

## Fixing Capital Gains at the Core

By Calvin H. Johnson

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The income tax brackets, with rates up to 35 percent, attempt to adjust the tax rate to the standard of living that the income supports. Capital gains get a 15 percent tax rate on the assumption that the gain will not be consumed but will be reinvested. In an efficient market, however, it is not appropriate to presume that sales are made for reinvestment, once relative prices adjust to known information. As a condition for the lower capital gains tax rates, the proposal would mandate reinvestment into an account not available for consumption. Later distributions of capital gains from the account would be treated as ordinary income, but with a credit for capital gains tax previously paid. Corporate stock would not be affected because the lower shareholder tax is a relief from double taxation. The proposal would also reduce the spread between capital gain and ordinary income to no more than 10 percent of gain because the global glut of capital means that not much preference needs to be given to old capital.

The proposal is made as a part of the Shelf Project, which is a collaboration among tax professionals to develop and perfect proposals to help Congress raise revenue. The current deficit, now at \$1.6 trillion or 11.2 percent of GDP, cannot be sustained. In the impending revenue crisis, base-protecting revenue provisions that were not possible under ordinary politics become political necessities. Shelf projects defend the tax base and improve the rationality and efficiency of the tax system. Shelf Project proposals are intended to raise revenue without raising rates because the best tax systems have the broadest possible base to reach the lowest feasible tax rates. A longer description of the Shelf Project is found at "The Shelf Project: Revenue-Raising Projects That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or 2007 *TNI* 238-37.

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Eligibility for the lower capital gains tax rate is now broader than it should be. Capital gains originally meant

amounts that were credited to the capital or corpus account. Capital gains were still capital or wealth and not available to income beneficiaries for consumption. The primary policy justification for the lower rates is to unlock old capital so that it can be reinvested, which presupposes that the gains will not be used for consumption. When amounts were consumable they ceased to be *capital*, and ceased to be capital gains. Capital gains that are consumed should be taxed at rates for ordinary income, which attempt to adjust the tax to the standard of living for which the proceeds are used.

The proposal would enforce reinvestment as a requirement for eligibility for lower capital gains rates. The proposal would allow gain from a sale of a capital asset to qualify for the lower rate on capital gain only if the proceeds of the sale were reinvested into an account that is not available to support consumption. The ultimate distributions of the proceeds from the account would be ordinary income with a credit for prior capital gains tax paid. Reinvestment would not be required, however, for stock of a corporation subject to corporate tax, because lower rates on shareholders is a rough but established form of relief from double tax on corporate income.<sup>1</sup>

The proposal would also reduce the difference between capital gains rates and ordinary income. The proposal adopts the traditional assumption that reinvestment of capital justifies some reduced rate, but not a complete exemption from tax. Not much preference needs to be given to capital gains, however. There is a large supply, even a glut, of capital worldwide from sources not affected by lock-in — including pensions, corporate earnings, charitable endowments, and foreign sources. With the adequate supply of capital for the best investments, the country should not pay much to unlock old capital. Lock-in is better met, moreover, by ending the amnesty for capital gains tax at death. As a matter of both fairness and efficiency, incentives for capital need to be focused on the formation of new capital and not on old capital.

Separate shelf projects will propose cuts to capital gains. Congress and the courts over the years have extended preferential capital gain rates to things bearing no resemblance to capital gain in its traditional sense. Capital gains should not be available to the product of services nor to outputs in which the input has been deducted from ordinary income. The proposal here would affect capital gain at its core.

<sup>1</sup>Much of the analysis here is a revision of Calvin H. Johnson, "Taxing the Consumption of Capital Gains," 28 *Va. Tax Rev.* 477 (2009).

## A. Reasons for Change

1. **The historical reinvestment presupposition.** The tax bracket system attempts to adjust tax rates to differing standards of living. The top rate, now at 35 percent, is imposed on income that supports the highest standard of living and least-needed consumption. Under the bracket system, the lower 15 percent tax rate is a tax rate for incomes used to support a standard of living near the national average. Married couples with incomes between \$16,050 and \$65,100<sup>2</sup> pay tax at a maximum of 15 percent. Capital gains, however, are subject to a 15 percent tax rate even for individuals who have incomes and standards of living putting them higher than the average income tax bracket. The people living off their capital gains, who are in higher than 15 percent brackets, are improperly getting access to consumption after passing through too low a tax rate.

In its original meaning, capital gain was “capital,” that is, continuing wealth or investment, and not available for consumption. Capital gains in the original sense under both English and American law were gains on sales of corpus property held in trust. Those gains were credited to capital and not income because they were not available to the income beneficiaries of the trust, and had to be returned to corpus for the benefit of future generations. Capital gains were still part of the wealth or *capital* of the nation.

Within the presumption that capital gains are still part of the wealth of the nation, taxpayers who use capital gain to support their standard of living are violating a defining prerequisite for a lower tax rate — that is, that the gain is capital. There is even a moral taint: People who are living off their capital gain are invading capital belonging to another and consuming the nation’s seed corn.

Congress first enacted lower rates for capital gains in 1921 in reaction to the facts of *Merchants’ Loan & Trust Co. v. Smietanka*.<sup>3</sup> In *Smietanka*, a trust sold stock of a family corporation, apparently to diversify its holdings, but the gains under the trust instrument had to be returned to corpus and were not available to the income beneficiaries. The Supreme Court held that the gain would nonetheless be subject to ordinary rates, then as high as 54 percent, because the gains were realized. Congress reacted within months of the decision by reversing *Smietanka*, creating the first lower tax rate on capital gains of 12.5 percent.<sup>4</sup>

Congress also said it was compromising between American law, which under *Smietanka* taxed capital gains at 54 percent, and British law, which at the time completely exempted capital gains from tax.<sup>5</sup> British income tax exempted capital gains because they were not cred-

ited to income beneficiaries but were considered investment or wealth and were not available for consumption by income beneficiaries.

At the time of the adoption of the British income tax in 1799, during the revenue crisis of the Napoleonic Wars, the great English estates were held predominantly under trust arrangements then called “strict settlements.” Strict settlements functioned to keep the ancestral manor and estate intact to be managed by one surviving and competent male heir. The terms of the strict trust were typically negotiated with the family of the bride in connection with the marriage of the first son, and typically dissolved at the death of that son, to be reset at the grandchild’s generation. With high mortality rates, determination of the final heir had to be contingent. The trust arrangement was required because the English common-law courts had held that contingent transfers under common-law feudal tenures, not in trust, were invalid restrictions on the marketability of land because no known heir had the final interest that could be sold. The strict settlement was a purely private arrangement. Some families did not believe in it. Merchants never tied up their capital with a trust, and a family might leave lands outside their ancestral estate out of the strict settlement so that the land could be sold when cash was needed. Still, the strict settlement pattern dominated ownership in England among the landed gentry at the time of the adoption of the income tax.<sup>6</sup> In 1882 Parliament allowed the current life beneficiary to sell the underlying land, without the permission of the contingent beneficiaries to the corpus, so as to make the land marketable without the “fetters” of the strict settlement, but the proceeds from the sale still had to be reinvested in trust corpus and ultimately distributed as the strict settlement provided.<sup>7</sup> Capital gains were not “income” subject to the British income tax because the gains had to be credited to capital and were not available to income beneficiaries.

England continued the tax exemption for capital gain in 1920 and again in 1955. In both cases Parliament explained that capital gains represented “a mere change in the identity of investments,” in which the sale proceeds would be reinvested.<sup>8</sup> Parliament ended the British exemption in 1965 because of the perception that some people were living off their exempt capital, and that the exemption was unjust because most British citizens were living from money that had been first subjected to tax.<sup>9</sup> Once Parliament perceived that capital gains could be consumed to support a standard of living, it ended the

<sup>6</sup>John Habakkuk, *Marriage, Debt, and The Estate System: English Landownership 1650-1950*, at 1-5, 17, 36, 46-47 (1994).

<sup>7</sup>Settled Land Act, 1882, 45 and 46 Vict., c. 38, section 3 (Eng.); *Bruce v. Ailesbury*, [1892] A.C. 361. (H.L.) (“fetters”).

<sup>8</sup>Royal Commission on the Taxation of Profits and Income 30 (1955). *Accord*, Report of the Royal Commission on the Income Tax 20, para. 90 (1920) (defining the capital gain problem as “profits that arise from ordinary changes of investments”). (Emphasis added.)

<sup>9</sup>716 Parl. Deb., H.C. (5th ser.) (1965) 794-795; see also *id.* at 920.

<sup>2</sup>Rev. Proc. 2007-66, 2007-2 C.B. 970, Doc 2007-23317, 2007 TNT 203-8.

<sup>3</sup>255 U.S. 509 (1921).

<sup>4</sup>Revenue Act of 1921, P.L. 67-98, section 206, 42 Stat. 227, 232 (1921).

<sup>5</sup>Senate Finance Committee Report on Revenue Act of 1921, S. Rep. No. 67-275, at 12-13 (1921).

exemption. The model of capital gain that both Parliament and Congress had in mind required that capital gains remain as investments.

2. The reinvestment presumption in lock-in. Reinvestment is also presupposed in the best argument in favor of lower capital gains rates. Taxes on sales lock capital into existing investments and make it unavailable for better investments.<sup>10</sup> Taxes on sales of property with built-in gain are a toll charge on moving from an old investment to better investments. An investor will sell an old investment to buy the new investment only if the new investment gives a return that exceeds the return from the old by enough to pay the toll charge. How much higher the return on the new investment must be depends not just on the capital gains rate, but also on how much gain has built up in the old investment.<sup>11</sup> Lowering the capital gains tax rate will lower the toll charge for any given amount of gain and will allow some changes in investment to go forward that would be blocked at higher rates. Even opponents of lower capital gains rates treat the lock-in argument as the most formidable argument in favor of the lower rates.<sup>12</sup>

The lock-in argument presumes that capital gains will be reinvested. In the debates on what rates capital gains should bear, capital gains taxes are described as taxes on reinvested capital. Reinvestment is assumed sometimes in the face of evidence cited to the contrary.<sup>13</sup>

<sup>10</sup>See, e.g., Jonathan A. Brown, "The Locked-In Problem," in *Federal Tax Policy for Economic Growth and Stability: Papers Submitted by Panelists Appearing Before the Subcommittee on Tax Policy* 367, 381 (Joint Comm. Print 1955); Richard Goode, *The Individual Income Tax* 197-208 (rev. ed. 1976); James Wetzler, "Capital Gains and Losses," in *Comprehensive Income Taxation* 115, 135-138 J. Pechman, ed., 1977); Cynthia Blum, "Rollover, an Alternative Treatment of Capital Gains," 41 *Tax L. Rev.* 383, 387-388 (1986); Charles C. Holt and John P. Shelton, "The Lock-In Effect of the Capital Gains Tax," 15 *Nat'l Tax J.* 337 (1962); Richard Schmalbeck, "The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?" *Tax Notes*, July 9, 1990, p. 195; Joel Slemrod and Martin Feldstein, "The Lock-In Effect of the Capital Gains Tax: Some Time-Series Evidence," *Tax Notes*, Aug. 7, 1978, p. 134.

<sup>11</sup>Richard Goode, *The Individual Income Tax* 200 (1964), shows how much higher the yield must be on the new investment to justify the change.

Stock investors apparently display some behavioral economics in selling gains and avoiding admitting their losses, even though sale of gains is penalized and sale of losses is subsidized by tax. See, e.g., Zoran Ivkovic, et al., "Tax Motivated Trading by Individual Investors," 95 *Am. Econ. Rev.* 1605 (2005).

<sup>12</sup>Joseph Dodge, "Restoring Preferential Capital Gains Treatment Under a Flat Rate Income Tax: Panacea or Placebo?" *Tax Notes*, Sept. 4, 1989, p. 1133; see also Walter Blum, "A Handy Summary of the Capital Gains Arguments," 35 *Taxes* 247, 257 (1957) (characterizing the lock-in argument as a "formidable indictment").

<sup>13</sup>"Capital Gains and Losses: Hearing Before the House Committee on Ways and Means," 93d Cong. 276 (1973) (statement of Henry C. Wallich, professor of economics at Yale) (asserting that "the capital gains tax reduces the supply of savings because the gains upon which it falls tend to be predominantly saved," but conceding that "statistical tests . . . increasingly find evidence of spending out of capital

(Footnote continued in next column.)

### 3. Presume no reinvestment.

a. Efficient market. A better presumption is that the capital gain will *not* be reinvested unless reinvestment is compelled. For all taxpayers, the efficient market thesis implies that sales to reinvest are ordinarily irrational. The efficient market thesis says that the market price of property traded on a broad market will reflect all public information as soon as it becomes available.<sup>14</sup> The current quoted prices of stock traded on an established market are the result of thousands of offers and bids and hundreds of thousands of dollars of research by sophisticated investors bidding in their self-interest. Bidders who consider a stock underpriced given its real future returns will bid up the stock price quickly; owners and short sellers who consider a stock overvalued by price will sell and drive down the price. Once the efficient

gains"); Alan J. Auerbach and Kenneth Hassett, "Corporate Savings and Shareholder Consumption," in *National Savings and Economic Performance* 75 (B. Bernheim and J. Shoven eds., 1991) (arguing that consumption rationally should not increase just because shareholders have involuntary cash realization of their wealth); Donald Kiefer, "Lock-In Effect Within a Simple Model of Corporate Stock Trading," 43 *Nat'l Tax J.* 75, 76 (1990) (excluding sales for consumption from the model).

<sup>14</sup>See, e.g., Burton Malkiel, "Is the Stock Market Efficient?" 243 *Science* 1313, 1317 (1989); see also Eugene F. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," 25 *J. Fin.* 383 (1970); Christopher Paul Saari, Note, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry," 29 *Stan. L. Rev.* 1031 (1977). Measurements of the efficiency of the market simultaneously test the pricing of stock according to discounted value of cash—that is, stock prices under the efficient market thesis reflect what is publicly known about future distributions, and appropriate discount rates. See, e.g., George Foster, *Financial Statement Analysis* 363 (1978); Michael C. Jensen, "Some Anomalous Evidence Regarding Market Efficiency," 6 *J. Fin. Econ.* 95, 95 (1978); see also *id.* at 96. ("In the literature of finance, accounting, and the economics of uncertainty, the Efficient Market Hypothesis is accepted as a fact of life, and a scholar who purports to model behavior in a manner which violates it faces a difficult task of justification.") The evidence that the stock markets are efficient includes evidence that future prices of stocks are independent of past prices; that prices adjust rapidly to newly disclosed information, and sometimes anticipate (or incorporate leaked) information; that changes in accounting methods do not affect stock prices; and that market professionals cannot consistently perform better, after research expenses, than randomly selected diversified portfolios do.

There are limits on how efficient the markets can be. Research that keeps price in tune with fundamental value is expensive. Institutional investors making large trades conduct the best research, as they can amortize high costs over large blocks of stock. The costs of research to the largest investors put a limit on how efficient the market can be. See Frank Easterbrook and Daniel Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer," 94 *Harv. L. Rev.* 1161, 1166-1167 (1981); Sanford Grossman and Joseph Stiglitz, "On the Impossibility of Informationally Efficient Markets," 70 *Am. Econ. Rev.* 393 (1980) (arguing that the markets reach not perfect knowledge, but an "equilibrium degree of disequilibrium"); Ronald Gilson and Reinier Kraakman, "The Mechanisms of Market Efficiency," 70 *Va. L. Rev.* 549, 610 (1984).

market has adjusted the price to reflect available information, movement in price is random until more information becomes available.<sup>15</sup>

Given an efficient market, an investor cannot assume that a change in investment will give a higher return, because adjustments in the price of the old and the new property have already equalized the risk-adjusted rate of return. One cannot find a bargain in moving to higher-quality goods or investments because the self-serving sellers of such quality investments are trying to extract the maximum price and because competing bidders have bid up the price to reflect the value. One also cannot profit from selling a low-quality asset to invest in something better in part because of the skepticism of self-serving buyers. Trading low-quality assets for high-quality assets will be unprofitable when the prices of the sold and purchased assets already reflect their relative quality.

The efficient market price does not mean that the market is true or is right about the future. The current price is likely an erroneous statement of the future cash flows because the future is unknown. But if the price reflects all information known by market traders, no investor can know in which way the unknown truth will cut and cannot profitably trade on the unknown. The efficient market thesis is less about the truth or accuracy of the price than it is about the inability of investors to exploit inaccuracy. When the truths become known generally, they will be quickly reflected in price.

The efficient market thesis is easiest to test for stock when there are readily available prices on an established stock market. As explained below, the proposal here would not require reinvestment of gains from stocks of corporations. The point tested with stock applies to bonds, financial instruments, and other properties traded on an established market. The wisdom of the efficient market also has application to properties with a thin market: An owner cannot expect to profit from moving from one property to another if there are transaction costs, unless the seller can outsmart the buyer regarding the fair market value of the property sold, or unless that seller can then outsmart other bidders and the owner of the replacement property regarding the value of the replacement property. Profit from reinvestment can never be assumed, so the purpose of the sale cannot be assumed to be reinvestment.

Price adjustments in an efficient market — or indeed in any market — filter out sales to reinvest, leaving the sales that do occur as being especially rich or especially likely to be sales made to support the seller's standard of living. A rate cut for capital gain gives the most benefit when there is the most gain built into the property, but perversely, those sales have the largest resulting toll charge even after the tax cut and are therefore the least likely sales to be made to reinvest.<sup>16</sup> In any event, if there

<sup>15</sup>Fama, "Random Walks in Stock Market Prices," 21 *Financial Analysts J.* 55 (1965).

<sup>16</sup>One could focus the capital gains reductions on cases when profitable investment might occur by forgiving small taxes rather than reducing tax by the same amount that leaves a large  
(Footnote continued in next column.)

is a sale, the proper presumption, given prices set by market bidding, is that the proceeds of the sale will not be naturally reinvested because sales to reinvest are irrational.

b. Diversification. Sales are rational even within a smart market to maintain diversification of investments. Modern portfolio theory mandates that an investor maintain a diverse portfolio of investments, so that losses on one investment or kind of investment will be offset by gains in other investments, and volatility will be dampened.<sup>17</sup> A portfolio of volatile investments that started with adequate diversification will become unbalanced over time because the usual pattern is that a few stocks have large appreciations, and many stocks have modest growth or decline.<sup>18</sup> The few dramatically appreciating stocks will come to dominate the portfolio. The stock that dominates the portfolio needs to be sold to retain diversification.

When stocks are volatile, however, sales to diversify can usually be protected by the shelter of losses recognized on other shares. Losses tend to be present when diversification is most necessary. A portfolio of low-volatility investments can be expected to rise slowly without dramatic gains and without losses. Without the gains or losses, an initially diversified portfolio will not become imbalanced. The imbalances arise within a portfolio of volatile investments. A volatile portfolio, however, will generate losses as well as gains, leaving the taxpayer on net with a portfolio that appreciates by a more stable rate. Section 1211, with a small exception, allows capital losses to be used only against capital gains. Tax-exempt sales to diversify, using up the losses within the volatile portfolio that would otherwise be worthless, will dominate taxable sales to diversify no matter what the level of capital gains tax.

4. Consumption violates the norm. Consumption of capital gains violates the original understanding. Capital gains were originally credited to capital that continued to be part of the wealth and investments of the nation. When capital gains are withdrawn from investment to support current consumption and standard of living, they cease to be capital and cease to deserve the lower tax rate.

capital gain toll charge. For example, the law could provide that sales are subject to ordinary income tax of 35 percent, but that if a taxpayer owed less than 10 percent of the property value in tax, no tax would be paid. If more than 10 percent of the property is due in tax, one can presume that the sale is not for reinvestment.

<sup>17</sup>The seminal theoretical work is Harry Markowitz, "Portfolio Selection," 7 *J. Fin.* 77 (1952); see also Markowitz, *Portfolio Selection: Efficient Diversification of Investments* (1959).

<sup>18</sup>See, e.g., Lester Thurow, *Dangerous Currents: The State of Economics* 152 (1983) (arguing that price reflects a wide distribution of possibilities with a long tail such that, for instance, investors who owned IBM stock in the 1930s would be very wealthy by 1983).

## B. Explanation of the Proposal

1. **Reinvestment into an account required.** This proposal would enforce reinvestment by requiring that the proceeds of the sale be deposited into an identified capital account to qualify for the lower capital gains tax rate. The amounts in the account could not be used for consumption or to support a standard of living. When proceeds are ultimately distributed from the account, the capital gain would be ordinary income with a credit for prior capital gains taxes paid. The proposal would not, however, require sale proceeds of stock of a corporation to be reinvested, because the lower rates on shareholders serve as a rough but established form of relief from double tax on corporate income.

The account into which capital-gain-eligible proceeds are deposited is a necessary simplification of the enforcement of reinvestment. Absent the account, it would be possible in theory to see if the taxpayer has increased new investments by the amount of the capital gains proceeds. But money is fungible and economically all money is in a common pool. To determine whether investment has gone up overall, it would be necessary to have a global balance sheet of the taxpayer's investments, reduced by depreciation or expensing, and borrowing would need to be treated as an anti-investment (which it is) that reduces the taxpayer's reinvestment.<sup>19</sup>

The capital gain account for reinvestment can be simple, as long as accurate records of contributions, earnings, and distributions are kept. The account can earn income and the income of the account would be computed, as in a grantor trust, but it would be allocated to the taxpayer and reported on his return and subject to his tax rate. The taxpayer need not give up investment control of the account. The taxpayer would be able to borrow on the account at arm's length, but repayments of the borrowing from the account would need to be treated as distributions from the account. Requiring contribution of the sales proceeds is a liberalization of the original meaning of capital gains in which the property was held before the sale as trust corpus, but the reinvestment of the proceeds seems to capture the essential characteristic of capital gains.

If the taxpayer deposits only part of the sale proceeds into the consumption-blocking account, the proposal would treat the withheld amounts much like boot in a nonrecognition transaction. Ordinary income would be recognized to the extent of the lesser of the amount of the gain or the amount withheld from the account. The rationale for taxing withheld amounts as ordinary gain and not recovery of basis is that any amount consumable should be run through the bracket system. The taxpayer, moreover, has not lost his basis in the property by contributing it to the account and should not be able to use that basis to shelter consumed income from tax until after all the realized gain is first taxed as ordinary income

<sup>19</sup>Johnson, *supra* note 1 at 522-527, attempts to address the problems of a global balance sheet approach without any confidence that the system proposed is watertight.

or the basis is lost. Amounts withheld from the account, however, would not be taxed beyond the realized gain from the transaction.

A distribution from the account would first be a distribution of previously taxed ordinary income within the account and would be tax free to the owner of the account, just as withdrawals from a bank account are tax free. After income has been distributed, however, the next tier of distributions would be stacked as previously taxed capital gain. The gain would be ordinary income, but it would carry a credit for the (now) 15 percent capital gains tax previously paid. Under current rates for ordinary income (35 percent) and capital gain (15 percent), the (second-tier) distribution of capital gain would be subject to a net tax of 20 percent. The credit for capital gain is in lieu of a step-up in basis for capital gain recognized so that the taxpayer would have the same basis in the account as he had in the property qualifying for capital gain by reason of deposit of the assets.

The third tier would be recovery of the taxpayer's basis. The fourth tier, distributions in excess of basis, would be ordinary income to the taxpayer unless reinvested. A single account would cover all the capital gains of the taxpayer. Because money is fungible, the taxpayer should not get an advantage by choosing between a large aggregate or single transaction account, nor would the taxpayer be able to designate which tier cash came from. The stacked order would be mandatory.

I assume tentatively that if the account purchases a home or a car for the taxpayer or other personal-use property, the purchase would be treated as a distribution. It is theoretically fine to treat the taxpayer's use of the property as the distribution, but administratively it would be quite difficult, especially as the property later changes in value. If the home or other consumption property is very large, however, the taxable distribution might be spread over some arbitrary period, perhaps five years, because the consumption follows the use of the property.

I assume tentatively that the account could use the credit for capital gains tax paid if the proceeds of its sale proceeds are not distributed. But the trust would then need to have a basis for the property equal to the taxpayer's basis before the sale. That solution would keep the inside and outside basis for the property the same.

2. **Corporate stock.** Reinvestment would not be required for dividends or sales of stock of a corporation subject to section 11 corporate tax. Corporations pay tax at 35 percent on their taxable income. If a corporation makes \$100 as taxable income, the corporation pays \$35 in tax. An individual shareholder who receives the after-tax earnings of \$65 must pay a second tax on the \$65. If the shareholder tax is at ordinary rates, the total tax can be  $\$35 + 35 \text{ percent} \times \$65$ , or \$57.75, which is 58 percent of the starting \$100. Shareholders can also reap the benefit of posttax corporate earnings, not by distributions from the corporation, but by selling their shares for a price that includes the accumulated earnings. The tax impact is the same 35 percent corporate tax, plus a shareholder tax. If the proceeds of the stock sale are not reinvested, and there were no exception for stock, the total tax on the earnings would be 58 percent.

If shareholder sales or distributions qualify for the lower capital gains rates, however, the total of corporate and shareholder tax would be no more than \$35 + 15 percent \* \$65, or \$44.75, roughly 45 percent of the starting \$100. Within a system in which 35 percent is the top bracket for consumed income, dropping the total tax of the corporation and shareholder from 58 percent to 45 percent seems reasonable, even if the shareholder consumes the earnings distributed to him or the sales proceeds. Dividends from out of corporate earnings are not capital gains in the traditional understanding, because they are distributable to income beneficiaries of a trust and are not capital returned to corpus of the trust.<sup>20</sup> But defining dividends as capital gain, as Congress did in 2003,<sup>21</sup> seems justified as a rough form of corporate integration.

The lower tax on dividends and shareholder sales is an imperfect form of corporate integration. A corporation's taxable income does not capture very much of its economic income, given the state of the tax base.<sup>22</sup> If the corporation has not paid its 35 percent tax, there needs to be *preemptive* or prepayment of tax by the corporation on a corporate distribution that the corporation could use as a credit toward future tax that is due.<sup>23</sup> There are proposals to drop the corporate tax and to increase the individual tax rate.<sup>24</sup> If the individual tax rate is significantly higher than the corporate tax rate, then corporations become relative tax havens, and managers will accumulate earnings just to avoid shareholder tax in ways difficult to police. Still, the lower shareholder tax is the form of corporate integration that is in place.

3. Reducing the spread. The proposal accepts the 1921 judgment that reinvestment is grounds for a reduction in the tax rate but argues that the case for using the lower rate as a remedy for lock-in is not very strong. It is not a best remedy either for lock-in or capital incentives. The proposal would accordingly limit the spread between ordinary tax rates and capital gain rates to no more than 10 percent of the gain.

a. No need to give up much. Lock-in is a problem for the economy only if better investments are unable to attract capital or if it affected the price signal for properties. There is enough new capital coming into the economy that the tax system does not need to give up

very much for old capital to move from one investment to another. There are large alternative pools of capital to satisfy the best investment opportunities. For example, pension funds and charitable endowments are tax exempt and they can move to the more attractive return investments without being affected by tax. New savings from corporate, foreign, or individual earnings will go to the most attractive available return, without paying a capital gains tax toll charge on the way. Opportunities not taken by taxpayers locked into their current investment will be taken up at their correct relative price by competing bids coming from pension funds, endowments, and new savings. Lock-in is thus not likely to damage allocation of capital in the economy as a whole, and lock-in will not deprive the best investments of necessary capital.<sup>25</sup> Indeed, there is apparently a global glut of capital, according to center, liberal, and conservative economists.<sup>26</sup> The global glut of capital generally means that there is no strong need to give up tax revenue to allow old capital to move into new investments. The country as a whole should probably be willing to give up some modest amount of tax to move old capital with big gains, but it should not give up much.

b. Lock-in caused by amnesty at death. Another reason the spread between ordinary and capital gains rates does not need to be large is that reduced rates are the third-best remedy for lock-in. If lock-in were to be addressed, the first remedy would be to end step-up in basis at death. The taxpayer's successor gets a basis for the property received by reason of death for an imaginary cost as if the successor had purchased the property at the taxpayer's death.<sup>27</sup> The fair market value basis means that any gain built into the property before death disappears from the tax system. As taxpayers age and their mortality risks increase, they see a real prospect of avoiding all tax. Taxpayers live off income from loss property or low-gain property and hold their high-gain properties if they can.

Given the amnesty available for capital gains at death, it is difficult to maintain a high tax on voluntary sales during life. The amnesty at death acts as a powerful suction. Forgiveness of capital gains tax at death absolves between 54 percent and 90 percent of capital gain from tax.<sup>28</sup> Because the step-up offers a zero tax on capital

<sup>20</sup>See W.E. Shipley, "Right as Between Life Beneficiaries and Remaindermen, or Successive Life Beneficiaries, in Corporate Dividends or Distributions," 44 A.L.R.2d 1277 (1955, updated to 2009).

<sup>21</sup>Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27, section 302(a), enacting section 1(h)(11).

<sup>22</sup>See, e.g., Johnson, "Replace the Corporate Tax With a Market Capitalization Tax," *Tax Notes*, Dec. 10, 2007, p. 1082, *Doc 2007-26347*, or 2007 TNT 238-36.

<sup>23</sup>See, e.g., Johnson, "The Bush 35 Percent Flat Tax on Distributions From Public Corporations," *Tax Notes*, Mar. 24, 2003, p. 1881, *Doc 2003-7383*, or 2003 TNT 57-24.

<sup>24</sup>See, e.g., Amy Elliott, "Kleinbard Warns of Growing Gap Between Individual and Corporate Rates," *Tax Notes*, Mar. 16, 2009, p. 1314 (chief of staff of the Joint Committee on Taxation discussing problems of the individual rate being at 40 percent and corporate rates at 28 percent).

<sup>25</sup>Congressional Budget Office, "Capital Gains Taxes and Federal Revenues," 5 (2002).

<sup>26</sup>Ben S. Bernanke, Federal Reserve chair, "The Global Saving Glut and the U.S. Current Account, Remarks at the Sandridge Lecture," Virginia Association of Economics, (Mar. 10, 2005), available at <http://www.federalreserve.gov/boarddocs/speeches/2005/200503102>; Paul Krugman, "Don't Cry for Me, America," *The New York Times*, Jan. 18, 2008, at A21; R. Glenn Hubbard, "A Paradox of Interest," *The Wall Street Journal*, June 23, 2005, at A12.

<sup>27</sup>Section 1014.

<sup>28</sup>Jane G. Gravelle, "Limit to Capital Gains Feedback Effects," at 4-6 (Congressional Research Service, Rep. No. 91-250 RCO, 1991) (finding that 30 percent of accrued gains are realized, but finding that, excluding timber, housing, and debt, 46 percent of accrued gains are taxed and 54 percent excluded). An earlier work, Gravelle and Lawrence B. Lindsey, "Capital (Footnote continued on next page.)

gain, any tax on capital gain requires that the taxpayer give up the zero tax. Ending this step-up in basis would improve mobility of capital. It is not consistent to both maintain the step-up and reduce tax rates. Giving both lower rates to unlock capital and forgiveness at death, which locks in capital, is like trying to freeze and boil water at the same time.

The most attractive political aspect of capital gains rate cuts is that they produce revenue. An increase in revenue from a tax cut is possible, however, only from the questionable baseline that tax must be forgiven at death. Increased realizations of the capital gain can generate permanent revenue increases only if taxpayers give up their tax amnesty at death and pay tax instead. If capital gains tax is just an early realization of gain that would be taxed eventually, any amount realized this year would reduce the gain left to be realized next year.<sup>29</sup> Starting from a premise that the gains will be taxed eventually, a rate cut does not increase government revenue.<sup>30</sup>

Lock-in would also be cured by taxing investment property as if it were sold each year at its then market value. This is the accounting now required by the nontax accounting standard for publicly traded stocks and financial instruments.<sup>31</sup> If property is marked to market, there would be no reason to give an incentive for sale because sale would not produce a gain or a loss. Lock-in would also be reduced if the decedent's gain were taxed on a final return at his death.

c. **Third-best savings incentive.** The spread between capital gains and ordinary rates can also be small because the lower rates on capital gains are an inferior remedy for the formation of new capital. A cut in capital gains taxes is sometimes advocated as necessary to give investors better returns on their investment after tax to induce more savings.<sup>32</sup> Reduction in capital gains rates is an

inefficient way to induce new savings, however, because so little of the benefit goes to new capital. Capital gain for any year is realized mostly on old capital that has already been formed. Only a very small fraction of capital gain that accrues every year is new capital — as savings rates have plummeted, the new capital represents an ever-smaller fraction of the whole. Capital gains also arise slowly over time so that the older the capital is, the larger the fraction it is of the total capital gains. A new saver cannot expect to get any material benefit from capital gain for many years. Capital gains cuts waste most of their revenue lost on savings that were made years before the enactment of the cut, before anyone could know what the capital gains tax rates were going to be. One cannot make retroactive incentives to have any effect to behavior before the incentives were known. Money spent to give an incentive to things that have already happened is pure waste.<sup>33</sup> If subsidies were to be given to encourage the formation of capital, the incentives should be delivered to new savings, as upfront deductions, credits, or the like. Indeed, old savings do not even need to participate.

One should also be skeptical that reducing tax rates on capital gains will even push savings in the right direction. Much of real savings is target savings trying to reach a real goal, and target savings drop when tax rates on returns to savings go down. Raising taxes on capital, by contrast, increases target savings. Assume, for instance, a parent needs \$500,000 in 18 years to send a child to four years of college. If return rates are 4 percent after tax, the parent must set aside \$247,000 now to reach the target.<sup>34</sup> If tax is reduced to increase after-tax returns to 7 percent, the same target can be reached by setting aside only \$118,000.<sup>35</sup> Increasing the return will allow the parent to spend the difference or reduce savings now by \$129,000. Savings to reach a down payment, basic retirement, or seed money for an enterprise also behave as target savings, going down when after-tax returns go up. Overall, target savings seem to dominate in our economy. When interest rates go down, savings can go up, apparently because of the reaction of target savers.<sup>36</sup> Over time and differing circumstances, the incentive effects of lower tax and the target savings phenomenon wrestle for dominance over savings with no clear winner.<sup>37</sup> Still, the incentive effect in increasing savings is never a clear winner.

Gains," *Tax Notes*, Jan. 25, 1988, p. 397, found that 76 percent of capital gains are held until death. Laurence Kotlikoff and Lawrence Summers argue that once invested, amounts are not commonly disinvested but are largely held until death. Only 20 percent of individual wealth is consumed by the household later in life, they find, and 80 percent of wealth is transferred to the next generation. Kotlikoff, "Intergenerational Transfers and Savings," 2 *J. Econ. Perspectives* 41, 43 (1988); Kotlikoff and Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulations," 89 *J. Pol. Econ.* 706 (1981). Given that taxpayers select property to be sold as those properties with the highest basis, a conclusion that only 10 percent of gains are liquidated during life is not unreasonable.

<sup>29</sup>E. Auten and Joseph J. Cordes, "Policy Watch: Cutting Capital Gains Taxes," 5 *J. Econ. Persp.* 181, 184 (1991) (arguing that for gain to be significantly higher in the long run, additional realizations would have to come primarily from gains otherwise not taxed at death).

<sup>30</sup>Cravelle, *supra* note 29, at 3 (also noting that in the long-term realizations cannot exceed accruals).

<sup>31</sup>Statement of Financial Accounting Standard No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (1993).

<sup>32</sup>See, e.g., "Savings and Investment Provisions in the Administration's Fiscal 1998 Budget Proposal: Hearing Before the H. Comm. on Ways and Means," 105th Cong. 149 (1997) (statement of James F. Higgins, chair of the Securities Industry Association);

(Footnote continued in next column.)

Stephen Moore and Phil Kerpen, "A Capital Gains Tax Cut: The Key to Economic Recovery" (2001), available at <http://dreier.house.gov/pdf/1P1%20-%20CapGainsKey.pdf>.

<sup>33</sup>See, e.g., Kotlikoff, "The Crisis in U.S. Saving and Proposals to Address the Crisis," 43 *Nat'l Tax J.* 233, 239 (1990) (arguing that capital gains tax cuts are poorly designed because of a windfall benefit to those who accrue gains before the act).

<sup>34</sup> $\$246,814 * (1 + 4 \text{ percent})^{18} = \$500,000$ .

<sup>35</sup> $\$148,000 * (1 + 7 \text{ percent})^{18} = \$500,000$ .

<sup>36</sup>See, e.g., A. Lars Bovenberg, "Tax Policy and National Saving in the United States: A Survey," 42 *Nat'l Tax J.* 123, 128 (1989) (reviewing literature finding that high interest rates decrease savings).

<sup>37</sup>See E. Philip Howrey and Saul Hymans, "The Measurement and Determination of Loanable-Funds Savings," in *What Should Be Taxed: Income or Expenditure?* 1, 30-31 (J. Pechman ed., (Footnote continued on next page.)

The federal deficit is now at \$1.6 trillion or 1.1 percent of GDP,<sup>38</sup> and that deficit must be closed. Lower capital gains tax rates are not a best remedy either for lock-in or for capital formation, and given the global glut of capital, a remedy for either lock-in or capital formation is not an important national priority.

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1980) (finding no response to increased interest); Robert Hall, "Intertemporal Substitution in Consumption," 96 *J. Pol. Econ.* 339 (1988) (finding no savings response to increased interest returns and explaining away apparent findings that savings respond to increased interest); Barry Bosworth, Gary Burtless, and John Sabelhaus, "The Decline in Saving: Evidence From Household Surveys," in *Brookings Papers on Economic Activity* 183 (vol. 1, 1991); Jonathan Skinner and Daniel Feenberg, *The Impact of the 1986 Tax Reform Act on Personal Savings* 17, Nat'l Bureau of Econ. Research, Working Paper No. 3257 (1990) (describing a consensus in the economic literature that any positive response of savings to an interest rate increase is "fragile and fleeting").

<sup>38</sup>CBO, *The Budget and Economic Outlook: An Update* (Aug. 2009), [http://www.cbo.gov/ftpdocs/105xx/doc10521/2009BudgetUpdate\\_summary.pdf](http://www.cbo.gov/ftpdocs/105xx/doc10521/2009BudgetUpdate_summary.pdf).

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