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John W. Lee
William & Mary Law School, jwlee@wm.edu

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THE CAPITAL GAINS “SIEVE” AND THE “FARCE” OF PROGRESSIVITY 1921-1986

John W. Lee, III*

I. INTRODUCTION

From the Revenue Act of 1921, which introduced an individual capital gains preference, to the Tax Reform Act of 1986, which repealed making the maximum individual permanent ordinary income rate and capital gains rate both 28 percent, the capital gains preference reduced, on average, the effective income tax rate of high income individuals substantially below the top nominal progressive income tax rates. This made progressivity “a farce, ... grotesquely unfair, ... a wicked fraud upon the small income taxpayer.” Economist Henry Simons described this combination of high

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* John William Lee, III, Professor of Law, College of William & Mary. B.A. 1965, University of North Carolina; LL.B. 1968, University of Virginia; LL.M. (Taxation) 1970, Georgetown University. I am grateful for the generous financial support of the College of William & Mary School of Law. I also wish to thank Ed Cohen, who taught me corporate tax, and recounted to me over the past three decades after tax conferences at the University of Virginia (often at his home) so much of the tax history which he experienced, and played a role in over the past seven decades.

1. * Cf 65 CONG. REC. H2085 (1924) (statement of Rep. Mills) (“[The progressive rate] becomes a farce, it becomes grotesquely unfair, it becomes a wicked fraud upon the small-income taxpayer if the law at the same time provides that the men with larger incomes may ... entirely avoid the taxes.”). Mills was referring to tax exempt interest not the capital gains preference, for which he was a leading proponent. *Id.* at 2848. “In Andrew Mellon’s view [which Mills shared], when faced with excessive taxation, investors will shift capital from productive enterprises into tax-exempt securities or other alternatives that can avoid the realization of taxable income.” G. Marc Worthy, Book Note, *An Examination of Tax Law and Supply-side Economics: Creed of Greed or Opportunity for All?*, 72 N. DAK. L. REV. 691, 699 (1996). Representative William A. Oldfield, D-Ark., proposing repeal of the capital gains preference [defeated 137 to 58 by a half empty Chamber], identified Representative Mills and Ways & Means Chair William R. Green, R-Iowa, as his chief opponents. 65 CONG. REC. H2846 (1924).
nominal individual ordinary income tax rates with a substantial individual capital gains preference as “a grand scheme of deception, whereby enormous surtaxes are voted in exchange for promises that they will not be made effective. . . . Politicians may point with pride to the rates, while quietly reminding their wealthy constituents of the loopholes. . . . Congress . . . [should] quit this ludicrous business of dipping deeply in large incomes with a sieve.” Based on the legislative history of capital gains for the next 80 years, maintenance of high ordinary income rates while granting preferential capital gains rates appears less duplicitous except, perhaps, in the case of Secretary of Treasury Andrew Mellon3 and between opposing

2. HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 68 (1938). See also Marc Lindner, Eisenhower-Era Marxist-Confiscatory Taxation: Requiem for the Rhetoric of Rate Reduction for the Rich, 70 TUL. L. REV. 905, 925-26 (1976); Marjorie E. Kornhauser, Section 1031: We Don’t Need Another Hero, 60 So. Cal. L. REV. 397, 418 (1987) (“While rhetoric and attention focused on nominal tax rates, real or effective rates could be lowered more quietly by creating preferential capital gains rates . . . .”). In closed hearings, a letter was read pointing out the broad language of the predecessor to Section 1031, like-kind exchange, “would seem to make possible the exchange of any security held for investment for any other security. . . . We would seem to be approaching what may be desirable – a practical elimination of any graduated tax.” Confidential Hearings on H.R. 8245 before the Senate Finance Committee, 67th Cong. 41 (1921) [hereinafter 1921 Confidential Senate Hearings] (letter to Sen. Reed Smoot, R-Utah, from Robert R. Reed, Esq.). See Greene v. Comm’r, 15 B.T.A. 401 (1929), aff’d, 42 F.2d 852 (2d Cir. 1930) (finding that stocks of all classes are of like-kind, such as common and preferred).

3. H.R. Rep. No. 68-179, at 77-82 (1924) (presenting the minority views of 11 Democratic House Ways and Means Committee members asserting that “the proposed Mellon bill is drawn for the purpose of giving principle [sic] relief to the large taxpayer and our plan is based upon giving relief to all income taxpayers, but the larger percentage of relief to the small taxpayer”); GEORGE BROWN TINDALL, AMERICA: A NARRATIVE HISTORY 1075 (1988) (“Mellon insisted that [tax reductions] should go mainly to the rich.”). But see Worthy, supra note 1, at 695-713 (defends Sec’y Mellon’s tax philosophy as not shifting the tax burden from the wealthy to the poor). For a more thorough analysis, see Marc Lindner, Eisenhower-era Marxist-confiscatory Taxation: Requiem for the Rhetoric of Rate Reduction for the Rich, 70 Tul. L. Rev. 905, 987-95 (1996). Secretary of the Treasury Andrew Mellon’s actions in providing preferences for capital gains and like-kind exchanges in 1921 and 1923 as well as lowering the top ordinary rates, see infra note 37, suggest that he actually did not favor progressivity. Indeed, Secretary Mellon stated that capital gains should not be subject to income taxation. Marjorie E. Kornhauser, The Morality of Money: American Attitudes Toward Wealth and the Income Tax, 70 Ind. L.J. 119, 151 (1994). Special Assistant to the Secretary of Treasury Dr. T.S. Adams said that the previous Secretary of the Treasury favored progressivity albeit at a lower level. Hearings on Revenue Revision before the House Ways and Means Committee, 66th Cong. 10-11(1920) [hereinafter 1920 House Hearings] (Sec’y Huston under President Woodrow Wilson “said [what] he would prefer is a simple reduction of the surtax rates to the point which would not force investments in tax-exempt securities. . . . As you know, our surtaxes go to 65 per cent. There is in addition 8 per cent normal tax, making a total maximum of 73 per cent. It is an
factions in Congress: one favoring progressivity, the other favoring lighter burdens on capital. This schism between an income tax and a consumption tax has existed for over 100 years. Any substantial individual capital gains preference substantially lowers the effective rate only at the highest income levels. This is because 80 percent of those who enjoy such preference earn the top 2 to 3 percent of income annually. Year-after-year those same individuals enjoy between 60 and 70 percent of the tax benefits of any substantial individual capital gains preference on economic income. They thereby achieved effective income tax rates substantially below the top individual income tax brackets. This distributive effect results from the concentration of capital wealth among three quarters of high-income taxpayers, as well as the higher ordinary income tax rates otherwise applicable there. In short, an individual capital gains preference produces vertical inequities for lower income taxpayers and horizontal inequities for high-income taxpayers not realizing capital gains.

4. Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of “Incomes,”* 33 ARIZ. ST. L.J. 1057, 1062, 1100-04, 1123-28, 1130-33, 1153-54 (2001); see also John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform,* 88 CALIF. L. REV. 2095 (2000); Susan B. Hansen, *The Politics of Taxation* 72 (1983) (Democrats historically favor more progressive forms of taxation; Republicans have historically opted for lower taxes on business and flat rate or regressive taxes.). But see Steven A. Bank, *Origins of a Flat Tax,* 73 DENV. U.L. REV. 329, 333 (1996) (“A struggle of more than fifty years to replace a regressive tax system with a proportional, not progressive, one . . . to balance out the regressive effects of other aspects of the federal revenue system and to require the wealthy to contribute their proportionate share.”). In a cash flow consumption tax, all cash flows are included in the tax base, and any amount not spent on consumption is deductible; thus the cost of investments would be deductible. J.M. Dodge et al., *Federal Income Tax: Doctrine, Structure & Policy* 70 (2004).

5. See infra notes 86, 112, 137 and 228, and accompanying text. See infra notes 142 and 203-06 and accompanying text.


7. See Tax Reform, 1969: *Hearings on the Subject of Tax Reform Before the House Ways & Means Comm.,* pt. 4, 91st Cong., 1st Sess. 1592 (1969) [hereinafter 1969 House Hearings] (Statement of Assistant Sec'y of the Treasury for Tax Policy Stanley Surrey) (“Fairness it seems to me comes down to two things – one, that as between people who have different levels of income, one higher and one lower, the person with higher income should pay a progressively greater tax [i.e., ‘vertical equity’]; and second, as between people who are at the same level of income and who are similarly situated, they should pay the same tax [i.e., ‘horizontal equity’].”).
"For the past one hundred years, the income tax laws and the surrounding debates have been incredibly repetitive in broad themes and in specific metaphors and references." This is particularly the case with individual capital gains preference debates that occurred between 1921 and 1986. Constant themes or arguments in support of a capital gains preference include:

1. ameliorating the bunching of realized gains which blocked realizations, and thus increased revenues.
2. after 1930, encouraging investments,
3. serving as a rough offset for inflation, and
4. benefitting the economy as a whole and allowing the benefits to trickle down to workers.

In addition to disproving these contentions (other than the preference contributing to a rise in the stock market for a time and temporarily increasing revenues); the principal argument against a capital gains preference since the 1930’s has been that its distributive effect undercuts the fundamental tax policy of ability to pay since higher income individuals garner 70 to 80 percent (over ninety percent in the beginning) of the tax benefits of any substantial capital gains preference. This concentration of benefits at the top occurs because stock constitutes as much as 85 percent of realizations in boom market years, and 50 percent in other years. Further, the top 1 percent hold such a large majority of individually owned stock that they report at least one-half of realized individual stock gains year after year. The increasing concentration of capital gains income results in a substantial capital gains preference lowering the effective individual income tax rates at the very top below the effective rates of the taxpayers directly below them, making it appear that some of the top

10. See infra notes 48-60, 84 (temporarily increase but at the cost of decreasing future revenues), 97, and 146 and accompanying text.
11. See infra notes 64 and 261 and accompanying text.
12. See infra notes 57, 82, 98, and 245 and accompanying text.
13. See infra note 64 and accompanying text. For refutations of the contentions of capital gains proponents listed in the preceding text, see John W. Lee, Critique of Current Congressional Capital Gains Contentions, 15 VA. TAX REV. 1 (1995).
14. See infra notes 43-4, 50, 86, and 136, 228, 267 and accompanying text.
15. See infra notes 57, 89, 91, and 134 and accompanying text.
16. See infra notes 112-13, 134-37, and 163 and accompanying text.
income taxpayers have effective income tax rates equal to the average taxpayer with modest income.\textsuperscript{17}

There has been a pattern of cloaking public stock – often, proponents’ real target for the capital gains preference – with more popular symbols, such as breaking up small farms in the beginning and more recently small investors or small business.\textsuperscript{18} Furthermore, from the 1940’s through 1986, supporters of a capital gains preference generally ignored more universal interests and larger annual realizations, and instead championed the tax preference for particular local constituent special interests accounting for minuscule percentages of annual realizations of capital assets, such as timber, farm livestock, land,\textsuperscript{19} and more recently, start up ventures.\textsuperscript{20}

Not surprisingly, taxation of capital gains has been intensely political. A Republican Congress and Administration (President Warren G. Harding) fashioned the first individual capital gains preference in the 1920’s;\textsuperscript{21} then a Democratic Congress and Administration (President Franklin D. Roosevelt) cut back on such preference in the early 1930’s.\textsuperscript{22} Next, a Conservative Coalition of predominantly Southern conservative Democrats and Republicans under both Democratic and Republican Administrations increased it several times from the late 1930’s through the early 1980’s.\textsuperscript{23} Then, a bi-partisan coalition of Conservatives and Liberals together with the Republican Administration of President Reagan ended the capital gains preference in 1986 in exchange for much lower ordinary rates.\textsuperscript{24}

The combination of the aforementioned political partisanship and the power of the capital gains special interests, especially in the eyes of the Conservative Coalition of Republicans and Southern Democrats, made reform of individual capital gains taxation exceedingly difficult. Ideal solutions such as (a) raising the capital gains rate and lowering the top ordinary rate to narrow the gap between them, thereby limiting capital

\textsuperscript{17.} See infra notes 140, 204-06 and accompanying text.
\textsuperscript{18.} See infra notes 51-3, 221-23, 270 and accompanying text.
\textsuperscript{19.} See infra notes 133-34 (data for 1959) and 329 (data for 1985).
\textsuperscript{20.} See infra notes 171, 226, 356, and 367-60 and accompanying text.
\textsuperscript{21.} See infra note 35 and accompanying text.
\textsuperscript{22.} See infra note 61 and accompanying text.
\textsuperscript{23.} See infra notes 65, 72-4, 106 and accompanying text.
\textsuperscript{24.} See infra notes 352 and 377 and accompanying text. I appreciate Professor Jim Bryce’s focusing my attention on this feature of capital gains legislation with his questions and the patience of many of my colleagues at the University of Alabama Law School during my fruitful visit last school year as I kept them posted on my progress in this area.
gains preference to the traditional targets of stock and real estate, and taxing unrealized capital appreciation at death;\textsuperscript{25} or (b) even better, universal indexing of capital and depreciable assets with no special rate treatment,\textsuperscript{26} proved politically impossible prior to 1986.

The Tax Reform Act of 1969 produced only symbolic reform. Surrogate limitation on the individual capital gains preference of high income taxpayers, the minimum tax on tax preferences (80 percent of which was the initial capital gains preference\textsuperscript{27}), was gutted in enactment by the same political process that made direct reform impossible.\textsuperscript{28} Further, the ultimate impact of this minimum tax on the individual capital gains preference was greatly reduced.\textsuperscript{29} Today, the successor Alternative Minimum Tax threatens to burden only middle income taxpayers, not the rich for whom the minimum tax was first intended.\textsuperscript{30}

The Second Best solution taken by the Tax Reform Act of 1986 was to make the top individual capital gains rate the same as the top permanent individual ordinary income rate of 28 percent.\textsuperscript{31} In substance, the capital gains preference had been eliminated by taxing ordinary income like capital gains.\textsuperscript{32} Even this solution was made politically possible only by the notion of distributional equity – that a tax cut must be equivalent as a percentage decrease in effective rates across income classes.\textsuperscript{33} For the reduction of the top individual income tax rate from 50 percent to 28 percent in the 1986 Act not to violate distributional equity, preferences concentrated at top income levels had to be eliminated, especially the individual capital gains preference.\textsuperscript{34}

\begin{itemize}
\item \textsuperscript{25} See infra notes 117-20, 131 and accompanying text.
\item \textsuperscript{26} See infra notes 337-40 and accompanying text.
\item \textsuperscript{27} See infra note 221 and accompanying text.
\item \textsuperscript{28} See infra notes 196-97 and 199 and accompanying text.
\item \textsuperscript{29} See infra note 253 and accompanying text.
\item \textsuperscript{30} See infra note 183 and accompanying text.
\item \textsuperscript{31} See infra note 352 and accompanying text.
\item \textsuperscript{32} A 28% maximum capital gains rate had been sandwiched between 1978 and 1980, see infra notes 248 and 290 and accompanying text; a 25% rate from 1942 to 1977, see infra notes 102-03 and accompanying text; and a 20% rate between 1981 and 1985, see infra notes 290, 348, 377 and accompanying text.
\item \textsuperscript{33} See infra note 353 and accompanying text.
\item \textsuperscript{34} Id.
\end{itemize}
II. THE EARLY YEARS: 1920'S TO 1950'S

A. 1920'S TO 1940'S SETTING THE STAGE: THE PREFERENCE FOR BIG INCOMES AND PUBLIC STOCK

Enactment of an individual capital gains preference in 1921—a flat 12½ percent for capital assets held two or more years at disposition "to distinguish between ordinary daily transactions of the speculator on one side, and the more deliberate and long transactions which characterize the investor on the other side"—coupled with a step up (or down) in basis of assets held at death to fair market value at that time, rendered the progressive individual ordinary income rates of the day a "farce."  

35. Revenue Act of 1921, Pub. L. No. 67-98, § 206(b), 42 Stat. 227, 233 (1921); 1920 House Hearings, supra note 3, at 128-32, 134-35 (statement of Frederick Kellogg, Esq.) (originator of separate capital gains rate and holding period concepts). There was no need for a corporate capital gains preference at this time, since the individual flat rate capital gains preference deliberately paralleled the corporate flat rate income tax. 1921 Confidential Senate Hearings, supra note 2, at 37 (statement of Dr. T.S. Adams, Special Tax Advisor).

36. Pub. L. No. 67-98, § 202(a), 42 Stat. 227, 229; 1921 Confidential Senate Hearings, supra note 2, at 307 (statement of Sen. Reed) (Anecdote of publisher with multimillion dollar building, who would rather give it to posterity than sell with 80% of profits going to the Government); see also 1920 House Hearings, supra note 3, at 14-15 (Statement of Ways and Means Chairman Fordney) (Example of retained earnings apparently by a closely-held corporation probably in the automotive business, such as Ford Motor Co.). Professor Bank shows, however, that corporations began to accumulate more earnings not in response to double taxation of distributed earnings. Steven A. Bank, Is Double Taxation a Scapegoat for Declining Dividends? Evidence From History, 56 TAX L. REV. 463, 466 (2003) ("[D]ouble taxation of corporate income first emerged between World War I and II in response to a shift in corporate attitudes toward retained earnings, and not vice versa.").

37. The Revenue Act of 1921 reduced the maximum rate from 73% to 58%. § 210, 42 Stat. 227, 233, 237. Secretary of Treasury Andrew Mellon directed further reductions in the Revenue Act of 1924, and the Revenue Act of 1926 reduced the top rate to 25%. Pub. L. No. 69-20, § 210 (maximum normal rate of 5%) and § 211 (maximum surtax of 20% of net income in excess of $100,000), 44 Stat. 9, 21-23 (1926). Interestingly, the House bill picked a top surtax rate of 33% because 32% was the spread in interest rates between tax exempt and taxable bonds. 1921 Confidential Senate Hearings, supra note 2, at 39-40 (colloquy between Sen. Smoot and Dr. Adams.).

During the Roaring Twenties' boom stock market years, capital gains amounted to almost 50 percent of individual sector taxable income.\textsuperscript{39} In the 1925 boom stock market year, the 12\(\frac{1}{2}\) percent flat rate capital gains preference benefitted only individuals with more than $30,000 of taxable income ($313,910 in 2004 dollars\textsuperscript{40}) where an ordinary income rate greater than the flat capital gains rate first applied.\textsuperscript{41} That year only 68,317 taxpayers reported over $30,000 a year,\textsuperscript{42} and among this small group, the 9,560 taxpayers reporting more than $100,000 ($1,070,286 in 2004 dollars) received $91 million in tax relief from the flat 12\(\frac{1}{2}\) percent capital gains rate while the remaining 62,757 taxpayers received only $13\(\frac{1}{2}\) million.\textsuperscript{43} Thus, fewer than 10,000 individual taxpayers with $100,000 or more in annual income paid about 50 percent of the individual income taxes\textsuperscript{44} and received almost 90 percent of the benefits of the flat capital gains rate. Accordingly, the effective income rate of the rich of the day was far below the nominal top income tax rates.

\textsuperscript{39} Proposed Revision of the Revenue Laws of 1938: Report of a Subcomm. on Internal Revenue Taxation of the House Comm. on Ways and Means, 75th Cong., 3rd Sess. 90 (1938) [hereinafter Vinson Report]. Since only 15% of personal income was then taxed, see infra note 45, capital gains constituted only 7.5% of personal income albeit 50% of taxed income. In the recent stock market boom years of 1998-2000, capital gains taxes constituted 10%, 11%, and 12% of income taxes respectively. CBO, Capital Gains Taxes and Federal Revenues 3 (Oct. 2, 2002) [hereinafter CBO, Capital Gains Taxes]. Since the maximum capital gains rate during this period was 20% and the maximum ordinary rate was 39.6% (before phase outs), capital gains income possibly made up as much as 20% of individual income during this period.

\textsuperscript{40} All calculations in this Article of changes in purchasing power over the referenced years were made with the Federal Reserve Bank of Minneapolis “calculator” at http://woodrow.minneapolis.frb.fed.us/research/data/us/calc/.

\textsuperscript{41} Revenue Act of 1921 § 211, 42 Stat. at 236. Dr. Adams disingenuously answered the query of Senator David Walsh, D-Mass., as to whether “you discriminate in favor of those who have an income of over $29,000” with “[w]e simply say that their tax on capital gain shall not be over 12.5 percent.” 1921 Confidential Senate Hearings, supra note 2, at 39.

\textsuperscript{42} 1 Staff of Joint Comm. on Internal Revenue Taxation, Supplemental Report on Capital Gains and Losses, pt. 7, at 4-5 (1929) [hereinafter 1929 Joint Comm. Supplemental Report].

\textsuperscript{43} Id.; see also Hearings on H.R. 7385 before the Senate Finance Committee, 73rd Cong. 180 (1934) (statement of Herbert Wood, Esq.) (“Out of seven billion and one hundred and some million of capital gains realized in the taxable years 1925 to 1929, over six billions occurred in incomes of $100,000 or more.”).

\textsuperscript{44} See Hearings on Revenue Revision, 1938 Before the House Committee on Ways & Means, 75th Cong. 110 (1938).
Most workers were exempted from the income tax due to generous personal exemptions, but were heavily burdened by regressive excise taxes, prompting the "Mellon Ditty." Undersecretary of Treasury Ogden Mills, who had been a Wall Street tax lawyer and member of the House Ways and Means Committee in the early 1920's, pointed out in the 1932 Senate Finance Committee Hearings that the real tax burden were state and local taxes borne by small and moderate income taxpayers.

Congress' articulated rationale for the initial capital gains preference was that "bunching" of gain accrued over many years into a single year subject to progressive rates "blocked" voluntary transactions such as sales of capital assets. On the eve of the Revenue Act of 1921, sales of public stock by the highest income individuals were indeed blocked. However,

45. Only 2.5 million individuals paid Federal income taxes in 1925 out of perhaps 30 million workers. See Kornhauser, supra note 38, at 873 n.18. From 1918 to 1920 only 9.5% of the U.S. population was subject to the Federal income tax; from 1921 through 1929, only 13% to 14% of personal income was taxed. U.S. DEP’T OF TREASURY, OFFICE OF TAX ANALYSIS, REPORT TO CONGRESS ON THE CAPITAL GAINS TAX REDUCTIONS OF 1978, at 49 n.14 (Sept. 1985) [hereinafter 1978 CAPITAL GAINS REPORT]. The $4,000 personal exemption for a married taxpayer was worth $41,855 in 2004 dollars. See generally Geier, supra note 6, at 103.

46. 65 CONG. REC. H3031-32 (statements of Rep. Lankford) (populist doggerel about the Mellon Plan's taxing farmers, laborers, and small businesses through excise taxes, while "urging less taxes for the millionaire profiteer and more for the common folks." The following lines from two verses give the flavor; "Tax the people, tax with care; Tax to help the millionaire; Tax the farmer; Tax his fowl; Tax the dog and tax his howl; . . . Tax his "Henry," tax the gas; Tax the road that he must pass; And make him travel o'er the grass; Tax him just all you can; This is, friends, the Mellon plan."). See generally John W. Lee, "Death and Taxes" and Hypocrisy, 60 TAX NOTES 1393 (1993).

47. Hearings on the Revenue Act of 1932 Before the Senate Finance Committee, 72nd Cong. 3 (1932) (testimony of Undersecretary Ogden Mills).

48. Thus, the capital gains preference was enacted "to permit such transactions to go forward without fear of a prohibitive tax ..." H.R. 350, 67th Cong., 1st Sess. (1921). See also id. at 128-32, 134-35 (Frederick Kellogg, Esq.) (proposing separate schedule for capital assets because of blockage of transactions with high individual surtax rates); 61 CONG. REC H5201 (1921) (statement of Rep. Hawley) (noting that the blocking surely was influenced by the prospect that with the end of WWI the high income rates would be slashed). TINDALL, supra note 3, at 1020-22 (discussing transition from wartime to peacetime). Cf. 61 CONG. REC. H5178 (Aug 18, 1921) (statement Rep. Oldfield) (Rich taxpayers knew that the Republican party was liable to come into power, and they knew you [Republicans] would . . . reduce the taxes on the rich . . .").

49. "For the year 1916, when the tax rate was low, there was reported by taxpayers having a net income of $300,000 over $992,000,000 in net income. . . By 1918 – that is to say, in two years, and good years – the amount of net income reported by taxpayers having incomes of $300,000 or over had fallen to $392,000,000. It seems to me the common sense of the situation indicates that we can not successfully enforce tax rates running to 73 per
such blocking arose from the high rates alone, not bunching, since the bulk of capital gains then, as now, are realized year-after-year by individual taxpayers with income otherwise taxable at the top nominal brackets.50

The legislative history reveals that from the beginning, capital gains proponents cloaked the true object of their bounty (public stock concentrated in high income taxpayers) with more popular symbols. For instance, the House floor debate on the Revenue Act of 1921 generally spoke first of high rates blocking sales of farm land before discussing their blocking sales of securities.51 A decade later the Chair of the House Ways and Means Committee, recalling that the 1921 introduction of a capital gains rate had been presented as having a tendency to permit the break up of large farms, asked what percentage of capital gains sales was attributable to such real estate.52 Undersecretary Ogden Mills (who had been a Ways &

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50. _Hearings on H.R. 7385 Before the Senate Finance Committee_, 73rd Cong. 176-79 (1934) (statement of Herbert Wood, Esq.); see also 1929 _JOINT COMM. SUPPLEMENTAL REPORT_, supra note 42.

51. See, e.g., _61 CONG. REC., pt. 5_, at H5201 (Aug. 18, 1921) (statement of Rep. Willis C. Hawley). Rep. William A. Oldfield, D-Ark., seeking repeal of the capital gains preference in 1924, recounted that the Ways and Means Committee had provided the preference, because “there were a great many people in America in 1921 . . . who had timberlands and coal lands and other lands which they had owned for some years, and they did not want to sell them at inflated prices which we had in 1920 and 1921 and pay the high surtax rate.” _65 CONG. REC., pt. 3_, at H2846 (Feb. 20, 1924) (statement of Rep. Oldfield). This story is suspiciously similar to the better-documented special interest origins in 1923 of the “stock or securities” exception to tax-free like-kind exchanges under the predecessor to Section 1031, which had been a companion provision to capital gains in 1921. See _64 CONG. REC., pt. 3_, at H2852-53 (Feb. 1, 1923) (statement of Rep. Garner).

52. _Hearings on Revenue Revision 1932 Before the House Committee on Ways & Means_, 72nd Cong. 42 (1932) (statement of Chair Collier) [hereinafter 1932 _House Hearings_].
Means Member in the early 1920’s) replied that he did not know the percentage, but acknowledged that a substantial part was from public stock.\(^5\) Actually, it was about 85 percent.\(^4\)

By the beginning of the New Deal, the Joint Committee on Taxation had reported the distributive effects of Mellon’s flat 12\(\frac{1}{2}\) percent capital gains rate for the 10,000 Oligarchs to the tax writing committees.\(^5\) In 1934 Congress tried to solve some of the distributive defects of a flat capital gains rate by employing a deduction instead, while concurrently attempting to preserve the “unblocking” benefits of a low rate.\(^6\) As a partial offset for inflation,\(^7\) the drafters of the Revenue Act of 1934 fashioned that deduction as a 4-step sliding scale\(^8\) with a maximum

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deduction of 70 percent, and thus, a maximum effective rate of 18.9 percent\(^59\) after a ten year or longer holding period.

Just as the Treasury had warned,\(^60\) top upper income individuals disproportionately sold their public stock at the last step, and obtained the greatest capital gains deductions while the moderate income taxpayers disproportionally sold at the shortest steps. Statistics from 1934 “indicate that of taxpayers with incomes of over $100,000 [$1,398,000 in 2004 dollars], 70 percent of their net capital gains was derived from transactions involving assets held over 10 years, whereas in the case of taxpayers with incomes not exceeding $25,000 [$349,430 in 2004 dollars], only 25 percent of their capital gains came from transactions in assets held over 10 years.”\(^61\) Thus, the sliding scale increased rather than lessened blocking. At the same time, disproportional benefit between income classes rose in substance, albeit not in form.

After quadrupling from its depression lows, the Stock Market suffered a more than 50 percent decline in 1937, and plunged the Nation into a recession.\(^62\) Business witnesses in the 1938 House and Senate tax writing Committee Hearings blamed a host of hated “soak-the-rich” tax provisions, accrued. 1938 Confidential Senate Hearings, pt. 1, at 11 (statement of Dr. Roswell Magill, Undersecretary of the Treasury).

59. Maximum individual rate was 63% (normal tax of 4% plus surtax of 59%) on income above one million dollars. Revenue Act of 1934 §§ 11 and 12(b), 48 Stat. at 684-85.

60. Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcomm. of the Comm. on Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws Together with Suggestions for the Simplification and Improvement Thereof, 73d Cong., 2d Sess. 6 (Comm. Print 1933) (1933 House Ways & Means Subcommittee bill’s 60% step-down after a five-year or longer holding period “would in fact operate to encourage taxpayers to hold appreciated assets for [five] years, instead of for [two], as at present, which would be an undesirable result.”); see also 1934 Confidential Senate Hearings, supra note 56, at 109 (statement of Sen. Gore).

61. H.R. REP. No. 2333, at 30 (1942). Due to continuation of the broad personal exemptions, the Federal income tax remained a tax only on higher income taxpayers who maintained low effective rates (in the 20% range) through the capital gains preference while the masses remained subject to regressive excise taxes. In short, only “symbolic reform” was affected as to capital gains in the Revenue Act of 1934, as with other FDR income tax changes. MARK H. LEFF, THE LIMITS OF SYMBOLIC REFORM 2-3, 288-93 (1984) (use of “political enemies” in political discourse which deflects and reassures reformists or at least the people undermines reform efforts; thus Roosevelt espoused soak-the-rich income tax policies, but regressive excise taxes raised even more revenues compared to income tax revenues during the New Deal Era than before (in 1920’s) or after (late 1940’s) the FDR years.

such as freezing capital, for causing a resurgence of the Great Depression.63 Congress accepted this conventional wisdom that the 1934 sliding scale capital gains deduction contributed to the 1937 stock market break, because it encouraged longer holding periods at the higher income levels where capital assets continued to be concentrated.64 Accordingly, in 1938 Congress collapsed the sliding scale into only two vestigial steps – a 33 percent deduction with a maximum effective rate of 20 percent at eighteen months, and a 50 percent deduction with a maximum effective rate of 15 percent at twenty-four months.65 Congress intended the 33 to 50 percent deductions to benefit taxpayers with small capital gains and net income, and the maximum rate ceilings of 20 to 15 percent to benefit the upper income individual taxpayers, who controlled the bulk of the public stock.66 Thus, Congress structurally brought back the disproportional benefit feature of the 1921 Act’s flat rate, but did not shut the “little fellow” – the moderate income taxpayer – out entirely this time due to the deduction alternative.

B. THE 1940’S: SPECIAL INTERESTS’ FOUNDATION FOR A CONSERVATIVE COALITION ON CAPITAL GAINS EMERGES, ALONG WITH THE FIRST APPEARANCE OF THE 25 PERCENT MAXIMUM CAPITAL GAINS RATE


64. S. REP. No. 75-1567, at 6 (1938) (“[T]he committee believes that the plan proposed in the House bill is excessively complicated and will not permit a free flow of capital into productive enterprises. The committee is convinced that at the present time transactions are prevented by the capital-gains tax and that the result has been a material hindrance to business and a considerable loss of revenue.”); accord, Harrison Demands End of Profits Tax, N.Y. TIMES, Mar. 13, 1938, at A-1 (quoting Senate Finance Chair Pat Harrison, D-Miss., that “a sit-down strike upon the part of capital . . . should [be broken] . . . and . . . effective work should be done toward removing some of the barriers that are checking the flow of capital and credit into new investment and new industries.”).


66. 1938 Confidential Senate Hearings, supra note 58, at 11, 15-16 (statement of Dr. Roswell Magill, Undersecretary of the Treasury).
With the expansion of the individual Federal income tax base in the early 1940’s, the modern federal income tax first became a mass tax (through lowering personal exemptions) with high rates (ultimately up to 88 percent). This transformation was also reflected in the expansion of the individual capital gains preference. In developing the Revenue Act of 1942, the House and Senate tax-writing committees reconsidered the treatment of capital gains for the third time in a decade. Citing declining capital gains revenue, they strengthened the capital gains preference by shortening the holding period to six months, and provided a single 50 percent deduction for the small taxpayer while increasing the alternative 15

67. Carolyn C. Jones, Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II, 37 B.U.L. Rev. 685, 686, 694-95 (1989) (By lowering personal exemptions, 1940 and 1941 Revenue Acts increased the number of taxpayers from 7,000,000 to 17,000,000 and then to 27,000,000; and then a 45% increase to around 40,000,000 taxpayers.). Randolph Paul regretted the further lowering of exemptions, but considerations of equity were trumped by the goal of avoiding inflationary price increases. TREASURY DEP’T AND HOUSE COMM. ON WAYS AND MEANS, DATA ON PROPOSED REVENUE BILL OF 1942 170 (Confidential Comm. Print 1942) [hereinafter DATA ON PROPOSED 1942 BILL] Exhibit 64 at 169 (statement of Sec’y of the Treasury Morgenthau) (lowering the personal exemptions under the individual income tax from $1,500 for a married person plus $400 for each dependent to $1,200 and $300, respectively, would produce additional revenue of $1,100,000,000 of which about 10 percent would come from 6,900,000 new taxpayers). Professor Carolyn Jones, supra, pointed out that the total reductions in the personal exemptions greatly increased the number of covered taxpayers: from 7 million to 40 million income taxpayers in the early 1940’s (possibly including both civilian and military populations).

In DATA ON PROPOSED 1942 BILL, supra at p. 170 Exhibit 65, Assistant Secretary Randolph E. Paul regretted the necessity of lowering exemptions because they were at the right level based on equity; but they had to be lowered in order to withdraw excess consumer purchasing power, which otherwise would create inflationary pressure. Historically, family exemptions offset any income otherwise reportable by the working masses during the Great Depression. Jones, supra.

Excess turns on the experience of the viewer. My maternal grandfather first paid income taxes in the early 1940’s when he worked as a carpenter at construction sites for munitions making plants or “powder plants” across the deep South and then the old Midwest in the early 1940’s. (Then he moved to Vallejo, California in late 1944 to work at the Naval munitions factory at Mare Island. My earliest memories commence then.) He would proudly show us the Powder Plants he had “built” in Southwest Ohio on some Sunday drives, when we lived in trailer camps in and around Dayton, Ohio in the early 1950’s. (All of those camps are still there, but stuffed with much larger trailers, not like the ones my grandfather used to pull with a car or a truck whenever we moved.)

68. Revenue Act of 1942, Pub. L. 77-753, § 102 (normal tax of 6%) and § 103 (maximum surtax of 82% on net income over $200,000), 56 Stat. 798, 802-03.

69. H.R. Rep. No. 77-2333, at 29 (1942) (“It has been shown that too high a capital gains tax will result in a loss of revenue to the Government.”).
percent flat rate" from the Revenue Act of 1938 to a single 25 percent maximum rate for the high income taxpayer.70

More significantly, in 1942 and 1943 Congress extended the preference beyond the public stock and real estate investments of high income individuals to benefit a wide range of middle class taxpayers who were often the Democrats’ constituent groups,71 such as taxpayers with timber royalties,72 revenue from the sales of used equipment and livestock73 and lump-sum distributions from qualified retirement plans.74 This laid the initial political foundation for a capital gains coalition of Republicans and conservative, predominantly Southern, Democrats – the Conservative Coalition.75 Incidentally, when President Roosevelt, vetoed the 1943 Act,

70. Revenue Act of 1942, § 150, 56 Stat. at 843-44; see supra note 65 and accompanying text.

71. Hearings on Revenue Revision of 1942 Before the House Comm. on Ways and Means, vol. 1, 77th Cong. 196-99 (1942) [hereinafter 1942 House Hearings] (statement of Merle Miller, Esq.).


73. Revenue Act of 1942 § 165(b), 56 Stat. at 863. The Senate Finance Committee bill afforded capital gains treatment to lump-sum distributions from qualified retirement plans on account of separation from service with neither a rationale, S. REP. No. 77-1631, at 138 (1942), nor prior discussion in the Senate hearings or on the House side, evidencing special interest influence, i.e., a “backroom deal.”

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75. Congressional Quarterly Almanac 1957-1994 surveyed roll call votes in both Houses in which a "Conservative Coalition" arose. A majority (usually almost all) of the
while specifically citing timber royalties, because it was “not a tax bill but a tax relief bill, providing relief not for the needy, but for the greedy.”

In response, a Conservative Coalition overrode this first tax bill veto. The innovation in the plea hearings for special capital gains relief that would have resulted in narrow provisions is a hallmark of special interest provisions.

The Treasury’s Special Tax Advisor, Randolph Paul, was ineffective in combating these special interest add-ons in 1942. He was too busy fending off the brush fire from the publicly supported Bland Amendment, which called for a flat rate of 10 percent with no holding period.

Republican members and a majority of the “Southern” Democrats voted one way and a majority of the “Northern” Democrats voted the other way. The Conservative Coalition first began to appear as a reaction to FDR’s attempt to “pack” the Supreme Court in 1937. See James T. Patterson, Congressional Conservatism and the New Deal 87-127 (1967). It appeared twice as often during Truman’s Administration. Joel P. Margolis, The Conservative Coalition in the United States Senate, 1933-1968 81 (1973) (unpublished Ph.D. thesis, University of Wisconsin - Madison) (on file with the University of Wisconsin Library) (most likely to appear on issues of taxes, economic policy, health, education, welfare, and labor); see Leonard Baker, Back to Back: The Duel Between FDR and the Supreme Court 109-36 (1967) (apparent electoral triumph of 1936 would be dissipated in 1937 because of the failure of the “court-packing” plan). It essentially disappeared after the 1994 elections as the newly empowered GOP did not need the votes of Southern Democrats (a dwindling breed) to advance its agenda. 51 Cong. Q. Almanac C-10 (1995).

The Conservative Coalition appeared stronger on capital gains than on other issues. 45 Cong. Q. Almanac 40-B (1989). This may well have been due more to a confluence of interest groups benefited, some favored by Republicans and others favored by Southern Democrats, than to any shared ideology as to capital gains taxation.

76. H.R. Doc. No. 78-443, at 1 (1943). President Franklin Roosevelt specifically criticized the treating of income from the cutting of timber as capital gain. Id. at 2.

77. Witte, supra note 72, at 121.

78. 1942 House Hearings, vol. 1, supra note 71, at 151 (statement of M.L. Seidman, N.Y. Board of Trade) (criticism of non-business bad debt rule); accord id., vol. 1, at 962-63 (statement of Frank L. McNeny) (origin of family guarantee rule once contained in Section 166); id. vol. 1, at 962 (statement of McNeny) (criticism of capital loss rule); id., vol. 2, at 1734 (statement of Paul E. Shorb, U.S. Chamber of Commerce) (criticism of worthless securities rule); id., vol. 2, at 1745 (statement of Shorb) (need specific rule for mortgage foreclosures); id., vol. 2, at 1784 (statement of Ellsworth Alvord, U.S. Chamber of Commerce) (criticism of involuntary conversion rule as not going far enough); id., vol. 1, at 470 (statement of Joseph Bright, estate analyst) (requesting approval of overlapping pension and profit-sharing plans).


80. Largely in response to Representative Bland’s proposed bill, Randolph Paul (Paul), the preeminent tax expert of the day, refuted the myths that the Government would be ahead if capital gains and losses were excluded from income and that the British tax system did so.
In the 1942 Hearings, Randolph Paul provided the most thoughtful analysis of the capital gains policy to date backed by extensive historical data. He debunked a long-time favorite rationalization for the preference, that the treatment of capital gains and losses had a major impact on the stock market, and addressed the inflation rationale. He presented data, including charts, showing the historical fluctuations in revenues from capital transactions reflected market conditions rather than capital gains tax rates. Nevertheless, conservative Republican capital gains cuts
proponents continued to assert that decreases in the capital gains rate were necessary to increase revenues by unblocking transactions.84

Paul’s most significant innovation in the 1942 Hearings was to proffer an “equity argument” against a rich capital gains preference supported by distribution statistics showing disproportional benefits received by the most wealthy taxpayers. He asserted that the Bland bill would reduce the taxes of not more than one-tenth of the taxpayers with the probable result that the other nine-tenths of taxpayers would be called upon to pay what the one-tenth saved.85

The capital transactions are largely concentrated in the higher income groups. In 1937 more than 60 percent of the returns with income above $25,000 [$325,174 in 2004 dollars] reported capital transactions. In 1938 statutory net capital gains constituted 64.7 percent of the net income of individuals with net incomes of $1,000,000 [$13,280,000 in 2004 dollars] and over, but less than 1 percent of the net incomes of individuals with net income under $5,000 [$64,200 in 2004 dollars].86

From these facts, it is inescapable that the highest income individuals had effective rates far below the top ordinary income rates.

In 1938, net capital gains income was concentrated among taxpayers with net incomes of $100,000 ($1,328,000 in 2004 dollars) to under $1,000,000 who reported 27.3 percent of net long term capital gains, and taxpayers with $1,000,000 and more than 21.9 percent net long term capital gains.87 In the House Ways and Means Hearings on the Revenue Revision of 1942 Act, Randolph Paul was asked what percentage of capital gains and

Similarly, notwithstanding the “increase” in rates under the 1934 Act, net capital gains almost doubled from 1935 to 1936 reflecting the economic recovery (i.e., $762 million to $1.456 billion). Id. at 256-57.

84. Paul argued that a capital gains rate reduction (if it were not expected to be permanent) would increase revenues temporarily but at the cost of future revenue yield resulting in net revenue loss, as had happened in 1938. 1942 House Hearings, vol. 1, supra note 71, at 1628-29. Compare id. at 262-3 and id., vol. 2, at 1652-25 (colloquy between Paul and Rep. Knudson) with id., vol. 1, supra note 83, at 265 and id., vol. 2, at 163-64 (colloquy between Paul and Rep. Reed) for Congressional disagreement. Paul also was the first to point out the conversion of ordinary income into capital gains problem (i.e., retention of corporate earnings example; discount bonds; liquidation-reincorporation). Id., vol. 1, at 1630-31.

85. 1942 House Hearings, vol. 1, supra note 71, at 253 (statement of Paul). In 1937 less than one in ten taxpayers reported a capital gain. Id.

86. Id. (statement of Paul). For 1959 distribution of individual ownership of stock, see infra note 136 and accompanying text.

losses arose from stock market transactions. Paul replied that it depended on the taxpayer’s income bracket. 88 “Under the $5,000 brackets it is shown that 74 percent of the gains come from profits on stocks and bonds. . . . These figures show that in incomes between $100,000 and $1,000,000, 81 percent of these gains were from profits on stocks and bonds, and when you get over $1,000,000, 99 percent were from that source.” 89 Third Ranking Representative Jere Cooper, D-Tenn., observed that every ten years or so the Committee was told that 85 percent of capital gains and losses consisted of stocks and bonds by income group, but the above data showed a 90 percent average. 90 Paul replied that the average was 80 percent of capital gains and 70 percent of the losses. 91

The unconvincing response of proponents of the Bland amendment was that these statistics reflected the desirable effects of closely-held businesses going public. 92 Similarly, the response of a pro-Bland capital gains cut witness, when questioned about the alleged 85 percent of capital gains realizations coming from public securities transactions, was the “cloaking” argument: the remaining 15 percent covered many hardships such as gains from residential sales. 93 Nevertheless, Paul failed to carry the day for the Treasury counter-proposal of a 50 percent deduction and an alternative 30 percent flat rate with an eighteen-month holding period. 94 However, he may have prevented adoption of the Bland 10 percent flat rate without any holding period.

Apparently detecting a cool breeze from Ways and Means, Paul revised the Treasury’s proposals between the time of the Ways & Means Hearings (and after consultation with the Joint Committee Staff) and the release of the House report. The new Treasury proposal called for a (reduced) holding period of fifteen months, a 50 percent deduction and a (reduced) alternative maximum capital gains effective rate of 25 percent. 95 While ten percentage points higher than the maximum individual capital gains rate

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89. Id. (statement of Paul).
90. Id. at 261 (statement of Rep. Cooper).
91. Id. (statement of Paul).
92. Id. at 924 (statement of Emil Schram, President of the New York Stock Exchange).
93. 1942 Senate Finance Comm. Hearings, supra note 63, at 1225 (statement of Friedman).
94. 1942 House Hearings, vol. 1, supra note 71, at 89-90 (statement of Paul).
95. DATA ON PROPOSED 1942 BILL, supra note 63, at 352-53.
under the Revenue Act of 1938, this maximum rate was roughly comparable to the 25.2 percent maximum effective rate after five years under the House Revenue Bill of 1934’s year one to five, 3-step sliding scale.96

The 1942 House Ways and Means Committee Report, as the public witnesses appearing before the Committee, did not acknowledge Paul’s arguments except to implicitly deny them.97 Notwithstanding the Ways and Means Committee Report’s implicit rejection of Treasury’s arguments, the final House bill abandoned the sliding scale approach due to its “tendency to delay the taking of gains [while] stimulat[ing] the realization of losses,” and instead adopted Treasury’s modified proposal: a fifteen month holding period, a 25 percent maximum rate, and an alternative 50 percent deduction.98

The 1942 Senate bill, following the pattern for the past decade, was more favorable to holders of capital assets than the House bill, which shortened the holding period to six months and expanded the definition of capital assets while generally following the House’s 25 percent maximum capital gains rate and alternative 50 percent capital gains deduction.99

96. H.R. 7835, 73d Cong. § II (2d Sess. 1934) (4% normal tax). Id. at § 12(b) (59% surtax at $1 million). Id. at § 117(a) (40% inclusion after five years). 40% x 63% = 25.2%.
97. “It has been shown that too high a capital gains tax will result in a loss of revenue to the Government.” H.R. REP. No. 2333, 77th Cong., 1st Sess., at 29 (1942); accord S. REP. No. 1631, 77th Cong., 2d Sess., at 49-50 (1942). The House Report, ignoring the implications of Treasury’s testimony as to the concentration of public stock at the upper income levels, asserted also that too high a capital gains tax would “have the effect of discouraging taxpayers from investing in new or productive enterprises,” reasoning that too high capital gains rates would discourage sales and hence reinvestment [in new and hence non-public stock]. H.R. REP. No. 2333, at 29. And rather than speaking of bringing the top capital gains rate into line with the increases in ordinary rates as Paul had, the Report noted that with a top ordinary rate of 88%, “it is not believed that a moderate increase in the capital-gain rate will retard capital transactions.” Id. at 30. (The “moderate increase” was from a maximum individual capital gains rate of 15 percent to 25 percent. This 25% maximum rate lasted until 1978 when the capital gains deduction was increased to 60% resulting then in a maximum individual rate of 28%--70% maximum rate on investment income 40% of gains remaining after the capital gains deduction. When President Ronald Reagan cut the top rate on unearned income in 1981 to the same as the top 50% rate on earned income, the capital gains rate ceiling fell to 20% (50% x 40% remaining after the capital gains deduction). The Tax Reform Act of 1986 raised the maximum individual capital rate back to 28%. President Bill Clinton in 1997 signed the first of a series of income tax cuts “for the greedy not for the needy.” If anything, the needy got spending cuts as to social services. It is worth noting the FDR so described the Revenue Act of 1944, which he vetoed, but the Conservative Coalition overrode.
98. Id. at 30, 31.
Citing the declining capital gains revenue data, the 1942 Finance Committee Report concluded that too high a rate reduced revenues. This ignores the adverse effect of WWII on the stock market (and hence, declining revenues).

The Conference followed the Senate bill fixing the 50 percent capital gains deduction for the next 36 years, with the long-term capital gain holding period remaining six months, except for 1978-1982 when a 1-year holding period applied. The 25 percent alternative maximum rate was, however, limited in 1969 and eliminated in 1978 at the same time that the individual capital gains deduction was increased to 60 percent.

C. THE 1950'S: BUSINESS AS USUAL (BUT ON A CLEAR DAY, YOU CAN SEE FOREVER)


The Revenue Act of 1951 extended capital gains coverage, through numerous exceptions, to the sale or exchange requirement and to resolution in favor of taxpayers in conflicts between the Internal Revenue Service and the courts over capital transaction treatment. This pattern extended

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100. S. REP. NO. 1631, at 49-50.
101. David James, The Main Campaign, BUS. REVIEW WEEKLY, Mar. 27, 2003, at 14 (charting initial decline in Dow Industrial average after Pearl Harbor, some rebound in month after, and decline again after three months and substantial decline after six months); Jason Kirby, Time Is On Your Side, CANADIAN BUS., Oct. 15, 2001, at 17 (touching on Americans' fears about the outcome of the Second World War, noting that at the time of the attack on Pearl Harbor, Dec. 7, 1941, the Dow was at 110, and five months after the Pearl Harbor attack the Dow had fallen 16%; when America's strength in WW II began to be felt, Dow began its rise).
105. WITTE, supra note 72, at 142.
106. See, e.g., S. REP. NO. 781, 73d Cong., 2d Sess. 31-37, 41-43, 47-48 (1951) (tax-free rollover on sale of residence, capital gains for coal royalties under predecessor to Section 631(c), and for sale of livestock and unharvested crops in the context of predecessor to Section 1231); WITTE, supra note 72, at 143. Sales of livestock also constituted a far greater percentage of capital gains realizations by lower income taxpayers than in any other income class, see infra note 134, reflecting the lower income of smaller farmers.
capital gains treatment (1) as a relief for certain types of income, (2) in lieu of an explicit averaging device, or (3) as an incentive.107

2. 1954 Code Continuation of Patterns of Late 1939 Code

The 1954 Code Hearings rehashed the previous two decades by either echoing the folklore of 1930’s and 1940’s Hearings as to rates, holding period and capital losses, or, as in the 1940’s, entertaining special interests pleas for aid.108 The original 1954 Code continued the late 1939 Code

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107. STAFF OF JOINT COMM. ON THE ECONOMIC REPORT, 84TH CONG., THE FEDERAL REVENUE SYSTEM: FACTS AND PROBLEMS 16 (Comm. Print 1956). The Staff study lists timber, livestock, unharvested crops, coal royalties, lump-sum distributions from retirement plans, lump-sum employment payments, and employee stock options. Id. at 16-21. The Staff Report was heavily influenced here by Professor Surrey’s paper submitted for the accompanying Hearing. See infra notes 116 and 117.

108. Some witnesses at the 1953 House General Revenue Revision Hearings raised the threadbare arguments that capital gains should be taxed at 10% or 12.5% at the most, or not at all. Further, they argued that capital losses should be deductible against ordinary income in order to (a) unblock transactions, (b) increase the revenue yield, and (c) reduce boom and bust distortions in the stock market. Hearings on Forty Topics Pertaining to the General Revision of the Internal Revenue Code Before the House Ways and Means Committee, pt. 2, 83d Cong. 1184, 1196, 1202, 1206 (1953) [hereinafter 1953 House Hearings] (statement of Ellsworth Alvord; National Association of Manufacturers; American Taxpayers Association; Council of State Chambers of Commerce; respectively); see also The Internal Revenue Code of 1954: Hearings on H.R. 8300 Before the Senate Finance Committee, pt. 2, 83d Cong., 2d Sess. 711, 741, 742, 997 (1954) [hereinafter 1954 Senate Hearings] (statements of Edward McCormick, American Stock Exchange [holding period]; G. Keith Funston, New York Stock Exchange [holding period, rate, and capital losses]; Walter Maynard, Association of Stock Exchanges [rate and holding period]; Arthur Jenkins [capital losses]; respectively); 1953 House Hearings, supra at 1185-91, 1198-1200, 1203-05, 1207 (statements of John W. Anderson, National Patent Council [“encourage inventors by increasing their rewards”]; Stuart McCarthy [termination of personal service agencies]; American Institute of Accountants [worthless stock in wholly owned subsidiary and bidding in at foreclosure sale]; Council of State Chambers of Commerce [bidding in at foreclosure sale and loss on abandonment of option]; respectively); 1954 Senate Hearings, pt. 1, supra at passim (statements of Fortescue Hopkins, Esq. [business bad debt treatment for shareholder loans]; Charles Briggs [seeking to reverse House capitalization of administrative timber cutting expenses]; Merrill Bradford [same]; Harold Kuhn [elective non-recognition of sale of residence and limitation of capital losses]; R.J. Dearborn [patents]; respectively); id., pt. 3, at passim (statements of J. Alter Meyers, Jr., Forest Farmers Ass’n of Atlanta; William Barnes [patents]; Rolla Campbell, National Council of Coal Lessees, Inc.; J.S. Seidman, American Institute of Accountants [foreclosure]; John Williamson, Nat’l Ass’n of Real Estate Boards [investment by dealers]; Robert Wadlington [same]; Brach, Gosswein & Lane [short sales]; Henry Isham, Clearing Industrial District, Inc. [investment by dealers]; respectively); id., pt. 4, at passim (statements of Richard Uhleman, Chicago Board of Trade [holding period]; Francis Davis [patents]; John Giesse [same]; Chamber of Commerce of the U.S. [capital losses and tacked holding period]; Ellsworth Alvord, Esq. [qualified stock options, capital gains rate, and like-kind exchange of
format of high and sharply progressive ordinary income rates (up to 91 percent or so) at the upper individual brackets coupled with a substantial preference for long-term (six months) individual capital gains in the form of a 50 percent deduction for individuals with small incomes and a maximum rate of 25 percent for the big incomes. Also included were a few more special interest provisions.

In the 1960's and 1970's the result in practice under the 1954 Code, due to these structural provisions, was an effective rate of 35 percent. This was primarily due to the concentration of capital gains income at the highest level of income individuals: top 1 percent or less. Every year on average, the top 1 percent of individuals realized 50 percent or more of the capital gains realized by individuals, who own nearly half of the public stock (with taxation of unrealized appreciation at death), respectively). See also S. REP. NO. 1622, 83d Cong., 2d Sess. 110, 114 (1954) (mortgage foreclosures and investment accounts of real estate dealers).


110. Given the number of appeals for extension of capital gains treatment by interest groups, the actual extension of the preference was moderate. Proponents of extension met with success as to patents and timber administrative costs, S. REP. NO. 1622, at 81, 114; but arguably failed with other controversial House special interest capital transactions, id. at 110 (mortgage foreclosure), 113 (investment account of real estate dealers), 116 (private annuities). The reason probably was that the Republican-controlled Senate Finance Committee, fearing the controversial provisions could delay the bill to the next term of Congress wherein the one-seat Republican control of the Senate might be lost (as it was). Hence, the proponents generally removed innovative and controversial House provisions. See John W. Lee, The Art of Regulation Drafting: Structured Discretionary Justice Under Section 355, 44 TAX NOTES 1029, 1033 n.44 (1989).

111. For example, in the 1960's high income individuals in general had an effective rate of around 35%. 110 CONG. REC., pt. 2, at S1438 (Feb. 1964) (statement of Floor Manager Sen. Long, Senate Finance Comm. Member).


113. CBO, HOW CAPITAL GAINS TAX RATES AFFECT REVENUES: THE HISTORICAL EVIDENCE 30-31 (1988) (around 50% of the realized capital gains in the 1950's and 1960's, dropping to 30% to 40% in the 1970's, and climbing back to 55% in 1982 through 1985); CBO, PERSPECTIVES ON THE OWNERSHIP OF CAPITAL ASSETS AND THE REALIZATION OF CAPITAL GAINS 2, 15, 20, 21 tbl.6, 22 fig.5 (1997) [hereinafter CBO, PERSPECTIVES ON
stock held by individuals. At this time, one fourth of high income individuals who did not enjoy significant amounts of capital gains had effective rates much closer to the nominal top individual ordinary income rate.

3. Mills Tax Policy Hearings: The Best Policy Discussion to that Date

Possibly in response to the Senate and Conference Committee’s thwarting of the most controversial provisions in the House version of the 1954 Code, soon to be Chairman of the House Ways and Means Committee, Representative Wilbur Mills, D-Ark., commenced innovative tax policy hearings in 1955 with submitted papers from invited witnesses, including academics rather than the special interest witnesses primarily used in the past. This culminated in the well-known 1959 TAX REVISION COMPRENDIUM and its accompanying PANEL DISCUSSIONS. The consensus conclusion of the Mills Hearings witnesses on capital gains was the notion propounded by Harvard Law Professor Stanley Surrey that the excessively high nominal individual ordinary income rates coupled with the excessively large individual capital gains preference created politically irresistible pressure to expand the categories of capital gains. The
consensus was to lower individual ordinary income rates, raise capital gains rates, repeal the 1940's and 1950's accretions to capital gains treatment, \textsuperscript{118} “recapture” depreciation deductions to correct the \textit{Crane} character mis-characterization, and tax unrealized capital gains at death and upon gifts. \textsuperscript{119}

\textsuperscript{118} Parallelizing “his” 1954 ALI Capital Gains Proposals, see supra note 116, Surrey presented the basic definitional issues as (1) distinguishing investment from (a) business, (b) speculation, and (c) personal efforts; (2) classifying recurring receipts; and (3) transformation of (a) tangible assets into intangible property, viz., equity interests in collapsible corporations and partnerships, and (b) retained corporate ordinary income into stock appreciation. 1955 Tax Policy Papers, supra note 117, at 406-15. By the 1959 Panel Discussions Chairman Mills at least clearly had accepted the policy argument that the capital gains preference should be limited to traditional investment assets and manifested a thorough knowledge of the host of exceptions. Panel Discussions on Income Tax Revisions before the House Committee on Ways & Means, 86th Cong. 693 (1960) [hereinafter 1959 Panel Discussions]. Even as the Assistant Secretary for Tax Policy under Presidents Kennedy and Johnson, Professor Surrey was unable to significantly reform the definition of capital gains. He was only able to change the definition of a depreciation recapture (which was 80% ineffective as to real estate improvements due to the compromise limitation of “recapture” to the excess of accelerated depreciation over straight-line depreciation) and ultimately service-flavored compensation (lump-sum and employer stock distributions from “qualified” profit sharing and stock bonus plans, and qualified stock option plans).

119. Crane v. Comm'r, 331 U.S. 1 (1947) (stating that exclusion of allowable depreciation deductions from consideration in computing gain would result, in effect, in a double deduction on the same loss of assets). See 1955 Tax Policy Papers, supra note 117 at 406-15; Message from the President of the United States relative to our Federal Tax System, H.R. Doc. No. 140, at 13 (1961) (“Our capital gains concept should not encompass this kind of income. This inequity should be eliminated, and especially so in view of the proposed investment credit. We should not encourage through tax incentives the further acquisition of such property as long as this loophole remains.”). \textit{Crane} required that non-recourse liabilities be included in the amount realized under the predecessor to Section 1001 in part because such liabilities had been included in basis at acquisition and thus supported depreciation deductions which reduced such basis. Mis-characterization arose because the depreciation deductions were ordinary, whereas the gain resulting from such basis reduction was capital under the predecessor to Section 1231, (enacted after the tax years in \textit{Crane} but long before the Court’s decision). See John W. Lee & Mark S. Bader, Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income, 12 J. Corp’r’n L. 137, 219-20 (1987).
III. UPS AND DOWNS OF CAPITAL GAINS
TAX REFORM: 1960'S-1980'S

A. 1960'S: THE FAILURE OF THE BEST, AND COMMENCEMENT OF
SURROGATE CAPITAL GAINS REFORM

1. President John F. Kennedy’s Reform Proposals: Uniting the Special
   Interest Opponents

   In the early 1960’s the Kennedy Administration formulated a tax plan
   incorporating several features of the 1950’s Mills Hearings radical
   consensus on the best capital gains tax policy: equitable limitations and
   taxation of unrealized capital appreciation at death.120 The common
denominator to the Kennedy proposals and to the Mills capital gains
consensus was Harvard Professor Stanley Surrey who served as JFK’s
Assistant Secretary of Treasury for Tax Policy.

   A combination of the traditional Republican tax cuts to spur the
economy leg and a traditional Democrat equity leg ran through the 1963
Kennedy tax proposals,121 no doubt motivated at least in part by a desire to

derived from Surrey’s paper to confine capital gains to “the sale or exchange of a much
narrower category of assets than at present, principally corporate securities.” STAFF OF
JOINT COMMITTEE ON ECONOMIC REPORT, 84TH CONG., THE FEDERAL REVENUE SYSTEM: FACTS
AND PROBLEMS 32 (Comm. Print 1956). “Other types of income currently receiving capital
gains treatment, such as those representing compensation for personal service (distributions
from retirement plans, stock options, patent royalties), gains from transactions involving
inventory-type assets (coal royalties, cutting of timber, livestock), and anticipation of future
income (in-oil payments, life interests in estates) would be subject to ordinary income
treatment or whatever preferential treatment specifically accorded with the special
circumstances.” Id. The principal objection was the virtual impossibility of distinguishing
“true” capital gains from the wide range of other income receiving capital treatment, which
often turned on the circumstances under which the income was received. Even strict
adherence to the capital asset-sale or exchange rule would still leave open the question of
what assets were to be included as capital assets. Id. at 32-33.

   When Section 1250 was enacted, real estate depreciation recapture was limited to
the excess of accelerated over straight-line depreciation, which Rep. Al Ullman, D-Wash.,
viewed as not costing the real estate industry greatly and not putting a damper on real estate
development. HEARINGS ON PRESIDENT’S 1963 TAX MESSAGE BEFORE THE HOUSE COMMITTEE ON
WAYS & MEANS, pt. 1, 88TH CONG. 895 (1963) [hereinafter 1963 HOUSE HEARINGS]. For the

120. PRESIDENT’S 1963 TAX MESSAGE 26, reprinted in 1963 HOUSE HEARINGS, pt. 1, supra note 119.

121. The JFK Administration believed that the reduction in the capital gains rate would
   be “somewhat more than offset by the increased revenue from the change in holding period,
   the taxation of capital gains at death and the changes in definitions . . . .” PRESIDENT’S 1963
broaden the support base for tax reform. This was also described as a “quid pro quo” concession by the Kennedy Administration. JFK’s proposed capital gains rate cuts – a 70 percent capital gains deduction not seen since FDR’s Revenue Act of 1934’s “sliding scale” deductions, coupled with a reduction of the top individual ordinary income rate from 90 to 65 percent, resulted in a maximum capital gains rate of 19.5 percent.122 This ran contrary, however, to the radical consensus of raising not cutting the capital gains rate. On the other hand, President Kennedy’s proposed cut in the top ordinary rates123 was thought to lessen the pressure for new capital gains add-ons.124

Nevertheless, the benefit of the Democratic “quid” (increased capital gains preference) was outweighed in the eyes of the Republicans by the burden of their “quo”125 (taxation of unrealized capital appreciation at death which would have more than paid for the capital gains cuts through increased realizations126) in the eyes of both wealthy individual taxpayers127

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122. Proposed top individual rate of 65% x 30% = 19.5%.
123. President’s 1963 Tax Message, supra note 120, at 6 (proposed reduction of top individual rate from 90% to 65%).
125. Revenue Act of 1963: Hearings on H.R. 8363 Before the Senate Finance Committee, pt. I, 88th Cong. 285 (1963) [hereinafter 1963 Senate Hearings] (statement of Sec’y C. Douglas Dillon) (“We did not get a quo. So that is why we are asking that provision be stricken.”).
126. Between 50% and 70% of annually accrued capital gains are not realized prior to the owner’s death at which point the estate or heirs take a date of death (or alternate valuation date) fair market value as their basis in the capital asset, Section 1014, with no income tax being paid on the appreciation in value. Jane Gravelle, Limits to Capital Gains Feedback Effects, 51 Tax Notes 363, 364-65 (Apr. 22, 1991) (Director of Congressional Research Service) (From 1949 to 1989 on the average about 30% of all capital gains accruals were recognized; with adjustments for gains not recognized because of reasons other than stepped up basis at death, e.g., owner-occupied housing sold after age fifty-five and corporate stock held by tax-exempts, taxable realizations were about 46% of accruals).
127. 1963 House Hearings, supra note 199, at 1419 (statement of Keith Funston, New York Stock Exchange) (capital gains cuts do reduce taxes, but taxation at death of unrealized appreciation “takes away the benefit-- so that I don’t believe, in general, the present tax bill is any great advantage to the persons above the middle-income bracket in
(long a Republican constituency) and special interests such as farmers, ranchers,\textsuperscript{128} and small businessmen,\textsuperscript{129} which were more likely than not to be Democrat constituencies in the South. Consequently, the House retained the traditional 50 percent deduction and six month holding period for both the special interest statutory add-ons and “classic” capital assets (stock and real estate) while granting an additional capital gains cut (60 percent deduction after 1-year holding period) for classic capital gains assets only.\textsuperscript{130} However, it did not provide for taxation of unrealized capital appreciation at death. Therefore the best capital gains reform proposals to that date (definitional purification and taxation of unrealized appreciation at death) united the interest groups in opposition, thereby dooming the Kennedy capital gains reform proposals.\textsuperscript{131}

\textsuperscript{128} See also 1963 Senate Hearings, supra note 125, at 496 (Joel Barlow, Chamber of Commerce of the U.S.) (would not support capital gains cut if dependent on taxation of unrealized capital appreciation).


\textsuperscript{130} The 1940s’ and 1950s’ add-ons were limited to the old 50% deduction. The Mills Hearings manifest that Chairman Mills had learned the difference between classic capital assets and the 1940’s and 1950’s special interest “hardship” add-ons. But the 1963 House Hearings equally manifest the attachment of Committee members to the special interest provisions. Chairman Mills’ compromise was not to cut back on the existing preference (50% deduction) for such items (newly labeled as “Class B” or “statutory” capital assets), but instead to limit the new additional preference (60% deduction) to “Class A” or classic capital assets. Indeed, the House bill extended the Section 631(c) capital gains treatment for timber and coal royalties to iron ore royalties. H.R. REP. No. 749, 88th Cong., 1st Sess. 93-94 (1963). The House bill used two holding periods (similar to the Revenue Act of 1938), providing the additional preference only to Class A Assets held two or more years. Id. at 96-97. Secretary Dillon criticized the House two step arrangement and two maximum rates as seriously complicating the capital gains portion of the tax return and the Code. 1963 Senate Hearings, supra note 125, at 129.

\textsuperscript{131} It was the date of death taxation of unrealized appreciation issue which was critical, not the too readily conceded definitional issues, as perhaps could have been predicted by the response of the Congressmen at the Mills Hearings. For example, Senator Douglas stated, “What has progressively happened has been that the reform elements which you [Sec’y Dillon] propose, and I think they were rather timid, I may say, have been progressively eliminated, and I think they have been eliminated in large part because the members of the legislative bodies and the special interests who throng these hearing halls and who call upon
Rhetoric in the 1963 House Hearings on JFK’s capital gains proposals constituted a transition from earlier decades. This rhetoric justified the capital gains preference on the basis of its alleged salutary effects on the stock market, the economy, or on increasing revenue, to an overt Congressional policy of principally intending that the capital gains preference benefit special interests as a subsidy,\(^{132}\) to small businessmen, farmers, ranchers, or timber owners with no attention explicitly given to the actual distribution of net capital gains by classes of assets and levels of income, although Treasury supplied the data for 1959.

For 1959, the largest percentage sources of individual net long-term capital gain were 41.5 percent from corporate stocks, and 18 percent from real estate.\(^{133}\) For higher income taxpayers the percentage of net capital gains coming from corporate stocks increased to 58.5 percent. Senators and Congressmen, have the impression that you are so anxious for a tax cut that you can throw all of these away and nothing will happen, so that by not presenting a virile position, not having a virile stance in favor of tax reform, you have permitted the tax reform measures to be progressively gutted.” 1963 Senate Hearings, supra note 125, at 286 (statement of Sen. Douglas).

132. See, e.g., 1963 Senate Hearings, pt. 2, supra note 125, at 483-84 (written statement of Joel Barlow, Director U.S. Chamber of Commerce); id. at 542-43 (written submission by Forest Industries); id. at 759-60 (statement of Harv. Prof. Dan Throop Smith); id. at 810 (written statement of Roswell Magill, Esq., Undersecretary of Treasury under FDR); id. at 916, 923-28 (statement of G. Keith Funston, New York Stock Exchange); id., pt. 3, at 1187 (statement of J. Sinclair Armstrong, U.S. Trust Co.); supra notes 128-29 and accompanying text.

By subsidy I mean a rate reduction or preference for an activity that the taxpayer probably would have engaged in anyway. Soon to be Chair Mills, D-Ark., noted that the statutory proliferation of categories of capital assets in effect lessened the channeling value of the preference. 1955 Tax Policy Hearings, supra note 117, at 326. See also S. REP. NO. 1310, at 8-9.

133. Net long-term capital gains, 1959, by type of gain, amounts and percent, 1963 Senate Hearings, supra note 125, at 197:

<table>
<thead>
<tr>
<th>[Dollar amounts in thousands]</th>
<th>[Percent]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate stocks</td>
<td>$5,116,261</td>
</tr>
<tr>
<td>Bonds and notes</td>
<td>$189,480</td>
</tr>
<tr>
<td>Distributions from mutual funds</td>
<td>$360,371</td>
</tr>
<tr>
<td>Share from partnerships/trusts</td>
<td>$1,010,202</td>
</tr>
</tbody>
</table>

\[Total \text{ net long term gain} = \sum(\text{Net capital gain}_i)\]
gains from sales of stock ranged from 53.5 percent for AGI’s from $50,000 to $100,000 ($322,000 to $644,000 in 2004 dollars) to 70.5 percent for $500,000 and above ($322 million in 2004 dollars).\textsuperscript{134} Conversely, the

\begin{tabular}{|l|c|c|}
\hline
Livestock & $701,116 & 5.7 \\
\hline
Natural resources & $262,593 & 2.1 \\
\hline
Depreciable assets used in trade or business & $537,631 & 4.4 \\
\hline
Real estate & $2,217,438 & 18.0 \\
\hline
Other capital assets & $1,936,775 & 15.7 \\
\hline
\end{tabular}

\textsuperscript{134} Net Long-term capital gains, 1959, percentage distribution by type, for AG income classes, \textit{id. at 197, tbl.5}, were as follows:

\begin{tabular}{|l|c|c|c|c|c|c|}
\hline
 & $0$ to $50$ & $50$ to $100$ & $100$ to $500$ & $500$ & All \\
\hline
Security-type gain & 30.4 & 59.9 & 67.2 & 70.6 & 78.4 & 54.1 \\
\hline
A. Securities & 19.4 & 43.1 & 55.2 & 61.6 & 72.4 & 43.0 \\
\hline
1. Corporate stock & 19.1 & 41.7 & 53.5 & 59.8 & 70.5 & 41.4 \\
\hline
2. Bonds & 0.3 & 1.4 & 1.8 & 1.9 & 1.6 & 7.1 \\
\hline
B. Mutual Fund Distributions & 3.8 & 4.0 & 2.2 & 0.7 & 0.4 & 2.9 \\
\hline
C. Gains from Partnerships/Trusts & 7.2 & 8.8 & 9.0 & 8.3 & 5.6 & 8.2 \\
\hline
Real Estate & 29.4 & 18.2 & 11.3 & 10.2 & 1.5 & 18.0 \\
\hline
Depreciable property & 5.9 & 5.3 & 2.2 & 1.5 & 1.0 & 4.4 \\
\hline
Livestock & 16.3 & 2.2 & 1.0 & 0.05 & 0.1 & 5.7 \\
\hline
Natural resources & 3.5 & 1.2 & 0.3 & 1.7 & 2.6 & 2.1 \\
\hline
Other & 13.9 & 16.6 & 17.3 & 15.6 & 16.2 & 15.7 \\
\hline
\end{tabular}
percentage of net long-term capital gains consisting of real estate and livestock, and to a lesser degree depreciable business property, decreased the higher the income class. Capital gains realizations were concentrated in higher income taxpayers, reflecting the concentration of ownership of public stock, which was concurrently in the hands of the top 14 percent of families, who owned 64 percent of all public stock, especially the top 4 percent, who owned 42 percent.

### Table: Amounts and Percentages of Net Long-term Capital Gain among Individual Income Classes in 1959

<table>
<thead>
<tr>
<th>AGI Classes</th>
<th>Amount of gains (thousands)</th>
<th>Percent of total gains</th>
<th>Average gain in income class reporting gains</th>
<th>Percent of all returns in income class</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$12,331,867</td>
<td>100.0</td>
<td>$2,516</td>
<td>8.1</td>
</tr>
<tr>
<td>Under $10,000</td>
<td>$3,562,976</td>
<td>28.8</td>
<td>$1,100</td>
<td>5.8</td>
</tr>
<tr>
<td>$10,000, under $50,000</td>
<td>$4,350,337</td>
<td>35.3</td>
<td>$3,428</td>
<td>29.0</td>
</tr>
<tr>
<td>$50,000, under $100,000</td>
<td>$1,454,337</td>
<td>11.8</td>
<td>$15,712</td>
<td>82.4</td>
</tr>
<tr>
<td>$100,000, under $500,000</td>
<td>$1,991,358</td>
<td>16.1</td>
<td>$87,346</td>
<td>85.7</td>
</tr>
<tr>
<td>$500,000 or more</td>
<td>$983,030</td>
<td>8.0</td>
<td>$1,028,242</td>
<td>95.8</td>
</tr>
</tbody>
</table>

135. *Id.*

136. Amounts and percentages of net long-term capital gain among individual income classes in 1959. *Id.* at 197 tbl.5.

137. Concentration of publicly traded common stockholdings, by income classes, 1960. *Id.* at 168.
For the first time the Senate Hearings and floor debate disclosed hard evidence on the use by the vast majority of highest income individuals of the capital gains preference (75 percent of their income then consisted of capital gains) to obtain low effective rates of income taxation with the very top high income taxpayers achieving even lower effective rates than those just below them.138 For example, most individuals with $1,000,000 or more annual income in 1963 ($6,100,000 in 2004 dollars) used the capital gains preference to obtain a 22 percent effective rate when the top individual ordinary rate was still 90 percent.139 High income individuals generally had an effective rate of approximately 35 percent. Such effective rates were averages with one-quarter of the high income taxpayers paying an effective rate much closer to the nominal rates, e.g., 50 to 60 percent in the early 1960’s, and 75 percent paying a much lower effective rate than the average.140 A structural feature of President Kennedy’s 1963 tax

<table>
<thead>
<tr>
<th>AGI classes</th>
<th>AGI</th>
<th>Adjusted AGI</th>
<th>Tax as percentage of AGI</th>
<th>Tax as percentage of Adjusted AGI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $5,000</td>
<td>$69,141</td>
<td>$69,564</td>
<td>9.1</td>
<td>9.0</td>
</tr>
<tr>
<td>$5,000 to $10,000</td>
<td>$138,456</td>
<td>$139,244</td>
<td>11.1</td>
<td>11.0</td>
</tr>
</tbody>
</table>

138. Senator Douglas, D-Ill., asked Secretary Dillon if certain tables (including those contained in the footnotes above) prepared by the Treasury Department in 1962, but not released, were accurate. Dillon dryly replied, “I recall those tables.” Senator Douglas then had them entered into the Record of the Hearing. 1963 Senate Hearings, supra note 125, at 278-83 ([Sen. Douglas]: “Now, Mr. Secretary, I find these figures shocking. Here are 20 men with adjusted gross incomes of over $5 million who paid no taxes.” Id. at 283); id. at 1253, 1291.

139. See supra note 114.

140. See supra note 131, and infra notes 204-06 and accompanying text. Effective tax rates on adjusted gross income and amended adjusted gross income 1960 are as follows (amended adjusted gross income includes full capital gains and losses realized in the tax year and excludes capital loss carryovers):

<table>
<thead>
<tr>
<th>AGI classes</th>
<th>AGI</th>
<th>Adjusted AGI</th>
<th>Tax as percentage of AGI</th>
<th>Tax as percentage of Adjusted AGI</th>
</tr>
</thead>
</table>
proposals was to weigh individual income tax reductions disproportionately to the lower income groups to increase consumer spending.\footnote{\textit{1963 House Hearings, supra} note 120, at 28 (distribution of proposed tax liability changes by income classes). The Kennedy tax proposals thereby neglected, according to conservatives, upper income groups who, under the trickle down theory, would invest the tax reduction. \textit{Id.} at 1069 (statement of Throop Smith); \textit{id.} at 1370-74, 1385, 1387 (statement of Roswell Magill, Esq., who had represented Treasury in the 1934 and 1938 Act Hearings, here a partner in Cravath, Swaine \& Moore) (arguing that lower brackets should not get as much of a tax cut because “investment money is largely produced by the middle and upper brackets and not by the lower brackets. . . . In sum, these structural [capital transaction] changes would steepen the progression of the individual income tax, add a new layer of complex restrictions and requirements on top of existing complexities, free some groups of taxpayers from any tax, and limit tax relief in the middle and higher income brackets."). Another structural feature of Kennedy’s 1963 tax proposals was financing the tax cuts with deficits rather than cuts in expenditures. \textit{1963 House Hearings, supra} note 120, at 534, 626 (statements of Reps. Byrnes and Curtis) (critical of such deficit financing). For subsequent compositions see \textit{infra} note 339.}

\begin{table}
\centering
\begin{tabular}{|c|c|c|c|c|c|}
\hline
Income Range & Current Tax Liability & Proposed Tax Liability & Current Tax Rate & Proposed Tax Rate \\
\hline
$10,000 to $20,000 & $56,128 & $57,060 & 15.0 & 14.8 \\
\hline
$20,000 to $50,000 & $21,901 & $22,902 & 22.8 & 21.3 \\
\hline
$50,000 to $100,000 & $6,648 & $7,300 & 34.3 & 31.1 \\
\hline
$100,000 to $150,000 & $1,688 & $1,971 & 40.3 & 34.6 \\
\hline
$150,000 to $200,000 & $750 & $920 & 42.6 & 34.7 \\
\hline
$200,000 to $500,000 & $1,370 & $1,821 & 44.3 & 33.3 \\
\hline
$500,000 to $1,000,000 & $486 & $726 & 46.4 & 31.1 \\
\hline
$1,000,000 upward & $584 & $869 & 47.8 & 32.3 \\
\hline
Total & $297,151 & $302,377 & 13.3 & 13.0 \\
\hline
\end{tabular}
\end{table}

In the Senate floor debate on the Revenue Act of 1964, Floor Manager Long, while successfully arguing against a capital gains cut not coupled with some treatment of unrealized capital appreciation at death, pointed out
that the vast majority of top bracket individuals used the capital gains preference (75 percent of their income then consisted of capital gains) to obtain "surprisingly" low effective rates of income taxation (22 percent).\footnote{142} Assistant Secretary Surrey testified at the end of lame duck President Johnson’s Administration, that in 1964 for approximately 75 percent of the individual taxpayers with over $1,000,000 in actual annual income, the effective income tax rate clustered in the area between 20 percent and 30 percent, which was comparable to the effective rates paid by approximately 60 percent of the individual taxpayers in the group, who earned between $20,000 and $50,000 of actual income.\footnote{143} The effective rate increased with actual income for taxpayers up to $50,000, flattened for those earning $50,000 to $100,000, and decreased for those earning above $100,000.\footnote{144} Surrey further testified that these figures did not appear to be a one-shot phenomenon as to high income individuals.\footnote{145} The capital gains preference constituted the primary reason for these low effective rates.\footnote{146} The purchasing power of a 1964 dollar was $6.04 in 2004. The super rich thus enjoyed a lower effective rate than the merely wealthy. In Long’s words, the "tax on this capital gains income is low enough already. In a long run, capital gains clearly represents an ability to pay taxes. . . . [b]ecause this income is bunched, we tax it at lower rates; but is not 25 percent low enough?"\footnote{147} Without taxation of unrealized appreciation, the JFK capital gains cut would have primarily benefitted upper income taxpayers, as the major capital gains preference legislation of the past had. Kennedy believed the reduction in capital gains rate would be "somewhat more than offset by the increased revenue from the change in holding period, the taxation of capital gains at death and the changes in definitions."\footnote{148} Consequently, the
Kennedy Administration opposed the aforementioned notion of two classes of stock compromise the House had passed, but without taxation at death of unrealized appreciation. The Senate (and the Conference Committee) agreed, rejecting the flawed House capital gains provisions with its quid without the quo. The end result was continuation of the 1954 Code’s 25 percent flat rate for the upper income, 50 percent deduction for the moderate income taxpayer, the special interest add-on of capital assets (e.g., coal, timber, livestock and, iron ore), and a step-up in basis at death of capital assets.

The Surrey/JFK capital gains reform attempt, and hence the Mills Tax Policy Hearings in this context, thus came to naught because it had united in opposition all of the interest groups underlying the Conservative Coalition on capital gains. Aiding this process was the fact that Chair Mills was so obsessed with obtaining consensus in his Ways and Means Committee and victory on the floor, that its bills were more conservative than Congress as a whole. Additionally, Secretary Dillon, who was demanded by Congress to present President Kennedy’s tax proposals instead of the theoretician Surrey, was overly willing to concede at least the capital gains definitional reforms. Even though Mills was personally convinced of the merits of capital gains definitional simplification, the Committee in 1963 only restricted the proposed additional capital gains

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149. See supra note 125. Secretary Dillon also criticized the House 2-step arrangement and 2 maximum rates, see supra note 130, as seriously complicating the capital gains portion of the tax return and the Code. Id. at 129.

150. Barber, Conable, Congress and the Income Tax 19-20 (1989) ("[S]ince Wilbur was a legislative psychologist who waited for the committee to make up its mind and then positioned himself at the head of the column, the result was that the Ways and Means Committee came to have a consensus that was much more conservative than was the case with the majority of the Democratic party in the House.").

151. Former Commissioner Morty Caplin recounted the story of this Congressional demand at a social event at Ed Cohen’s house following a Virginia Tax Conference. Rep. John W. Byrnes, R-Wis., announced to Secretary Dillon at the beginning of the 1963 House Hearings “that the greater part of the proposed structural reforms had better be put in deep freeze if we are going to get a tax bill this year.” 1963 House Hearings, supra note 120, at 534. Indeed, when Secretary Dillon conceded that the proposed elimination of coal royalties from capital gains treatment was probably the smallest “suggestion in the whole bill,” Rep. Howard Baker, R-Tenn., quipped: “and could well be put in Mr. Byrnes’ deep-freeze.” Secretary Dillon responded, “I don’t think the bill would suffer if that happened.” Id. at 607.

152. See supra note 130.
preference to classic capital assets. Further, Mills did not favor taxation of 
unrealized appreciation at death.\textsuperscript{153}

2. Surrey Papers and Tax Reform Act of 1969: Surrogate Limitations on 
the Capital Gains Preference

In 1968, Surrey, continuing as Assistant Secretary of Treasury for Tax 
Policy under President Johnson, designed a different approach to tax 
reform of capital gains and other areas. Surrey’s approach, which included 
surrogate limitations aimed at the \textit{effect} of tax “preferences” or 
“expenditures”\textsuperscript{154} rather than at the cause,\textsuperscript{155} was backed up by a 
complicated allocation of deduction provisions that Surrey wrote of in the 
landmark \textsc{Treasury Department, Tax Reform Studies and 
Proposals}, which came to be known as the “Surrey Papers.”\textsuperscript{156}

\begin{flushright}
\begin{footnotesize}
\textsuperscript{153} 1959 Panel Discussions, supra note 118, at 55–59.
\textsuperscript{154} U.S. \textsc{Treasury Dept’t, Tax Reform Studies and Proposals}, pts. 1-4 (Comm. Print 1969) [hereinafter \textit{Surrey Papers}] (prepared in 1968 and published in 1969); Joseph J. Minarik, \textit{How Tax Reform Came About}, 37 \textsc{Tax Notes} 1359, 1362 (Dec. 27, 1987); Sylvia Porter, \textit{Your Income Tax}, \textsc{Wash. Post}, Sept. 14, 1969, at B-1 (“the most sweeping blueprint for tax reform ever to come out of government”). Text accompanying \textit{infra} notes 154-67 sketches the Strange Political Story of (a) President Lyndon Johnson refusing to publish the Surrey Papers despite a Congressional directive to do, and (b) really short-term Secretary of Treasury Joseph Barr’s letting several cats out of the tax bag by (i) handing over the Surrey tax studies to the incoming Secretary of Treasury in the first Nixon Administration, and (ii) revealing to a Congressional Committee that 155 “millionaires” had paid no federal income taxes in 1967 and explaining to it the role played by tax preferences (especially the capital gains preference). Mostly likely this explains the publishing of Treasury Studies jointly by the House Ways & Means Committee headed by powerful Chair Wilbur Mills in his finest hour in 1969, having directed tax reform studies often with hearings with invited witnesses only in the first four or five years following enactment of the 1954 Code, and the Senate Finance Committee. The Committee Print stated that the document had not been considered by either Committee and was “being printed for information purposes only so as to make it available.” Id. pt. 1, supra at p. i. Professor Stanley Surrey had frequently appeared in Mill’s reform hearings. \textit{See, e.g.}, notes 116-19 supra.

\textsuperscript{155} “Stanley S. Surrey, a lawyer, contributed a new view of the selective tax preferences in the law [i.e., departures from a uniform or ideal tax base]. He likened the tax savings from a preference for a particular purpose, say encouraging business investment, to a government outlay for the same purpose. Thus was coined the term, ‘tax expenditures.’” Minarik, supra note 154, at 1361; see generally Barry Forman, \textit{Origins of the Tax Expenditure Budget}, 30 \textsc{Tax Notes} 537 (Feb. 10, 1986). Senator Jacob Javits, R-NY, argued that a list of tax expenditures should be part of Treasury data. \textit{1969 House Hearings} pt. 4, supra note 8, at 2358 (statement of Sen. Javits). “This concept was institutionalized on an illustrative basis in the federal budget in the mid-1960s [sic, mid-1970s], and has had a powerful influence on virtually all deliberations on the Federal income tax ever since.” Minarik, supra note 154, at 1361.

\textsuperscript{156} The \textit{Surrey Papers} computed the minimum tax base by adding back to taxable
Surely reflecting the 1963–64 experience, the Surrey Papers did not tighten the capital gains definition, but did include “Supplementary Material” as to the tax treatment of timber and real estate. They documented the concentration of preference in high income individuals and corporate taxpayers along with other inequities, including the relative inefficiency of “recapture” of depreciation under Section 1250. Similar to the 1963 JFK capital gains proposals, the Surrey Papers proposed taxing unrealized capital gains at death. The author suspects that Surrey knew that this proposal would go nowhere in Congress at this time notwithstanding the support of some liberals. If so, he was right.

The Surrey Papers also addressed the other side of the capital gains problem: artificially high nominal ordinary income rates that seldom actually applied. When they did apply, they presented substantial horizontal inequity as Senator Long had pointed out on the Senate Floor in 1964. The Surrey Papers would have applied an optional, alternative maximum 50 percent tax to an expanded tax base substantially identical to

income (in the order of revenue importance) (1) one-half of net long-term capital gain, (2) tax-exempt interest, (3) charitable contributions of appreciated property, and (4) percentage depletion in excess of cost depletion. Surrey Papers, pt. I, supra note 154, at II (ranking of items reducing taxes for high income taxpayers); id., pt. 2, at 136–40 (minimum tax base). Surrey proposed a graduated minimum tax rate of 7% to 35% (roughly parallel to half of graduated rates under the regular rates), limited to a maximum rate of 25 percent in the case of unrealized appreciation in capital assets taxed at death. Id., pt. 2, at 141–42.

The Surrey Papers pointed out (as Sen. Long had noted in 1964) that the wealthy with large amounts (and percentages) of capital gains income often achieved substantially lower effective rates than the 25 percent alternate maximum capital gains rate by offsetting or “sheltering” the taxable income remaining after the 50 percent capital gains deduction with other deductions. Surrey Papers, pt. 1, supra note 154, at 84–86; id., pt. 2, at 142–45. Therefore, Surrey’s Treasury proposed that non-business deductions be allocated between taxable income and the more common sources of tax exempt income and only the former portion be allowed as a deduction. Id., pt. 2, at 145–46.

157. Surrey Papers, pt. 1, supra note 154, at 211 (ranking of items reducing taxes for high income taxpayers); id., pt. 2, at 136–40 (minimum tax base). Surrey proposed a graduated minimum tax rate of 7% to 35% (roughly parallel to half of graduated rates under the regular rates), limited to a maximum rate of 25 percent in the case of unrealized appreciation in capital assets taxed at death. Id., pt. 2, at 141–42.


161. H.R. Rep. No. 413, pt. 1, at 2 (1969) (“[Y]our committee found that the time available did not permit the inclusion of reform measures relating to the revision of the estate and gift tax laws or the related problem of the tax treatment of property passing at death.”).

162. Surrey Papers, pt. 1, supra note 154, at 172 (29 percent of individuals with adjusted gross income of $500,000 or more would pay more than 50 percent of their true income in taxes). See supra notes 142–45 and accompanying text.

163. See supra notes 142–149 and accompanying text.
the alternative minimum tax base (plus the value of any stock options exercised during the tax year in excess of the option price). The articulated purpose was to reduce the incentive to use tax loopholes. Thus, with the minimum tax raising the effective rate of high income individuals for capital gains to a 35 percent range, and the maximum tax lowering the maximum rate on ordinary income to 50 percent (if no preferences were present), Surrey would have achieved his agenda of a decade and a half earlier.

President Lyndon Johnson refused to release the Surrey Tax Reform Studies and Proposals even though Congress had directed him to submit specific tax reform proposals by the end of 1968. On January 17, 1969 just three days prior to President Richard Nixon taking office, Treasury Secretary Barr (who held office just eighteen days) warned of a “taxpayer’s revolt” pointing to the 155 individuals with adjusted gross incomes of $200,000 or more—$1,522,000 in 2004 dollars (including 25 with incomes topping $1,000,000)—who paid no federal income tax in 1967; and handed the Surrey Papers over to Treasury Secretary-Designate Kennedy.

165. Porter, supra note 154; cf. H.R. REP. NO. 413, at 208 (“The 50-percent limit on the tax rate applicable to earned income was adopted not as a tax relief measure but to reduce the pressure for the use of tax loopholes.”).
The 1969 House Hearings revealed a split on capital gains between two sides. The first was comprised of academic and labor witnesses and Members of Congress favoring some of the following capital gains reforms: extending the holding period to one year; repealing the alternative 25 percent rate; taxing unrealized appreciation at death; allowing only deduction of 50 percent of capital losses against ordinary income; tightening up capital asset definitions; tightening up tax-free exchanges; and even substituting income averaging for a percentage exclusion. Their opposition consisted of conservative economists, stock exchange representatives and investor group witnesses who favored the status quo; advocated an increased preference along the 1920’s lines with shorter holding periods and a special interest repeal of depreciation recapture; and only rarely called for channeling the preference by tightening the definition or adopting a 1930’s sliding scale-like holding period. Both sides by-and-large rehashed arguments raised in the Mills tax policy Hearings over the previous decade. Responding to the Surrey Papers’ strong criticism of


169. E.g., 1969 House Hearings, pt. 12, supra note 8, at 4253–54 (statement of Norman Ture, economist).
capital gains for timber royalties, timber interests were especially well-represented in the capital gains discussion.

House Ways and Means Committee Chair Mills was unwilling to wait for a comprehensive survey promised by the Nixon Administration by November 30, 1969. In marathon executive sessions, the Committee reported out a bill, and won its passage in the House before the summer recess to the amazement of friends and foes alike. The House bill

170. The Surrey Papers critiqued capital gains for timber royalties, focusing on the heavy concentration in a handful of corporations. Sixteen of the largest timber and plywood corporations had more than 50 percent of their income from timber royalties, as compared to the overall corporate pattern of only five percent of income from capital gains. The five largest wood processing corporations had half of their corporate capital gains from timber, with the largest corporation enjoying 25 percent of the total corporate timber royalties. Surrey Papers, pt. 1, supra note 154, at 140 and id., pt. 3, at 434–38, respectively. The Surrey Papers also argued that the tax benefit of timber (and coal) royalties disproportionately went to high income individuals. “Of the 43,977 taxable [1962] returns with net gain or loss from timber and coal, 3,427 returns had adjusted gross income of $25,000 or more [about $155,000 in 2004 dollars, and] . . . reported 25.4 percent of the gross gains.” Id., pt. 3, at 435. In fact this was the mirror image of stock transactions where 75 percent of the gains were concentrated above that level. See table for net long-term capital gains, supra note 133. In any event, undoubtedly reflecting the 1963–64 experience, the Surrey Papers made no explicit recommendation as to timber royalties.

171. The members of the Ways and Means Committee appeared particularly well-coached, and were sent to stage colloquies with public witnesses, to "establish" that (1) timber needed the capital gains preference because of the long time it took for a stand of forest to mature (twenty to fifty even seventy years) and the resulting low rate of return, E.g., 1969 House Hearings, pt. 8, supra note 8, at 2859 (statement of Collett); (2) such preference supported reforestation, which began to grow only after the introduction of capital gains for timber royalties in 1943; e.g., id. at 2903 (statement of Rep. Dorn); id. at 2949 (statement of Dr. Zivnuska, Dean of School of Forestry and Conservation, University of California); and (3) encouraged scientific management, development, and practices, e.g., id. at 2875–76 (colloquy between Rep. Landrum, D-Oa., and Collet and Langdale); id. at 2878 (colloquy between Rep. Ullman, D-Ore., and Collet). But timber’s case was hurt a little by the fact that a supply pinch had recently resulted in substantial price increases, which particularly disturbed Congressmen with ties to developers, id. at 2878–79 (Rep. Joel Broyhill, R-Va.). But see id. at 2822 (statement of Rep. Wyatt) (increase would have been more without capital gains preference); id. at 2881 (colloquy between Rep. Watts, D-Ky., and Collet). More significantly, questioning drew out that the capital gains tax savings ranged from 10 percent to 20 percent of profits, id. at 2894–95 (colloquy between Rep. Schneebeli and Stewart and Bendetsen); timber producers often bought mature stands, id. at 2899 (colloquy between Rep. Barber Conable, R-N.Y., and Bendetsen); and much of the timber harvested came from stands owned by the Federal Government and managed by the Forestry Service, id. at 2896 (statement of Bendetsen).


173. Id.
generally erected two lines of defense against preferences: direct curbs and surrogate limitations. For capital gains, the House bill eliminated the 25 percent alternative maximum rate, imposed a 50 percent limit on the amount of long-term capital losses deductible against ordinary income (to parallel the then 50 percent deduction on long-term gains), lengthened the holding period to one year, and pared the definition of capital gains slightly (eliminating capital gains treatment of collections of letters and memoranda, of lump sum distributions, and transfers of franchises in certain circumstances). It also imposed a minimum tax that would have impacted more than 80 percent on the individual capital gains preference.

Witnesses testifying on the minimum tax (as contained in the Surrey Papers) at the 1969 House Hearings either (a) favored it; (b) would strengthen it; (c) were “sympathetic,” but suggested alternatives; or


176. H.R. 13270, supra note 175, at § 301; H.R. REP. No. 413, supra note 161, at 77-80. The House bill included as tax preference items both the 50 percent individual long-term capital gains deduction and tax-exempt interest. At the time, the Treasury knew that the individual minimum tax would mostly tax capital gains. See 1969 House Hearings, pt. 14, supra note 8, at 5524 (statement of Undersecretary of Treasury Walker). See infra note 221.


178. Id., pt. 5, at 1776-77 (statement of former Comm’r Mortimer Caplin) (sound beginning, strongly supported by late Senator Robert Kennedy, D-N.Y., and owing much to Senator Long’s work, but should include accelerated depreciation and intangible drilling costs); id., pt. 7, at 2356 (statement of Sen. Javits, R-N.Y.); id., pt. 12, at 4204-06 (statement of former Comm’r Sheldon Cohen) (it is unrealistic to assume that all preferences giving rise to inequities can be corrected over the short run. The minimum tax, however, prevents preferences from becoming tax escape routes, and should be strengthened as Caplin and Javits recommend); id. at 4333 (Written statement of George Meany, AFL/CIO) (if one can not immediately tax exempt and partially exempt income, e.g., impose a 25 percent rate on preferences, including capital gains, tax-exempt interest, appreciation in charitable contributions, and accelerated depreciation except as to low-income housing); and id., pt. 13, at 4590 (Statement of Walter Reuther, UAW) (the most serious defect is too generous: a 50 percent ceiling on income can be sheltered; a rate should be 75 percent of the existing graduated rate).

179. Id., pt. 12, supra note 8, at 4319 (statement of Rep. Bingham, D-N.Y.) (it should be
opposed it. A consensus of academics who favored directly attacking the underlying abuses and special interest representatives, claimed that the underlying abuses should be examined. A lobbyist for the U.S. Chamber of Commerce presciently argued that the new tax intended to obtain revenue from relatively small numbers of persons would expand in burden and scope until virtually all taxpayers come under a gross receipts tax. Its current incarnation (the individual Alternative Minimum Tax) covers 3 percent of taxpayers today but is projected to cover 30 percent by 2010.

Representative George H.W. Bush complained that the individual side cuts were to be paid for under the House bill in large part by tax increases on the corporate side. He also argued that the total individual side...
package, as in the Revenue Act of 1964, was skewed to low and moderate income taxpayers. \textsuperscript{185} House Conservatives supported the Tax Reform Act of 1969 because of tax relief, not because of tax reform. \textsuperscript{186} House Liberals supported it because of limitations on preferences. \textsuperscript{187} With one exception, this bi-partisan coalition was able to prevent the Conservative Coalition in the House from emerging on the Tax Reform Act of 1969. \textsuperscript{188}

Representative George H.W. Bush, R-Tex., had the gall to cloak his opposition to the minimum tax in the mantle of the small, black business person \textsuperscript{189} when actually 80 percent of its impact would fall on capital gains sales of public stock held by the rich. \textsuperscript{190} In contrast, Senator Jacob Javits, R-N.Y., laid out a rationale (besides symbolic reform) to not directly attack taxpayer by the tax cut is coming from corporations.


\textsuperscript{186} Id. at 22582, 22768-69 (Aug. 6 and 7, 1969, respectively) (statement of Rep. George H.W. Bush, R-Tex.) (also decried “trend towards centralization”). Bush ultimately voted against the House bill on August 7, 1969. \textit{25 Cong. Q. Almanac} at 611. Bush had earlier criticized the 1969 Ways and Means Committee Report as eroding the difference between capital and income, and opposed lengthening of the holding period, repeal of individual maximum 25 percent capital gains rate and inclusion of the capital gains deduction in the limitation on tax preferences, and the allocation of deduction provisions. \textit{H.R. Rep. No. 413, supra note 161, at 225.}


\textsuperscript{188} \textit{25 Cong. Q. Almanac} at 1054 (“In the House, the coalition appeared only once in connection with the tax reform bill.”).

\textsuperscript{189} \textit{1969 House Hearings, pt. 5, supra note 8, at 1805} (Rep. George Bush, R-Tex.) (“[U]nless we can find some way around that the small businessman gets clobbered, he gets $10,000 gross income and he suffers a $15,000 loss of some sort, business doesn’t go well, he is just struggling along in the ghetto getting started, say under one of those small business programs, that he should be taxed with a minimum tax on him regardless of the fact that he is struggling to get a business started under say a black capitalism approach.”). As President, George H.W. Bush became known for his “choppy” sentences and “fractured syntax.” A.L. May, \textit{Jobs to Get Top Priority, Clinton Says; He Names Advisory Team for “High Gear” Transition, Atlanta J. & Const., Nov. 13, 1992, at A-1}; Charles-Gene McDaniel, \textit{The Truth About Arkansas, Chi. Sun-Times, Dec. 18, 1992, at 42}; Paul Richter, \textit{The President-elect: Just the Average Joe (Or Bill); Personality: A Golf Duffer Who’s Often Tardy and Battles His Weight, Clinton Has Share of Human Foibles, L.A. Times, Nov. 23, 1992, at A-1}; Michael Kranish, \textit{Day of Decision; Emotions ran high in Bush finale; Campaign ’92, Boston Globe, Nov. 3, 1992, at 1.}

\textsuperscript{190} See infra note 221. George Bush represented a district in Houston, Texas, later represented by Bill Archer, R-Tex., at which time it would be the 6th most wealthy congressional districts in the nation. See David E. Rosenbaum, \textit{With a Passion for Tax Cuts, and in Power, N.Y. Times, Apr. 4, 1995, at A-1.}
preferences popularly called loopholes, and reduce them in the light of the new standards of fairness and equity:

[S]ome of these preferences may be found desirable for retention for social or economic reasons. When a taxpayer is in a position to take advantage of a great number of these preferences at one time . . . the resulting cumulative effect is the real inequity in our tax system. Therefore, I urge . . . as an interim step . . . [that] we establish a minimum tax below which tax liabilities would not be permitted by reason of the preferences or loopholes to which I have referred.

The witnesses at the Senate Finance Hearings on the Tax Reform Act of 1969 addressing capital gains reform overwhelmingly opposed the House-passed reforms, particularly the repeal of the alternative 25 percent capital gains rate, the lengthening of the holding period, and the elimination of capital gains for lump-sum distributions from qualified retirement plans. Those witnesses not opposing the House capital gains proposals generally thought that they did not go far enough, and should reach unrealized capital appreciation at death, relying on the distributive effects of a capital gains preference. Moreover, the vocal Committee members,

191. 1969 House Hearings, pt. 7, supra note 8, at 2356 (Sen. Jacob Javits, R-N.Y.). See also Hearings on High-Income Taxpayers and Related Partnership Tax Issues before the Subcomm. on Oversight of the House Ways & Means Comm., 99th Cong., 1st Sess. 68 (1985) (Assistant Sec’y for Tax Policy Ronald Pearlman); cf. Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms before the House Committee on Ways and Means, 98th Cong., 2d Sess. 29 (1984) (Chapoton, Assistant Sec’y for Tax Policy). Another liberal rationale offered later was that reliance on the minimum tax rather than increased capital gains rates (in response to the charge that the 50 percent capital gains deduction constituted at least 80 percent of the individual tax preference items) added progressivity by increasing the effective rate on capital gains income only for higher income individuals. 122 CONG. REC., pt. 16, 20239 (June 24, 1976) (statement of Sen. Walter Mondale, D-Minn.). A conservative Senator scathingly replied that the minimum tax was imposed, because Congress could not “find any other way to get to capital gains.” Id. at 20244 (statement of Sen. William Brock, R-Tenn.).

192. E.g., 1969 Senate Hearings, pt. 3, supra note 167, at 955 (statements of Philip H. Wielke, Rural-Small Town, Small City Coalition, Inc.); id. at 979–80 (Charles Stewart, Pres. Mach. & Allied Prod’s Inst.); id. at 1011–12 (Colum. Prof. of Econ. Saulnier); id. at 1018 ; (John Higgins, Chair Tax Comm. of Amer. Textile Mfrs. Inst.); id. at 1882–84 (statements of NYSE Pres. Haack); id. at 1904 (Merrill Lynch Pres. Donald Regan); id. at 1910 (Roland Bixler, Chair, the Tax Counsel); id. at 1923 (Gibraltar Growth Fund Pres. Ehlers); id. at 1975 (Sears, Roebuck and Co. Pres. Wood); id. at 1986 (Council of Profit-Sharing Indus. Chair Geisecke); id. at 2001 (William Drake and Henry Rothschild, Am. Pension Conference).

193. Id., pt. 2, at 918 (Philip Stern, Nat’l Comm. on Tax Justice); id., pt. 3, at 1928–31, 1941–43 (Statements of Naval Acad. and U. Md. Econ. Prof. Hinrichs and Minn. Law Prof. Waterbury) (showed capital gains preference biggest source of inequity causing effective rate above $1,000,000 annual income to drop and advocated eliminating preference and
particularly Chair Long, were predisposed to view the House provisions as disincentives to investment. Not surprisingly, the Senate Finance Committee retreated on both direct and indirect capital gains tax reform by limiting the 25 percent alternative capital gains rate to $140,000 of net long-term capital gains provided that other preference income did not exceed $10,000; restoring the six month holding period; and imposing only a 5 percent minimum tax on tax preference items, which included the capital gains preference.

On the Floor, the Senate gutted the minimum tax on tax preferences by providing an offset for ordinary income taxes paid, which reduced the potential revenue by more than 60 percent. This offset required the

imposing taxation at death, substituting averaging and using revenues to reduce rate on ordinary income to maximum rate of 40 percent to 50 percent, since no progressivity in practice anyway) and (Minn. Law Prof. Waterbury), respectively.

194. E.g., id., pt. 3, at 1957 (statement of Sen. Robert Bennett, R-Utah, Senate Finance Comm. Member); id., pt. 3, at 1905-06 (statement of Sen. Long, D-La.) (House changes would cause capital to move to Canada where no capital gains tax), 1913 (lower capital gains rates would induce greater investments).


196. The Senators raised the alternative minimum tax rate to 10 percent, but the rate increase was more than offset by the Miller amendment adding to the $30,000 trigger an alternative floor of the regular income taxes paid for the year. 115 CONG. REC., pt. 28, at 38297 (Dec. 10, 1969) (statement of Sen. Jack Miller, R-Iowa). The Senate Finance Committee provision would have raised $700 million; the Miller amendment was estimated to pick up $740 million; id. at 38298 (Statement of Sen. Miller). Subsequent events, however, showed that the Miller amendment in fact gutted at least the individual minimum tax. The Conservative Coalition defeated an amendment by Senator Vance Hartke, D-Ind., which would have reduced the taxes offset by 50 percent. Id. at 38315 (Rollcall vote 52 nays to 31 yea). See 25 CONG. Q. ALMANAC at 34-S. The Conservative Coalition also defeated amendments by Senator Edward Kennedy, D-Mass., which would have added unrealized appreciation in charitable contributions to the tax preference items, and would have substituted a four-bracket graduated minimum tax schedule (as proposed in the Surrey Papers) in lieu of the five percent rate reported out by the Senate Finance Committee. 25 CONG. Q. ALMANAC at 34-S.

197. This offset came to be known as the “Executive Suite” loophole to tax reformers. See 122 CONG. REC., pt. 16, 20206 (June 24, 1976) (statement of Sen. Walter Mondale, D-Minn.); id. at 20209, 20225 (statement of Sen. Edward Kennedy, D-Mass.). The Miller amendment, by providing an offset to the minimum tax base for regular income taxes paid, “substantially cut the effectiveness of the minimum tax.” 121 CONG. REC., pt. 29, 38291
Senate to raise the minimum tax rate to 10 percent and include corporations in order to approach the projected revenues from the House version. The Senate minimum tax provision prevailed in Conference. In the end Congress enacted an extremely watered down version of Surrey’s minimum tax on tax preferences (which principally applied to the capital gains preference (80 percent or so of the individual tax preference items) and limited the alternative 25 percent maximum capital gains ceiling to $50,000 of annual capital gain.

The justification for the individual minimum tax was “fairness” or horizontal equity (i.e., all similarly situated taxpayers bear equal tax burdens). Existing tax law with high rates on ordinary income and a deep capital gains preference of a maximum rate of 25 percent resulted in large variations in the tax burdens placed on taxpayers who received different kinds of income.

198. The House Bill would have increased tax liabilities by $40 million in 1970 and $85 million a year when fully effective, half from taxpayers with incomes of $50,000 and over. H.R. REP. No. 413, supra note 161, at 80. The Cohen Treasury Proposal would have raised $80 million a year when effective, but the big revenue raiser, as in the House bill, would have been the allocation of deductions provision – $500 million a year. 1969 House Hearings, pt. 14, supra note 8, at 5522–28 (statement of Assistant Sec’y for Tax Policy Edwin Cohen). The Senate 5% minimum tax as reported out by the Finance Committee would have raised $380 million a year from corporations and $320 million from individuals when fully effective (the allocation of deductions provisions was dropped). S. REP. 552, supra note 103, at 118.


200. See infra note 221.


the bulk of their income from personal services were taxed at high effective rates (60 to 65 percent) near the nominal top rates; meanwhile, those who reported the bulk of their income from capital gains or who could benefit from accelerated depreciation on real estate paid relatively low rates of tax (20 to 25 percent) primarily due to capital gains income.204 In fact, individuals with high incomes who could benefit from these provisions might pay lower average rates of tax than many individuals with modest incomes.205

For example, most taxpayers with incomes in the $20,000 to $50,000 income class pay rates between 20 percent and 30 percent. Most taxpayers with incomes between $500,000 and $1 million also pay rates of 20 percent; however, the latter group has, on the average, about twenty times the income of the former group.

Another way of examining the favorable treatment of certain higher income tax returns is to observe that almost five of every ten returns with income ranging from $50,000 to $500,000 pays an effective rate of tax of less than 30 percent, while almost seven out of every ten returns with income from $500,000 to $1 million and about eight out of ten returns with income in excess of $1 million pay an average tax rate lower than 30 percent. This runs contrary to the expected results of a nominally progressive tax rate schedule.206

The splitting of the Conservative Coalition on capital gains in the Tax Reform Act of 1969 by the bi-partisan Liberal-Conservative Coalition was facilitated, if not driven, by (a) the popular outrage at zero tax millionaires arising from Treasury’s disclosure very late in the lame duck Johnson Administration,207 and (b) the Vietnam War surtax,208 enabling Chair Mills to direct the tax reform that he had been preparing for the previous fifteen years.209 Popular enthusiasm for change opened the way for the tax

204. Id. at 82, 84, 110.
206. Id. at 96-97.
207. See 1969 Senate Hearings, pt. 26, supra note 167. In total, the disclosure indicated 155 high-income zero-tax individual taxpayers including 22 millionaires.
208. See id. I still remember filling out my first income tax return after law school. Calculating the tax, and adding 10 percent for the “the Vietnam War surtax” provoked even more antipathy to that war (in which my brother Bob was then serving).
209. On the House floor, Mills opened the debate on the Tax Reform Act of 1969, proclaiming that “this is the day that I have looked forward to for a long, long time.” 115
reformers to side step reluctance to reform capital gains taxation by the Nixon Administration and the Senate Finance Chair.210

The individual minimum tax initially served as a mere “excise or privilege tax” on the use of tax preferences.211 The low minimum tax rate, particularly the offset for regular income taxes paid, rendered the individual minimum tax on preferences only “symbolic reform.”212 By publicizing the problem, but merely enacting a weakened surrogate technique, the reformers set the stage for endless further incremental revisions until true reform was reached, the problem went away, or tax transaction costs outweighed the tax benefits.213 Meanwhile, the populace became cynical about Federal taxes and changed perceptions about its fairness.214

B. 1970’S: SPECIAL INTERESTS FULLY UNCLOAKED AND FIRST APPEARANCE OF THE 28 PERCENT RATE

1. Prelude to the Tax Reform Act of 1976

In March 1973, the House Ways and Means Committee held extensive panel discussions and public hearings on tax reform, but did not report out a bill.215 In 1974, with the Nixon Administration severely weakened by the Watergate scandal, the impetus for tax reform shifted to Congress. From

CONG. REC., pt. 17, at H22562 (statement of Chair Mills).

210. Tax reform had not been among Nixon’s top priorities, but initiative shifted to Congress where concerned legislators were inundated by irate mail from constituents protesting tax breaks for the rich. Porter, supra note 154. See also 115 CONG. REC., pt. 17, at 22562. For Long’s attitude, see 1969 Senate Hearings, pt. 3, supra note 167.


212. See LEFF, supra note 61.


214. Thomas F. Field, The Emperor Has No Clothes, 101 TAX NOTES 1125 (2003) (the “public has lost faith in the claim that our tax system treats both rich and poor fairly. For a generation, tax reformers have highlighted the ability of wealthy taxpayers to successfully avoid their tax burdens. Simultaneously, tax planners have trumpeted their ability to reduce taxes through clever stratagem. Together they have convinced the public that ‘only little people pay taxes.’”). Reformers’ exposes via the media may have opened the eyes of many to opportunities of such tax reductions. But cf. Daniel Shaviro, Perception, Reality & Strategy: The New Alternative Minimum Tax, 66 Taxes 91, 98 (1988) (“the significance of the connection between [publicized] tax avoidance and reduced compliance . . . is far from clear”).

late August 1974 to mid-September 1974 (bracketing President Nixon’s August 9 resignation) the House Ways & Means Committee, as a follow-up to the 1973 Hearings, reached a number of tentative decisions in executive mark-up sessions. These included the alternative minimum tax and an additional sliding scale capital gains deduction, reminiscent of 1934 and 1963, but only for securities, businesses and non-residential real estate of 1 percent per year holding period up to 25 percent of the gain realized upon disposition.216 Chair Mills, reflecting political weakness resulting from scandals of his own, was unable to secure passage in the House of this double-dipping, sliding scale capital deduction regime.217

In 1974, Representative Al Ullman, D-Ore., replaced Mills as Chair, and was also unable to achieve any capital gains legislation for a variety of reasons.218 Yet proposals for (1) additional sliding scale capital gains deductions (or indexing of basis for inflation) and (2) differentiation between categories of capital gains assets were to resurface repeatedly over

216. See Staff of House Comm. on Ways and Means, 93d Cong., Brief Description of Tentative Decisions for Drafting Purposes on Tax Reform Proposals (Comm. Print Aug. 22, 1974) (ultimate annual revenue loss of $850 million, but in the next few years, revenue gains from an increase in realizations of locked-in capital gains). In the 1969 House Hearings, Chair Mills had indicated a preference for a sliding scale, either applying to the entire gain, or working in conjunction with a 50 percent exclusion. This would account for inflation over a long period of time, 25 years for example. 1969 House Hearing, pt. 14, supra note 8, at 5524.


218. Surrey notes that the Committee had increased by 50 percent, with over half of all new members favoring tax reform, even thought they were unversed in tax matters. Surrey, supra note 215, at 303-04. Moreover, Al Ullman was a “decent man,” but a weak Chair. See Peter Milius, Ullman shakes “Loser” Tag in Give-and-Take with Long, Wash. Post, Sept. 13, 1976, at C7. Part of the problem was the shift from the Mills school of consensus building to a committee accountable to the majority party in the House. Conable, supra note 150, at 23. Conventional wisdom holds that Al Ullman, D-Ore., lost his re-election, notwithstanding his Chairmanship, due to his sponsoring the Tax Restructuring Act of 1979, H.R. 5665, 96th Cong. (1979), which would have integrated individual and corporate income taxes and imposed a 10 percent value added tax on sales of property and services at each stage of the production and distribution process). Jane Seaberry, Treasury Dept. Releases VAT Study; Tax Called Close Contender to Plan Submitted by Regan, Wash. Post, Dec. 22, 1984 at B1; Michael White, “Spreading the pain” tax reform will mean juggling “fairness,” The Guardian (London), July 15, 1985. (“Everyone remembers the horrible fate of Rosty’s predecessor, Al Ullman, voted out of office for backing VAT.”); Lee A. Sheppard, News Analysis: Will U.S. Ever Adopt a Consumption Tax?, 93 Tax Notes Today 238-S (1993). In any event, it soon died because the Secretary of Treasury opposed it and no other Committee members supported it. John Copelan, Burying the Income Tax?, 95 Tax Notes Today 171-52 (Aug. 31, 1995)
The other recurring capital gains taxation issues before Congress throughout the tumultuous 1970’s were mostly carry-overs from the unfulfilled capital gains reform of the 1960’s including: (3) the length of long-term capital gains holding period, (4) the treatment of capital losses, (5) the taxation of unrealized capital appreciation at death (or the second best alternative of a carryover basis), and (6) the capital gains tax rate (including the minimum tax on tax preferences).

2. Tax Reform Act of 1976: High Water Mark of first Wave of Tax Reform

The Tax Reform Act of 1976 enacted by the “Watergate Baby” Congress substantially strengthened the minimum tax. Eighty percent of the covered preferences for individuals consisted of the 50 percent long-term capital gains deduction. Chair Russell Long, D-La., objected,

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219. After the window covered by this article, 1989, 1992

220. Public Hearings and Panel Discussions on Federal Estate and Gift Taxes before the House Ways and Means Committee, pt. 1, 94th Cong. (1976) [hereinafter 1976 Panel Discussions] (statement of Rep. Barber Conable) (“this is a very liberal Congress”); 1975 Senate Hearings, supra note 167, at 1684, 1703 (statement of Sen. Carl Curtis and Sen. Long). See also Surrey, supra note 215, at 305 (Sen. Long in defending the Committee bill on the Senate floor “was pressed by a tax reform group better informed and more ably led than the Senate had seen before. The center of this activity was Senator Edward Kennedy, who . . . coordinated a steady drumfire against the bill.”). However, by-and-large the Liberal Coalition’s amendments failed on the Senate floor, often to the Conservative Coalition, including an attempt to eliminate the minimum tax regular income tax offset. See 32 CONG. Q. ALMANAC 50-51 (1976). In a “rare victory for the liberals” they did defeat the Conservative Coalition, id. at 61, attempting to amend the Senate bill to provide an additional sliding scale deduction of 1% a year up to twenty-five years with a maximum deduction of 75%. The coalition relied mostly on need for additional capital and mobility and to a lesser degree on inflation. 122 CONG. REC., pt. 21, at S26096–98, S26099–102 (Aug. 6, 1976) (statement of Sen. Curtis, Sen. Charles Percy and Sen. Cliff Hansen). A Liberal Coalition, defeating the amendment 39 to 44 (Republicans and Southern Democrats supported it 23 to 7 and 10 to 8, respectively, roll call vote 493, id. at S26102, relied upon arguments that (1) inflation gains were unrelated to time held; (2) a sliding scale would result in more lock-in, and (3) 66 percent of the benefits would go to taxpayers earning $50,000 and above ($164,590 in 2004 dollars). Id. at S26092 and S26095 (Statement of Sen. Ed Muskie and Sen. Ted Kennedy).


222. In the debate leading up to the Tax Reform Act of 1976 most spoke of 80 percent of the individual tax preference items consisting of the 50 percent capital gains preference. E.g., 1976 Panel Discussions, supra note 220, at 80 (statement of Rep. Duncan); 1975 Senate Hearings, pt. 1, supra 167, at 42 (statement of Sec’y of the Treasury Bill Simon); 122 CONG. REC., pt. 16, at S20232 (June 24, 1976) (statement of Chair Long) (80 to 90 percent of the minimum tax revenues come out of capital gains); id. at S20240 (statement of Sen. Bennett Johnson) (“. . . I am wondering of that 75 or 80 percent what percentage is paid
however, to a floor amendment by Senator Edward Kennedy, D-Mass., reducing the minimum offset for regular taxes to 50 percent of the taxes paid, because if the Senate Conferees go to conference with a 50 percent offset as opposed to the House’s total elimination, the compromise would be an offset of 25 percent of regular taxes paid.\textsuperscript{223} That amendment was defeated 44 to 35 by the Conservative Coalition.\textsuperscript{224} Additionally, the tax reformers, spearheaded by Senator Kennedy, enacted “carryover basis” at death, a watered down substitute for taxation at death of unrealized appreciation in capital assets.\textsuperscript{225}

Significantly, the Hearings and floor debate on capital gains and related items such as minimum tax, taxation of unrealized appreciation, and tax shelters over the decade of the 1970’s revealed more clearly than ever (a) the relative weight of the special interests for which the majority in Congress now ostensibly maintained the capital gains preference (consisting of small business, farming, ranching and timber interests, venture capitalists and entrepreneurs);\textsuperscript{226} (b) the processes of masking the by high rollers and what percentage would be paid by ordinary people selling homes, and that sort of thing.\textsuperscript{220} S. REP. NO. 938, 94th Cong. (1976) (existing minimum tax is largely a tax on long-term capital gains “which constitutes about seven-eighths of the income in the minimum base”). In short, the realized capital gains of wealthy taxpayers would have been taxed in the 30 percent range rather than in the low 20 percent range.

\textsuperscript{223} 122 CONG. REC., pt. 21, at S26164 (Aug. 6, 1976)

\textsuperscript{224} Rollcall vote No. 503. \textit{Id.} at S26164; 32 CONG. Q. ALMANAC at 69-S (Republicans and Southern Democrats opposed it 25 to 4 and 10 to 5, respectively; while Northern Democrats supported it 26 to 9).

\textsuperscript{225} Tax Reform Act of 1976 § 2005, 90 Stat. 1872-76. The House Ways and Means initially reported the ambitious, long-postponed restructuring of the estate and gift tax (H.R. 14844), which by a 24 to 10 vote included carryover basis at death of capital assets. 32 CONG. Q. ALMANAC at 65. Professor Surrey appears the conceptual father of this compromise to taxation of capital appreciation at death. \textit{1959 Panel Discussions, supra} note 118, at 710-11 (statement of Prof. Surrey). Heated opposition on the Floor by the Conservative Coalition led to withdrawal of the bill by Chair Ullman on August 30, 1976. 32 CONG. Q. ALMANAC at 66-67. The Senate Tax Reform Bill of 1976 contained, however, estate and gift tax reform and the Conference bill adopted carryover basis as well. \textit{Id.} at 64. On the House side, the Conference estate and gift tax provisions were separately voted on and an attempt by the Conservative Coalition to delete carryover basis was defeated 229 to 181. Rolcall vote No. 740. 122 CONG. REC., pt. 24, at H30858-59 (Sept. 16, 1976).

Republicans supported the attempt 129 to 9, and Southern Democrats tied 42 to 42, while Northern Democrats opposed it 178 to 10. 32 CONG. Q. ALMANAC at 158-H and 65-S (1976). Interestingly by this point Professor Surrey had changed his tune, severely criticizing carryover basis. Surrey, \textit{supra} note 215 at 326-27.

\textsuperscript{226} Revenue Act of 1978: Hearings on H.R. 13511 Before the Senate Finance Committee, pt. 4, 95th Cong. (1978) [hereinafter 1978 Senate Hearings] (statement of Robert Brandon, Director of Public Citizen’s Tax Reform Research Group) (75 percent of
real special interests in capital gains tax legislation; and (c) the distributive effects of the capital gains preference.

Senator Lloyd Bentsen, D-Tex. (subsequently Chair of the Senate Finance Committee and President Clinton’s first Secretary of the Treasury), confirmed in a 1976 colloquy with Treasury Secretary Bill Simon that a major Congressional target of an additional sliding capital gains deduction proposed by the Ford Administration was retirement bailouts by small businessmen. After being chastised by Senator Abraham Ribicoff, D-Conn., for arguing that an increased capital gains preference was the most effective way to encourage more investment by small income taxpayers, when the brokerage firm’s true interest was the large investor,

“capital gains reduction would go to non-stock-market-related investment, primarily in real estate speculation, farmland speculation and the like—not very productive investment.”); accord, id. at 759 (statement of Sen. Bentsen, D-Tex.); 124 CONG. REC., pt. 124, at S35824, S35249-50 (Oct. 10, 1978) (statement of Sen. Kennedy). In fact the decreased percentage of capital gains attributable to stock was in large part caused by the recognition of recent stock market losses. See supra note 101 and infra note 261.

227. See infra text accompanying notes 231-33.

228. 1978 Senate Hearings, pt. 4, supra note 226, at 755 (Under Hansen-Steiger bill 3000 people earning over $1,000,000 [$2,870,000 in 2004 dollars] a year would get tax reductions averaging over $200,000 each [$574,500 in 2004 dollars] – 40 percent of the revenue reduction under the bill – and average reductions of $60,000 each [$172,400 in 2004 dollars] would result for the 20,000 individuals earning over $200,000 a year [$574,500 in 2004 dollars] with no benefits to 99.4 percent of individuals or to 93 percent of the individuals reporting capital gains; similar statistics for the House bill except 94 percent of individuals reporting capital gains would receive no benefit from proposed cuts). See also 124 CONG. REC., pt. 26, at S35261 (Oct. 10, 1978) (statement of Sen. Kennedy) (distributive effects of 70 percent capital gains deduction).


230. Senator Ribicoff preferring an argument for the true interest of the firm, asked what percentage was new customers, the witness stated that a quarter of Merrill Lynch’s new individual accounts were opened by customers with incomes under $15,000 ($43,090 in 2004 dollars) and the median income was about $22,000 ($63,200 in 2004 dollars). Id. at 1845-46.

231. Senator Ribicoff stated that:

And while I’m certainly aware of the need for large-scale investments by wealthy individuals and major institutions, we also need the cumulative contributions of the smaller investor. The small investors are especially conscious of the fact that the Government is their partner in gains, but not in losses; that many of their long-term gains result from inflation; and above all, that making any change in their investments requires the surrender of part of the total capital built up over the years. This hits hardest those in or near retirement who, as a matter of prudence, should now seek out more conservative, income-type securities but who, to do so, must surrender part of their income-producing assets.

Id.
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a spokesman for Merrill Lynch & Co explained that his real point was that an investor retiring from a small business was subject to high capital gains taxes in one year.\textsuperscript{232} Thus, the witness just dug his cloaking hole deeper, since stock of a small business entrepreneur isn’t even listed on the stock exchanges. Capital gains cuts proponents often cloaked their interests in the mantle of the small businessmen and residences,\textsuperscript{233} which even then were largely taken out of capital gain realizations with tax-free roll-overs into another home until age fifty-five, when a $100,000 gain exclusion became available.\textsuperscript{234}


In the Revenue Act of 1978, the pendulum of tax reform swung back as the Conservative Coalition reversed the tax legislation pattern that began with the Revenue Act of 1964’s skewing of tax benefits to the lower and middle income groups. The 1978 Act provided proportionally greater benefits to higher income groups, epitomized in the direct and indirect capital gains cuts.\textsuperscript{235} The Conservative Coalition was bolstered by the raging inflation increasing the phantom element in capital gains and the “tax revolt”\textsuperscript{236} engendered in part by popular outrage at “bracket creep”\textsuperscript{237}

\begin{itemize}
\item[232.] “I think the point I was trying to make is that the capital gains tax has fully as great if not greater impact of the investor who has one or two investments in the market [sic] and might for instance have invested in his own company, a growth investment for years, and when he gets— when he retires he has a transaction which may result in a 42-percent tax on that transaction in 1 year.” \textit{Id.} at 1850 (statement of Chrystie).
\item[233.] E.g., 124 CONG. REC., pt. 19, at H25474 (Aug. 10, 1978) (statement of Rep. Bill Frenzel) (inflation gain in home). See also H.R. REP. NO. 1445, 95th Cong., 2d Sess. 119 (1978) (“In addition, the committee believes that the present level of capital gains taxes has contributed to the shortage of investment funds needed for small businesses and for capital formation generally. Moreover, the committee believes that it is inappropriate to subject many once-in-a-lifetime gains on the sale of property, such as small businesses or personal residences, to the minimum tax.”) (emphasis added).
\item[234.] Internal Revenue Code of 1954 §§ 121, 1034.
\item[236.] 34 CONG. Q. ALMANAC at 219 (“[L]awmakers, riding the crest of a middle class ‘taxpayer’s revolt,’ reversed some of the prized liberal ‘reforms’ of the past – cutting back the minimum tax on preferences, and approving a potentially fatal delay of . . . [carryover basis].”); 1978 Senate Hearings pt. 4, supra note 226, at 834 (statement of Sen. William V. Roth, Jr.) (tax revolt has trumped in Congress income redistribution and higher capital gains rates); see generally Robert G. Kaiser & Mary Russel, A Middle-Class Congress – Haves Over Have-Not’s, WASH. POST, Oct. 15, 1978, A-1 (“Majorities in both House and Senate
arising from increases in nominal compensation due to such inflation, which elevated taxpayers into higher brackets without any increase in real compensation.

The story of the increase in the capital gains preference enacted in 1978 on the ruins of President Jimmy Carter’s capital gains tax proposals reveals the Conservative Coalition’s strength at this time. President Carter had campaigned in 1976 on repeal of the capital gains preference among other tax reforms, repeatedly declaiming that the Federal tax system is “a disgrace to the human race.” This united in opposition the capital gains special interests that forced President Carter to back down on repeal. He were searching feverishly for legislative Acts that could cater to a ‘tax revolt’ that many members believed was sweeping the country.”). See generally E.J. DIONNE, WHY AMERICANS HATE POLITICS 246 (1991) (“[I]nflation raised tax rates on the middle class so high and so suddenly that its members could not believe that what they were getting out of government had any connection with what they were paying. The New Deal had taught that government was the middle class’s friend. The inflation-tax surge of the 1970s taught that government was the enemy.”). Others explained the Republican successes in the 1970’s and 1980’s Presidential Campaigns (Nixon, Reagan and Bush) in capturing the votes of working class white males, who formerly voted the Democratic ticket (often, incorrectly called “Reagan Democrats”) first in the South and then in the Northern, often ethnic, white working class neighborhoods as resting on a linked-chain of (a) reaction to the civil rights movement (school desegregation in the South followed by cross neighborhood bussing in the North as well affirmative action in the workplace), and (b) the above “tax revolt” coupled with the perception that the Federal taxes were largely being redistributed to minorities, reinforced by (c) culturally potent “rights” and “value” issues. T.B. EDSALL & M.D. EDSALL, CHAIN REACTION passim (1991) (“Under the banner of a conservative ‘egalitarianism,’ the political right can maintain the loyalty of its low-income supporters by calling for an end to ‘reverse discrimination,’ while simultaneously maintaining the loyalty of the richest citizens by shaping to their advantage government policies that provide them with the greatest economic benefits.”).

237. “Bracket creep” is taxation of the same real income at higher marginal and effective rates due to inflation. What happened during the 1970’s and 1980’s was that wages at the bottom did not keep up with inflation. See infra note 375.

238. 34 CONG. Q. ALMANAC at 219 (“The bill bore little resemblance to the tax program the president had proposed in January. Almost all of his proposed ‘reforms,’ except for a few tokens, had been scrapped, and the cuts were much more skewed towards the upper end of the income scale than he had recommended.”).

239. Carter repeatedly used this phrase on the stump and in his acceptance speech at the Democratic National Convention: It is time for a complete overhaul of our tax system. I still tell you: It is a disgrace to the human race. All my life I have heard promises of tax reform, but it never quite happens. With your help, we are finally going to make it happen! And you can depend on it!

Text of Carter’s Speech Accepting the Nomination, 510 FACTS ON FILE WORLD NEWS DIGEST, at A1 (July 17, 1976).
still proposed tightening up on capital gains on high income individuals.\textsuperscript{240} Once the capital gains lobby was geared up with no major defensive battle to fight, it shifted to the offense of routing the capital gains reformers.\textsuperscript{241} Consequentially, the House Conservative Coalition\textsuperscript{242} passed, over the objections of then Chair Al Ullman, D-Ore.,\textsuperscript{243} and future Chair Rep. Dan Rostenkowski, D-III,\textsuperscript{244} an \textit{additional} sliding scale deduction of 1 percent per year up to twenty-five years for a maximum deduction of 75 percent for stock and depreciable capital assets. The primary rationale for the “double

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\item \textsuperscript{240} President Carter proposed eliminating the residual individual alternative capital gains rate and eliminating the minimum tax offset of $\frac{1}{2}$ of the regular taxes. \textit{Message from the President of the United States Transmitting Proposals for Tax Reductions and Reform,} 95th Cong. (House Doc. No. 95-283 1978) (estimated annual increases in revenue of $284 million and $100 million, respectively); \textit{see generally} 34 CONG. Q. ALMANAC at 226.
\item \textsuperscript{241} \textit{Tax Cut for Capital Gains Stalled,} 7 TAX NOTES 702 (June 19, 1978) (Because a majority [the Conservative Coalition] on the Ways and Means favored the Steiger proposal of indexing capital gains for inflation, Chair Ullman refused to call the Committee together for three months lest it approve the Steiger amendment.). In the floor debate Rep. Charles Vanik, D-Oh., recounted that President Carter and his advisors were “totally naive about the fundamental legislative process and gave Chairman Ullman no help.” 124 CONG. REC., pt. 19, at H25425 (Aug. 10, 1978).
\item \textsuperscript{242} When Chair Ullman reconvened the Ways & Means Committee to consider the Revenue Bill of 1978 after a three month delay (to allow the Carter Administration to lobby for a lesser capital gains cut, unsuccessfully), the Committee in an unexpected move voted 21 to 16 to adopt the proposal of Rep. Bill Archer, R-Tex., indexing certain capital gains for inflation. Art Pine, \textit{House Unit Votes Inflation Factor for Capital Gains,} WASH. POST, July 26, 1978, at A-1. “The measure was approved by an unlikely coalition of conservative Republicans and Democrats, who are intent upon providing over a billion dollars in tax relief for investors, and Democratic liberals, who aim to stop the momentum for the gains cut by loading the Jones bill with enough tax breaks to insure its defeat on the House floor.” 124 CONG. Q. ALMANAC 226 (1974); \textit{see generally} Pine, supra. This Liberal strategy backfired as a classic Conservative Coalition on capital gains passed a capital gains indexing provision on the House floor. 124 CONG. REC., pt. 19, at H25474-75 (August 10, 1978) (Rollcall vote No. 680, 249 yeas to 167 nays). The Conservative Coalition prevailed: the Republicans supported the indexing amendment 142 to 1; the Southern Democrats, 59 to 26; while the Northern Democrats opposed it 140 to 48. 34 CONG. Q. ALMANAC at 170-H.
\item \textsuperscript{243} 124 CONG. REC., pt. 19, at H25472 (Aug. 10, 1978) (statement of Chair Ullman) (“this is not the time or place to provide indexing on capital gains. . . . the committee is going to look at capital formation. It may be that we will provide indexing in some form, but we ought to do it in relation to some other moves that ought to be made at the same time; so I strongly urge a no vote on this committee amendment.”).
\item \textsuperscript{244} Id. at H25471 (statement of Rep. Rostenkowski) (“It is inconceivable that we can choose to totally insulate from inflation the one type of income in this country already cushioned from inflation-- capital gains [by the then 50 percent of gain exclusion] -- while at the same time ignore the eroding effect of inflation on savings, wages, and salaries.”).
\end{itemize}
dipping” additional deduction up to 25 percent was to offset the then raging inflation. 245

The Finance Committee proposed a repeal of the residual 25 percent maximum individual capital gains rate (on the first $50,000 of capital gain in a tax year), long a goal of tax reformers, rationalizing that it was unnecessary with a 70 percent deduction and, hence, maximum 21 percent rate. 246 Given the tendency of Conferees to split the difference between conflicting House and Senate versions of a tax bill, the author surmises that Chairman Long and others expected a 60 percent deduction (with a resultant 28 percent maximum individual capital gains rate) would prevail in Conference. 247 And so it was that the Conference Committee compromised on a 60 percent deduction, 248 which in conjunction with the then maximum ordinary rate of 70 percent on investment income, resulted in a maximum capital gains rate of 28 percent. At the same time, the

245. William H. Jones, Consumer Prices in Area Rise 1½% in Two Months, WASH. POST, Dec. 23, 1978, at A-6; William H. Jones, AT&T Decision: Cut Rates Or Raise Earnings Level, WASH. POST, Dec. 22, 1978, at E-3 (continuing inflation and interest rates at near record levels); Art Pine, Boost in Prime Rate to 11% Triggers Big Market Drop: Prime Rate Increase Triggers Market Drop; New Fears Of Recession, WASH. POST, Nov. 14, 1978, at D-7 (inflation rate 7 to 8 percent). While the effect of inflation on nominal gains and the shortage of venture capital due to high capital gains rates frequently were heard in the Hearings and on the Floor, see infra note 252, the crescendo was reached in the repeated plaint that the maximum tax on capital gains was almost 50 percent counting the AMT and maximum tax preference offset or poison. See e.g., 1978 Senate Hearings, supra note 226, at 672 (statements of Deans Stewart, Nat’l Oil Jobbers Council). The conservative coalition in the House Ways and Means Committee and its Report by-and-large ignored the facts. Farmers, and small businessmen in fact did better than inflation, 1976 Panel Discussions, pt. 2, supra note 220, at 1233-34, 1237, 1239 (statements of Prof. Michael J. Graetz as to farm real estate). Moreover, many capital assets are financed with debt; new equity issues followed the market rather than rates, and market followed interest rates; and the actual average effective rate on capital gains was 18 percent. 1978 Senate Hearings, supra at 500, 755, 799, 801.


247. President Carter was now receptive to a 28 percent rate. See 124 CONG. REC., pt. 26, at S35262 (Oct. 10, 1978) (statement of Sen. Nelson, Senate Finance Committee Member); 34 CONG. Q. ALMANAC at 235. Also the House in 1963 had passed a 60 percent rather than President Kennedy’s proposed 70 percent deduction. In light of this, motivation for requesting a ruling that Senator Nelson’s amendment to limit the capital gains cut to 60 percent deduction out of order (due to a drafting defect) so that it never came to a vote, 34 CONG. Q. ALMANAC at 243, may have been to preserve bargaining power in the Conference. Senator Ted Kennedy’s amendment to delete the increase in the capital gains deduction to 70 percent was defeated 82 to 10 by a majority of not only the Republicans (34 to 0) and Southern Democrats (17 to 1), but also a majority of Northern Democrats (31 to 9), 34 CONG. Q. ALMANAC at 68-S, so that technically, the Conservative Coalition did not emerge.

Revenue Act of 1978 finally repealed the alternative 25 percent rate.\textsuperscript{249} The Conservative Coalition also retroactively postponed the effective date of “carryover basis”\textsuperscript{250} enacted in the Tax Reform Act of 1976 in lieu of the more meaningful taxation of unrealized capital appreciation at death, which ultimately was repealed in 1980.\textsuperscript{251} The Act fashioned a separate minimum tax for capital gains and excess itemized deductions with a 10 – 25 percent graduated rate, but with an offset for 100 percent of regular income taxes paid, and repealed the preference poison.\textsuperscript{252} This substantially weakened the individual minimum tax as to the capital gains preference.\textsuperscript{253}

With a 50 percent capital gains deduction against a top rate of 70 percent (if the maximum capital gains rate of 25 percent were eliminated), and the alternative minimum tax imposing a 15 percent tax on that deduction or 8.75 percent, the top nominal capital gains rate would be 43.75 percent and higher if the earned income subject to a 50 percent maximum were reduced by the capital gains deduction as well.\textsuperscript{254} The 1978 Senate Committee Report justified the increased capital gains deduction, rather than just modifications to the Alternative Minimum Tax effecting a rate reduction just at the top, as benefiting “all taxpayers with capital gains, regardless of their respective income levels.”\textsuperscript{255} Similarly it rationalized an increased deduction as tending “to offset the effect of inflation,” and “unlike the automatic adjustments generally provided for in various indexation proposals, it should not tend to exacerbate inflationary increases.”\textsuperscript{256}

The testimony by private and public interest groups, economists and their interchanges with the Senate Finance Committee members in the 1978

\textsuperscript{249} Id.
\textsuperscript{250} Id. § 515, 92 Stat. at 2884. \textit{See supra note 250.}
\textsuperscript{252} Revenue Act of 1978 §§ 421, 441, 92 Stat 2872, 2878; \textit{see supra note 250.}
\textsuperscript{253} Lawrence B. Lindsey, \textit{Giving and Tax Cuts: Recent Experience}, 28 \textit{TAX NOTES} 1399 (Sept. 16, 1985) (In 1978 tax treatment of capital gains under both the maximum tax and the additional minimum tax was made far more generous.); John Zimmerman, \textit{Should the Income Tax System Be Overhauled?}, 25 \textit{TAX NOTES} 1143, 1145 (Dec. 17, 1984) (“minimum and alternative minimum tax only applied to 262,000 of the more than 95 million filers in 1981. (Statistics of Income for Individual Returns for 1981, 3 S.O.I. Bull. No. 1, p. 9 (1983)). Less than 10 percent involved capital gains and losses.”).
\textsuperscript{254} \textit{See infra note 260.}
\textsuperscript{255} S. REP. NO. 1263, at 192.
\textsuperscript{256} Id.
Senate Hearings reveal a somewhat higher level of capital gains debate than in earlier years. More attention was being paid to econometric studies, which also surfaced in the floor debate, and to consideration of different solutions. The Hearings and floor debate made extensive use of symbols, particularly the alleged 50 percent maximum capital gains effective rate, the drying up of venture capital issues, and the impact of

257. 1978 Senate Hearings, pt. 2, supra note 226, at 207 (statement of Ronald Bixler, Nat’l Ass’n Mfrs.) (strong support of econometric analysis); id. at 693 (statement of Feldstein) (perpetual revenue unlock theory, akin to an argument that capital gains cut would unlock a flood of technological improvements); but see id. at 707 (statement of Nw. Econ. Prof. Eisner) (response); id., pt. 1, at 148 (statement of Sec’y Blumenthal critiquing Feldstein’s study); id., pt. 1, at 698 (solloquy Sen. Hansen, R-Wyo., and Feldstein) (Treasury had engaged Feldstein for study in question). Senator Bob Dole, R-Kan., sagely concluded that different models yield different answers. Id., pt. 1, at 832. See generally Dionne, supra note 236, at 250-51 (“Following a brilliant lobbying and public relations campaign, complete with careful academic studies that were to become so central to conservative political breakthroughs, Congress voted in 1978 to cut the capital gains tax. The theory was not that the rich ‘deserved’ a break. It was that government would promote more investment by taxing it less, and that everyone would benefit from a surge in productivity and employment. Advocates of Calvin-Coolidge-style economics thus stole away New Dealism’s most potent word, ‘jobs.’”).

Stagflation, the combination of inflation and a recession or stagnant economy, John Jacobs, Carter Lacks Plan to Attack Inflation, U.S. Ex-Aide Says, WASH. POST, Jan. 2, 1978, at A-3, had an adverse effect on the stock market in the 1970’s, Sylvia Nasar, Private Sector: An Economic Reality Check From Someone Who’s Seen It All, N. Y. TIMES, Sept. 29, 2002, at B-1; Tom Saler, Ready or Not, Old Man Inflation Is Knocking at the Door Again, MILWAUKEE J. SENTINEL, June 9, 2001, at D-1 (“inverse relationship between inflation and valuations is one of the stock market’s most enduring principles”).


260. See id., pt. 2, at 672 (written statement of Deans Stewart, Nat’l Oil Jobbers Council); id., pt. 2, at 685 (written statement of William McCamant, Nat’l Ass’n of Wholesaler-Distributors); id., pt. 2 at 886 (written statement of Dr. Ture in Econometric Study); id., pt. 5, at 1088 (written statement of Mark Tanenbaum for the Int’l Council of Shopping Ctrs). For the computations behind the “rare” 49.1 percent effective rate, see Calvin Johnson, The Economic Waste in Cutting Capital Gains Taxes, 7 TAX NOTES 203 n.1 (Aug. 21, 1978) (“53% of this maximum arises because half of capital gains can be taxed like other income . . . [subject to 70 percent rate]. The other 14.1% . . . arises because capital gains is a tax preference, which is subject to the minimum tax . . . , and disqualifies a taxpayer in part from the benefits of the 50% ceiling on the rate for his salary and other service income.”). For more extreme calculations, see 1978 CAPITAL GAINS REPORT, supra note 45, at 37.

261. 1978 Senate Hearings, pt. 2, supra note 226, at 460 (solloquy between Sen. Charles
inflation on entrepreneurs and homeowners\textsuperscript{262} despite contrary facts.\textsuperscript{263} Moreover, one of the co-sponsors of the Steiger amendment claimed broad

Hanson, R-Wyo., and former Sec'y of the Treasury Fowler (stating that Tax Reform Acts of 1969 and 1976 treatment of capital gains have had a very real impact in drying up sources of equity capital); accord, 124 CONG. REC., pt. 19, at H25439 (Aug. 10, 1978) (statement of Rep. Stockman) (noting that supply of risk capital has almost entirely dried up so capital is flowing to the low-growth industries rather than the high-productivity, high growth new industries; entrepreneurship is waning because of the very high tax rates on high incomes. “Today, if you put all those things together you can see why the economy has been growing at such an anemic rate and why our rate of growth has been reduced.”). But see 1978 Senate Hearings, pt. 2, supra note 226, at 800 (written statement of Robert Brandon, Public Citizen’s Tax Reform Research Group) (debunking myth that Tax Reform Act of 1969 caused decline in capital gains realizations by showing lack of correlation with effective dates of reforms and other causes such as bursting of the stock speculation bubble of the 1960s, guns and butter inflationary policy of the Johnson Administration, energy crisis and Watergate scandal of the early 1970’s, and inflation, devaluation of dollar and dislike of President Carter of late 1970’s); accord 124 CONG. REC., pt. 24, at S34825, S35250 (statement of Sen. Kennedy). Cf. 1978 Senate Hearings, pt. 2, supra note 226, at 707 (statement of Nw. Econ. Prof. Eisner) (small investor left stock market, because of better tax treatment of retirement plan investments and poor performance of market).

262. Indexing proponents frequently raised the symbol of the entrepreneur precluded from raising capital by the minimum tax, \textit{id.}, pt. 2, at 216–17 (statement of Sen. Charles Hansen, R-Wyo., S. Fin. Comm. Member); \textit{id.}, pt. 2, at 437 (statement of John Davidson, Nat’l Taxpayers Union); \textit{id.}, pt. 2, at 476 (statement of Thomas Corcoran, Esq. [Key FDR Braintrust]); \textit{id.}, pt. 2, at 503 (statement of Chair Long). For the “homeowner” myth and its debunking, see supra note 224. See also 124 CONG. REC., pt. 19, at H25428 (statement of Rep. Frenzel); \textit{id.}, at H25437 (statement of Rep. Clausen); accord \textit{id.}, at H25474 (statement of Rep. Frenzel) (inflation gain in home). Rep. Dan Rostenkowski correctly pointed out that inflation gain in homes was largely a red herring due to then Section 121’s once-in-a-lifetime post-age fifty-five exclusion of up to $100,000 gain. \textit{id.} at H25471. Typically up to that age the tax-free rollover provisions of Section 1034 were used. \textit{See 1978 Senate Hearings, pt. 1, supra note 226, at 176 (statement of Sec’y Blumenthal); 1978 Capital Gains Report, supra note 45, at 20. For these reasons in 1985 gains from the sale of principal residences accounted for only 2 percent of gains subject to tax. Gerald Auten & Janette Wilson, \textit{Sales of Capital Assets Reported on Individual Income Tax Returns, 1985}, 18 S.O.I. BULL. No. 4, at 113, 115 (Spring 1998).

263. The actual average marginal rate on capital gains had been 18.5 percent and the average capital gains tax rate for 1976 had been 15.9 percent, up from 14.5 percent in 1970 (beginning of minimum tax and of limitation on alternative 25 percent rate under the Tax Reform Act of 1969) and 11.5 percent in 1954. \textit{New Work by Treasury on Capital Gains, 6 TAX NOTES 728 (June 26, 1978). The 18.5 percent figure was widely cited by tax reformers in the Hearings. \textit{See 1978 Senate Hearings pt. 2, supra note 226, at 500 (statement of Leon Shull, Am. for Democratic Action); \textit{id.}, pt. 4, at 755-56 (statement of Robert Brandon, Public Citizen’s Tax Reform Research Group) (capital gains still primary cause in high income taxpayers paying little or no tax; further pointing out that carryover basis or even taxation of capital appreciation at death would be better unlock capital transactions than a rate reduction); \textit{id.}, pt. 4, at 799, 801 (written statement of Brandon) (citing above Treasury study).}
economic benefits from indexing: “[i]f enacted, our proposal will get this country moving again. These are the very words used by President Kennedy in the early 1960’s when he proposed a bold tax reduction plan slashing individual and corporate tax rates.”

The Representative supported, of course, repeal of carryover basis, while President Kennedy had conditioned his capital gains rate cut on enactment of analogous taxation of unrealized capital appreciation at death.

When opponents of a capital gains cut criticized its distribution in favor of high income taxpayers, some supporters of the cut brought up the once in a lifetime sale of the family farm or small business, while others characterized such opponents as repeating “anti-rich statements but they are


265. 35 CONG. Q. ALMANAC 194-H (1979) (vote 657: Rep. Clausen along all other House Republicans but one voted to direct the House Conferees to accept the Senate Bill’s repeal of carryover basis).

266. See supra note 121.

267. 1978 Senate Hearings, pt. 4, supra note 226, at 755 (statement of Robert Brandon, Director of Public Citizen’s Tax Reform Research Group) (75 percent of “capital gains reduction would go to non-stock-market-related investment, primarily in real estate speculation, farmland speculation and the like – not very productive investment.”); accord id., pt. 4, at 759 (Statement of Sen. Bentsen); 124 CONG. REC., pt. 24, at S35249–50, S35251–52, S35824 (Oct. 10, 1978) (statement of Sen. Kennedy) (“I am amazed we have not heard about the mom and pop farm yet. But I am sure we will hear about it. Or mom and pop’s little store.”) Of course, they did. Id., pt. 24, at S35355 (statement of Sen. Curtis). See also 1978 Senate Hearings, pt. 4, supra note 226, at 755 (Under Hansen-Steiger bill, 3000 people earning over $1,000,000 a year would get tax reductions averaging over $200,000 each – 40 percent of the revenue reduction under the bill – and average reductions of $60,000 each would result of the 20,000 individuals earning over $200,000 a year with no benefits to 99.4 percent of individuals or to 93 percent of the individuals reporting capital gains; similar statistics for the House bill except 94 percent of individuals reporting capital gains would receive no benefit from proposed cuts.).

268. 124 CONG. REC. S35252 (Oct. 10, 1978) (statement of S. Fin. Comm. Chair Long) (“It was my good fortune to buy a piece of land from a dear old couple who had lived on it [for 50 years] since they were young. The sale price was $200,000. Those people never made more than $25,000 in their lives. . . She was a retired schoolteacher and her husband a retired plant worker.”); accord id. at S35253 (statement of Sen. Hansen) (“[B]ecause a family that may have practically every dime of its savings invested in a small business, or a farm, or whatever kind of operation, will make a once-in-a-lifetime sale and, as a consequence, they can appear in the expanded income columns of the IRS as being in the group of taxpayers with incomes of $50,000, $100,000, or $200,000.”). Chair Long was given to “rhetorical ‘histrionics’ at the expense of strict objectivity.” Daniel Shaviro, Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s, 138 U. PENN. L. REV. 1, 13 n.41 (1990).
Small business was a preeminent special interest in the 1978 capital gains debate, as Representative Ed Jenkins, a Georgia hill country Democrat with textile mills in his district, and the Ways & Means Committee Report attested:

[MR. JENKINS:] I was somewhat surprised to see that the one area for which your members [National Federation of Independent Business] in my district showed great interest in the field of taxation was the issue of capital gains.

I think that is primarily attributable to one of two things. Perhaps they believe that if the value of their business builds, they will be able to retain some reasonable portion of the value when they sell it. Really, this is the main reason that most business people are working. They wish to retain something when they finally dispose of the business. Perhaps many of them are also investors in land or other capital assets unrelated to their business. This is an extremely important issue to them in my district. . . . All my small businessmen simply tell me don’t do anything to hurt capital gains treatment. Basically this is the message I get from small business.

Indeed, Senator Jacob Javits, R-N.Y., an opponent of the 1978 House bill capital gains cut, stated that small, not big, business owners now were the biggest overt backers of the capital gains preference, rather than the reverse as in the 1930’s. A capital gains cut would not help big industry, but only small businesses, which tended to raise capital by retention of earnings and borrowed funds not through new equity issues, and therefore,

269. 1978 Senate Hearings, pt. 4, supra note 226, at 791 (statement of Sen. Packwood). Senator Packwood went on to ask whether Brandon would oppose (capital gains) tax cuts which took the rich off the tax roll even if they increased revenue. Id., pt. 4, at 791-92. Brandon would. “Again, I would rather have whatever level of revenue there is to be borne fairly by all taxpayers. I think that is the basic notion of our tax system.” Id., pt. 4, at 792.

270. See H.R. Rep. No. 1445, at 119 (“In addition, the committee believes that the present level of capital gains taxes has contributed to the shortage of investment funds needed for small businesses and for capital formation . . . generally. Moreover, the committee believes that it is inappropriate to subject many once-in-a-lifetime gains on the sale of property, such as small businesses or personal residences, to the minimum tax.”) (emphasis added).


was taken care of by more rapid depreciation rules and a corporate tax cut. It would, however, benefit the rich with their large portfolios of public stock.

Senator John C. Danforth, R-Mo., a capital gains cut proponent characterized these remarks as class warfare.

[Mr. Danforth]: [T]he course of the debate often takes the form of what is in it for me, what is in it for this group or that group, as though we are involved in some sort of warfare between the rich and the poor, as though we always have to choose up sides between those who are relatively well to do and those who are not, as though we always have... cast our vote on whether we are for the side of big business or for the side of small business.”

The 1978 Committee Reports incorporated most of the themes presented by the proponents of an increased preference in the Hearings. The Finance Committee Report, explaining its reduction in the maximum capital gains rate (by increasing the capital gains deduction to 70 percent from 50 percent), repeated the notion from the 1978 House Ways and Means Committee Report that the combined level of direct and indirect capital gains taxes contributed to a slower rate of economic growth with fewer realizations and a shortage of investment funds. The Senate Report omitted the 1978 House Ways and Means Committee Report explanation that it was “inappropriate to subject many once-in-a-lifetime gains on the sale of property, such as small business or personal residences, to the minimum tax.”

The Finance Committee added its belief that:

[L]ower capital gains taxes will markedly increase sales of appreciated assets, which will offset much of the revenue loss from the tax cut, and potentially lead to an actual increase in revenues. In addition, the improved mobility of capital will stimulate investment, thereby generating more economic activity and more tax revenue. Six former Secretaries of the Treasury have informed the committee that they believe lower capital gains taxes will raise, not lower, revenues.

273. Id. at S35255.
274. S. REP. NO. 1263, at 192; H.R. REP. NO. 1445, at 119. This was an oblique reference to the intense debate on use of “feedback effects” in revenue estimates. See 1978 Senate Hearings, pt. 1, supra note 226, at 179, 197 (statement of Sec’y Blumenthal); id., pt. 2, at 211 (statement of Chair Long); id., pt. 2, at 452 (statement of former Treasury Sec’y Fowler); id., pt. 2, at 495 (statement of Samuel Cohn, Comm. for Capital Formation through Dividend Reinvestment); id., pt. 3, at 688, 697 (statement of Martin Feldstein, Nat’l Bureau of Research and Econ., Harv. Univ.).
The data for 1979 shows that the effective rate for the top 1 percent of taxpayers for all federal taxes remained in the mid 30’s (37 percent). It

Gains Cuts showed revenue gains from the 1978 capital gains cut under the “cross-section” analysis now used by Treasury, Chief of Staff Pearlman pointed out that the “time series” data, then used by Treasury and still used by the Joint Committee Staff, showed revenue losses after the first year or two. Hearings on Tax Incentives for Increasing Savings and Investments Before the Senate Finance Committee, 101st Cong. (1990) [hereinafter 1990 Senate Tax Incentives Hearings]; see 1978 CAPITAL GAINS REPORT, supra note 45, at ix. The former looks at a large group of taxpayers horizontally across a single year, whereas the latter looks vertically through a period of time at aggregate taxpayer data. Revenue and Spending Proposals for Fiscal Year 1990: Hearings Before the Senate Comm. on Finance, pt. 2, 101st Cong. (1989) (statement of Thomas Barthold, Joint Comm. Staff Economist).

Since a capital gains tax cut generally spurs a one-time realization of capital gains that otherwise would be realized in future years, a “time series” approach appears preferable. Additionally there is the old difficulty of separating market effects from the effects of the capital gains rate cut. See id. at 156 (written statement of Robert McIntyre, Citizens for Tax Justice) (growth in venture capital already underway before 1978 capital gains cut).

277. Effective Federal Tax Rates for All Households by Household Income Category, 1979

<table>
<thead>
<tr>
<th>Income Category</th>
<th>Total</th>
<th>Individual Income Tax</th>
<th>Social Insurance Tax</th>
<th>Corporate Income Tax</th>
<th>Excise Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest Quintile</td>
<td>8.0</td>
<td>0</td>
<td>5.3</td>
<td>1.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Second Quintile</td>
<td>14.3</td>
<td>4.1</td>
<td>7.7</td>
<td>1.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Middle Quintile</td>
<td>18.6</td>
<td>7.5</td>
<td>8.6</td>
<td>1.4</td>
<td>1.1</td>
</tr>
<tr>
<td>Fourth Quintile</td>
<td>21.2</td>
<td>10.1</td>
<td>8.5</td>
<td>1.6</td>
<td>0.9</td>
</tr>
<tr>
<td>Highest Quintile</td>
<td>27.5</td>
<td>15.7</td>
<td>5.4</td>
<td>5.7</td>
<td>0.7</td>
</tr>
<tr>
<td>All Quintiles</td>
<td>22.2</td>
<td>11.0</td>
<td>6.9</td>
<td>3.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Top 10 percent</td>
<td>29.6</td>
<td>17.4</td>
<td>4.2</td>
<td>7.4</td>
<td>0.7</td>
</tr>
<tr>
<td>Top 5 percent</td>
<td>31.8</td>
<td>19.0</td>
<td>2.8</td>
<td>9.5</td>
<td>0.6</td>
</tr>
<tr>
<td>Top 1 percent</td>
<td>37.0</td>
<td>21.8</td>
<td>0.9</td>
<td>13.8</td>
<td>0.5</td>
</tr>
</tbody>
</table>

is noteworthy that the effective income tax rate of the top 1 percent was 21.8 percent, and all but 1.4 percent of the remaining effective federal tax rate was attributable to imputation of the corporate income tax rate according to ownership of capital (13.8 percent).  

C. 1980's: RISE (20 PERCENT RATE) AND FALL (BACK TO 28 PERCENT RATE) OF THE CAPITAL GAINS PREFERENCE


In 1980, Republican California Governor Ronald Reagan campaigned for President vowing to cut taxes and government while increasing defense spending without increasing the deficit. Administration witnesses in the 1981 Hearings on the President’s tax proposals asserted that resulting increased incentives would lead to higher output in the economy, generating increased tax revenues under “supply side economics,” while

In the analysis, households were assumed to bear the burden of the taxes that they pay directly (for example, individual income and payroll taxes). Excise taxes were assumed to be borne by households according to their consumption of taxed goods (tobacco and alcohol) or – in the case of excise taxes that affect intermediate goods – in proportion to overall consumption. Taxes on businesses were attributed to households. CBO assumed, as do most economists, that employers’ shares of payroll taxes fall on employees and therefore that the amount of those taxes should be included in employees’ income and the taxes counted as part of employees’ tax burden. Corporate income taxes were assumed to be borne by owners of capital. CBO allocated corporate tax liabilities to households in proportion to their income from interest, dividends, rents, and capital gains.

This analysis is based on adjusted pretax comprehensive household income. That measure includes all cash income (both taxable and tax-exempt), taxes paid by businesses (which are imputed to individuals on the basis of assumptions about incidence), employee contributions to 401(k) retirement plans, and the value of income received in kind from various sources (including employer-paid health insurance premiums, Medicare and Medicaid benefits, and food stamps, among others). The tables use the Census Bureau’s fungible value measure to determine the cash equivalent of in-kind government transfers.  


making tax shelters relatively less attractive. Such revenue increases coupled with spending cuts, higher real economic growth and lower inflation would supposedly permit balancing of the budget at a lower level of taxation. Such results were based on an “economic scenario” rather than traditional econometric models. OMB Director David Stockman later admitted that supply-side economics was merely a cover for the trickle-down theory, bragging that the across-the-board rate cuts (Kemp-Roth) were always a Trojan Horse to bring down the top investment income and capital gains rate.

Many Democrats on the Ways & Means Committee were quite skeptical of these assumptions, particularly the effects of the across-the-board cuts on savings rates. They were right to be skeptical. “Despite
these generous economic stimuli, the hoped-for supply-side ‘miracle’ did not come to pass. Unemployment soared to postwar highs in 1981 and 1982, while the stock market plummeted and real interest rates escalated in spite of a reduction in inflation. More troubling still, the federal deficit exploded to levels unimaginable under any of the previous supposedly free-spending administrations. Senator Bob Packwood, R-Ore., later pointed out that at the time of the 1981 cuts, the Congressional Budget Office was projecting a surplus.

The reduction by the Economic Recovery Tax Act of 1981 (“ERTA”) of the maximum regular tax rate on investment income from 70 percent to 50 percent, with no adjustment to the three year old 60 percent capital gains deduction applicable to all capital assets reduced the maximum capital gains rate from 28 percent to 20 percent. By 1985, the top 5 percent of individuals had an effective Federal income tax rate of 17.2 percent (down from 20.7 percent in 1980) when the maximum ordinary rate was 50 percent and maximum capital gains rate was 20 percent. Congress also enacted a three year across the board 25 percent reduction in individual rates and an indexing of tax brackets, exemptions and the standard deduction.

At the same time, the 1981 Act put capital recovery methods (ACRS), now encompassing real estate depreciation, on steroids through accelerated rates and much shorter than true economic useful lives for depreciation

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287. CONLAND, supra note 280, at 33.
288. 139 CONG. REC. S7696 (1993).
purposes\textsuperscript{293} that resulted in the sheltering of (a) investment and business income by many more high- and even middle-income individuals,\textsuperscript{294} and (b) of business income by big corporations.\textsuperscript{295} Of 260,000 individual returns in 1983 with “positive income” in excess of $250,000 [$470,130 in 2004 dollars], 11 percent paid less than 5 percent in Federal income taxes and 76.4 percent paid less than 30 percent.\textsuperscript{296} Sixty-four percent of these 260,000 returns showed partnership losses, a major cause of the low effective rates. While Treasury could not break out tax-motivated losses from economic losses, the largest source of deductions in these loss partnerships was interest, depreciation, and depletion.

By the early 1980’s, high income individuals as a whole ($200,000 in annual income) had an effective rate of around 22 percent when the maximum rate was 50 percent.\textsuperscript{297} In contrast, during the 1960’s and 1970’s the average effective rate of high income individuals as a whole was 35 percent, and only the richest enjoyed a 22 percent effective rate.\textsuperscript{298} After the 1981 Act cuts were effective in 1982, the effective federal tax rates fell, especially at the top, with the greatest decrease there in imputed corporate income rates.\textsuperscript{299}

\textsuperscript{293} Id., § 201, 95 Stat. 203-19; 37 Cong. Q. Almanac 91 (1981); 127 Cong. Rec. at S15768 (July 15, 1981) (statement of Senate Finance Chair Dole).


\textsuperscript{295} “[I]n 1955, corporate income taxes represented 27.3 percent of total tax receipts. In 1989, it was down to 10.5 percent.” Hearing on Decline of Corporate Tax Revenues before the Senate Finance Committee, 101st Cong., 2d Sess. (1990) [hereinafter 1990 Senate Hearings] (statement of Chair Bentsen); id. at 4 (statement of Deputy Assistant Sec’y for Tax Analysis Rosen) (By 1986 percentage of corporate taxes as a percentage of Federal total revenue receipts had dropped to 5.1 percent, thereafter declining trend reversed.). See Lee, supra note 291, at 129 n.324 (corporate taxes had declined from 27 percent of total budget receipts in 1950 to 8 percent in 1985). For a discussion of the causes, see 1990 Senate Hearings, supra at 5-6 (primarily corporate pre-tax profits were lower than estimated, due to higher wages and salaries and interest payments than expected) (statement of Harvey Rosen); id. at 11 (statement of Director of Congressional Budget Office Reischauer) (58 percent of shortfall due to CBO overestimation of corporate profits – due to error in model, increased debt financing, and underestimation of depreciation deductions; and 42 percent attributable to other factors such as ESOPs and increased use of S Corporations).

\textsuperscript{296} 1985 House Hearings, supra note 294.

\textsuperscript{297} STAFF OF JOINT COMM. ON TAXATION, DATA ON DISTRIBUTION BY INCOME CLASS OF EFFECTS OF THE TAX REFORM ACT OF 1986 (Comm. Print Oct. 1, 1986).

\textsuperscript{298} See supra notes 122, 165.

\textsuperscript{299} Effective Federal Tax Rates for All Households by Household Income Category,
One of the structural signatures of President Reagan’s 1981 tax cut, deficit financing (found also in JFK’s 1963 tax proposals\(^{300}\)) came to give the term a new meaning.\(^{301}\) In 1963, Republicans had opposed deficit financing.\(^{302}\) In 1981, Chair Rostenkowski attempted (unsuccessfully) to out-bid Republicans for the swing votes of Southern Democrats by granting tax preferences including the Reagan-sponsored rate cuts and investment

\[
\begin{array}{|c|c|c|c|c|c|}
\hline
\text{Income Category} & \text{Total} & \text{Individual Income Tax} & \text{Social Insurance Tax} & \text{Corporate Income Tax} & \text{Excise Tax} \\
\hline
\text{Lowest Quintile} & 8.2 & 0.4 & 5.9 & 0.5 & 1.4 \\
\hline
\text{Second Quintile} & 13.8 & 4.2 & 8.0 & 0.5 & 1.1 \\
\hline
\text{Middle Quintile} & 17.9 & 7.4 & 8.9 & 0.7 & 0.9 \\
\hline
\text{Fourth Quintile} & 20.6 & 10.0 & 9.1 & 0.7 & 0.8 \\
\hline
\text{Highest Quintile} & 24.4 & 15.3 & 6.3 & 2.1 & 0.6 \\
\hline
\text{All Quintiles} & 20.4 & 11.0 & 7.5 & 1.4 & 0.8 \\
\hline
\text{Top 10 percent} & 25.3 & 16.9 & 5.1 & 2.8 & 0.5 \\
\hline
\text{Top 5 percent} & 25.6 & 18.3 & 3.7 & 3.5 & 0.5 \\
\hline
\text{Top 1 percent} & 27.7 & 20.0 & 1.6 & 5.4 & 0.4 \\
\hline
\end{array}
\]


300. See supra note 141.

301. In fairness to President Reagan, the looming deficit was the product of years of fiscal mismanagement, as well as changing macroeconomic forces (including reduced inflation that resulted in lower federal revenues), not merely the direct consequence of Reaganesm. Indeed, as Gene Steuerle has shown, the “era of easy financing” that characterized postwar fiscal policy ended before Reagan took office (Steuerle, 1992, 1996). Nevertheless, ERTA 1981 and Reagan’s increased defense spending accelerated the day of reckoning. Dennis J Ventry Jr., The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99, 53 Nat’l Tax J. 983, 1064 n.76 (Dec. 1, 2000).

302. See supra note 14; Dionne, supra note 236, at 251.
incentives. Congress took the “Riverboat Gamble” that supply-side economics would work.

The other major signature of the Kennedy tax proposals, enactment by projecting benefits to income groups skewed to lower income groups to increase consumer spending was written in reverse by the 1981 Reagan tax cuts. Like the Revenue Act of 1978, the 1981 cuts benefitted disproportionally higher income individuals and large corporations to

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303. Chair Rostenkowski’s open competition for the votes of conservative Southern Democrats (“boll weevils”) and oil Democrats initially resulted in a Ways and Means Committee bill they would support. In the end the Reagan Administration outbid Rostenkowski, e.g., with support for Georgia’s peanut crop. Melissa Brown, Democratic Strategy Backfires – GOP Wins in the House, 13 TAX NOTES 315 (Aug. 3, 1981); Congress Enacts President Reagan’s Tax Policy, 37 CONG. Q. ALMANAC at 91, 100. Forty-eight Democrats defected to Reagan in adopting the Republican Substitute for the House Ways and Means bill. Id. See Rollcall vote No. 177, 126 CONG. REC. H18261-62 (1981). Technically, the Conservative Coalition did not arise in that a slim majority of Southern Democrats remained in the Democratic fold. (Republicans supported the alternative to 1, while Southern Democrats opposed it 43 to 36 and Northern Democrats 151 to 12. 37 CONG. Q. ALMANAC at 58-H. The Conservative Coalition did emerge and prevail in the final vote on the entire tax bill which lowered the maximum individual capital gains rate to its lowest level (20 percent) since 1942. Republicans and Southern Democrats supported the bill 190 to 1 and 69 to 9, respectively, while Northern Democrats opposed it 97 to 64. Rollcall vote No. 178. 127 CONG. REC. at H18262-63; 37 CONG. Q. ALMANAC at 58-H.

304. In the Republican controlled Senate, the Finance Committee bill, which was much closer to Reagan’s proposals, overwhelmingly passed 89 to 11 with majorities of Republicans and Northern and Southern Democrats. Rollcall Vote No. 239. 127 CONG. REC. at S17983; 37 CONG. Q. ALMANAC at 41-S. Indexing of rates and brackets (to begin in 1985 after the third year of the rate cuts) was separately voted on, passing 57 to 40 along partisan lines. Id. at 35-S, 100-01. Such indexing prevailed in Conference. Economic Recovery Tax Act of 1981 § 104, 95 Stat. at 188-90. On the House side in the Conference Chairman Rostenkowski leveled the charge that the legislation was not written in Committee but “in some downtown hideaway,” and carefully laid the Act, “a bold-and risky-economic strategy” at President Reagan’s door. 127 CONG. REC. at H19521. Others called it “a riverboat gamble that is going to make every Member of this body and every citizen in the United States pay a big price in the next few years if it does not work out.” 127 CONG. REC. at H19525 (Aug. 4, 1981) (statement of Shannon). And so it did. Senate Majority Leader Howard Baker, R-Tenn., originated the phrase. See 147 CONG. REC. S4778 (2001) (statement of Sen. Byrd); 139 CONG. REC. S3601 (1993) (statement of Sen. Hollings) (“Twelve years ago, the new President stepped forth with an audacious plan to slash taxes by one-third, drastically increase the defense budget, and trimming domestic spending. President Reagan promised that his plan would balance the budget in a year’s time. Then-majority leader Howard Baker called Reganomics a riverboat gamble, but he urged us to vote for it as a solid bet, and a majority of Senators went along with that gamble. I, for one dissented. I voted against the Reagan tax cuts. Any simpleton should have foreseen that Mr. Reagan’s riverboat gamble would leave us up the creek, drowning in deficits.”).

305. See supra text accompanying note 104.
encourage productive investments. The 25 percent across the board rate cuts, created by raising the bracket breakpoints, were proportional but phased in over three years. Other elements, including accelerated real estate depreciation that enabled the use of tax shelters to explode, the 28.6 percent cut in year one in the maximum investment income tax rate from 70 percent to 50 percent, and the maximum capital gains rate change from 28 percent to 20 percent, all disproportionately favored the top income individuals. Their effective income tax rate fell from the mid-30s to about 22 percent.

2. 1982 TEFRA: Reappearance of Indexing Proposals

The Supply Side miracle did not come to pass. The economy went into a recession in 1981 that continued into 1982, which coupled with the 1981 tax cuts and increases in defense spending, caused the Federal deficits to increase significantly above prior levels. The Administration then pushed for loophole closing and improved collections while maintaining the three year phased-in across the board individual tax cut and indexing. The Senate Finance Committee was inspired by the Budget Reconciliation directives to raise revenues and cut spending. By adding the Tax Equity

306. 1981 House Hearings, supra note 280, at 13 (statement of Sec'y Regan); id. at 115 (statement of Weidenbaum).
307. See supra note 297.
308. CONLAND, supra note 280, at 34.
309. The 1981 deficit ($57.9 billion) was about the same as 1980 ($59.6 billion) but almost twice that of 1979 ($27.7 billion), while 1982 was almost double 1981’s ($110.6 billion) and the worst was yet to come (1983, $195.4 billion and 1984 $175.36 billion). 40 CONG. Q. ALMANAC 142 (1984). The 1982-83 recession was the worst recession as far as unemployment went (just under 11 percent) since the Great Depression. 1992 Senate Hearing, supra note 63, at 23 (statement of Sen. Sarbanes, Chair of the Joint Economic Comm.). Chair of the Senate Finance Committee Dole, now had no patience with “supply­siders,” quipping in early 1982 that the good news was that a bus full of supply-siders went off a cliff; the bad news, two empty seats. JEFFREY BIRNBAUM & ALAN MURRAY, SHOWDOWN AT GUCCI GULCH 31 (1987).
310. Tax Increases Meet Deficit Reduction Target, 38 CONG. Q. ALMANAC 29 (1982). Notwithstanding floor fights the Senate maintained the three year individual tax cut intact. Rollecall vote No. 234. 128 CONG. REC. S17195 (July 21, 1982); 38 CONG. Q. ALMANAC at 36 (amendment to delay scheduled rate cuts for high income individual taxpayers only was defeated along largely partisan lines).
311. See Elizabeth Garrett, Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process, 65 U. CHI. L. REV. 501, 514 (1998) (“Section 311(a) [of the Budget Act, 2 USC § 642(a)(1) (1994)] effectively requires that any amendment to a reconciliation bill be revenue neutral, thereby limiting the ability of members to amend reconciliation legislation on the floor. Unlike PAYGO, the offset cannot come from
and Fiscal Responsibility Act of 1982 ("TEFRA") as a rider to an unrelated House revenue bill, the Committee, followed the Administration’s approach of loophole closing. The individual minimum tax was strengthened: it covered the capital gains preference again, and safe harbor leasing was restricted. They strengthened compliance while adding increases in excise taxes and eliminating additional depreciation and other corporate changes scheduled in ERTA to be phased in, which actually constituted the bulk of the revenue "increases.” The Finance Committee bill also shortened the capital gains holding period back to six months.

On the Senate floor, the Conservative Coalition added indexing for stocks and real estate to start prospectively in out years. The amendment was strongly opposed by Senator Dale Bumpers, D-Ark., because he was a long-time supporter of a capital gains preference limited to venture capital investments, and double indexing (with ordinary rate being indexed as reducing entitlement spending. As with reserve fund limitations, the Senate can waive this requirement only by a three-fifths vote; Section 311(a) also applies to amendments in the House, which can waive it in a special rule or by majority vote."

PAYGO expired in 2002 and the Senate attempted in 2004 to reinstitute it as to taxes as well as discretionary spending while the House and the Administration were opposed as to taxes because they wanted to make the 2001 and 2003 cuts permanent. Richard A. Oppel Jr., *Panel Vote Draws Battle Lines for Pay-as-You-Go Tax Cuts*, WASH. POST, Mar. 18, 2004, at A-30 ("Acknowledging that applying so-called pay-as-you-go rules to taxes would complicate efforts to make the tax cuts permanent, White House officials have been lobbying hard against the legislation. The House speaker, J. Dennis Hastert of Illinois, has signaled that House leaders intend to kill the provision when House and Senate budget writers meet to reconcile differences in their proposals. Republicans say it would be foolish to erect barriers to extending tax cuts that have spurred economic growth; Democrats say the cuts are the main reason the nation faces its largest-ever deficit in dollar terms.")


313. TEFRA, § 206, 97 Stat. at 431-32.


315. Rolf call vote no. 243 (64 yeas to 32 nays, 4 not voting). 128 CONG. REC. at S17537. The Conservative Coalition prevailed: Republicans (45 to 8) and Southern Democrats (11 to 4) supported the amendment while Northern Democrats opposed it 20 to 8. 38 CONG. Q. ALMANAC at 43-S. Southern Democrat Senators voting for the amendment consisted of Senators Bentsen (Tex.), Boren (Okla.), Bumpers (Ark.) (voted yes in order to be able to move for reconsideration), Byrd (Va., Independent caucusing with Democrats), Ford (Ky.), Heflin (Ala.), Johnston (La.), Long (La.), Nunn (Ga.), and Pryor (Ark.). On the motion to reconsider, Senators Bumpers, Nunn and Pryor in effect changed their vote. Id. at 17541 (Rolf call vote 244, 61 nays to 35 yeas). For a general discussion of the conservative coalition in the Senate in 1982, see 37 CONG. Q. ALMANAC at 40-C.
well) on distributive grounds would encourage speculation rather than true investment.316

Senator Bill Armstrong (R-Col.), sponsor of the capital gains indexing amendment, pointed to recent data showing that all of the reported gain on average was inflation gain, and mostly relied upon examples of residences.317 He also employed familiar rhetoric from the late 1970s that “in many instances people do own houses, farms, small businesses which have been in the families for long periods of time.”318 Subsequent studies would show that the inflation argument was only half true, and that the other grounds accounted for small portions of total capital gains realizations.319 For instance, for 1985 all capital assets, except bonds, for taxpayers with $200,000 and over ($348,000 in 2004 dollars) real gains constituted 81.5 percent of their nominal gains.320 Similarly, the Congressional Budget Office’s 1990 study of inflation and capital gains using Treasury data concluded that real gains on corporate stock sales on the average were positive only as to taxpayers with AGI above $100,000 in 1981 dollars [$206,000 in 2004 dollars] and negative for taxpayers with AGI below $100,000.321 “[T]he average real gain [in 1981] for taxpayers with AGI over $100,000 was positive and accounted for 53 percent of their total nominal gains. For the tiny fraction of taxpayers with AGI over $1,000,000, who accounted for 18 percent of realized nominal gains on stock in 1981, real gains amounted to 82 percent of their total gains.”322

Several Treasury or Joint Committee studies of capital gains realizations in the early 1960s, the 1970s, and the early 1980s also concluded that the top half by income of these individuals realizing capital gains in most years have a real or economic gain of roughly 50 percent of the nominal gains reported.323 In all of these studies, the higher the income bracket, the better the individuals’ rate of return as to realized capital gains was in comparison to the rate of inflation. The lower half in annual income

316. 128 CONG. REC. at S17537-38.
317. 128 CONG. REC. at S17534-35.
318. Id.
319. See notes 320-25 infra and accompanying text.
322. Id. at 24
323. E.g., 1978 CAPITAL GAINS REPORT, supra note 45, at 10-11 (In 1977, only taxpayers with over $100,000 adjusted gross income realized any real gains as to stock sales; for those with over $200,000, real gains were of nominal gains).
of the individual taxpayers annually reporting capital gains actually incurred economic losses on average.\footnote{CBO, INDEXING CAPITAL GAINS, supra note 320; accord, JOINT COMM. ON TAXATION STAFF, TAX TREATMENT OF CAPITAL GAINS AND LOSSES 26 (Comm. Print 1989).} For example, a 1990 Joint Committee study demonstrates that this class of taxpayers enjoyed a reported capital gain no more than once in a five year period for an average gain of $2,000 in 1980 dollars ($4,600 in 2004 dollars) that amounted to less than 10 percent of the capital gains realized.\footnote{1990 Senate Tax Incentives Hearings, supra note 276, at 70 (colloquy between Sen. Bradley, D-NJ, and Joint Comm. on Taxation Chief of Staff Pearlman).}

The House unexpectedly went straight to Conference.\footnote{The House barely agreed (208 to 197) with Chair Rostenkowski's decision, which rested on the technicality that the Senate bill had been a "rider" on an unrelated House "revenue bill." Rollcall vote No. 225. 128 CONG. REC. at H18385-86. This action meant that the House would have little hand in shaping the legislation for which House Democrats were grateful. 38 CONG. Q. ALMANAC at 37.} The Conference naturally followed the Senate bill, but dropped both the provisions that would have shortened the capital gains holding period and indexed selected capital assets.\footnote{H.R. CONF. REP. NO. 760, 477-78 (1982).} The Conference Report barely passed the House (226 to 207),\footnote{Rollcall vote No. 303. 128 CONG. REC. at 22239-40.} but nearly half of the Republicans who had previously supported President Reagan voted against it, arguing that a recession was not a time to increase taxes.\footnote{38 CONG. Q. ALMANAC at 38.}

3. DEFRA of 1984: Holding Period Tinkering

In 1984, even though the recession had ended, the deficit continued to grow. Again Budget Reconciliation directed tax increases, domestic spending cuts and slowed down defense buildup.\footnote{31. S. REP. NO. 97-144, at 8-14 (1981), reprinted in 1981 U.S.C.C.A.N. 105. This encompassed a host of partnership and tax accounting changes aimed at tax shelters which had exploded, notwithstanding the lowering of the top rate on investment income from 70 percent to 50 percent, justified in part as reducing tax sheltering due to the 1981 increased richness of real estate depreciation. In reality tax shelters exploded after 1981 Act due to the rich capital recovery provisions.} A consensus emerged among the House, the Senate and the administration on how much, and how to, raise taxes consisting of: (a) closing loopholes,\footnote{30. 40 CONG. Q. ALMANAC 143 (1984).} (b) delaying or eliminating a number still to be phased in 1981 cuts besides the three year, 25 percent individual rate cut and indexing, and (c) levying minor
Excise taxes. Additionally, in the Deficit Reduction Act of 1984 ("DEFRA") Congress changed the 1978 Act's 1-year capital gains holding period back to six months as a trade-off for increasing the tax credit for working poor from $500 to $550 per year.


Near the end of his first term President Reagan announced the appointment of a Treasury Group to study tax reform, and report back to the President in December 1984 (just after the November Presidential elections) provoking laughter among the White House journalists. To the surprise of many, the timely 1984 Treasury Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth ("Treasury I"), espoused many positions producing more equitable results than then current law. It would have lowered the top ordinary rate to 35 percent, eliminated the Alternative Minimum Tax regimes, resolved major capital gains and capital recovery problems by indexing the basis of debt and depreciable and other capital assets (while using economic lives rather than the much shorter tax recovery periods).

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332. 40 CONG. Q. ALMANAC at 149-50.
334. 40 CONG. Q. ALMANAC at 154.
335. BIRNBAUM & MURRAY, supra note 309, at 40-41. Although viewed at the time as a political ploy, Treasury took the task seriously. CONLAND, supra note 280, at 45.
336. 2 TREASURY DEPARTMENT REPORT TO THE PRESIDENT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS I, 131 (1984) [hereinafter TREASURY I]. Its overriding objective was to subject real economic income from all sources to the same tax treatment. 1 TREASURY I, at xii, 13. One of the chief architects of Treasury I was then Assistant Secretary of Treasury for Tax Policy Ronald Pearlman. See BIRNBAUM & MURRAY, supra note 309, at 46 (along with economist Charles McClure had Treasury Secretary Regan's ear; Pearlman had "a thorough knowledge of the tax code and a theoretical bent"). Pearlman and McClure were "allowed to design what they thought was a perfect tax system." Id. at 47. "They called for a 'neutral' tax system, a system that does not influence private decisions." Id. This was a recurring theme in the floor debate on the Tax Reform Act of 1986.
337. TREASURY I, supra note 336, at 65, 181, 177-200; BIRNBAUM & MURRAY, supra note 309, at 53-54. Secretary Regan who previously was proponent of a capital gains preference was persuaded to support indexing instead of a preference when shown that most realizations would result in no taxable gain under indexing.
Commentators criticized it as too elegant. However, its fatal weaknesses were more likely political. The most powerful pressure groups thought that they could do better than indexing. The favored individual special interests either had scant basis in capital or sold too soon for inflation to have much effect. Meanwhile, large corporate America apparently concluded (correctly it turned out) that it could retain the existing accelerated capital recovery for personal property such as equipment. Much like Surrey’s proposals, Treasury I united all interest groups against it. “The Best is the enemy of the good.” The 1985 Administration tax reform proposals and the 1985 House Tax Reform Bill, therefore, retained the capital gains provisions and accelerated cost recovery.
5. Tax Reform Act of 1986 Compact of Lower Rates and Broader Base: Unexpected Second Best End of the Capital Gains Preference Due to Distributional Equity

In the case of personal property, the total package of post-ERTA preferences was the equivalent of currently deducting the cost of such property on a present value basis – a backdoor consumption tax.343 The recovery period for real estate improvements also was much shorter than economic life. Capital intensive public corporations reported little or no taxable income in comparison to their financial income.344 Adverse publicity of the zero tax multi-million dollar income corporations drove the Tax Reform Act of 1986,345 much as the zero tax high income individual story had driven the Tax Reform Act of 1969.346 Secretary Regan convinced President Reagan of the inequities of the 1954 Code by showing “him that General Electric (Reagan’s old employer) paid less in taxes than the chief executive’s personal secretary.”347

The Tax Reform Act of 1986, which was largely fashioned conceptually on the Senate side, followed both the Treasury I, and Senator Bill Bradley’s notion of lowering the top rates (to 28 percent on the individual side and 34 percent on the corporate side) by limiting preferences.348 Like the Tax Reform Act of 1969, the Tax Reform Act of

years beginning in 1991, i.e., preferential deduction for high income and indexing for moderate income); H.R. REP. NO. 99-426, at 196-7 (1985) (50 percent deduction for individual long-term capital gains in 1986, and 42 percent thereafter, resulting in maximum rate of 22 percent in 1986 and 22.04 percent thereafter).
344. BIRNBAUM & MURRAY, supra note 309, at 11-13 (McIntyre disclosures naming names and media interest).
345. 132 CONG. REC S13867 (1986) (statement of Sen. Bentsen) (“Consider an employee of a company working out his tax return on April 15 who reads about his own company making hundreds of millions of dollars year after year and paying no taxes. He says something is wrong with the system. You know, he is right. That is what we have to change. There is a perception of unfairness in the tax system. It is more than a perception. It is a reality.”); BIRNBAUM & MURRAY, supra note 309, at 11-12; Minarik, supra note 154, at 1365-66; CONLAND, supra note 280, at 36-37.
346. See supra note 167.
347. CONLAND, supra note 280, at 36.
348. 132 CONG. REC. at S13782 (statement of Sen. Packwood) (many of suggestions of Sen. Bradley, who has been advocating tax reform for at least 4 to 5 years, are incorporated in bill); id. (statement of Sen. Biden) (Sen. Bradley played key role in bringing tax reform to the American people). Birnbaum and Murray recount that Chair Packwood in presenting his initial individual top rate of 25 percent to his Finance Committee, first showed them the
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1986 limited preferences mostly by surrogate approaches. The main exception was the unexpected elimination of the individual capital gains preference, thus ending the vertical and horizontal inequities among individual taxpayers from a capital gains preference for the first time since 1921349 by a “Second Best” 28 percent compromise. If the top rate was low enough, special interests were willing to give up their preferences.350

Consistent with the 1986 Code’s theme of lower rates paid for by a broader base,351 the top individual “permanent” ordinary income rate was lowered from 50 percent to 28 percent while the top individual capital gains rate was increased from 20 percent to 28 percent.352 Such increase was necessitated by the notion of distributional equity, i.e., high income taxpayers could not receive as an income class a greater tax cut than the middle and lower income taxpayers.353 Distributional equity, however,

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349. Many conservatives criticized elimination of the individual capital gains preference. E.g., 132 CONG. REC. at S13686 (statement of Sen. Gorton) (capital gains preference since 1921; bothered by repeal without replacing with indexing basis for inflation); id. at S8164 (statement of Sen. Heflin) (since 1921 capital gains preference has a proven track record in stimulating new enterprises and risk taking); id. at S13929 (1986) (statement of Sen. Wicker) (since 1921 capital gains have always been taxed at lower rates to encourage investments in capital assets recognizing the greater risks undertaken by one who invests in the future and to avoid the unfairness of bunching. “Our system thrives on such risk-taking and now we will upset all tradition in this country by telling investors they are no better off investing in a risky start-up than simply putting their money in blue chips.”).

350. 132 CONG. REC. at S13784 (statement of Chair Packwood) (many witnesses willing to give up their preferences if the maximum individual rates were in the range of 20 to 30 percent.).

351. 132 CONG. REC. at S13917 (statement of Sen. Dominici) (“The overall structure of the bill is to reduce the rates and broaden the tax base. Adding back deductions, rules or credits would mean a rate increase -- this should be avoided.”)

352. Tax Reform Act of 1986, Pub. L. 99-514, §§ 1, 301-02,100 Stat. 2085, 2096, 2217-18. A 5% rate applied above $71,900 to phase out the 15 percent bracket (thus the maximum tax under this provision was 13% of the amount of income to which the 15 percent rate had applied. Id. § 1(g). See note 358 infra.

froze in place the recent erosion of effective rates at the top, because ordinary income and capital gains rates were lowered in 1981. The capital gains income at the top increased during the leveraged buyout run on the market, and was offset to some degree by the increase in the effective rate of corporate income tax. Effective tax rates for the bottom 80 percent concurrently increased, because the effective Social Insurance Tax Rate and the Excise Tax Rate went up. As in earlier years, the largest

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<th>Income Category</th>
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<th>Social Insurance Tax</th>
<th>Corporate Income Tax</th>
<th>Excise Tax</th>
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<td>Highest Quintile</td>
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<td>6.5</td>
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<td>0.7</td>
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354. 132 CONG. REC. at S13899 (statement of Sen. Rockefeller) (great weakness is that it provides yet another tax cut to the wealthiest Americans who have had their tax burden cut by enormous amounts during the Reagan years; accord Floyd Haskell, Tax Reform, 35 TAX NOTES 301, 305 (1987); see also Marjorie E. Korshaiser, The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction, 86 MICH. L. REV. 465 (1987) (Tax Reform Act of 1986 took a large structural step away from progressivity towards a flat tax); 132 CONG. REC. at S13893 (statement of Sen. Kerry) (“I am troubled by the fact that the bill abandons our traditional commitment to a progressive rate structure in the Tax Code. When added to the burden of payroll taxes, the two rates in this bill create what comes close to a flat tax for all Americans, with effective rates that actually decline as income rises into the range of the wealthy.”); id. at S13939 (statement of Sen. Chiles) (“How fair is tax reform when the average taxpayer earning between $30,000 and $40,000 receives a tax cut of a couple hundred dollars when the most wealthy individual receives a tax cut of almost 3 grand? How fair is a tax system that taxes middle- and high-income households at the same rate and, in fact, includes a higher marginal tax rate of 33 percent for upper-middle-income individuals, while offering a lower 28-percent rate for the very wealthy?”); accord id. at S13919 (statement of Sen. Sasser) (serious mistake and unfair to treat a person with $30,000 taxable income the same a person with a taxable income of $200,000). By 1990, the effective rate at the top had been raised back to 27 percent, CBO, 1997-2000 TAX RATES, supra note 277, primarily due to repeal of the capital gains preference and the passive activity loss limitations of Section 469.

355. 136 CONG. REC. at H8321 (statement of Rep. Downey) (171% increase in capital gains income from 1978 to 1990). Compare with the table for 1982, supra note 273, with the following Effective Federal Tax Rates for All Households by Household Income Category 1985:
category of net capital gains by dollar value was corporate stock (37.8 percent); followed by net capital gains from partnerships, S Corporations, and trusts (23.2 percent); residential rental property (10.8 percent); and depreciable property (9.2 percent). Meanwhile the percentage dollar value of capital gains from livestock, timber and farmland was 1 percent or less. In 1985, joint returns reporting $200,000 or more reported 69 percent of the capital gains, and those reporting $100,000 to $200,000 reported 17 percent.

Distributional equity required curbing preferences concentrated in high income taxpayers, especially capital gains and tax shelters, to offset

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<th>All Quintiles</th>
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<td>Top 10 percent</td>
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<td>Top 1 percent</td>
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<td>1.3</td>
<td>6.4</td>
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356. CBO, Perspectives on Ownership, supra note 113, at 48 tbl.A-7; accord Auten & Wilson, supra note 262, at 115. Slightly different percentages (stock, 42 percent; real estate 26 percent; and passed through 19 percent) are contained in CBO, Capital Gains Taxes, supra note 39, at 2 fig.1, but the overall pattern is the same.

357. Id. at 69 tbl.A-28.

358. Additionally, distributional equity required the “bubble” 33 percent rate on the near rich and limitation on deduction of consumer interest, as well as eliminating the deductibility of consumer interest and barring IRA’s to upper middle and high income taxpayers. Kies, supra note 353, at 183. IRA’s were used most exclusively by those with incomes over $50,000, 131 CONG. REC. H12816 (1985) (statement of Rep. Guarini). Because individual capital gains realizations after 1987 were less than estimated in the Tax Reform Act of 1986, some of the projected increase in individual progressivity did not come about. Andrew Hoerner, Economists Examine Whether Progressivity Has Regressed, 56 Tax Notes 1520 (Sept. 21, 1992).

On the corporate side the principal surrogate approach was a strengthened minimum tax, but repeal of the Investment Tax Credit was the big revenue raiser. Lee, supra note 291, at 72 & n.52. Little if any of the corporate sector increases appeared either, with annual corporate income tax revenues falling short by $20 to 30 billion. 1990 Senate Hearings, supra note 295, at 1 (statement of Chair Bentsen). About 60 percent of the shortfall arose from since-changed errors in the Congressional Budget Office “model” and lower than predicted corporate before tax profits due to higher than predicted wage and salary and interest payments. Id. at 6 (statement of Harvey Rosen, Ph.D., Deputy Assistant Sec’y for Tax Analysis, Treasury) and id. at 11-12 (statement of Robert Reischauer, Ph.D., CBO Director). The increase in interest payments possibly was less due to leveraged
cutting the top nominal rate from 50 percent to 28 percent for the minority of high income taxpayers without capital gains or tax shelters, thereby dividing the rich. President Reagan’s pre-condition of revenue neutrality meant that the 5 percent cut for each individual income class required an equal revenue increase – $120 billion over the five year revenue window and a much higher percentage increase on the capital intensive (but not services) corporate side. This provoked strong criticism from Senators of industrial, or wannabe industrial states, such as New Jersey, Pennsylvania, and South Carolina.

The Tax Reform Act of 1986 and the repeal of the capital gains preference rested on a new “bi-partisan” coalition of Liberals favoring buyout activity and more due to high interest rates of the 1980s, but data was still insufficient. Id. Forty percent of the shortfall was due to unexpectedly higher use of Employee Stock Ownership Plans in the late 1980’s and more use of partnerships and S corporations as the form of business organization than projected. Id. at 11-12 (statement of Reischauer). See 132 CONG. REC. at S13926 (statement of Sen. Mathias) (“The proponents claim that the bill is revenue neutral, that it will not increase or decrease revenues over the next five years. I hope they are correct. Too many of the provisions designed to raise the revenue being lost through rate reduction may not provide the revenue that has been estimated through the static analysis used by the tax committees.”)

359. CONLAND, supra note 280, at 51; IRNBBAUM & MURRAY, supra note 309.

360. John Waggoner, Sizing up Tax Reform; Tax Debate Centers on Fairness, USA TODAY, Apr. 17, 1990, at B-1 (“Are businesses paying a bigger share? No. Congress meant to make corporations pay a bigger share of the tax bill so individuals could pay less. It hasn’t worked out that way, though. One explanation: ‘Although Congress tried to close corporate tax loopholes, they left some,’ says William Melton, senior financial economist for IDS Financial Services in Minneapolis. ‘And corporations have faster and better tax lawyers than individuals do.’”).

361. E.g., 132 CONG. REC. at S13926 (statement of Sen. Mathias) (Act requires the manufacturing sector to finance tax reductions for the rest of the economy, i.e., individuals and non-capital intensive corporations.); id. at S13927 (statement of Sen. Hollings) (noting that saddling corporate America with $120 billion in additional taxes over 6 years, while also ending investment credits and preferential treatment of capital gains, is simply robbing Peter to pay Paul; “[a]nd, more serious, it could impair the ability of our industry to achieve price competitiveness in international markets.”); id. at 13929 (statement of Sen. Weicker); id. at S13942-43 (statement of Sen. Heinz) (shift in part of tax burden from individuals to corporations including elimination of capital gains will harm fragile economy).

362. E.g., id. at S13962 (1986) (Statement of Sen. Dole) (“[B]ipartisan from the start – nonpartisan may be even a better word. We have had 2 or 3 years of discussion, and it has been on the merits.”); 131 CONG. REC. H12233 (1985) (statement of Rep. Bonior)) (bipartisan coalition underlay 1985 House bill); 132 CONG. REC. at S13881 (statement of Sen. Kasten).

363. 132 CONG. REC. at S13899 (statement of Sen. Jay Rockefeller, D-W.Va.) (stating that the principal purpose is to improve equity by removing numerous special breaks and privileges, most importantly restrictions on tax shelters and repeal of capital gains preference, that cause the tax burdens of people with similar incomes and family
the limitation of preferences, and Conservatives favoring the lowered rates and equalized taxation of all income and among different kinds of businesses. Some Liberals also agreed with such equalized taxation. However, as evidenced by the Senate debate on the Conference Bill on the Tax Reform Act of 1986, some Members of Congress railed against elimination of the individual capital gains preference, often identifying a special interest of their particular state, such as farmers or ranchers as to livestock, farm or ranch land, timber, real estate, small business or circumstances to differ so greatly; also noting the perceptions that tax laws aren’t fair have done much to destroy public confidence in the system; accord id. at S13867 (statement of Sen. Gary Hart, D-Col.).

364. Id. at S1312 (June 23, 1986) (statement of Sen. Charles Grassley, R-Iowa) (major benefit is lower rates which will make the Tax Code less important in making economic decisions); id. at S13918 (Sept. 27, 1986) (statement of Sen. Steven Symms, R-Idaho) (“They move the Tax Code generally in a positive direction with respect to rates and the policy of allowing the free market to control the flow of capital. I intend to oppose any attempt in the future to raise the rates.”); id. at S13948 (statement of Sen. Alan Cranston, D-Cal.) (“The 1986 Tax Reform Act is progressive because it broadens the tax base by closing loopholes and limiting deductions which advantage high income taxpayers. This increases the tax burden on these taxpayers and makes it possible to reduce the tax burden on lower income taxpayers. And it makes it possible to lower the rates for all individuals and corporations.”); id. at S13785 (Sept. 26, 1986) (statement of Sen. Fin. Comm. Chair Packwood, R-Ore.) (“I am in favor of special tax treatment for capital assets held for long periods of time such as the old family farm, small businesses which have passed from generation to generation and timber which takes several decades to mature. In times like these, some are having to sell the fruits of a lifetime to pay off debts. To tax them at ordinary income rates is simply unfair. I am particularly concerned about


366. 132 CONG. REC. at S13949 (Sept. 27, 1986) (statement of Sen. Joseph Biden, D-Del.) (“[T]his bill will also create a more efficient economy by greatly reducing tax advantage as a consideration in economic decision-making. Investors will give more thought to the economic value of their decisions, and less to achieving tax advantage. The Federal Government will have a reduced role in ‘managing’ the economy.”)

367. E.g., id. at S8132 (1986) (statement of Sen. Charles E. Grassley, R-Iowa) (supports but has reservations as to elimination of preference as to farmland); id. at S13934 (Sept. 27, 1986) (statement of Sen. Jeremiah Denton, R-Ala.) (“I am in favor of special tax treatment for capital assets held for long periods of time such as the old family farm, small businesses which have passed from generation to generation and timber which takes several decades to mature. In times like these, some are having to sell the fruits of a lifetime to pay off debts. To tax them at ordinary income rates is simply unfair. I am particularly concerned about
start ups, and rarely mentioned public stock (in the guise of concern for capital formation, jobs, and international competitiveness). Alternatively, they criticized it for failing to account for inflation.

Senator Bob Dole noted that Congress now "knew a lot more about how corporations and individuals avoid paying taxes on all of their economic income," namely using preferences such as the special rate on capital gains income. "We have had an opportunity to review and reevaluate our priorities, and we have made the decisions we think are appropriate." Surrey's goals of identifying tax preferences to lower rates how the loss of this deduction will effect the timber industry and other capital intensive industries."

368. Id. at S13888 (statement of Sen. Howell Hefflin, D-Ala.) (undecided but opposed repeal of capital gains preference for livestock and timber).

369. Id. at S13927 (Sept 27, 1986) (statement of Sen. Ernest Hollings, D-S.C.) (discourage investment in timber and real estate.); id. at S13939 (statement of Sen. Mark O. Hatfield, R-Ore.) (in favor of bill but, "elimination of capital gains for individuals and corporations likely will have a serious impact on Oregon's Christmas tree farmers and small woodlot owners"); id. at S13875-76 (statement of Sen. Alan Dixon, D-Ill.) (family business, small farm and timber); id. at S13918 (Sept. 27, 1986) (statement of Sen. Steven Symms, R-Idaho) (elimination of capital gains preference together with repeal of rule that corporations are not taxed on appreciation in assets distributed in liquidation or sold pursuant to timely liquidation would have "devastating to a retiring small farmer").

370. Id. at S13793 (Sept. 27, 1986) (statement of Sen. Russell Long, D-La.) ("What are we doing to the future of America? Venture capital where somebody is willing to take a risk, somebody is willing to take a risk and put off instant payoff for the possibility of long-term reward -- so we repeal the capital gains differential. We tax everything the same. We say, in effect, to our business people: 'Get something safe, get something that returns money now. There is no special reason for you to make a long-term investment or take a long-term'... The effect of the repeal of the capital gains differential on stock options will mean that it is much more difficult for a new company, a company that is starting up, to go out and hire first-rate, experienced people. What do they have to offer the people? A risk for nothing.' Stock options that do not take advantage of the capital gains differential."); id. at S13929 (statement of Sen. Lowell Weicker, R-Conn.) ("Lowering the top individual rate from 50 percent to 28 percent and the top corporate rate from 46 percent to 34 percent sounds good. But in the process of slashing the top rates, we're bulldozing over a generation of deductions and credits many of which achieved important social and economic goals. . . . [I]t will have devastating, perhaps even crippling effects on capital formation especially for small business [start-ups]."); id. at 13919 (statement of Sen. Sasser, D-Tenn.) (elimination threatens business start ups).

371. Id. at S13886 (statement of Sen. Tribble).

372. E.g., id. at S13962 (statement of Sen. Dole) ("[W]e retained some tax incentives in the tax law that will reduce taxable income in some cases below real economic income.
by base broadening had finally bore fruit. Since the high ordinary rates only existed “on paper” with progressivity “more apparent than real,” a farce due to the capital gains sieve, the lowered top rates merely brought the nominal top rates closer to the actual effective rates. Those rates had however, recently fallen substantially at the top due to the 1981 ordinary and capital gains income cuts, and substantial increase in capital gains income at the top. In short, the disparity between capital gains and ordinary income rates was finally eliminated, but at a much lower meeting point than the 50 percent envisioned by Surrey in the 1950’s and 1960’s. Time would tell that lowering the ordinary rate, even halving it, did not lessen the desire of special interests, or at least of some politicians, for a

That caused some concern about whether some corporations could escape tax, even under the new rules. As a result, the Senate adopted a very stringent minimum tax. . . . We should feel confident that we now have an “escape-proof” minimum tax.”; id. at S13931 (statement of Sen. Andrews) (“Our present Tax Code has evolved into a maze of tax deductions, credits, and loopholes which have only helped the rich get richer and the poor get poorer.”).

373. 139 CONG. REC. S5985 (1993) (statement of Sen. Moynihan) (“It was Stanley Surrey’s particular fate that few of his ideas for tax reform ever were really adopted by the Kennedy or the Johnson administrations in which he served. But two decades later, in 1984, in the celebrated Treasury I proposal, it was pure, if I may coin the term, ‘Surreyan.’ All his large ideas about cleaning the Tax Code, cleaning out the loopholes and the avoidances and the ambiguities and circularities and getting rates down by broadening the base, there it was.”); CONLAND, supra note 280, at 22.

374. See 132 CONG. REC. at S13889 (statement of Sen. Hart) (“current law’s progressivity is more apparent than real. We have high rates on paper, but the rich can shelter, exclude, or exempt far more of their income than lower or middle income people. Some estimates indicate that those who make more than $200,000 can now exempt as much as half of it.”); id. at S13911 (statement of Sen. Boschwitz) (“[D]ual rates of 15 and 28 percent are just terrific. [A higher rate] would be fine if people in the higher rate and higher incomes were paying them. But I think history shows if you are making over $200,000 that indeed you know how to protect your tax situation, and people were not paying those rates.”).

375. The resultant true limitation of (individual) preferences described below finally reversed the pattern of tax reform from 1969-81. Each tax reform during this period had taken the budget “surpluses” from bracket creep (inflation moving individuals into higher brackets) (a) to give a ballyhooed tax cut through rate reductions or more frequently raising the rate breakpoint coupled with partially curbing some abuses, while (b) actually using the greater portion of the bracket creep revenues to increase tax preferences primarily used by high income individuals and corporations, whose effective rates fell while an ever increasing portion of the revenue burden was borne by the middle class. William Greider, The Tax Machine, WASH. POST, Oct. 16, 1978, at A1 (describing process every two years in 1960s and 1970s of a bracket creep tax cut); Lee, supra note 291, at 128-33. Because only the high income taxpayers had a substantial increase in real income from 1979 through 1985, see supra note 355 and accompanying text, their share of the Federal income tax burden during this period actually grew. See CBO, 1997-2000 Tax Rates, supra note 277, app. B, at 22-24 tbl.2B.
capital gains preference. A study of the capital gains preference in the 1920’s and early 1930’s would have predicted that.\textsuperscript{376}

The Conference and the Tax Reform Act of 1986 followed the Senate repeal of the capital gain preference for individuals and corporations.\textsuperscript{377} However, the 1986 Act left the capital gains and losses definitions in place explicitly so that the preference could be simply restored if Congress subsequently increased the ordinary rates.\textsuperscript{378}

IV. CONCLUSION

From enactment in 1921 until repeal in 1986, the individual capital gains tax preference undercut the progressivity of the Federal income system, thus violating vertical equity. With the advent of high income taxpayers with large service income but small capital income, the preference violated horizontal equity as well by favoring capital income over services income.\textsuperscript{379} All of the classic arguments in favor of the individual capital gains preference are ill-founded with one possible exception: offsetting for inflation.\textsuperscript{380} Even there, the higher the taxpayer’s income the more on average that recognized capital gain was real or economic.\textsuperscript{381}

Why then has reform of the individual capital gains preference proven so exceedingly difficult? Part of this difficulty is due to the influence of high income taxpayers owning the majority of public stock in individual hands on the political system to obtain special legislative privileges as Populism would predict.\textsuperscript{382} Another factor is the power of local special

\textsuperscript{376} 1932 House Hearings, supra note 52, at 41 (colloquy House Ways and Means Chair J.W. Collier, D-Miss., and Undersecretary of Treasury Mills) (repeal of 12½ percent flat capital gains rate when top surtax rate was 20 percent would still block transactions).

\textsuperscript{377} Tax Reform Act of 1986 § 301, 100 Stat. at 2216.

\textsuperscript{378} I.R.C. § 1(h) (2005). S. REP. No. 99-313, at 169 (1986). Some feared that this was “Freudian slip because this fits hand in glove with what the chairman of the Ways and Means Committee has been saying for some time, and that is we are going to have to have a tax increase.” 132 CONG. REC. at H9408 (statement of Rep. Swindall); id. at H9416 (statement of Rep. Gingrich).

\textsuperscript{379} E.g., text accompanying supra note 204.

\textsuperscript{380} See Lee, supra note 13, at 8-10.

\textsuperscript{381} See supra text accompanying notes 320-25.

\textsuperscript{382} Populism may be defined as distrust of aggregations of economic power because of resulting ability to obtain special privileges. Lee, supra note 112, at 947; compare William Julius Wilson, Rising Inequality and the Case for Coalition Politics, 568 ANNALS OF AM. ACADEMY OF POL. AND SOC. SCIENCE 78 (Mar. 2000) (“Political power is disproportionately
interests, other than large owners of public stock (who garner the bulk of the benefits of the preference), such as timber, livestock, start ups and small business in general. An underlying factor during the first period of the capital gains preference is that the creation, and further substantial increases in the capital gains preference in 1921, 1938, 1942, 1978, and 1981 all coincided with a downturn in the economy and/or in the stock market. Finally, proponents of a capital gains preference have often cloaked their interest in public stock in more appealing garb, such as the family farm or family residence.

The same political pressures that promoted an individual capital gains preference also led within a dozen years after Tax Reform Act of 1969 to the Conservative Coalition greatly weakening the individual capital gains preference in the Revenue Act of 1978. Initially, 80 percent of the individual minimum tax base consisted of the 50 percent capital gains deduction. After the Revenue Act of 1978 made the minimum tax treatment of capital gains more generous, less than 10 percent of the individual minimum tax reported involved capital gains.

Clearly most of the political pressure arises from any large gap between the income tax rates applicable to ordinary income and to capital gains. Only by eliminating this gap was the Tax Reform Act of 1986 able to repeal the capital gains preference. Other potential approaches to splitting the special interest groups from the wealthy holders of public stock were not attempted during this era of the first capital gains

concentrated among the elite, most advantaged segments of society. The monetary, trade, and tax policies of recent years have arisen from and, in turn, deepened this power imbalance. And, although elite members of society have benefited, ordinary families have fallen further behind.

A more nuanced political science analysis is that "[r]ather than using coercive power, economic elites exercise power by controlling values and limiting the scope of alternatives considered in public decisions (i.e., by limiting the definition of what is politically possible). This control of the 'agenda,' which serves to limit the bounds of government action, is not seriously opposed because of mass inculcation of capitalist values." Geier, supra note 6, at 122. For an excellent illustration of such mass inculcation, see William Blatt, The American Dream in Legislation: The Role of Popular Symbols in Wealth Tax Policy, 51 TAX L. REV. 287 (1996).

383. See supra note 49.
385. See supra note 101.
386. See supra notes 257, 261.
387. See supra note 301.
388. See supra note 221 and accompanying text.
389. See supra note 253.
preference, such as providing more favorable capital gains rates for the special interest groups 390 or modest income sellers of public stock, whose gains are devalued by inflation, than for wealthy sellers, whose gains are mostly real.

390. A stock exchange representative in the 1955 Mills Tax Policy Hearings facetiously suggested:

I might suggest instead of having just one basket labeled “capital gains” and the other with everybody subject to ordinary income rates, you might consider having 5 or 10 baskets, each of them labeled different things, each of them carrying a different rate, or as an alternative, may I suggest facetiously you might subject everybody’s income, by definition, to a capital-gains rate, then we can start all over again. [Laughter.]