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Errata

Page 127, lines 7 & 8. For "'economic loss' exceeds" read "medical and related expenses exceed;" for "disfigurement" read "significant disfigurement."
Page 145, line 30. For "*Schneck*" read "*Schenck*."
Page 178, note 1. For "A.B.A. Antitrust" read "ABA Antitrust Section."
Page 241, line 7. For "ths" read "this."
Page 563, note 11. To fix transposition of lines, read:

> "11. Springer v. Philippine Islands, 277 U.S. 189, 211 (1928) (Holmes & Brandeis, JJ., dissenting). Accord, Youngstown Sheet & Tube Co. v. Sawyer, 343 U.S. 579, 635-37 (1952) (Jackson, J., concurring). See generally C. Swisher, The Growth of Constitutional Power in the United States 50-76 (1946); A. Vanderbilt, The Doctrine of the Separation of Powers."

Page 612, note 14. For "Id. at 650 (footnote omitted);" read "Id. at 650;".
Page 651, line 5. For "Colorado Gen. Assembly" read "Colorado General Assembly."

Student Contributors

Student Contributors to the October issue not recognized therein were as follows:

The Effect of New York Insurance Law Section 167(3) upon Claims for Contribution and Indemnity .... Theodore P. Manno
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Subsequent Dispositions of Principal Cases Noted

Page 180, note 15. The Supreme Court granted an extension for the filing of a petition for certiorari, but ultimately denied the petition. National Petroleum Refiners Ass'n v. FTC, 94 S. Ct. 1475 (1974).
Page 197, United States v. White, 477 F.2d 757, aff'd, 487 F.2d 1335 (5th Cir. 1973) (en banc), *petition for cert. filed*, 42 U.S.L.W. 3502 (U.S. Feb. 25, 1974) (No. 73-1303).
Page 211, Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), *vacated & remanded sub nom.* Lehman Bros. v. Schein, 42 U.S.L.W. 4603 (U.S. Apr. 29, 1974).
Page 361, United States v. Moore, the principal subject of the Comment, Criminal Responsibility and the Drug Dependence Defense—A Need for Judicial Clarification, was reported at 486 F.2d 1139. The following approximate table may be used to correlate citations to the slip opinion used in the Comment. The column at the left refers to pages in the slip opinion:

1-32 may be found at 486 F.2d 1139 plus ½(x), where x is the slip opinion page number.

33-49	at 1139 plus ½(x)-½.
50-91	at 1139 plus ½(x)-1.

92-106	at 1139 plus ½(x)-1½.
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Page 425, United States v. Vigo, was reported at 487 F.2d 295.

Page 688, Eason v. General Motors Acceptance Corp., was reported at 490 F.2d 654. The Supreme Court has denied certiorari, 42 U.S.L.W. 3595 (U.S. Apr. 22, 1974).

Page 695, note 63. Manor Drug Stores v. Blue Chip Stamps Corp., was reported as modified on denial of rehearing and rehearing en banc at 492 F.2d 136.

Page 716, In re Samuels & Co., 483 F.2d 557 (5th Cir. 1973), *cert. granted, rev'd & remanded per curiam sub nom.* Mahon v. Stowers, 42 U.S.L.W. 3577 (U.S. Apr. 15, 1974).

Page 878 et seq., shortly before press time, the following cases cited in Note, The Evolving Right of Due Process at Prison Disciplinary Hearings, were reported as indicated:

Gomes v. Travisono, 490 F.2d 1209 (1st Cir. 1973);
Knell v. Bensinger, 489 F.2d 1014 (7th Cir. 1973);
Sands v. Wainwright, 357 F. Supp. 1062 (M.D. Fla.), *vacated & remanded on other grounds*, 491 F.2d 417 (5th Cir. 1973);
O'Brien v. Moriarty, 489 F.2d 941 (1st Cir. 1974).

IN DEFENSE OF CAPITAL GAINS

*CONSTANTINE N. KATSORIS**

I. Introduction

TAX reform has long been a common phrase in the political arena. Unfortunately, all too often, any change—whether beneficial, detrimental or meaningless—is heralded to constituents as a tax accomplishment. That some tax reform is necessary is undeniable. Great care, however, should be exercised lest so-called equitable tax reform turns out to be anything but equitable. Perhaps the most truthful appraisal of our tax laws was made by Wilbur Mills, when he stated: "The laws have long since lost sight of the real purpose of taxation, which is simply to raise the money the government needs to pay its bills."[1]

It is axiomatic that tax laws should be fair. Unfortunately, so simple a statement evokes a wide spectrum of opinion as to what constitutes fairness.

At one end of this spectrum, there are those who believe that the "Internal Revenue Code is now used to redistribute income from the poor to the rich."[2] Instead, they argue, "taxes should be utilized positively as a means of correcting structural inequities in the distribution of income in this country."[3]

A distinctly different point of view, however, has been voiced by no less an authority than Al Capp. In discussing the tax philosophy of a recent presidential candidate, he counters:

> The fact is that his "soak the rich" policy is based on what may turn out to be a fatal misreading of our national aspirations. Americans today don't want so much to soak the rich as to be rich.
>
> Bob Owen, a twenty-eight-year-old salesman from Pleasanton, California, gave the *New York Times* the answer most of us would give McGovern: "I spent long, hard hours going to school and getting where I am," he said. "My income is just above the mean now, and I don't want to be pulled back to the mean. I don't want them to redistribute my wealth."
>
> "Soak the rich!" was a rallying cry that aroused the bloodlust of the masses thirty and forty years ago when "the rich" was an unreachable, privileged group. Today "the rich" is what Bob Owen and millions of others with his energy hope to

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1. Mills, Are You a Pet or a Patsy?, Life, Nov. 23, 1959, at 51, 52.

2. Harrington, Ideally, We Should Abolish Every Subsidy in the Internal Revenue Code, Sat. Rev., Oct. 21, 1972, at 49.

3. Id.

become part of if the government will let them. And they seem, by all signs, to prefer a government that will let them.[4]

It also has been suggested authoritatively that the fairness of taxes is indeed a moral issue,[5] and thus:

> An income tax remains fair, however, only if it reaches all income, only if there are no preferences or loopholes through which some people can escape. The very integrity of the tax system is challenged today when many persons, especially those well off, are provided with readily available escapes.[6]

Yet, some tax concessions can serve the needs of society and good government. To name a few existing provisions in this category, consider the following: the credit given for expenses of work incentive programs;[7] a credit[8] or deduction[9] for political contributions; rapid amortization of pollution control equipment,[10] of mine safety equipment,[11] and of certain expenditures for child-care or on-the-job training facilities;[12] rapid write-off of capital expenditures for the rehabilitation of slum or substandard housing;[13] a deduction for charitable contributions;[14] and the seven percent investment credit,[15] which has been used quite successfully as a spur to the economy in times of economic slump.

But why finance many of these goals through tax preferences or so-called loopholes? Instead, why shouldn't the government directly finance or perform these ventures itself? The simple truth is that many such preferences achieve the desired results without the creation of additional bureaucracy at the federal level. Moreover, there are those who contend that given tax incentives, private industry—often spending its own money

4. Capp, What This Country Wants Is More Tax Loopholes, Not Less, Sat. Rev., Oct. 21, 1972, at 48.

5. Surrey, Taxes Are a Moral Issue, Sat. Rev., Oct. 21, 1972, at 51.

The concern for fairness in taxation, however, long predates our present taxing system. Many years ago Aristophanes satirized in The Frogs:

"Bah, your modern rich man has adopted the fashion, for remission of taxes to bid;

'He couldn't provide a trireme if he tried'; he implores us his state to behold.

Though rags outside may very well hide good woollens beneath, if it's cold!

And when once he's exempted, he gaily departs and pops up at the fishmongers' stalls." (G. Murray transl.).

6. Surrey, supra note 5, at 51.

7. Int. Rev. Code of 1954, § 40.

8. Id. § 41.

9. Id. § 218.

10. Id. § 169.

11. Id. § 187.

12. Id. § 188.

13. Id. § 167(k).

14. Id. § 170.

15. Id. §§ 38, 46-50.

along the way—achieves better results than many governmental agencies would.

The purpose of this article, however, is not to examine all the so-called "loopholes" or subsidies in the Internal Revenue Code to determine whether they are justified or not. Such an inquiry would fill volumes and should instead be made in a non-partisan effort, by a responsible Congress, as part of an all-inclusive revision of the tax laws.[16]

In the forefront of many tax reform proposals is the alteration and/or elimination of the present treatment of capital gains.[17] The onslaught against capital gains has surged on two fronts. First, there are those who feel that capital gains should be taxed as ordinary income. The second attack would tax unrealized capital gains each year, or at the time of gift, or at death. It is the purpose of this article, therefore, to explore the desirability of these proposals.

II. Is All Income The Same?

It has been asserted that "when a man dies, the sum of income tax and estate tax is much higher if he accumulated his estate out of wages and interest payments than if he accumulated his estate out of capital gains."[18] Accordingly, it is suggested that "income ought to be defined as the accretion to a person's wealth over a period"[19] and that "the sources or uses of that accretion ought to be a matter of indifference."[20] In like vein, the comparison is made that "[a]ll wages and salaries are taxed today,"[21] yet "only half of profits from investments are taxed."[22] Indeed, "none of the gain is taxed if an individual dies holding appreciated investments."[23] This is so because there is no capital gains tax currently recognized at death—a subject which will be dealt with later in this article.[24]

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16. The House Ways and Means Committee is contemplating an examination of the so-called "tax shelters" this fall. Wall St. J., June 4, 1973, at 2, col. 3.

17. For the present treatment of capital gains see Int. Rev. Code of 1954, §§ 1201-02.

18. Interview with Richard A. Musgrave, in Forbes, Mar. 1, 1973, at 50. For a contrary view see Stein, Money Made by Money Is Already Taxed More Than Money Made by Men, Sat. Rev., Oct. 21, 1972, at 47: "[T]he fact is that money made by money—more precisely, the income from capital—is probably already taxed more heavily than income resulting from work. Income from capital is taxed not only through individual income taxes—federal, state, and others—but also through capital-gains taxes, corporate-profits taxes, property taxes, and inheritance taxes. When these are added together, the tax burden on capital is probably much higher than the tax burden on labor."

19. Musgrave, supra note 18, at 50.

20. Id.

21. Surrey, supra note 5, at 51.

22. Id.

23. Id.

24. See text accompanying notes 99-129 infra.

The popular appeal of so basic a concept—that all income is the same, and thus should be taxed equally—is undeniable. The real question, however, is whether all income *is* the same. Such inquiry requires an analysis of the various sources of income. Our inquiry cannot end there, however, for to achieve true equality of treatment, all income itself must be computable in like manner. Finally, even if we conclude that all income is by nature the same, and computable in like manner, we must still ask ourselves whether, in the last analysis, it should be taxed in the same way.

The difficulty in defining so elusive a concept as income is made evident by the Internal Revenue Code itself, which merely defines gross income as "all income from whatever source derived."[25] If this definition leaves something to be desired, the Supreme Court, in *Eisner v. Macomber*,[26] defined income as "'the gain derived from capital, from labor, or from both combined. . . .'"[27] But later, in *Commissioner v. Glenshaw Glass Co.*,[28] it declared that the *Eisner* definition was never intended "to provide a touchstone to all future gross income questions."[29] Thus, in holding the punitive two-thirds portion of a treble damages antitrust recovery to be income, the Court stated:

> Respondents contend that punitive damages, characterized as "windfalls" flowing from the culpable conduct of third parties, are not within the scope of the section. But Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad

25. Int. Rev. Code of 1954, § 61 provides: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust."

26. 252 U.S. 189 (1920).

27. Id. at 207 (citations omitted).

28. 348 U.S. 426 (1955).

29. Id. at 431.

phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. . . .

. . . .

Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients.[30]

If, however, we adopt a rigid, all-inclusive concept that all "accretion to a person's wealth over a period"[31] is income, we must consider the elimination of all potentially preferential exclusions from gross income, such as life insurance proceeds,[32] compensation for injuries or sickness,[33] amounts received under accident and health plans,[34] and scholarships and fellowships,[35] to mention but a few. This result is neither desirable, nor likely.

Nor can the search for equality of taxation be limited to an examination of gross income. One must also, therefore, consider other elements of taxation, such as deductions, credits and tax rates themselves. Moreover, just as gross income seems incapable of a simple laconic explanation, so too for the concept of net income; and, as with gross income, the application of inflexible rules to the other components of taxation similarly will prevent true equality and fairness.

Some variations must exist in order to reflect changing economic circumstances, differing forms of doing business, and meaningful distinctions in the nature of the business itself. Some differences are real, others more arbitrary. Nevertheless they do exist. Business income, for example, can be greatly varied, depending on the method of depreciation chosen.[36] In order to encourage research, a taxpayer has the choice of deducting such expenditures currently or not.[37] To give flexibility to the area of determining cost of goods sold, the taxpayer can often choose his method of inventory identification and valuation.[38] Similarly, taxpayers are given some leeway in the selection of the method of accounting under which they choose to report.[39] Furthermore, when the proceeds of a sale are to be collected in installments, the option is often available to spread the profit

30. Id. at 429-31 (emphasis added).
31. Musgrave, supra note 18, at 50.
32. Int. Rev. Code of 1954, § 101.
33. Id. § 104.
34. Id. § 105.
35. Id. § 117.
36. See id. § 167(b).
37. Id. § 174.
38. See id. §§ 471-72.
39. See id. § 446.

thereon over a period of time.[40] There are also numerous situations where the recognition of an otherwise realized gain is deferred to a later date because the taxpayer has, for one reason or other, not really changed his position.[41] Many such tax electives are reasonable and necessary, just as some differing methods of accounting are desirable in the area of financial reporting.[42] Indeed, the reasons for such options are often the same, and the accounting profession believes there should be closer conformity of tax accounting and generally accepted accounting principles.[43]

It would be interesting to measure, against utopian ideals of equality, the varying applications of deductions, credits, and tax rates currently provided by our tax laws. Such an analysis, however, would scan the entire breadth of the Internal Revenue Code and go beyond the scope of this article. On the other hand, it would appear germane to compare capital gains with certain other forms of income.

In the first place, capital gains taxation is strictly a one-sided proposition when personal assets are involved, such as homes, boats, automobiles, etc. If you manage to sell them at a profit, you must pay a capital gains tax. Yet, if there is a loss, it is not recognized because it is personal in nature. In addition, capital gains are taxable when realized, but there is a limitation on the deductibility of recognized capital losses.[44]

It has been suggested that capital gains taxation constitutes a tax dodge when compared to taxes on income from wages or interest. Such a contention ignores not only the fact that the upper rates on capital gains taxation recently have been increased,[45] but also that capital gains can now also constitute a "tax preference," and will be taxed as such.[46] On

40. See id. § 453.

41. See, e.g., id. §§ 1031-39, dealing with common nontaxable exchanges.

42. See generally Katsoris, Accountants' Third Party Liability—How Far Do We Go?, 36 Fordham L. Rev. 191, 222-34 (1967).

43. "Statement on Conformity of Tax and Financial Accounting," adopted by the Board of Directors of the American Institute of Certified Public Accountants on Oct. 8, 1971, quoted in Simonetti, Conformity of Tax and Financial Accounting, J. of Accountancy, Dec. 1971, at 75, 75-76.

44. Capital losses are generally restricted to capital gains for corporations and to capital gains plus no more than $1,000 for individuals. Int. Rev. Code of 1954, § 1211.

45. Id. § 1201; see Look at What's Happening to Capital Gains, Fortune, Aug. 1972, at 193: "Some accountants, particularly those familiar with Wall Street tax problems, find more than a little irony in all this talk about increasing the capital-gains tax. Even as the election-year appeals for tax relief, tax reform, and more tax revenues resound, taxpayers in the upper income brackets are already in for higher taxes on their 1972 capital gains, and some of the working rich may be in for even higher rates than they themselves realize. For the Tax Reform Act of 1969 has been taking effect in stages, and this year the rate on realized net long-term capital gains exceeding $50,000 goes up a final notch, from 32.5 to 35 percent, while the maximum rate on earned income goes down a final notch, from 60 to 50 percent."

46. Int. Rev. Code of 1954, § 57(a)(9).

the other hand, wages are but one form of remuneration for services rendered. Other forms of compensation receiving favorable income tax treatment include such items as employer-financed life insurance,[47] medical insurance,[48] pension plans,[49] and other fringe benefits unavailable to the unemployed or retired. Foreign wage earnings are to a great extent excluded from income taxation.[50] Moreover, a maximum tax of 50 percent has been placed on earned wages.[51] In short—desirable as these wage-related features may be—income earned from wages is not entirely free from preferential treatment.

It is also interesting to note the tax treatment of interest income—that is, income earned for the use of money. Interest rates depend to a large extent on the security of the borrower, generally measured in terms of net book or asset value backing up the loan itself and/or earnings' coverage of the interest to be paid by the borrower. The more secure the loan, the lower the rate. This is a rule of palpable common sense imposed by the marketplace.

In the case of a state or municipal bond, however, the interest paid is exempt from income taxation.[52] This exemption to the lender enables these political subdivisions to borrow vast sums of low-cost money, so necessary for governmental operation and expansion at the state and local level. Such bonds are attractive, of course, to the high-bracket taxpayer. Reformers have long sought to eliminate this exemption, but to date have failed for a variety of reasons. So complete has been the exemption that the interest on these bonds was not even included as a tax preference under the minimum tax provisions.[53] Perhaps the chief obstacle to the elimination of the exemption has been doubt as to the constitutionality of taxing such income.[54] To avoid the constitutional issue and at the same time to increase the net revenue available to the federal government, it has been proposed that the federal government induce localities voluntarily to issue taxable bonds by paying to the locality a subsidy which would equal or exceed the increased interest cost the taxable bond would bear.[55] The federal government, in turn, would profit to the extent that

47. Id. § 79.
48. Id. § 106.
49. Id. §§ 401-07.
50. Id. § 911.
51. Id. § 1348.
52. Id. § 103.
53. See id. §§ 56-58.
54. See Chances for a Tax Cut, Interview with Wilbur D. Mills, U.S. News & World Rep., Apr. 16, 1973, at 53, 56.
55. Id. at 55-56.

tax revenue received on such bond interest exceeds the subsidy it must pay to the localities.[56]

In the case of taxable interest, be it in the form of a bond, note, or other indebtedness, secured or not, the rate of ordinary return is usually significantly higher and more secure than most forms of equity investments. Moreover, the corporate borrower is perfectly willing to pay a higher fixed rate on a straight indebtedness because, generally, it in turn can deduct such interest from its taxable income. No such deduction is allowable for dividends paid to its shareholders.

Each form of investment, therefore, has its peculiar economic and tax advantages. If reducing or eliminating the tax exemption for interest on state and municipal bonds is feasible,[57] so be it. The principal objectives here are to keep state and municipal borrowing rates low, and at the same time increase net federal revenue. Placing capital gains, however, on a rigid tax par with interest income would be both unfair and foolish. This is particularly true in view of the enormous sums of capital that must be raised to meet this nation's economic and social needs. Accordingly, it has been emphasized:

Some economists have estimated our capital needs to be at least $100 billion per year for the foreseeable future. If we are to meet the challenges of greatly increased competition from abroad (both in domestic and foreign markets) and also the needs to solve problems at home—social, environmental and economic—we must continue

56. "For example, assume a State issues a nontaxable bond at 6 per cent. Also assume that it would go at an 8 per cent rate if taxed. The Federal Government would subsidize this State if it issued a taxable bond instead of a tax-exempt one. The U.S. Treasury would pay back to the State or city, say, 40 per cent of that 8 per cent. That means the 8 per cent then becomes 4.8 per cent. So the State and city would be paying less in the long run than if they issued a tax-exempt bond. But the taxes the Federal Government would collect if States and cities did issue taxable bonds would be greater than the amount of the subsidy to the localities.

. . . .

"No one loses except the people who would otherwise enjoy the income from tax-exempt bonds." Id. at 56.

57. It is not entirely clear, however, whether many of such obligations, once the tax exemption incentive is removed, can be sold competitively in the open market in relation to prime corporate bonds. But see Fortune, The Impact of Taxable Municipal Bonds: Policy Simulations with a Large Econometric Model, 26 Nat'l Tax J. 29 (1973) (contending that the option of issuing subsidized taxable state and local bonds "would broaden the market for S&L [state and local] debt by inducing low tax sectors such as life insurance companies and pension funds to purchase (taxable) S&L debt, thereby providing a secularly larger amount of funds for S&L government capital expenditures. It would also mitigate the sensitivity of S&L finance to monetary policy since in periods of tight money, when commercial banks are withdrawing from the market for tax-exempt debt, S&L governments could issue taxable debt which investors other than commercial banks would be willing to purchase.") (footnote omitted).

a tax structure that will encourage citizens to accumulate capital and take the risk inherent in investing it.

As an example of the problems faced by American business in competing in worldwide markets, a *Fortune* survey of our 500 largest industrial companies shows that the average amount of capital investment per employee has risen from approximately $16,400 in 1957 to $31,800 in 1971. Total assets for these companies increased over this period from roughly $150 billion to over $450 billion. In spite of this increase in capital investment, U.S. industry presently has the highest percentage of obsolete industrial facilities of any leading industrial nation. Furthermore, we are replacing facilities at a slower rate than other leading countries. As an example, fixed asset investment in relation to gross national product for Japan and West Germany is currently running about 27% to 20% respectively, while our rate is less than 13%.

Rapidly changing technology and modernization of facilities will continue to require large amounts of capital. If preferential treatment for capital gains is eliminated, there are serious doubts as to the availability of the capital needed and the willingness of investors to take the risks.[58]

Congress would also be advised to consider the tax treatment accorded capital gains by other countries,[59] for taxation is a determining factor in the "cost" of capital, which in turn is "naturally reflected in the price of goods."[60] Thus, capital gains treatment affects our competitive position in world markets.

Nor will the treatment of capital gains as ordinary income go unnoticed in our securities markets. Indeed, this would be particularly true in the case of the individual public investor, whose numbers of late have been dwindling.[61] His importance to the securities markets and, indeed, to our economy, has been highlighted as follows:

A few years ago, Wall Street wished the little man—the small investor—would go away and, sure enough, he did. Now, Wall Street is striving to get him back.

. . . .

No longer can stock firms view their marketplace as the automatic investment vehicle for Americans with extra money. For many brokerage firms, beset by mounting costs, new competition and regulatory problems, the question of the small investors is turning on the survival of the stock market as it is now constituted.[62]

58. Testimony of R. Skinner, chairman of the American Institute of Certified Public Accountants division of federal taxation, before the House Ways and Means Committee, Mar. 12, 1973, reported in Forster, Tax Division Testifies on Tax Reform, J. of Accountancy, May 1973, at 30, 31-32.

59. The Capital Gains Debate, Investor's Reader, Mar. 7, 1973, at 20. "Different countries vary in their treatment of capital gains. Britain and Canada only started to tax them in 1965 and 1972 respectively. However, in fast-growing West Germany and Japan capital gains are generally exempt from taxes." Id. at 24-25.

60. Id. at 25.

61. Vartan, Shareholder's Ranks Down, N.Y. Times, Mar. 26, 1973, at 63, col. 8.

62. McKenna, Wall Street and the Small Investor: They Need Him. Can They Woo Him Back?, N.Y. Daily News, Apr. 16, 1973, at 38, col. 1. See also Hooper, What About the Individual Investor?, Forbes, June 1, 1973, at 73, 73-74; Loomis, How the Terrible Two-Tier Market Came to Wall Street, Fortune, July 1973, at 82:

It is not surprising, therefore, that the New York Stock Exchange, recognizing the importance of the public investor, presented to the House Ways and Means Committee a series of tax proposals designed to make securities once again an attractive investment to the individual; namely:

The tax incentives proposed would increase to $200 from $100 the exclusion for dividend income; allow commissions paid on purchases or sales of securities to be treated as a deduction against ordinary income; permit limited tax deduction for retirement savings, and encourage voluntary employee contributions to employer-sponsored profit-sharing or stock bonus plans.

[In addition,] adoption of a sliding-scale system under which the percentage of capital gains subject to taxes would decline gradually from 50% to 20% over a 30-year period.[63]

Not all people share these views, however. For example, in a recent interview, Professor Richard A. Musgrave, who supports both the taxation of capital gains at ordinary income rates and the taxation of unrealized capital gains at the time of death or transfer by gift, was asked if his proposals would not discourage capital investment and economic growth.[64] He responded, in part:

"To many businessmen the stock market this year has seemed inexplicable, about as bizarre, say, as Watergate. The market has ignored the large, and often sensational, earnings gains being reported by corporations, and has gone relentlessly down. More than that, it has gone down with a great unevenness, much as a giant popover might lose steam.

"On the one hand, the prices and price-earnings ratios of a few dozen institutional favorites—known around as 'the Vestal Virgins'—have fallen only moderately. . . . In contrast, the great majority of stocks have sunk to levels that suggest they have become virtual pariahs. In the early months of this year, Wall Street was already talking about a 'two-tier market' of remarkable proportions. By May, stocks that had seemed cheap at March prices had collapsed still further—many to levels of four or five times expected 1973 earnings—and the situation was being described as unique in stock-market history.

. . . .

"The basic questions concern the country's capital markets, which have in the past demonstrated an outstanding ability to deliver equity capital to a broad range of companies. The two-tier market suggests, however, that the range is narrowing and the universe in which investors are willing to sink their money is shrinking. If this situation persists, how are the great majority of companies to raise the equity capital they may need? Beyond that, what happens to the new company seeking equity capital for the first time? Optimistic answers to these questions are hard to come by." Id. at 82-83.

For more on the impact of institutional investing on the securities market see T. Russo & W. Wang, The Structure of the Securities Market—Past and Future, 41 Fordham L. Rev. 1, 1-2 (1972).

63. Public Quitting Mart, N.Y. Daily News, Mar. 26, 1973, at 38, col. 4. Furthermore, it has been suggested elsewhere "that small investors be allowed a full tax deduction against ordinary income for net capital losses during the year up to a maximum limit of $5,000 instead of the present $1,000 limit." Tax Aid Urged For Little Guy, N.Y. Daily News, Sept. 26, 1973, at 60, col. 5.

64. Musgrave, supra note 18, at 52.

The question is, if we want to do something tax-wise to encourage growth, is the blanket exemption of capital gains the right way to do it? Suppose, instead, you increase the investment tax credit to 25%. That would do as much good to capital investment as fully taxing capital gains would do harm to capital investment. And you would be left with a much more equitable system.[65]

The Musgrave proposal is objectionable on several grounds. For purely selfish reasons, the small investor would prefer the direct tax benefit of favorable capital gains rates for himself rather than have the benefit inure to a large corporation through the use of an increased investment credit. Moreover, it is doubtful that the Treasury would be significantly enriched by the substitution of one tax preference for the other. Even if it were, the currently allowable "flow through" effect that the seven percent investment credit has on earnings is distorting enough, without more than tripling it.[66] There is also the danger that the elimination of the present capital gains tax treatment might loose a tidal wave of securities selling. And far greater long range harm might result from such changes if they further alienate the public investor to the point of destroying the liquidity of, and thus endangering the very existence of, our present securities exchanges as viable marketplaces.[67]

Some consideration should also be given to the role of the foreign investor in this country. Net sales or purchases of domestic securities by foreigners during the last few years have been quite substantial and seemingly in generally increasing amounts.[68] Such foreign investments have

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65. Id.

66. See Metz, Accounting Profession, Vexed by Lawsuits, Weighs Responsibility to Shareholders, N.Y. Times, Nov. 20, 1966, § 3, at 1, col. 1. "When Congress passed the 7 per cent credit for investment in business equipment, this accounting problem arose: Should the 7 per cent credit that permitted businessmen to reduce their taxes by up to 7 per cent of the cost of equipment be reflected in earnings in the year in question?

"The Accounting Principles Board decided that . . . it should be charged off a bit at a time over the life of the equipment—a conservative approach.

"The S.E.C., reportedly spurred by the Administration, ruled that for its purposes either method would be considered satisfactory. The Administration was anxious to have the credit spur investment in plant and equipment, and the higher earnings that resulted from an immediate reflection in earnings was designed to build business confidence.

"Thus, despite the best efforts of the Accounting Principles Board, two methods were permitted and the difficulty of comparing two corporations in the same industry became that much harder when each used different methods." Id. at 14, col. 4.

67. See text accompanying notes 61-63 supra.

68. The following statistics demonstrate trends in the buying of U.S. stock by foreigners:

"Net Sales by Foreigners of Stock in U.S. Corporations

1965	$413 mil.
1966	$333 mil.

been encouraged for a variety of reasons—principally because they have a favorable effect on our balance of payments.[69] Thus, non-resident alien individuals generally are not taxed on capital gains if they are substantially not present in the United States during the taxable year.[70] Similarly, foreign corporations generally are taxed only on capital gains effectively connected with a United States business.[71] The need for some inducement to our own citizens, therefore, becomes more apparent when one considers the effect a foreign-dominated securities market could have on our economy.[72]

Net Purchases by Foreigners of Stock in U.S. Corporations

1967	$757 mil.
1968	$2,270 mil.
1969	$1,487 mil.
1970	$626 mil.
1971	$731 mil.
1972	$2,140 mil.

In 1973: Foreigners, in the first three months, bought $1.3 billion more stock in U.S. companies than they sold—a pace which, authorities say, indicates strongly that the record set in 1968 will be broken this year." When You Take a Close Look at the Stock Market . . . , U.S. News & World Rep., June 4, 1973, at 61, 62.

69. H.R. Rep. No. 1450, 89th Cong., 2d Sess. 5-6 (1966); see S. Rep. No. 1707, 89th Cong., 2d Sess. 9 (1966).

70. Int. Rev. Code of 1954, § 871(a)(2) provides for such taxation in the case of non-resident alien individuals who are "present in the United States for a period or periods aggregating 183 days or more during the taxable year. . . ."

71. See id. §§ 881, 882(a).

72. Recent dollar devaluations have made our securities quite attractive to investors holding foreign currencies. See Elia, On The Prowl: Europeans, Japanese Find the Time Is Ripe to Acquire U.S. Firms, Wall St. J., June 22, 1973, at 1, col. 6. "Underlying this spate of activity, observers say, is a situation involving exquisite timing. On the one hand, a declining stock market has put the cost of buying the earning power of many U.S. firms at bargain-basement levels (nearly 1,000 companies listed on the New York Stock Exchange were selling at or below 11 times one year's earnings on May 31). At the same time, successive devaluations of the dollar have sharply boosted the purchasing power of many foreign currencies in terms of the dollar assets for sale in this country. Finally, an estimated $75 billion to $80 billion is currently held abroad, and some foreign holders of this money are regarding their own countries' currencies as over-valued in relation to American dollars." Id. See also Arab Oil Money Piles Up—A Burden or a Blessing?, U.S. News & World Rep., Aug. 6, 1973, at 65; Warshauer, Japan Investment in Wall Street Seen at $1 Billion in '74, N.Y. Daily News, July 2, 1973, at 38, col. 1; Wright, Imported Capital: Foreigners Step Up Investment in U.S., N.Y. Times, July 15, 1973, § 3, at 1, col. 6.

Moreover, in projecting the aggregate foreign investment in United States companies or assets, consideration should also be given to the possibility of significant future acquisitions of or investments in domestic downstream operations by foreign oil-producing nations. The general motivation behind such acquisitions or investments is that they should guarantee supplies for a crude-deficient U.S. refiner or marketer, insure an outlet for the foreign crude of the producer nation, and permit the oil producer to share in the downstream profits. See, e.g., Wall St. J., July 27, 1973, at 7, col. 1.

Opponents of capital gains point to the fact that the "rich" are permitted to avoid taxes by borrowing money for capital investments which will appreciate in later years and then be taxed at capital gains rates.[73] In the interim, the interest on the indebtedness used to purchase or carry the capital asset is currently deductible from other ordinary income of the taxpayer. The argument has merit, and this is precisely why such interest deductions are now limited.[74]

Capital gains foes will also emphasize recent disclosures which confirm that many wealthy people, despite the minimum tax provisions of the Internal Revenue Code,[75] are still paying little or no income tax at all.[76] Such revelations will no doubt be put forward by reformers as a reason for eliminating the capital gains preference. The fact remains, however, that realized capital gains are themselves taxable. Moreover, capital gains can constitute a taxable preference item.[77] If these wealthy persons, therefore, are paying no tax, they are escaping through other sections of the Code. If the minimum tax provisions are ineffectual, then they should be amended. It would be irrational, however, to attain the laudable goal of requiring the wealthy to pay their fair share by destroying the concept of capital gains for everyone.[78] Such action would constitute a classic example of the tail wagging the dog.

This article does not mean to suggest that capital gains should remain in status quo. Its thesis, rather, is that the elimination of capital gains as

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73. See Halperin, Capital Gains and Ordinary Deductions: Negative Income Tax for the Wealthy, 12 B.C. Ind. & Com. L. Rev. 387, 389 (1971).

74. Int. Rev. Code of 1954, § 163(d).

75. Id. §§ 56-58.

76. See Results of a Special Tax on the Wealthy, U.S. News & World Rep., Apr. 30, 1973, at 99. It has been reported that Congressional liberals now plan to press for a higher minimum tax, using reports of the small tax payments made by President Nixon as one argument for their side. Wall St. J., Oct. 12, 1973, at 1, col. 5.

77. Int. Rev. Code of 1954, § 57(a)(9).

78. "Who benefits from special capital gains treatment? It has generally been thought that capital gains are largely attributed to upper bracket taxpayers while middle and lower bracket taxpayers bear a disproportionate share of capital losses. However, recent Treasury studies indicate that . . . in 1970 . . . 50% of all capital gains was realized by persons with adjusted gross income under $30,000. To the extent that reliance can be placed on adjusted gross income statistics that exclude tax exempt interest and one-half of realized long-term capital gains and that are arrived at after tax sheltering deductions, they indicate that any increase in capital gains taxation would fall nearly as heavily on 'victims' of the present system as on the so-called 'transgressors.' " Darrell, Reflections on the Federal Income Tax, 28 Record of N.Y.C.B.A. 412, 421-22 (1973) (footnotes omitted).

It is also reported that persons with "incomes of less than $15,000" represent about two-thirds of all people who have capital gains and that their aggregate gains represent approximately 30 percent "of the dollar total of capital gains." Shanahan, Lobbying on Capital Gains, N.Y. Times, Sept. 23, 1973, § 3, at 3, cols. 1, 4-5.

such is not the answer. Instead, what should be reappraised is the question of which assets and transactions should qualify for capital gains treatment.[79] Purely as examples, "distributions from retirement plans, stock options, patent royalties, coal royalties, [and] cutting of timber and livestock" have already been suggested[80] as candidates for ordinary income treatment.

In determining what is a fair treatment for capital gains, consideration should also be given to the effect of inflation upon capital investments. For example:

> Capital gains foes rally round such outwardly appealing arguments as that "money earned by money" should be taxed as heavily as the money earned by the sweat of the laborer's brow. But, other arguments aside, the plain fact is that a capital gain simply isn't that kind of money. The money which money earns is usually in the form of dividends and interest which are subject to regular tax. In capital gains, it's not that money has "earned" something; rather, the money itself (in the form of the asset in which it has been invested) has increased in dollar value—sometimes simply because of inflation. And the key point is, when you sell the asset to realize your gain, you've given up your chance to reap future regular income from it.[81]

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79. Int. Rev. Code of 1954, § 1221 currently defines a capital asset as property held by the taxpayer, but not including:

"(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue." Id. § 1231 further extends the concept of capital gains to situations where the gains on sales or exchanges, and compulsory or involuntary conversion of certain types of property (held for varying periods of time), exceed the recognized losses from such sales, exchanges and conversions. Such qualifying property includes: a) depreciable property or real property used in a trade or business; b) timber, coal, or domestic iron ore; c) livestock; and d) unharvested crops.

80. Marshall & Crumbley, Reform Proposals for Taxation of Capital Gains, 108 Trusts & Estates 871, 879 (1969).

81. The Capital Gains Debate, supra note 59, at 20.

Otherwise, who is to compensate the investor for the erosion of his buying power?[82] A wage-earner, on the other hand, is usually accommodated through an increase in the rate of his wages to reflect the inflation factor.[83]

Taken in this inflation context, however, it would appear that the present six-month holding period may not be long enough to qualify an investor for preferential treatment. Instead, perhaps such holding period should be extended to at least one year.[84] Such change, however, should be accompanied by a tax rate which becomes progressively smaller as the holding period increases.[85] Together they should have the overall effect of increasing tax revenues,[86] alleviating any necessity for a rollover approach

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82. See, e.g., Forster, supra note 58, at 32, wherein it is said: "[T]he Consumer Price Index has risen nearly 50% in the last 15 years, and about 25% in the last five years.

"If a taxpayer invested $100,000 in a corporate security in 1957 and sold it for $150,000 in 1972, he would have been approximately even in terms of purchasing power. However, even under our present capital gains tax structure, he probably would have incurred a tax of at least $12,500. This would have placed him in a worse position economically in 1972 than he would have been 15 years earlier. In effect, this represents a tax on capital and not a tax on income or real gain. By analogy, it represents a failure to distinguish between the tree and its fruit—a tax on the tree, rather than on the fruit. The combined effects of inflation and taxation have clearly eroded the amount of capital available for additional investment. If the present preferential treatment for capital gains were eliminated, the erosion of capital would be much greater, and in our judgment could create serious problems for our economy."

83. See, e.g., Kuhn, Inflation: It May Only Hurt a Little, N.Y. Times, Aug. 5, 1973, § 6 (Magazine), at 14, 16.

84. Admittedly, such extension could somewhat affect the liquidity of the marketplace by creating a temporary "lock-in" effect on securities being held for the additional six-month period in order to achieve capital gains benefits. For a discussion of "lock-in" generally, see text accompanying notes 102-03 infra. See also The Capital Gains Debate, supra note 59, which, in discussing the qualifying holding period generally, provides:

"Special tax treatment of capital gains was then instituted and for 1922-33 gains on capital assets held more than two years got a top rate of 12.5%. For capital losses, up to 12.5% of the loss could be subtracted right from the tax otherwise payable on ordinary income. In the Thirties a sliding scale of holding periods was adopted; gains were taxed 100% as regular income if held one year or less; least taxed (30%) were assets held over ten years. With Congress and the public disturbed by news of fat cats paring their tax bills to the bone, the 1938 Act eliminated the deduction of short-term losses from ordinary income.

"The now familiar six-month holding period was adopted in 1942 with the Depression's lack of trading very much in mind. The Senate Finance Committee noted the tax revenues from capital gains had been dropping steadily and 'the lowering of the holding period will have the effect of encouraging the realization of capital gains and thereby result in added revenue to the Treasury.' Six months is not a magic figure but Congress thought it was sufficiently long to differentiate ordinary business from capital transactions." Id. at 21.

85. For examples of varying sliding scales that have been proposed, see Forster, supra note 58, at 33; Marshall & Crumbley, supra note 80, at 879; Wormser, The Case Against a Capital Gains Tax at Death, 51 A.B.A.J. 851, 854 (1965); The Capital Gains Debate, supra note 59, at 23; and Public Quitting Mart, supra note 63.

86. Wormser, supra note 85, at 854: "[M]ore sales would be taxed with ordinary income tax and more 'long-term' sales would be made as the rates would be lower."

to capital gains taxation,[87] and treating the truly long-term investor more fairly by easing his tax burden in order to compensate him for his loss through inflation. Furthermore, such proposals would ultimately assist in easing the "lock-in"[88] effect that the present system seems to foster, for the hesitancy to sell and face a capital gains tax would be lessened as the tax rate gradually were decreased.

III. REALIZATION OF INCOME

Another assault upon capital gains is based upon the time they are taxed. There are those who feel a tax should be levied as property appreciates in value—even though the taxpayer still retains it.[89] Similarly, there is a movement to tax capital gains at the time of gift, or at death.[90]

A. *Appreciation During Inter Vivos Retention*

There is a school of thought which rejects the proposition that income should be taxable only when realized.[91] It contends that the insistence that income must be first realized to be taxable has its roots in "accounting thinking."[92] It is this sort of philosophy that underlies the so-called "Accrual Method" of taxing capital gains. This method calls for the tax recognition of both accrued and realized capital gains and losses each year. It usually provides for "the taxation of capital gains at the same progressive rates that are applicable to ordinary income along with the full offset of accrued capital losses against ordinary income."[93] In other words, each year the taxpayer "would be required to include in or exclude from taxable income the net accrued gain or loss on capital assets owned, whether or not such gain or loss is realized."[94] Recognizing that taxing unrealized income each year would present "too much of a task,"[95] it has been suggested that taxpayers "would settle up every five years, with a fifth of them being audited each year."[96] Such proposals are generally rejected, however, because the enforcement problems would be enormous.[97] Aside from the obvious problems of valuation, the "owners of rapidly growing companies might have to sell out to pay their taxes."[98] Moreover, if un-

87. For an explanation of the rollover concept see text accompanying notes 107-14 infra.
88. See text accompanying notes 102-03 infra.
89. See Armstrong, The Right Kind of Tax Reform, Fortune, Dec. 1972, at 86, 182.
90. Somers, The Case For a Capital Gains Tax at Death, 52 A.B.A.J. 346 (1966).
91. Musgrave, supra note 18, at 50.
92. Id.
93. Marshall & Crumbley, supra note 80, at 878.
94. Id. (footnote omitted).
95. Musgrave, supra note 18, at 50.
96. Armstrong, supra note 89, at 182.
97. Id.
98. Id.

realized appreciation is to be taxed, then, for the sake of consistency (and solely for the sake of argument), why not also tax a wage-earner, in advance, on the appreciation in the value of his skills—through further education or practical experience—instead of waiting until such appreciated skills are actually translated into higher wages or fees?

B. *Appreciation at Time of Gift or Death*

In the search for additional tax revenues, increased pressure is also mounting for the imposition of a capital gains tax on the unrealized appreciation in assets transferred by gift or at death.[99] The taxation of appreciated property at death would have little effect, however, unless a transfer by gift was also a taxable event; otherwise, the gains tax at death could be easily avoided merely by transferring such property by gift before death. This article, however, will not deal specifically with the pros and cons of taxing such gains at the time of gift, because that subject is basically ancillary and incidental to the much broader topic of such taxation at death; instead, it will examine only the latter topic. The problems presented by a proposal to tax capital gains at death are great; the stakes are high; and the emotions even higher.

1. Need for Revenue

Proponents for reform usually express the great need for additional revenue on the part of the government.[100] It is estimated that imposing a capital gains tax at death would at the outset reap the Treasury somewhere in the vicinity of an additional three billion dollars annually.[101] No one can deny the ever-increasing need for revenue. But this hardly seems justification, in and of itself, for raising such revenue by the imposition of a capital gains tax at death. For example, such argument for additional revenue can be applied with equal fervor in support of the proposition that instead, tax rates should generally be increased across the board.

2. Lock-In Effect

Proponents for reform object to the present capital-gains-avoidance at death, because it inhibits the free flow of investment capital within the economy. This so-called "lock-in" occurs when an investor, seeking to avoid or delay the recognition of income, retains the investment for a long period of time. Under present law, until the gain is realized, it is not recognized. The result is that capital becomes immobilized. This effect

99. See Seidman, Status of Federal Estate and Gift Tax Legislative Proposals, 51 Taxes 197, 200-01 (1973).

100. See Comment, Taxing Appreciated Property at Death: The Case for Reform, 51 Ore. L. Rev. 364, 366-67 (1972).

101. Id. at 367.

becomes even more acute because of the motive of avoiding capital gains entirely by retaining appreciated property until death;[102] yet the heirs receive a stepped-up basis at decedent's death.[103]

If one of the motives for retaining appreciated property until death is to receive a stepped-up basis, it can easily be removed by dispensing with the stepping up of the basis. "With no step-up in basis in the offing, there would be no tax incentive to hold appreciated assets until death,"[104] for the heirs would ordinarily incur the gain upon their disposal of the property. This procedure for appreciated assets would therefore be similar to the one provided in the present law for gifts[105]—that is, a carryover of the donor's basis to the donee.[106]

3. Rollover Approach

In passing, mention should be made of the so-called "rollover approach." This involves the deferral of tax on the net realized rollover gains to the extent that the gains are reinvested in other rollover assets. Such rollover approach is already recognized in the cases of involuntary conversions,[107] sales of residences,[108] exchanges in kind,[109] and others. In the instant situation, in "order to keep deferred tax on rollover gains from being postponed indefinitely, the proposal requires that the death of the taxpayer be treated as constructive realization."[110] Although such approach alleviates the lock-in problem, it would have the effect of permitting interest-free loans to the extent of the amount of tax deferred during the lifetime of the taxpayer.[111]

Under rollover, such gains are deferred to the extent of reinvestment in

102. Holt & Shelton, The Lock-in Effect of the Capital Gains Tax, 15 Nat'l Tax J. 337, 340 (1962).

103. Int. Rev. Code of 1954, § 1014. This new basis has been described as "a rough way of compensating for inflation." Perspectives on Suggested Revisions in Federal Estate & Gift Taxation, 112 Trust & Estates 102, 107 (1973).

104. Comment, Proposed IRC Sec. 84: Income Taxation of Unrealized Appreciation at Death: Unwise; Unwieldy; Unconstitutional, 34 U. Pitt. L. Rev. 23, 24 (1972).

105. Marshall & Crumbley, supra note 80, at 878.

106. The rules for determining basis of property acquired by gift are found in Int. Rev. Code of 1954, § 1015. It generally provides that for purposes of gain, the basis of the donee is the same as the donor's basis increased by the amount of gift tax paid on the gift, but it is not to be so increased above the fair market value of the property at the time of the gift. The donee's basis for purposes of loss is the same as for gain, or the fair market value of the property at the time of gift, whichever is lower.

107. Int. Rev. Code of 1954, § 1033.

108. Id. § 1034.

109. Id. § 1031.

110. Marshall & Crumbley, supra note 80, at 874.

111. Taxing Appreciated Property at Death, supra note 100, at 379.

qualified rollover assets,[112] and the "cost basis of the new property acquired as reinvestment would be reduced on a pro rata basis by the amount of the gain currently not recognized."[113] The major problem in the implementation of the rollover concept, however, is complexity, and thus this proposed approach seems neither practical nor feasible.[114]

4. Equitable Considerations

Reformers also argue that the present system results in inequality of treatment based upon the accident of death.[115] At present, a man who liquidates his holdings just before he dies incurs both a capital gains tax and an estate tax, whereas a man who dies without such inter vivos liquidation pays only an estate tax.[116] In the former situation, however, the taxpayer usually gets a stepped-up basis on the property he receives in the liquidation. Accordingly, if, in the situation of the taxpayer who did not liquidate before death, no stepped-up basis was to be had upon his death for such property,[117] this would greatly help remove inequities, because his heirs would pay the capital gains tax when they liquidate.

5. Administrative Difficulties

Opponents of a capital gains tax at death emphasize that such legislation necessitates tracing the cost basis of capital assets. In many instances, this would cause no problem. In other situations, however, such tracing can be extremely difficult. For example, in the case of realty it would be almost impossible to establish the cost of the numerous capital improvements and additions made over the years. The same problem could arise in the case of a closely held business.[118] Moreover, after the decedent's death, the cost basis of his securities might be very difficult to ascertain where the decedent had held them for a long period of time, during which they were the subject of stock dividends, splits, mergers, reorganizations, etc. Additional complications occur when the property was "received by the decedent by gift from a donor who, in turn, received them by gift from a previous donor who himself had received them by gift from an earlier donor."[119] In that case, as "the cost basis of the original, antecedent donor

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112. As to a suggested class of qualified rollover assets see Marshall & Crumbley, supra note 80, at 874.

113. Id.

114. For a contrary opinion see Clark, An Alternative to Capital Gains Taxation: A "Roll-over" Account for Investment Assets, 4 How. L.J. 157, 162-63 (1958).

115. Taxing Appreciated Property at Death, supra note 100, at 367-68.

116. Somers, supra note 90, at 346.

117. See text accompanying notes 103-06 supra.

118. Proposed IRC Sec. 84, supra note 104, at 27.

119. Wormser, supra note 85, at 854.

would be the decedent's cost basis and, therefore, that of the estate, tracing the cost basis could become an impossible job."[120]

It may seem that this administrative problem might be resolved in some instances by adopting the corollary that capital gains legislation should tax only gains accruing after its enactment; thus, "decedent's basis could be no less than the fair market value of the property at the date of enactment."[121] This approach, however, "does not alleviate the administrative difficulty, for in order to determine which value is higher, both must be ascertained."[122] It still is necessary, therefore, to compute decedent's cost basis.

6. Additional State Tax

The imposition of federal taxation on capital gains at death could also lead to additional taxation at the state level. In this regard, one author has concluded:

> The result could be virtual confiscation in many instances.
>
> Moreover, can we be sure that the states would recognize the capital gain tax at death as a debt of the decedent? Whatever the Internal Revenue Code may call it, a state might deem this tax to be the equivalent of an additional death tax and, therefore, allow no debt deduction. Indeed, it would seem to me that the states would have to take this position in self-defense. If they did not, then their own tax take would be reduced. I should think, therefore, that the state governments would rise up against the proposal, and if it were enacted, they would be likely to institute a capital-gain-at-death tax of their own to make up the loss in state tax receipts. This new state imposition, piled on top of the federal, would punish the taxpayer nobly.[123]

7. Liquidity

A capital gains tax at death can cause serious problems with estates holding nonliquid assets, such as interests in closely held businesses. Such interests often are of a decedent's own creation and their value may have appreciated greatly over the years. Unfortunately, at the time of the taxpayer's death, these interests often are not readily marketable. Even more frequently, they are salable only at a discount. In both instances, the tragic result may be that the cash needs of the estate require the divestiture of the family enterprise.

These liquidity problems have become even more acute because of the reduction of the time for the payment of the Federal Estate Tax from fifteen months to nine months.[124] The slight advantage gained by the government through the acceleration of such estate tax receipts callously

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120. Id.

121. Taxing Appreciated Property at Death, supra note 100, at 377 (footnote omitted).

122. Proposed IRC Sec. 84, supra note 104, at 28.

123. Wormser, supra note 85, at 853.

124. See Int. Rev. Code of 1954, § 6075(a), as amended, Act of Dec. 31, 1970, Pub. L. No. 91-614, § 101(b), 84 Stat. 1836.

disregards the grief such speed-up can cause many estates.[125] To impose an additional capital gains tax at death would immeasurably complicate the problem.

Tax reformers suggest that the problem could be alleviated, upon a determination of hardship, by merely extending the time for paying the tax, *e.g.*, in installments over a period of years. This suggestion presupposes that the Internal Revenue Service agrees that there is a hardship. Secondly, in the case of closely held corporate stock, "[a]part from redemption, which is usually impractical because of a shortage of working capital, the only other way to raise enough money to pay the estate and income taxes due is with personal earnings or dividends."[126] It is doubtful whether enough could be accumulated during that time to meet the installment payments.

It has been suggested that Int. Rev. Code of 1954, § 303 (dealing with the redemption of stock to pay death taxes) might be used to ease the crunch of illiquidity. Its application, however, would depend upon whether the present section would be amended to cover as well the payment of capital gains taxes at death. Even if it were, and the estate could meet the valuation requirements of the section (such stock must comprise 35 percent of the gross estate or 50 percent of the taxable estate), there would still be the problem of whether the corporation had sufficient working capital to effect the redemption. Moreover, as has been pointed out aptly:

> Whatever the problems of the estate whose decedent held control of an enterprise, consider the added problem of the estate holding only a minority stock interest. Who would buy this minority interest in a small or middle-sized, untraded company? And if there is no purchaser available, how is the estate to liquidate enough to pay its obligations? In some few cases Section 303 of the Internal Revenue Code might be available—*if* the corporate finances permitted, and *if* the majority stockholders were gracious and *if* Section 303 were amended to permit redemption for capital gains tax purposes. In most instances, Section 303 would be unavailable. I suppose, then, that the executors would have to sell the stock at auction. I point out again that it is the smaller and middle-sized estates which would be most injured by the additional necessity of liquidating to pay a capital gains tax at death.[127]

8. When is Income Taxable?

The question of whether a gain on property is "realized" merely by the death of the holder raises two interesting questions. The first is whether taxing the unrealized gain at the death of the holder is constitutional.

125. E.g., estates involving will contests; estates where there is disagreement as to the appointment of an administrator; estates involving foreign assets, closely held businesses, and other non-liquid assets; and estates involving foreign or unknown heirs.

126. Koudelis, Some Observations on the Proposed Capital Gains Reforms, 37 Temp. L.Q. 289, 316 (1964).

127. Wormser, supra note 85, at 852.

Assuming the answer to the first question is in the affirmative, the next issue is whether such taxation is fair.

The issue of constitutionality has been the subject of no small controversy. Indeed, both sides have been discussed extensively.[128] For example:

> A basic problem is the constitutional one. Such distinguished tax lawyers as Randolph Paul and Stanley Surrey have asserted that a tax on capital gains at death would be constitutional. Granted that *Eisner* v. *Macomber*, 252 U.S. 189 (1920), has been whittled away over the years, it never actually has been overruled. It might yet come back to haunt those who seek to tax the constructive realization of capital gains at death. Congress certainly may declare death to be a "taxable event", but whether the Sixteenth Amendment can stand the strain is not so clear: the capital gains tax is still part of the income tax.[129]

There is no need to add further rhetoric and speculation to this problem. As things stand now, the ultimate decision can only be made by the Supreme Court.

On the issue of fairness, let us look at a valuation problem that currently is causing great concern in the estate tax area, and which would be greatly compounded by a capital gains tax at death. Take, for example, farm acreage that has been owned and tilled by one family for many generations. The present owner, in his will, devises this land to his children who intend and desire to continue to farm it. Upon the death of the father, are we to value the land for estate tax purposes as farm land, or as potential industrial development land? Unfortunately, with greater frequency, the latter valuation is sought by the government, with the result that the traditions, dreams, and desires of generations are abruptly ended in order to pay the estate taxes. If this concept of valuation has any validity in connection with estate taxes, it certainly has none in the realm of income realization. Admittedly, there must be a tax on the transmission of wealth,

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128. Concluding that such taxation would be unconstitutional, see Roehner & Roehner, Realization: Administrative Convenience Or Constitutional Requirement?, 8 Tax L. Rev. 173, 175 (1953); Proposed IRC Sec. 84, supra note 104, at 30-41. Contra, Surrey, The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions, 35 Ill. L. Rev. 779 (1941); Taxing Appreciated Property at Death, supra note 100, at 371-75.

129. Somers, supra note 90, at 347 (footnotes omitted). Cf. Marshall & Crumbley, supra note 80:

"The implementation of a tax on unrealized gains has been discounted since it was thought to have constitutional difficulties. The realization principle was enunciated by the Supreme Court in the Macomber case, and this indicates that an accrual method may be unconstitutional. Presently, however, the chances of an accrual method being upheld are much improved as indicated by testimony before the House Ways and Means Committee in connection with the taxation of capital gains (unrealized) at point of transfer by gift or death. The opinion is not directed toward a complete accrual basis, but the reasoning given indicates that subsequent decisions have impaired the authority of the Macomber case. Other authorities agree with this favorable opinion where transfer by donation or death is involved." Id. at 878 (footnotes omitted) (italics deleted).

but has the children's income position changed from that of their ancestors in tilling the same land? It is submitted that such income taxation would be patently unfair.

IV. Conclusion

The concept of capital gains should be retained, albeit changed somewhat. The changes should recognize the need for revenue, the need for fairness among all taxpayers, and yet preserve the benefits of a concept that has real value and usefulness to this country, its economy and its taxpayers.

True capital gains realized in an inter vivos manner should not be taxed as ordinary income. Instead, they should continue to be taxed differently, with a progressively lower rate as the holding period increases. To qualify for such preferential treatment, however, the minimum holding period might be extended from the present six months to at least one year. Furthermore, the types of gains that qualify should be restricted solely to gains that are truly capital in nature. Those that are not should be excluded.[130] Such changes will increase revenue for the government and raise it more fairly, preserve the utility of capital gains, and help alleviate the "lock-in" effect on investments which the present rules seem to foster.[131]

The rules for capital gains at the time of gift should remain unchanged. That is, capital gains should not be recognized at the time of gift, and the donee, in the case of appreciated property, should basically retain the donor's basis. Gain, therefore, will be recognized when the donee sells or exchanges the property.

As for capital gains at death, the decedent's estate should be given the

130. For example, if authors and artists are no longer entitled to capital gains treatment on their creations (Int. Rev. Code of 1954, § 1221(3)), there appears to be little reason to continue it in the case of patents (id. § 1235). On the other hand, a careful examination should be made of all capital gains items. It is beyond the scope of this article to undertake such scrutiny. Far better it be done item by item, with all interested parties having an opportunity to be heard.

131. Admittedly, one could also argue that, to insure that no lock-in effect develops under the proposals set forth herein, it should also be provided that, in applying the gradually decreasing rates, the holding period of the decedent would not be added to the holding period of his heirs. Such provision would, in many instances, clearly act as an inducement (for a long-time owner of appreciated property) to sell before his death. This would generally be so because his rates should be lower (as a result of his extended holding period) than those of his heirs, who, denied credit for decedent's holding period, would (at least initially) have to pay at a higher capital gains rate. Despite some merit to this suggestion, it is submitted that it be kept in abeyance until actual experience showed a serious lock-in effect would also develop under the alternative optional treatment recommended herein for appreciated assets at death.

option of either: a) having no capital gains tax at death, with the estate retaining the donor's basis as in the case of gifts;[132] or, b) taxing the unrealized capital gains at death, with the estate receiving the stepped-up basis. Offering such an election[133] would increase the revenue to the government, yet at the same time be much fairer to an estate than an inflexible rule that absolutely requires such taxation upon death, no matter what the consequences. Moreover, if an estate freely chooses to pay the capital gains tax at death (in order to obtain the stepped-up basis), it would appear that its consent should go a long way towards resolving the constitutional objections currently raised against such taxation.

132. Consideration should also be given to alleviating the problem of computing such basis. See text accompanying notes 118-22 supra. This could be done by changing the rules with respect to the proof of basis. See Perspectives on Suggested Revisions, supra note 103, at 106-07: "Further, if we are to do away with the step up in basis and use the gift tax rule of a carryover basis, it would be in order to change the rules with respect to the proof of basis. At the present time, this burden is shifted to the taxpayer if the Government refuses to accept what the taxpayer reports. One proposal would be to change this rule by saying that there is a presumption, where basis cannot be proved, that the basis is the property's fair market value on the date of acquisition."

133. Such election could be signified on the Federal Estate Tax return in a manner similar to the present method by which the estate fiduciary indicates that he chooses to value the estate as of the alternate valuation date. See Int. Rev. Code of 1954, § 2032.