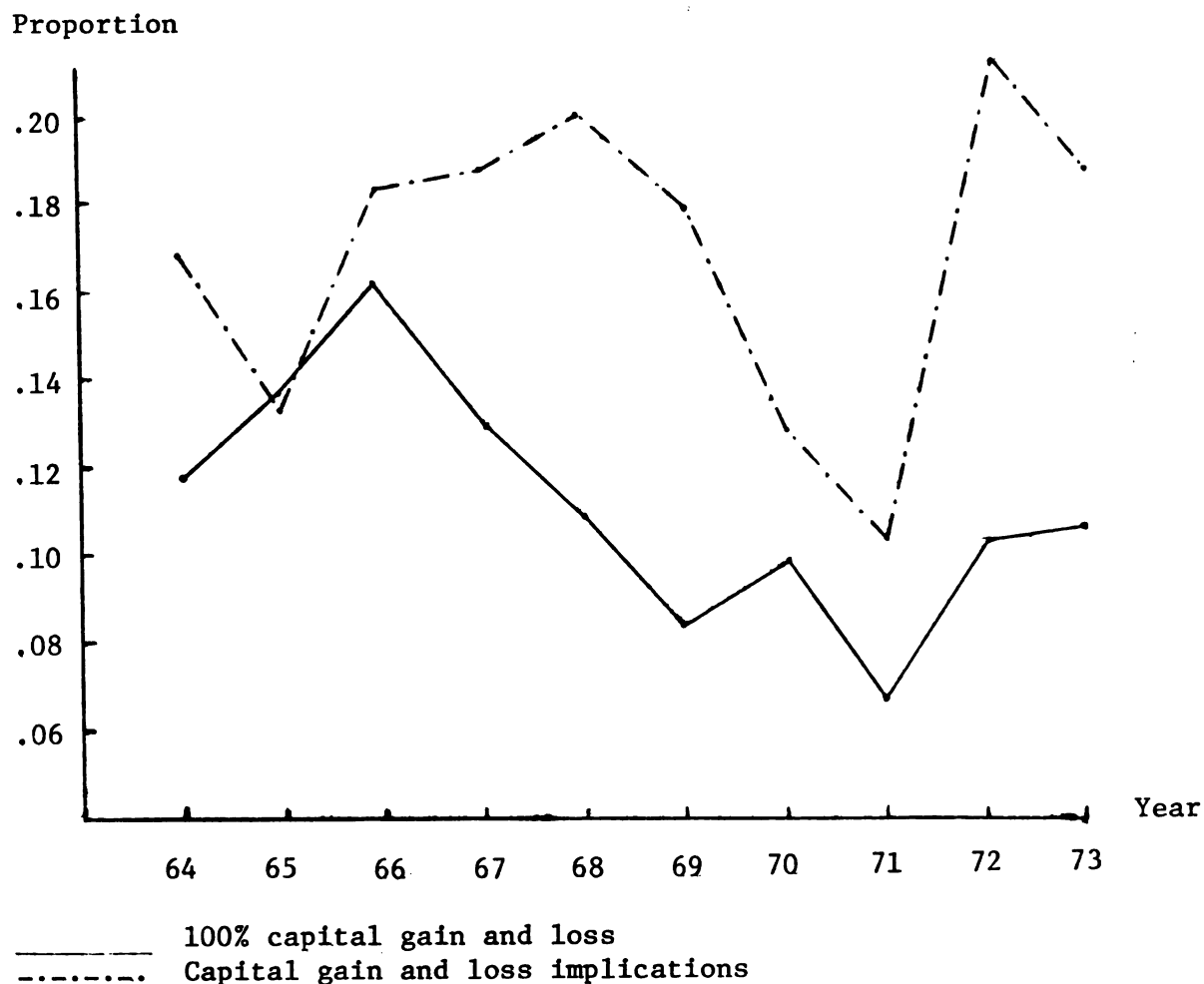
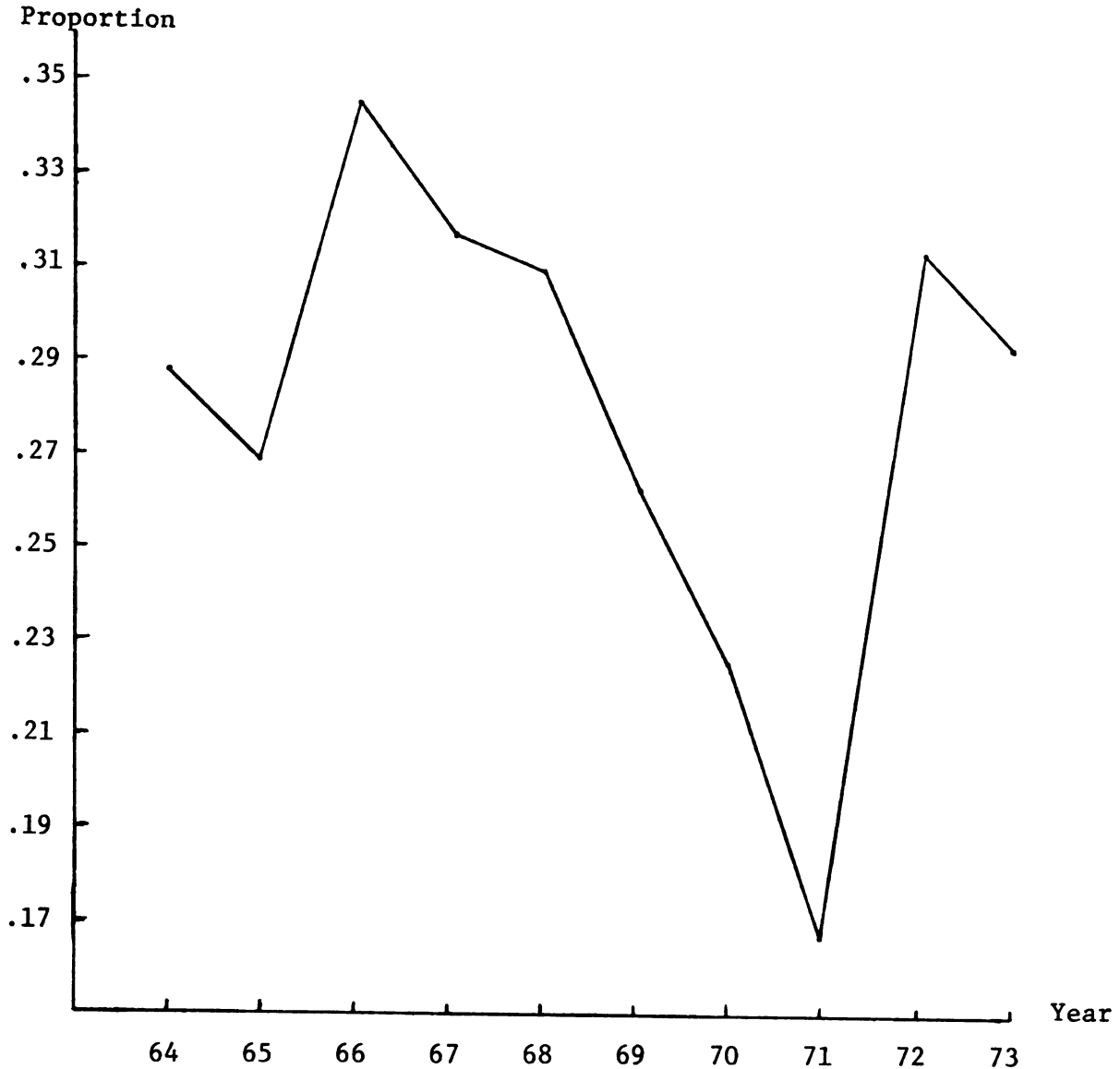


FIGURE 7

ESTIMATED PROPORTIONS OF COURT CASES WHICH WERE 100% CAPITAL GAIN AND LOSS CASES PLUS THE ESTIMATED PROPORTIONS OF COURT CASES WHICH HAD CAPITAL GAIN AND LOSS IMPLICATIONS, FOR THE PERIOD 1964-1973



As with Revenue Rulings, in order to determine if there were any trends involved, the proportion of cases in the three categories were combined into two time periods, 1964 through 1968 and 1969 through 1973. The results of this consolidation are shown in table 11.

As indicated by table 11, the proportion of court cases for the

TABLE 11

ESTIMATED PROPORTIONS OF ALL COURT CASES COMBINED WHICH WERE 100% CAPITAL GAIN AND LOSS CASES, HAD CAPITAL GAIN AND LOSS IMPLICATIONS, OR BOTH, FOR THE PERIODS 1964 THROUGH 1968 AND 1969 THROUGH 1973

	1964-1968	1969-1973
100% Capital Gain and Loss	.1304	.0909
Capital Gain and Loss Implications	.1742	.1567
100% Capital Gain and Loss plus Capital Gain and Loss Implications	.3046	.2476

second five year period was less than the proportion of cases for the first five year period in all three classification categories. As with Revenue Rulings, it is possible to statistically test whether or not the trend is significant. The following three sets of hypotheses are proposed:

(a) H_0 : The proportion of court cases for the period 1964 through 1968 which were 100% capital gain and loss was the same as the proportion of court cases for the period 1969 through 1973 which were 100% capital gain and loss. $p_1 = p_2$.

H_1 : The proportion of court cases for the period 1964 through 1968 which were 100% capital gain and loss was greater than the proportion of court cases for the period 1969 through 1973 which were 100% capital gain and loss. $p_1 > p_2$.

At the 5% level of significance, the decision criteria are: reject H_0 if $z > 1.64$; accept H_0 if $z \leq 1.64$. Since $\hat{p}_1 = .1304$, $\hat{p}_2 = .0909$, and $\hat{\sigma}_{\hat{p}_1 - \hat{p}_2} = .0155$, then $z = 2.5484$. Since z (2.5484) is greater than z_α (1.64), H_0 is rejected. The test shows that the proportion of court cases for the period 1964 through 1968 which were 100% capital gain and loss cases was significantly greater than the proportion of court cases for the period 1969 through 1973 which were 100% capital gain and loss cases, thus, there was a statistically significant downward trend.

(b) H_0 : $p_1 = p_2$ for court cases which had capital gain and loss implications but were not 100% capital gain and loss cases.

H_1 : $p_1 > p_2$.

At the 5% level of significance, the decision criteria are: reject H_0 if $z > 1.64$; accept H_0 if $z \leq 1.64$. Since $\hat{p}_1 = .1724$, $\hat{p}_2 = .1567$, and $\hat{\sigma}_{\hat{p}_1 - \hat{p}_2} = .0193$, then $z = .9067$. Since $z (.9067)$ is not greater than $z_\alpha (1.64)$, H_0 is accepted. There is no significant difference between the proportion of cases with capital gains implications for the periods 1964 through 1968 and 1969 through 1973, thus, there was not a statistically significant downward trend.

(c) $H_0: p_1 = p_2$ for court cases which were 100% capital gain and loss plus court cases which had capital gain and loss implications.

$$H_1: p_1 > p_2.$$

Since $\hat{p}_1 = .3046$, $\hat{p}_2 = .2476$, and $\hat{\sigma}_{\hat{p}_1 - \hat{p}_2} = .0229$, then $z = 2.4891$. Since 2.4891 is greater than 1.64, H_0 is rejected. The downward trend, between the two periods 1964 through 1968 and 1969 through 1973 for the combination of 100% capital gain and loss cases and capital gain and loss implication cases, was statistically significant at the 5% level of significance.

Relative Importance of the Categories

If the two categories, 100% capital gain and loss and capital gain and loss implications, are compared, it can be seen that the estimated proportion in the first category is smaller than the estimated proportion in the second category for both Revenue Rulings and all court cases combined (see table 12). It is possible to test whether or not the difference in the estimated proportion is statistically significant, that is, whether or not the capital gain and loss implication category contained a greater proportion of Revenue Rulings or court cases than the 100% capital gain and loss category.

TABLE 12

ESTIMATED PROPORTIONS OF REVENUE RULINGS AND COURT CASES IN THE
CATEGORIES 100% CAPITAL GAIN AND LOSS, AND CAPITAL GAIN
AND LOSS IMPLICATIONS

	Revenue Rulings	Court Cases
100% Capital Gain and Loss	.0546	.1104
Capital Gain and Loss Implications	.0624	.1655

For Revenue Rulings;

$$H_0: p_1 = p_2$$

$$H_1: p_1 \neq p_2$$

where p_1 = the proportion of Revenue Rulings in the capital gain and loss implication category and p_2 = the proportion of Revenue Rulings in the 100% capital gain and loss category. At the 5% level of significance, the decision criteria are: reject H_0 if $z > 1.64$; accept H_0 if $z \leq 1.64$. Since $\hat{p}_1 = .0624$, $\hat{p}_2 = .0546$, and $\hat{\sigma}_{\hat{p}_1 - \hat{p}_2} = .0192$, then $z = .4623$. Since $z (.4623)$ is not greater than $z_\alpha (1.64)$, H_0 is accepted. The proportions of Revenue Rulings in the two categories were not significantly different.

For court cases:

$$H_0: p_1 = p_2$$

$$H_1: p_1 > p_2$$

where p_1 = the proportion of court cases in the capital gain and loss implication category, and p_2 = the proportion of court cases in the 100% capital gain and loss category. Since $\hat{p}_1 = .1665$, $\hat{p}_2 = .1104$, and $\hat{\sigma}_{\hat{p}_1 - \hat{p}_2} = .0124$, then $z = 4.44$. Since $z (4.44)$ is greater than $z_\alpha (1.64)$, H_0 is rejected. At the 5% level of significance, there was a significantly larger proportion of court cases with capital gain and loss implications

than court cases which were 100% capital gain and loss.

Not only can the relative importance of the two categories be measured for each of the sources of tax law, but also the relative importance of each source of tax law within each category can be measured. From Table 13 it can be seen that within the category 100% capital gain and loss, the judicial source of tax law was the most important in terms of the proportion, and the administrative source the least important. In the category capital gain and loss implications, the legislative source of tax law predominated in terms of the proportion while the administrative source was the least important.

TABLE 13

RELATIVE IMPORTANCE OF THE LEGISLATIVE, ADMINISTRATIVE, AND JUDICIAL SOURCES OF TAX LAW WITHIN THE CATEGORIES 100% CAPITAL GAIN AND LOSS, AND CAPITAL GAIN AND LOSS IMPLICATIONS

100% Capital Gain and Loss		Capital Gain and Loss Implications	
Judicial	.1104	Legislative	.3259
Legislative	.0819	Judicial	.1655
Administrative	.0546	Administrative	.0624

The question arises as to whether or not these differences were statistically significant within the two categories. Using the test for the difference in sample proportions, each difference was statistically significant at the 5% level of significance for both categories. In the category 100% capital gain and loss, from the standpoint of the proportion of court cases, Code sections, and Revenue Rulings, the judicial source of tax law was the most important, and the administrative source the least important. In the category capital gain and loss implications, the legislative source of tax law was the most important and the administrative source again the least important.

Interpretation of the Research Results

The interpretation of the results of the research for the legislative sources of tax law (Internal Revenue Code) is relatively straightforward. If there were no special treatment of capital gains and losses, 44 Code sections or 8.19% of all Code sections dealing with the federal income tax could be excised from the tax law. In addition, there are 175 sections or 32.59% of all Code sections dealing with the federal income tax which have capital gain and loss implications even though they could not be completely eliminated because of other considerations. If the two categories are combined, a total of 219 sections or 40.78% of all Code sections dealing with the federal income tax are affected in some way by the concept of capital gain and loss. This is a quantitative measurement of the importance of capital gain and loss provisions, nothing has been said about the qualitative characteristics of these capital gain and loss provisions. From a qualitative standpoint, these capital gain and loss sections represent some of the most difficult to apply provisions in the Code--ranging from the complex computational difficulties associated with the alternative tax on long-term capital gains to the intricate rules associated with sales of property to determine whether or not the property was held "primarily for sale to customers in the ordinary course of business." Thus, not only are the capital gain and loss provisions important from a quantitative standpoint, they are also important qualitatively.

The interpretation of the research results for the administrative area is somewhat less straightforward than for the legislative area because the technique of stratified random sampling was used as opposed to an examination of the entire population. The effect of using a

sampling technique as opposed to a 100% examination is that the results are stated in terms of an unbiased estimate of the population proportion around which a confidence interval is constructed. For Revenue Rulings sampled, the estimated population proportion of Revenue Rulings that were 100% capital gain and loss was 5.46% with a 95% confidence interval of .0279-.0813. For Revenue Rulings that had capital gain and loss implications but could not be completely eliminated if there were no special treatment of capital gains and losses, the estimated population proportion was 6.24% and the 95% confidence interval was .0357-.0891. For the two categories combined, the estimated population proportion was 11.70% and the 95% confidence interval was .0802-.1538.

In all categories, there were statistically significantly less Revenue Rulings dealing either directly or indirectly with capital gain and loss provisions than is the case with either Code sections or court cases. This can probably be accounted for by the fact that Revenue Rulings are only one source, and not even the most important source, of tax law within the administrative area. The primary source for guidance as to the position of the Treasury Department in the interpretation of the Internal Revenue Code lies in their Regulations program. Since the Regulations are correlated with the Code, the results of the examination of the Code could also serve as an approximation of the proportion of Regulations affected by capital gain and loss issues. If the position of the Treasury relative to capital gain and loss issues is thoroughly presented in the Regulations, there would be no reason to reiterate that position by way of Revenue Rulings. Therefore, there would be a relatively small proportion of Revenue Rulings dealing with capital gain and loss issues.

For the judicial source of tax law, the interpretation of results is similar to that of the Revenue Rulings--there was an estimate of the population proportion around which a confidence interval could be constructed. The estimated population proportion and the 95% confidence level for each type of case was presented in Table 9. For the category 100% capital gain and loss cases, the estimated population proportions ranged from a low of 5.72% for memorandum Tax Court cases to a high of 22.22% for Supreme Court cases. For the category capital gain implication cases, the estimated population proportions ranged from a low of 14.80% for Court of Appeals cases to a high of 18.52% for District Court cases. For the two categories combined, the estimated population proportions ranged from a low of 21.91% for memorandum Tax Court cases to a high of 38.89% of Supreme Court cases,

If all court cases are combined, the estimated population proportion for 100% capital gain and loss cases was 11.04%, the estimated population proportion for capital gain and loss implication cases was 16.55%, and for the two categories combined, the estimated population proportion was 27.59%. The proportion of court cases which were 100% capital gain and loss was significantly larger at the 5% level of significance than either Code sections or Revenue Rulings in that category. The proportion of court cases that have capital gain and loss implications was significantly larger at the 5% level of significance, but significantly smaller than Code sections in that category. Thus from a relative standpoint, court cases had the greatest impact in the 100% gain and loss category, but were second in importance to Code sections in the capital gain and loss implication category (see table 11).

A final word of caution in interpreting the research results

should be mentioned. For Revenue Rulings and court cases, historical data provided the raw material for the research. This historical data cannot necessarily be relied upon as a prediction of the future. To illustrate, when Supreme Court cases were examined and analyzed, it was determined that 22.22% of the cases were 100% capital gain and loss cases. This does not mean that in the future 22.22% of all Supreme Court cases will be 100% capital gain and loss cases. This is particularly true for Supreme Court cases, since once an issue is settled by the Supreme Court, it becomes the law of the land and must be followed by everyone. That particular issue will not come before the Supreme Court again. Even with this caveat in mind, it can be seen that capital gain and loss provisions do have a significant impact upon our tax laws from a quantitative standpoint certainly, and probably also from a qualitative standpoint.

FOOTNOTES CHAPTER IV

¹Mitchell Rogovin, "The Four R's: Regulations, Rulings, Reliance, and Retroactivity—A View from Within," Standard Federal Tax Reporter, Vol. 6 (1973) : 67,035.

²Ibid.

³Ibid., p. 67,040.

⁴Bullen v. State of Wisconsin, 240 U.S. 625, 630-31 (1916).

⁵Specifically, it is the position of the Internal Revenue Service that these sources of information are exempt from the disclosure requirements of the Freedom of Information Act, 5 U.S.C. 552, in accordance with subsections (b)(3) as specifically exempted from disclosure by statute, including 26 U.S.C. 6103 and 7213 and 18 U.S.C. 1905, (b)(4) as trade secrets and commercial or financial information obtained from a person and privileged or confidential, (b)(5) as inter-agency or intra-agency memoranda or letters which would not be available by law to a party other than an agency in litigation with the agency and (b)(7) as investigatory records compiled for law enforcement purposes.

CHAPTER V

RECOMMENDATIONS

Summary

The purpose of this study was to examine the various sources of tax law with a view towards determining the effect that the capital gain and loss provisions have on the scope and complexity of the federal income tax law. The Internal Revenue Code, published Revenue Rulings of the Internal Revenue Service, and federal court cases were selected for examination from the legislative, administrative, and judicial branches of government respectively. The Code sections examined were limited to those dealing with the federal income tax, sections 1-1399. The Revenue Rulings and court cases examined were limited to those dealing with problems arising under Code sections 1-1399. In addition, the Revenue Rulings and court cases examined were limited to the ten year period 1964 through 1973. The Code sections examined were classified into three categories, (1) those Code sections which would be completely eliminated if there were no special treatment of capital gains and losses, (2) those Code sections which have capital gain and loss implications, but for other reasons could not be completely eliminated if there were no special treatment of capital gains and losses, and (3) those Code sections which are not affected by special treatment of capital gains and losses. Similarly, Revenue Rulings and court cases were examined and classified into three categories, (1) those Rulings or cases which would have been unnecessary were there no special treatment of capital gains and losses, (2) those

Rulings or cases which have capital gain and loss implications, but for other reasons would still have been necessary even if there were no special treatment of capital gains and losses, and (3) those Rulings or cases which would have been unaffected by elimination of special treatment of capital gains and losses. The results of the examination are presented in table 14 and for convenience, category (1) is labeled "all," category (2) "some," and category (3) "none."

TABLE 14

PERCENTAGE OF CODE SECTIONS, REVENUE RULINGS, AND COURT CASES
IN THE THREE CLASSIFICATION CATEGORIES

	All	Some	None
Code Sections	8.19	32.59	59.22
Revenue Rulings	5.46	6.24	88.30
Court Cases	11.04	16.55	72.41

The research results for Code sections are the consequence of a 100% sample of all Code sections dealing with the federal income tax, sections 1-1399. The research results for Revenue Rulings are the consequence of a stratified random sample of Revenue Rulings for the time period 1964-1973, with each year representing a different strata. For court cases, the research results are the consequence of combining the research results for the various types of court decisions, memorandum Tax Court, regular Tax Court, District Court, Court of Claims, Court of Appeals, and Supreme Court, for the time period 1964-1973. The Court of Claims and Supreme Court decisions were examined on a 100% sample basis. The other court decisions were examined on a stratified random sample basis, with each year representing a different strata.

Since Revenue Rulings and court cases were examined for the 10

year period 1964-1973, it was possible to divide both of them into two five year periods, 1964-1968 and 1969-1973, in order to determine if there were any statistically significant trends. For Revenue Rulings, there were no statistically significant trends for the categories all, some, and the category all plus some combined, at the 5% level of significance. For all court cases combined, there was a statistically significant downward trend for the categories all and all plus some, at the 5% level of significance. For the category some, taken by itself, there was no statistically significant trend at the 5% level of significance. The partial downward trend for all court cases combined can perhaps be explained by the fact that the longer a tax provision remains a part of the tax law, the more settled the legal principles become, resulting in a reduced likelihood of controversy.

The question of whether or not there would be a significant reduction in the complexity of the federal income tax law if there were no special treatment of capital gains and losses naturally arises. In examining table 14, the proportions in the category all, containing those Code sections, Revenue Rulings, and court cases which would be unnecessary if there were no special treatment of capital gains and losses, range from a low of .0546 for Revenue Rulings to a high of .1104 for court cases. In addition, for the category "some" the proportions range from a low of .0624 for Revenue Rulings to a high of .3259 for Code sections.

In interpreting the significance of these proportions, it would be a mistake to underestimate their addition to the complexity of the tax law. The proportions obtained are a relatively crude measure of the complexity added to the federal income tax law by the capital gain and loss provisions. As stated in chapter III, there is much complexity

which is strictly the result of the revenue raising function of the federal income tax, and thus can not be eliminated. Examples include the requirement that returns be filed annually, the requirement that different entities be taxed differently, the political necessity for a progressive tax rate structure, etc. In addition to complexity which is unavoidable, there exists avoidable complexity evidenced by what has been called the "tax expenditure apparatus." It is this avoidable complexity, of which the capital gain and loss provisions are a part, which offers the greatest hope for simplification. Although the proportions in table 14 may appear relatively small when based upon the total amount of complexity in the tax law, it may be that when taken as a proportion of avoidable complexity, rather than total complexity, the capital gain and loss provisions make up a significant proportion of this avoidable complexity. And it is this avoidable complexity which makes the tax law needlessly complex.

The cost of complex tax laws is unmeasurable in terms of dollars. However, it is undoubtedly very large. There are the substantial administrative costs of communicating the tax laws, collecting the tax, auditing the returns, and investigating and prosecuting tax evaders. In addition, on the part of the taxpayer, there are equally substantial costs of complying with income tax laws. These costs include record-keeping, filing of returns, and dealing with tax audits with their attendant controversy. For the taxpayer, there are also costs which must be periodically incurred to become acquainted with ever changing statutory provisions, to hire expert advisors, or in the absence of these, the cost of inadvertantly overpaying one's taxes. A non-monetary cost associated with complex tax laws is the effect on taxpayer morale. This cost is

potentially the most important, particularly in view of the fact that our tax system is based upon self-assessment by the taxpayer and thus is heavily dependent upon taxpayer goodwill for its efficient operation. It is difficult to judge the fairness of complex tax provisions because of the inability to accurately determine the relative tax burdens of taxpayers. And if a taxpayer believes, either rightly or wrongly, that the tax system is not fair, he may feel justified in being less than honest in computing his tax liability. If this attitude became widespread, it would result in the demise of our federal income tax system as it exists today.

What is the cause of complexity in our federal income tax system? The answer to this question in a word is distinctions. Whenever a distinction is made in tax law, it is equivalent to drawing a line, and once this line is drawn it must be decided upon which side of the line a taxpayer or a transaction falls. This decision, in turn, may have significant economic consequences for a taxpayer. One example of a distinction which adds complexity to the tax law is the additional \$750 exemption for blind taxpayers. Superficially this distinction would not appear to add a great deal of complexity to the tax law. However, it is not absolutely necessary to be sightless in order to obtain the benefit of the additional blindness exemption. The statute provides that a taxpayer whose vision in the better eye is no better than 20/200 with corrective lenses or whose vision subtends an angle no greater than 20° shall be considered to be blind for purposes of the blindness exemption.¹ Even these very objective tests were not enough to prevent controversy between the taxpayer and the government. A taxpayer was held by the Tax Court to be entitled to the blindness exemption even though his vision was better than 20/200 with

corrective lenses.² The taxpayer's argument, with which the court agreed, was that there was actual physical discomfort in the form of headaches from wearing corrective lenses which were extremely heavy and cumbersome. Thus, the Tax Court introduced the subjectivity of physical discomfort into what started out as a very objective condition, blindness. Therefore, the effect of the blindness exemption is to add complexity to an already complex tax law.

The original rationale for granting this additional exemption was to partially compensate blind taxpayers for increased living costs occasioned by their blindness. It is usually argued in general that this type of provision accounts for the different circumstances of taxpayers, and is thus more fair than a tax system which does not account for such differences. However, this rationale ignores two important points. First, the taxpayer who is in the greatest need of economic assistance receives the least assistance, that is, the monetary benefit of the additional blindness exemption varies directly with the marginal tax bracket of the taxpayer. This, of course, is the consequence of our progressive tax structure. For the blind taxpayer in the 70% tax bracket, which for a married individual filing a joint return starts at taxable income in excess of \$200,000, the additional \$750 exemption means a tax savings of \$525. For the blind taxpayer in the zero percent tax bracket the additional \$750 exemption results in a tax saving of zero. Thus, a tax provision designed to assist the blind has the effect of granting the greatest assistance to the wealthiest taxpayer, and the least assistance to those in greatest need. The second point to consider when judging the fairness of this particular provision is its selectivity. If a blind person deserves an additional exemption, is not a deaf person or a person

with some other mental or physical handicap equally deserving? On the one hand, it would be difficult to answer this question negatively, but on the other hand, it would be an impossible task to design a tax system which accounts for the many different circumstances of the taxpaying public. In addition, each time the tax base is eroded through special exemptions, deductions, exclusions, credits, etc., the lost revenues must be made up from some other source. The tax burden is merely shifted to another group of taxpayers not eligible for special treatment. Given the differing tax impact on taxpayers which is a consequence of our progressive tax rate structure, and the selectivity of special tax provisions, it is highly doubtful that these types of provisions improve the fairness of our income tax system.

Another difficulty involved is that in order to account for the differing circumstances of taxpayers, it is necessary to define what is meant by circumstances. A common denominator is needed in order to properly measure the economic circumstances of a diverse taxpaying population. The common denominator used should be the dollar, and the concept of income used to measure taxpaying capacity should be the accretion concept of income. Under the accretion concept of income, taxpaying capacity is measured by a taxpayer's consumption for a period of time plus or minus his change in net worth for that period. This concept of income treats all income in an identical fashion without regard to source of income. In addition, no deductions for expenditures are allowed which are not incurred in the earning of income.

Primary Recommendation

The primary recommendation is that special treatment for capital gains and losses be eliminated. The reasons for this recommendation are

twofold. First, the complexity of the federal income tax is greatly intensified by the existence of these special provisions. This fact is evidenced by the results of this research. For the Internal Revenue Code, over 40% of the income tax sections are directly or indirectly affected by the capital gain and loss provisions. In addition, for court cases, it was estimated that almost 30% of the cases dealing with the federal income tax for the period 1964 through 1973 dealt directly or indirectly with capital gains and losses. These are significant proportions particularly in light of the fact that a great deal of Code sections and court cases are concerned with what was called the revenue raising function of the income tax, and thus are an unavoidable source of complexity. Unavoidable complexity is contrasted with complexity resulting from special exemptions, deductions, exclusions, credits, etc., which are unrelated to the revenue raising function of the income tax. If capital gain and loss sections, cases, or rulings, were measured as a proportion of avoidable complexity, the resulting proportions would certainly be a great deal larger.

The second reason for recommending the elimination of special treatment of capital gains and losses is that these provisions result in a most unfair tax law. The two concepts of equity which apply to income taxation are the concepts of horizontal and vertical equity. Horizontal equity implies the similar taxation of those in similar economic circumstances, and vertical equity implies different taxation for those in different economic circumstances. The capital gain and loss provisions violate both of these concepts of equity. By taxing capital gains and losses in such a radically different manner than ordinary gains and losses, those in similar economic circumstances are not taxed similarly

and those in different economic circumstances are not taxed differently. This is a consequence of violating the dollar as the common unit of measure by treating a dollar of capital gain or loss differently than a dollar of ordinary gain or loss. By way of contrast, the accretion concept of income treats all accretions to economic power in the same manner.

Additional Recommendations

A major requirement of the accretion concept of income is that assets and liabilities be valued at periodic intervals in order to determine the change in net worth for the period. Since a periodic revaluation would result in tremendous administrative and compliance difficulties, it is proposed that the accounting convention of realization be maintained for tax purposes. Thus, gain or loss would be deferred until the point of time or realization. This proposal should be recognized as a departure from the accretion concept of income made necessary for purposes of administrative convenience and not as a part of the income concept itself.

If the realization convention is maintained for tax purposes in combination with full taxation of capital gains and losses, the lock-in effect would become intolerable. As discussed in chapter II, the lock-in effect is the tendency for investors to avoid recognition of gains on appreciated assets by not realizing those gains. The lock-in effect is the consequence of the tax differential between selling an appreciated asset and holding that asset. The effect is further aggravated by the federal income tax provisions allowing appreciated property to pass to beneficiaries of a taxpayer at a "stepped-up" basis, thus avoiding permanently any income taxes on the appreciation of property prior to the date of a taxpayer's death. In order to reduce the strength of the

lock-in effect, it is necessary to reduce the tax differential between holding and selling an asset. This can be accomplished by requiring all appreciation of an asset to be taxed to the holder of the asset. In order to accomplish this, two changes in the tax law are proposed, (1) tax all unrealized appreciation to the owner of an asset at the date of death of the taxpayer, and (2) tax all unrealized appreciation to the donor of an asset at the date of gift. These proposals would alleviate the lock-in problem because a taxpayer would be certain that all appreciation would eventually be taxed to him. The first proposal would be particularly effective in unlocking the portfolio of the elderly taxpayer since the strength of the lock-in effect varies directly with the age of the taxpayer. The only advantage remaining to the taxpayer, if these proposals were adopted, would be the advantage of tax deferral, which could be eliminated by charging interest on unrealized appreciation at the time of realization.

Another major argument against taxing capital gain in full is that it would be unfair to tax the appreciation of an asset in the year of realization at progressive income tax rates, when the rise in asset value has taken place over a number of years. While there is merit in this argument, there are income averaging provisions available to taxpayers in the current tax law to alleviate this difficulty. If it was felt necessary to grant further relief, income averaging provisions could be liberalized to permit the spreading of a gain over the number of years an asset was held. This latter proposal has the additional benefit of granting the greatest amount of relief to the taxpayer who has held an asset for the greatest amount of time,

Possibilities for Future Research

The results of this research suggest two possibilities for future research. First, if there were no special treatment of capital gains and losses, it would be possible to eliminate the corporate income tax, except perhaps as a withholding device. This possibility exists because the income of a corporation would be taxed either as ordinary income when a dividend is paid, or as ordinary income when corporate securities were sold. Thus, the income of a corporation would always be taxed to the owners of the stock of the corporation, either as a dividend, or as the gain from the sale of stock in the corporation which has chosen to retain its income, as opposed to paying a current dividend. The possibility for future research in this instance lies in examining the extent to which the sources of tax law would be simplified if the corporate income tax were eliminated. The second possibility for future research results from the fact that a major first step towards a comprehensive income tax base would be taken if special treatment of capital gains and losses were eliminated. A possibility for future research is the examination of the sources of federal income tax law to determine the amount of complexity which is the result of using the federal income tax for purposes other than revenue raising. In effect, the goal of such a study would be to classify the sources of complexity in the tax law into avoidable and unavoidable complexity. The results of such research would provide a rough approximation of the price we are paying for allowing our income tax system to be used for other than revenue raising functions.

Conclusion

It is the contention of many knowledgeable tax experts that our federal income tax laws are in general too complicated, and the capital

gains area in particular is especially complex. This study has provided a measure of the complexity resulting from special treatment of capital gains and losses. However, increased complexity is not the only result of the capital gain and loss provisions. In addition, there is the effect of such provisions on the equity of the tax system. The capital gain and loss provisions do damage to the principles of both horizontal and vertical equity. Thus, not only are these provisions a complicating factor in our tax law, but they also result in a less equitable tax law.

FOOTNOTES CHAPTER V

¹Internal Revenue Code, Sec. 151(d)(3).

²E. Hollman v. Commissioner, 38 T.C. 251.

APPENDICES

APPENDIX A

APPENDIX A

COURT CASES AND REVENUE RULINGS SELECTED FOR EXAMINATION AND THE RESULTS OF THE EXAMINATION

The Revenue Rulings selected for examination were taken from the Internal Revenue Cumulative Bulletin for the years 1964-1973. A sample of thirty was selected for each year and classified according to whether they would be unnecessary were there no special treatment of capital gains and losses (All), whether they have capital gain and loss implications though they would not be able to be eliminated (Some), or whether they have no capital gain or loss implications (None). Memorandum Tax Court decisions are from Commerce Clearing House' Tax Court Memorandum Decisions, Regular Tax Court decisions are from the United States Tax Court Reports published by the U. S. Government Printing Office, and all other court cases are from Commerce Clearing House' United States Tax Cases.

Revenue Rulings

Revenue Ruling	All	Some	None	Revenue Ruling	All	Some	None	Revenue Ruling	All	Some	None
1964-31			x	1965- 5			x	1966-28			x
47			x	10			x	34			x
54			x	20			x	45			x
55			x	21			x	51			x
63			x	58			x	70			x
70			x	80		x		101			x
71			x	81			x	106			x
89			x	83			x	138			x
90			x	105			x	143			x
108			x	107			x	145			x
127			x	109			x	156			x
174			x	117			x	207			x
193			x	143			x	209			x
198			x	162		x		220			x
212			x	201			x	224			x
218			x	228		x		251			x
221			x	235			x	263			x
222			x	241		x		266			x
224			x	259			x	282			x
225			x	270			x	314			x
236			x	286			x	320			x
246			x	289		x		321	x		
273			x	294			x	324			x
277			x	298			x	339			x
282			x	299			x	346			x
284		x		307			x	358			x
313			x	308			x	360			x
314			x	310			x	363			x
328			x	314			x	364			x
330			x	315			x	366		x	

Revenue Rulings

Revenue Ruling	All	Some	None	Revenue Ruling	All	Some	None	Revenue Ruling	All	Some	None
1967- 4			x	1968-32		x		1969- 3			x
14			x	55	x			13			x
15			x	59			x	35			x
16	x			68			x	36			x
31			x	77			x	87			x
33			x	122			x	171			x
35			x	131			x	175			x
51			x	153			x	177			x
63			x	167			x	191			x
67			x	183			x	216			x
69			x	184			x	230			x
80			x	215			x	233			x
107			x	227			x	242			x
149			x	232			x	250			x
166		x		233		x		255			x
180			x	242			x	261		x	
182			x	264			x	265			x
215			x	289			x	296			x
220			x	294			x	297	x		
227			x	407		x		385			x
254			x	415			x	407			x
303			x	423			x	423			x
346			x	436			x	428		x	
349			x	450			x	434			x
376			x	472	x			458	x		
379		x		496			x	473			x
391			x	565			x	494			x
425		x		607			x	602			x
437			x	609			x	627			x
443			x	657			x	631			x

Revenue Rulings

Revenue Ruling	All	Some	None	Revenue Ruling	All	Some	None	Revenue Ruling	All	Some	None
1970-1			x	1971-28			x	1972-52			x
16			x	32			x	78			x
26			x	43			x	83			x
31			x	71			x	98			x
38			x	98			x	139			x
80			x	121			x	165			x
83			x	151			x	172	x		
94			x	156			x	200	x		
126			x	167			x	206			x
161			x	196			x	226			x
180			x	233			x	227			x
228			x	234			x	251		x	
229			x	251		x		252	x		
236			x	282			x	257			x
240	x			283			x	273			x
243			x	302			x	304			x
249			x	335			x	341			x
279			x	372		x		357			x
316			x	383		x		383			x
425			x	393			x	399			x
426			x	402			x	403			x
490			x	404			x	411			x
506			x	421			x	419			x
509			x	449			x	438			x
519			x	469			x	450			x
552			x	476			x	456			x
636			x	479			x	495			x
644	x			503			x	544			x
651			x	505			x	562			x
655			x	577			x	580			x

Revenue Ruling	All	Some	None	Revenue Ruling	All	Some	None
1973-13			x	1973-228			x
32			x	247			x
42			x	277		x	
43	x			300	x		
46			x	360			x
59			x	386			x
69			x	391			x
80	x			411			x
94			x	448			x
103			x	505			x
114			x	520			x
138			x	536			x
155			x	578			x
176			x	583			x
227			x	605			x

Memorandum Tax Court Decisions

Case Number	All	Some	None	Case Number	All	Some	None	Case Number	All	Some	None
1964-24			x	1965-41			x	1966- 1			x
32			x	55			x	3			x
38			x	66			x	10			x
45			x	98	x			18	x		
53		x		110			x	23			x
54			x	118			x	24			x
56		x		123			x	26		x	
63			x	132		x		30		x	
73			x	135			x	62			x
79			x	141			x	70			x
85			x	142			x	73			x
105			x	149			x	84			x
116			x	152			x	85			x
125			x	161			x	107		x	
148			x	167			x	109	x		
178		x		168			x	130			x
179	x			174			x	140		x	
184			x	187	x			143			x
190		x		197			x	159			x
191			x	218			x	167		x	
209			x	224			x	197			x
213			x	250			x	202			x
223			x	265			x	206			x
236			x	268			x	207			x
264		x		273		x		210			x
294		x		279			x	216			x
297		x		294			x	224			x
307			x	296			x	239		x	
310			x	305		x		243			x
338			x	322	x			266			x

Memorandum Tax Court Decisions

Case Number	All	Some	None	Case Number	All	Some	None	Case Number	All	Some	None
1967- 9			x	1968-17		x		1969- 4			x
27			x	18			x	16			x
28		x		19		x		24			x
33			x	27			x	27			x
50			x	29			x	32			x
51		x		31			x	46			x
55			x	34			x	56			x
61			x	45			x	79			x
70			x	50			x	85			x
99			x	56			x	96			x
106		x		59	x			100			x
122		x		72			x	102			x
126			x	82			x	149			x
132			x	90			x	151			x
142			x	119		x		162		x	
145			x	132			x	166			x
146			x	144			x	170			x
162		x		146		x		179			x
165			x	166			x	193		x	
173		x		171			x	227			x
174			x	177		x		230			x
177	x			179			x	234	x		
178			x	196			x	247			x
182			x	227			x	249			x
186			x	237			x	259			x
188		x		246			x	262			x
191			x	272			x	263			x
206			x	275	x			265			x
212			x	288	x			277			x
222			x	295		x		283			x

Memorandum Tax Court Decisions

Case Number	All	Some	None	Case Number	All	Some	None	Case Number	All	Some	None
1970- 8			x	1971- 4			x	1972- 9			x
15	x			57			x	13			x
20			x	64			x	18			x
31			x	77			x	24			x
34			x	107			x	26			x
45			x	114	x			42			x
47			x	124			x	46		x	
63		x		149			x	58			x
86			x	160			x	66			x
107			x	164	x			82			x
128			x	175			x	93			x
131			x	177			x	97		x	
142		x		179			x	104			x
148			x	186			x	106			x
158			x	187			x	109			x
173			x	190			x	110			x
174			x	198			x	120		x	
175			x	209			x	140			x
191			x	212		x		146			x
204			x	219			x	148			x
214		x		237			x	160			x
226			x	250			x	161			x
242			x	267			x	165			x
252			x	274			x	168			x
254			x	276			x	173		x	
256			x	290			x	195		x	
302			x	291			x	203		x	
318			x	292			x	216			x
322			x	297			x	220			x
332		x		325			x	230			x

Case Number	All	Some	None	Case Number	All	Some	None
1973- 9			x	1973-132			x
27			x	159			x
30			x	169			x
31	x			173		x	
34		x		183			x
36		x		191		x	
37		x		220			x
38			x	229		x	
43			x	230			x
56			x	233			x
82	x			234			x
88			x	242			x
98		x		251			x
105			x	263		x	
122			x	283	x		

Regular Tax Court Decisions

Page Number	All	Some	None	Page Number	All	Some	None	Page Number	All	Some	None
1964-468		x		1965-448			x	1966-397		x	
582			x	487	x			439			x
605			x	500			x	501		x	
608			x	572			x	615		x	
685			x	663			x	1			x
840			x	667	x			25			x
9			x	723	x			41			x
13		x		733			x	47			x
72			x	743	x			219	x		
211			x	824			x	272		x	
273		x		836			x	295	x		
283			x	900			x	302			x
419			x	20			x	375			x
441			x	39			x	382			x
482			x	137	x			492			x
732		x		159			x	502			x
769			x	178	x			505			x
793			x	193			x	572			x
894		x		411		x		597	x		
953			x	485			x	641			x
1067	x			632			x	706	x		
1			x	647			x	796		x	
8			x	718			x	842			x
105			x	731		x		848			x
127	x			787		x		1			x
168			x	1			x	75		x	
182			x	54			x	207			x
270			x	137	x			258	x		
322			x	217			x	326			x
358	x			277			x	335			x

Regular Tax Court Decisions

Page Number	All	Some	None	Page Number	All	Some	None	Page Number	All	Some	None
1967-391			x	1968-377		x		1969-543		x	
399			x	430			x	611			x
415			x	461			x	651			x
428			x	541			x	805		x	
467			x	570			x	841			x
471			x	575			x	915			x
483		x		599		x		927	x		
537			x	670			x	987			x
560			x	52			x	76		x	
613	x			409			x	130			x
630			x	536	x			135			x
42			x	650			x	155			x
86		x		688		x		210			x
118			x	710			x	281	x		
156			x	723			x	315	x		
190			x	740	x			346		x	
218			x	823			x	394			x
245			x	982			x	484	x		
318	x			1			x	572			x
330			x	49			x	907			x
411			x	121		x		911	x		
439			x	195		x		929			x
515		x		203		x		946			x
586			x	213			x	986			x
636			x	235		x		1006		x	
640			x	337			x	1038			x
872		x		410			x	37			x
1			x	467			x	394		x	
32			x	475			x	459			x
230			x	482		x		477		x	

Regular Tax Court Decisions

Page Number	All	Some	None	Page Number	All	Some	None	Page Number	All	Some	None
1970-170			x	1971-620			x	1972-539			x
221			x	720		x		587		x	
327			x	761			x	633		x	
355			x	796			x	666			x
408	x			1020			x	872			x
653			x	1046			x	884		x	
663			x	248			x	94			x
702			x	263			x	174	x		
705			x	434		x		207	x		
722			x	453			x	219			x
734			x	548			x	241			x
905			x	556		x		381		x	
1614			x	569			x	417			x
1675			x	710			x	526			x
1691			x	770			x	659			x
1707			x	828			x	679			x
1716			x	910		x		736		x	
1			x	961			x	757			x
6			x	1142			x	825	x		
94			x	1216		x		900			x
115			x	1242			x	940			x
156		x		1261			x	949			x
271			x	12			x	146	x		
275			x	174			x	207	x		
320			x	205			x	220		x	
335	x			249			x	248		x	
429	x			265			x	272			x
434			x	302			x	302		x	
441		x		315			x	461			x
538			x	349			x	516			x

Page Number	All	Some	None	Page Number	All	Some	None
1973-531			x	1973-647	x		
681	x			663			x
783			x	807			x
791			x	957			x
857			x	988			x
13			x	1004		x	
91	x			68		x	
114			x	78			x
125			x	140		x	
141			x	155			x
158			x	189			x
199			x	249			x
227			x	268			x
480		x		298			x
549			x	398	x		

District Court Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1964-9144			x	1965-9111			x	1966-9114			x
9145			x	9146			x	9141			x
9163			x	9176			x	9158	x		
9174		x		9182			x	9181		x	
9210	x			9186	x			9183			x
9211			x	9224			x	9208			x
9275			x	9241			x	9248		x	
9301	x			9242	x			9275	x		
9303			x	9263			x	9382		x	
9360			x	9281			x	9429			x
9368			x	9302		x		9524	x		
9418			x	9366		x		9533			x
9519			x	9385		x		9564	x		
9530	x			9455		x		9575			x
9628			x	9485			x	9590		x	
9651	x			9488			x	9608			x
9653			x	9494			x	9622			x
9672			x	9500			x	9638			x
9681			x	9528		x		9654			x
9695			x	9556			x	9662		x	
9710			x	9599			x	9665			x
9716			x	9608			x	9679			x
9738			x	9609		x		9683			x
9773		x		9636			x	9690			x
9774			x	9674			x	9702			x
9784	x			9695	x			9705	x		
9798		x		9700			x	9725			x
9799			x	9713		x		9728	x		
9808			x	9717		x		9734		x	
9812			x	9759			x	9766			x
9819			x	9765	x			9768			x

District Court Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1967-9156			x	1968-9130	x			1969-9121			x
9162			x	9151			x	9122		x	
9210			x	9152	x			9141			x
9226			x	9153			x	9147			x
9230			x	9188		x		9185			x
9232			x	9190			x	9189			x
9245			x	9212			x	9194			x
9247			x	9215			x	9220		x	
9251			x	9228	x			9228			x
9255			x	9229		x		9237			x
9277		x		9230		x		9243			x
9299	x			9233			x	9256		x	
9313	x			9252			x	9271			x
9316			x	9287			x	9284			x
9366			x	9307			x	9297		x	
9386			x	9348			x	9308			x
9401	x			9374			x	9324			x
9431			x	9396		x		9346			x
9454	x			9405			x	9356		x	
9482			x	9411			x	9359			x
9506		x		9483			x	9454			x
9531	x			9510			x	9543			x
9532		x		9538			x	9546	x		
9554			x	9581			x	9563			x
9576			x	9588	x			9583			x
9601			x	9590			x	9602		x	
9615		x		9595			x	9618			x
9628			x	9602	x			9659			x
9639	x			9649	x			9722		x	
9642		x		9652			x	9725			x
9705	x			9657			x	9740			x

District Court Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1970-9113	x			1971-9128			x	1972-9109			x
9114			x	9138			x	9123	x		
9131		x		9145			x	9165	x		
9151		x		9159			x	9170			x
9163			x	9179		x		9175			x
9169			x	9200			x	9197			x
9188		x		9201		x		9202		x	
9192			x	9211			x	9216			x
9239		x		9215			x	9316			x
9267			x	9216			x	9320		x	
9292			x	9231			x	9324		x	
9303			x	9266			x	9330	x		
9392			x	9290			x	9364	x		
9450			x	9291			x	9382			x
9459			x	9300	x			9430			x
9501		x		9308			x	9446			x
9526	x			9330			x	9493			x
9527		x		9332			x	9500			x
9528			x	9354	x			9511		x	
9530			x	9508		x		9581			x
9549			x	9548		x		9585		x	
9618			x	9563			x	9670			x
9621			x	9580		x		9675			x
9641			x	9582			x	9677			x
9664	x			9619			x	9683		x	
9676		x		9691			x	9698			x
9699			x	9709		x		9707			x
9709			x	9715			x	9713			x
9710			x	9741			x	9731			x
9712			x	9752			x	9732		x	
9720			x	9759			x	9762			x

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1973-9111			x	1973-9575			x
9140			x	9631			x
9157			x	9639			x
9178			x	9644			x
9217			x	9671	x		
9219		x		9677			x
9272			x	9681			x
9297		x		9705			x
9314			x	9723			x
9416			x	9726	x		
9425		x		9735		x	
9458		x		9744			x
9495			x	9770			x
9512			x	9774	x		
9553			x	9791		x	
9555			x				

Court of Claims Decisions

Paragraph				Paragraph				Paragraph			
Number	All	Some	None	Number	All	Some	None	Number	All	Some	None
1964-9121	x			1965-9116			x	1966-9118			x
9122	x			9117	x			9120			x
9213			x	9118			x	9189	x		
9214			x	9249			x	9243	x		
9215			x	9358	x			9244			x
9249			x	9359		x		9310			x
9250			x	9419			x	9311			x
9309			x	9422			x	9361			x
9310			x	9470			x	9460	x		
9311			x	9560			x	9461			x
9412			x	9561			x	9462	x		
9494			x	9562			x	9544			x
9495	x			9563			x	9545			x
9496			x	9564			x	9546			x
9546			x	9565			x	9547	x		
9547	x			9566			x	9548	x		
9637			x	9683			x	9550			x
9638			x	9684		x		9552			x
9639			x	9728			x	9553			x
9725			x	9730			x	9691			x
9791			x	9731			x	9692			x
9792			x	9732			x	9693			x
9793			x					9694		x	
9840			x					9740			x
9841	x							9741			x
9842			x								
9848		x									

Court of Claims Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1967-9123	x			1968-9122		x		1969-9124			x
9124		x		9123		x		9125			x
9186		x		9124			x	9126		x	
9188		x		9171	x			9127			x
9189		x		9172			x	9190			x
9248			x	9220			x	9192			x
9249			x	9221	x			9193		x	
9302			x	9223		x		9223	x		
9304	x			9224	x			9224	x		
9305			x	9237			x	9230			x
9371			x	9266			x	9275			x
9372	x			9267			x	9276			x
9373			x	9268			x	9325		x	
9374			x	9273			x	9402			x
9375			x	9274			x	9403			x
9376			x	9330	x			9404			x
9377			x	9366			x	9473			x
9378		x		9367	x			9474			x
9439			x	9368			x	9475		x	
9440			x	9373			x	9476			x
9499		x		9427			x	9477			x
9500		x		9428			x	9501			x
9501			x	9429		x		9537		x	
9569			x	9472			x	9538			x
9570			x	9473			x	9539			x
9571		x		9474		x		9718	x		
9572		x		9476			x	9719			x
9573	x			9621			x	9720		x	
9574		x		9622			x				
9685		x		9623		x					
9722			x	9624	x						
9723			x	9626		x					
9724	x			9650			x				

Court of Claims Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1970-9125		x		1971-9108		x		1972-9113			x
9126			x	9110			x	9114			x
9190			x	9170			x	9115	x		
9191			x	9285			x	9253		x	
9242			x	9337			x	9254			x
9243	x			9416			x	9255			x
9244		x		9478	x			9256			x
9245			x	9479		x		9355		x	
9284			x	9482			x	9418			x
9285			x	9483			x	9419		x	
9286			x	9542	x			9420			x
9287			x	9543			x	9421			x
9341	x			9544			x	9491			x
9344			x	9682			x	9554			x
9345			x	9683			x	9555			x
9346			x					9557			x
9406	x							9560			x
9407			x					9561			x
9408	x							9740			x
9455			x								
9456	x										
9457			x								
9458			x								
9517			x								
9518			x								
9519		x									
9651			x								
9652			x								
9698		x									

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1973-9114			x	1973-9351			x
9115			x	9353	x		
9116			x	9433			x
9183			x	9434	x		
9184			x	9507			x
9234			x	9508			x
9235			x	9549			x
9292			x	9564		x	
9293			x	9720			x
9347		x		9785			x
9348	x			9786		x	
9350			x	9788			x

Court of Appeals Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1964-9173			x	1965-9106			x	1966-9104			x
9184			x	9126			x	9133			x
9185	x			9147			x	9157	x		
9221			x	9179			x	9168	x		
9226			x	9180			x	9195			x
9240		x		9192			x	9227			x
9251			x	9193			x	9240			x
9253	x			9214			x	9264			x
9254			x	9245			x	9340			x
9268			x	9247	x			9355			x
9306		x		9277			x	9400	x		
9415			x	9328			x	9414			x
9447			x	9338		x		9434			x
9469			x	9363			x	9447	x		
9470			x	9388		x		9494			x
9473	x			9392			x	9501			x
9483			x	9393	x			9526			x
9510			x	9396	x			9561			x
9524			x	9438			x	9566			x
9572	x			9467			x	9585		x	
9580			x	9505			x	9604	x		
9583		x		9519			x	9610		x	
9611		x		9539			x	9647			x
9614			x	9572			x	9685			x
9625	x			9614			x	9688	x		
9634			x	9673			x	9696			x
9670	x			9698			x	9697			x
9676		x		9699			x	9707	x		
9783			x	9733	x			9722			x
9855			x	9737		x		9751		x	
9886			x	9762			x	9758		x	

Court of Appeals Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1967-9141			x	1968-9118		x		1969-9119		x	
9145			x	9120	x			9120	x		
9178			x	9142			x	9129		x	
9179			x	9143		x		9207		x	
9180			x	9194			x	9208			x
9184			x	9200			x	9211			x
9191		x		9241			x	9222			x
9218	x			9245		x		9241			x
9219	x			9255			x	9267			x
9238			x	9256			x	9302	x		
9286		x		9257			x	9350			x
9306			x	9262			x	9370			x
9307			x	9270			x	9375			x
9322			x	9279		x		9389	x		
9339	x			9322			x	9442		x	
9369			x	9355			x	9448			x
9370			x	9363			x	9455			x
9385			x	9392			x	9456			x
9461		x		9402	x			9483			x
9488			x	9406			x	9521		x	
9502	x			9434			x	9523			x
9529			x	9445			x	9566			x
9548			x	9460			x	9575		x	
9555			x	9539			x	9579			x
9560	x			9540		x		9589			x
9626		x		9551		x		9632	x		
9632			x	9592			x	9634			x
9659		x		9601			x	9678		x	
9675			x	9634			x	9698			x
9700	x			9637			x	9737			x
9709			x	9638			x	9739			x

Court of Appeals Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1970-9101			x	1971-9131			x	1972-9104			x
9110	x			9141			x	9154			x
9152			x	9155			x	9157			x
9223	x			9161			x	9183			x
9236	x			9164			x	9242			x
9271			x	9178			x	9250			x
9276		x		9187			x	9261			x
9279		x		9258	x			9273		x	
9297			x	9259		x		9277			x
9301			x	9268	x			9280			x
9309			x	9272			x	9317			x
9327			x	9312			x	9353		x	
9330			x	9339			x	9366	x		
9347			x	9374			x	9375			x
9378	x			9540			x	9400		x	
9411			x	9558			x	9402			x
9435	x			9574			x	9450			x
9484		x		9588			x	9472	x		
9486			x	9622			x	9485	x		
9503			x	9634	x			9548			x
9539			x	9647			x	9594			x
9543			x	9659			x	9610		x	
9552			x	9671			x	9612			x
9568	x			9675			x	9628		x	
9589			x	9680			x	9660			x
9627			x	9689			x	9679	x		
9642			x	9699			x	9688			x
9643			x	9706			x	9694			x
9650			x	9712			x	9729			x
9674			x	9713		x		9733	x		
9678			x	9764			x	9741			x

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1973-9133			x	1973-9541			x
9139			x	9543	x		
9145		x		9545			x
9180			x	9577			x
9196			x	9595			x
9214		x		9596			x
9298			x	9608			x
9365	x			9614			x
9398			x	9620			x
9403		x		9630	x		
9405			x	9650			x
9422		x		9659			x
9443			x	9664			x
9455			x	9773			x
9484			x	9778			x
9538			x				

Supreme Court Decisions

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1964				1965-9375	x			1966-9280	x		
				9379			x	9317	x		
				9381			x	9318	x		
				9382	x			9319			x
				9387	x			9376			x
				9406			x				
				9407			x				
				9409			x				

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1967-9115			x	1968-9101			x	1969-9167			x
9117		x		9258	x			9198		x	
9309			x	9383			x	9343			x
								9348			x

Paragraph Number	All	Some	None	Paragraph Number	All	Some	None	Paragraph Number	All	Some	None
1970-9289	x			1971-9476			x	1972-9123A			x
9405			x					9259		x	
9653			x					9276		x	
								9292A			x

Paragraph Number	All	Some	None
1973-9250			x
9412			x
9478			x
9515			x
9780			x

APPENDIX B

APPENDIX B

ANALYSIS OF INTERNAL REVENUE CODE SECTIONS AFFECTED BY SPECIAL TREATMENT OF CAPITAL GAINS AND LOSSES

Section Number	All	Some	None	Section Number	All	Some	None	Section Number	All	Some	None
1			x	79			x	166		x	
2			x	80		x		167		x	
3			x	81			x	169			x
4			x	82			x	170		x	
5		x		101			x	171		x	
11			x	102			x	172		x	
12		x		103			x	173		x	
21			x	104			x	174		x	
31			x	105			x	175		x	
32			x	106			x	176			x
33			x	107			x	177		x	
35			x	108			x	178		x	
36			x	109			x	179		x	
37			x	110			x	180		x	
38			x	111		x		181			x
39			x	112			x	182		x	
40			x	113			x	183			x
41			x	114			x	184		x	
42			x	115			x	185		x	
46			x	116			x	186			x
47			x	117			x	187			x
48			x	118			x	188			x
49			x	119			x	211			x
50			x	121			x	212			x
50A			x	122			x	213			x
50B			x	123			x	214			x
51			x	124			x	215			x
56			x	141			x	216			x
57		x		142			x	217			x
58		x		143			x	218			x
61		x		144			x	219		x	
62		x		145			x	241		x	
63		x		151			x	242		x	
71			x	152			x	243		x	
72			x	153			x	244		x	
73			x	154			x	245		x	
74			x	161			x	246		x	
75			x	162		x		247			x
76			x	163		x		248		x	
77			x	164			x	249		x	
78			x	165		x		250			x

Section Number	All	Some	None	Section Number	All	Some	None	Section Number	All	Some	None
261		x		371		x		515			x
262			x	372		x		521			x
263		x		373			x	526			x
264			x	374		x		531		x	
265			x	381		x		532		x	
266		x		382			x	533		x	
267			x	383		x		534		x	
268	x			385			x	535		x	
269			x	391			x	536		x	
271			x	392			x	537		x	
272		x		393			x	541		x	
273			x	394			x	542		x	
275			x	395			x	543		x	
276			x	401		x		544		x	
277			x	402		x		545		x	
278		x		403		x		546		x	
279			x	404			x	547		x	
281			x	405		x		551		x	
301		x		406		x		552		x	
302		x		407		x		553		x	
303	x			421			x	554		x	
304		x		422		x		555		x	
305			x	423		x		556		x	
306	x			424		x		557		x	
307			x	425			x	558		x	
311		x		441			x	561		x	
312		x		442			x	562		x	
316			x	443		x		563		x	
317			x	446			x	564		x	
318			x	451			x	565		x	
331	x			453		x		581			x
332			x	454			x	582	x		
333		x		455			x	583			x
334		x		456			x	584		x	
336			x	461			x	585			x
337		x		471			x	586			x
338		x		472			x	591			x
341	x			481			x	592			x
342	x			482			x	593		x	
346			x	483	x			594		x	
351			x	501			x	595		x	
354			x	502			x	596			x
355			x	503			x	601			x
356		x		504			x	611			x
357		x		507			x	612			x
358			x	508			x	613		x	
361		x		509		x		614			x
362		x		511		x		615			x
363		x		512		x		616			x
367			x	513			x	617		x	
368			x	514		x		621			x

Section Number	All	Some	None	Section Number	All	Some	None	Section Number	All	Some	None
631	x			752			x	878			x
632			x	753		x		881		x	
636			x	754		x		882			x
638			x	755		x		883			x
641		x		761			x	884			x
642		x		771		x		891			x
643		x		801		x		892			x
651		x		802		x		893			x
652		x		804		x		894			x
661		x		805			x	895			x
662		x		806			x	896			x
663			x	809		x		901			x
664		x		810			x	902			x
665		x		811			x	903			x
666		x		812			x	904			x
667			x	815		x		905			x
668		x		817	x			906			x
669	x			818		x		911			x
671			x	819			x	912			x
672			x	820		x		921			x
673			x	821		x		922			x
674			x	822		x		931			x
675			x	823			x	932			x
676			x	824			x	933			x
677			x	825			x	934			x
678			x	826			x	935			x
681			x	831		x		941			x
682			x	832		x		942			x
683			x	841			x	943			x
691		x		842			x	951		x	
692			x	843			x	952		x	
701			x	844		x		953		x	
702		x		851			x	954			x
703		x		852		x		955			x
704		x		853			x	956			x
705			x	854		x		957			x
706			x	855			x	958			x
707		x		856			x	959			x
721			x	857		x		960			x
722			x	858			x	961		x	
723			x	861			x	962			x
731		x		862			x	963			x
732			x	863			x	964			x
733			x	864			x	970			x
734			x	871		x		971			x
735	x			872			x	972			x
736			x	873			x	981			x
741	x			874			x	991			x
742			x	875			x	992			x
743		x		876			x	993			x
751	x			877		x		994			x

Section Number	All	Some	None	Section Number	All	Some	None	Section Number	All	Some	None
995		x		1234	x			1379			x
996		x		1235	x			1381			x
997			x	1236	x			1382			x
1001			x	1237	x			1383			x
1002			x	1238	x			1385		x	
1011		x		1239	x			1388			x
1012		x		1240	x						
1013			x	1241	x						
1014			x	1242	x						
1015			x	1243	x						
1016		x		1244	x						
1017		x		1245	x						
1018			x	1246	x						
1019			x	1247	x						
1020			x	1248	x						
1021			x	1249	x						
1022			x	1250	x						
1031			x	1251	x						
1032			x	1252	x						
1033		x		1253	x						
1034			x	1301		x					
1035			x	1302		x					
1036			x	1303			x				
1037		x		1304		x					
1038			x	1305			x				
1039			x	1311			x				
1051			x	1312			x				
1052			x	1313			x				
1053			x	1314		x					
1054			x	1321			x				
1055			x	1331		x					
1056			x	1332		x					
1071			x	1333		x					
1081		x		1334		x					
1082			x	1335			x				
1083			x	1336			x				
1091		x		1337			x				
1101			x	1341		x					
1102			x	1342			x				
1103			x	1346			x				
1111			x	1347			x				
1201	x			1348			x				
1202	x			1351		x					
1211	x			1371			x				
1212	x			1372			x				
1221	x			1373			x				
1222	x			1374			x				
1223		x		1375		x					
1231	x			1376			x				
1232	x			1377			x				
1233	x			1378	x						

APPENDIX C

APPENDIX C*†

FEDERAL INCOME TAX EXPENDITURES CALENDAR YEAR 1972 (By Budget Function)

National Defense

Exclusion of benefits and allowances to Armed Forces personnel

International Affairs and Finance

Exemption for certain income earned abroad by United States citizens
Western Hemisphere Trade Corporations

Exclusion of gross-up on dividends of less-developed country corporations

Deferral of income of controlled foreign corporations

Exclusion of income earned in United States possessions

Deferral of export income (DISC)

Agriculture

Farming: expensing and capital gain treatment

Timber: capital gain treatment for certain income

Natural Resources

Expensing of exploration and development costs

Excess of percentage over cost depletion

Capital gain treatment of royalties on coal and iron ore

Commerce and Transportation

Investment credit

Depreciation on buildings (other than rental housing) in excess of
straight-line depreciation

Asset depreciation range system for depreciation

Dividend exclusion

Capital gains: corporation (other than farming and timber)

Capital gains: individuals (other than farming and timber)

Bad debt reserves of financial institutions in excess of actual

Exemption of credit unions

Deductibility of interest on consumer credit

Expensing of research and development expenditures

\$25,000 corporate surtax exemption

Deferral of tax on shipping companies

Five-year amortization of railroad rolling stock

Housing and Community Development

Deductibility of interest on mortgages on owner-occupied homes

Deductibility of property taxes on owner-occupied homes

Depreciation on rental housing in excess of straight-line depreciation

Five-year amortization of housing rehabilitation expenditures

Deferral of capital gain on sale to occupants of certain low-income
housing

Health, Labor and Welfare

Exclusion of employer-provided disability insurance benefits
 Provisions relating to aged: combined cost for additional exemptions,
 retirement income credit, and exclusion of social security payments
 Additional exemption for blind
 Exclusion of unemployment insurance benefits
 Sick pay exclusion
 Exclusion of workmen's compensation benefits
 Exclusion of public assistance benefits
 Net exclusion of pension contributions and earnings:
 Plans for employees
 Plans for self-employed persons
 Exclusion of other employee benefits:
 Premiums on group term life insurance
 Accident and accidental death premiums
 Medical insurance premiums and medical care
 Privately financed supplementary unemployment benefits
 Meals and lodging
 Exclusion of interest on life insurance savings
 Deductibility of charitable contributions (other than education)
 Deductibility of medical expenses
 Deductibility of child and dependent care and household expenses
 Deductibility of casualty losses
 Standard deduction in excess of minimum standard deduction
 Five-year amortization of pollution control facilities (pre-1969 plants)
 Credit for employment of public assistance recipients under WIN program
 Five-year amortization of employer child care and on-the-job training
 facilities

Education

Additional parental personal exemption for students
 Deductibility of contributions to educational institutions
 Exclusion of scholarships and fellowships

Veterans Benefits and Services

Exclusion of certain veterans benefits

General Government

Credit and deduction for political contributions

Aid to State and Local Financing

Exemption of interest on state and local debt
 Deductibility of nonbusiness state and local taxes (other than on
 owner-occupied homes)

*Source: Estimates of Federal Tax Expenditures, House Committee on Ways and Means, June 1, 1973.

†The tax expenditure apparatus as a source of complexity is discussed in chapter III.

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