President Clinton's Capital Gains Proposals

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John Lee is a professor of law at the Marshall-Wythe School of Law, College of William & Mary, Williamsburg, Virginia. Professor Lee believes that the generic capital gains rate should not be increased over 28 percent for revenue and political reasons. But to reflect that, on the average, capital gains realized by middle-income families consists entirely of inflation gain, while half of the capital gain realized at the 31-percent bracket and above consists of economic gain, increasing to 80-percent economic at the very top, he argues that a greater exclusion should be provided at the 28- and 15-percent brackets, either by a "progressive schedule" or by a $3,500 annual exclusion. To strengthen the political base for increasing the top rates and to avoid the risk of the conservative coalition in Congress passing a generic capital gains cut as an offset, he advocates that the top current rate on income retained in expansion of an active business by a passthrough entity be limited to 34 percent, with the full top individual rates imposed when the retained earnings are withdrawn or the interest in the entity disposed of. The author also recommends that the proposed small business corporation tax cut should expire as to subsequent new small-business issues if the provision does not attract sufficient outside capital during a test period. Lee further recommends against taxing at death unrealized capital appreciation, because it almost certainly would engender a generic capital gains cut.

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I. FLAT RATE CAPITAL GAINS PREFERENCE

A. Background

1. Clinton's flat rate preference. President Clinton’s income tax proposals would increase the top ordinary rates to 36 percent at around $140,000 in taxable family income and, in effect, to more than 41 percent at $250,000 in taxable income. At the same time, the maximum individual across-the-board or generic capital gains tax rate would remain at 28 percent. This flat rate capital gains preference of 13 points or so would provide the practical effect of a 9.6-percent exclusion at the 31-percent bracket (commencing at $89,150 in taxable family income), a 22-percent exclusion at the 36-percent bracket, and a 31.7-percent exclusion at the 41-percent rate. At the 28-percent and the lower 15-percent brackets, a generic capital gain would be afforded no preference. Over 70 percent of individual capital gains are realized by individuals at the 31-percent and, especially, at the highest brackets, where nearly 75 percent of the families annually realize capital gains with an average gain of $100,000 or so, according to a 1990 Joint Committee on Taxation (JCT) study. At such higher levels, according to a 1985 CBO study, on the average, 50 percent of realized capital gains are economic, i.e., in excess of the rate of inflation while held, rising to 80 percent at the very top. At lower levels, on the average, none of the usually irregularly realized capital gains exceed the rate of inflation. Thus, the effective exclusion under the 28-percent flat rate capital gains preference regressively would increase proportionately with both economic gains and higher income and decrease proportionately with both percentage of inflation gain and lower income.

2. Congressional criticism. Some tax-writing members of Congress, including Senator Bill Bradley, D-N.J., and Representatives Robert Matsui, D-Calif., and Sander Levin, D-Mich., in the February 24 Senate Finance Committee and March 9 and 10 House Ways and Means hearings on the president's economic plan, have criticized a flat maximum 28-percent generic capital gains rate. These members questioned the Secretary of the Treasury, Lloyd Bentsen, and the Chair of the President’s Economic Council, Laura Tyson, at these hearings as to why (a) generic capital gains were not subject to the higher rates, and (b) the generic capital gains preference was only available to high-income individuals.

3. Administration's rationales. Candidate Clinton had opposed a generic capital gains cut on the stump. The administration's answer to the charge that the 28-percent flat rate ceiling is the equivalent of a generic capital gains cut no doubt would be that this flat rate is not a "cut," but merely retains the existing capital gains cap.

Dr. Tyson's response at the March 9, 1993 House hearing was that the objectives of the Clinton tax package were "deficit reduction, balance, progressivity, and incentives for investment — I would say those are our main objectives — and [we will try to be sure that the package accomplishes them] . . . in a way which is as least distortionary as possible." In short, the 28-percent generic capital gains cap rested on "balance,"

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1“My objection is to an across-the-board capital gains cut on stocks traded on the stock exchange, which is where Senator Tsongas concentrates his — and let me argue one, we tripled the stock market in the '80s. That's fine. We can't do any better than that in the '90s. We can't do better than triple. But average wages went down, the work week lengthened, poverty exploded, we lost our competitive edge. So my argument is, this inequality that we got was accompanied by declining economic growth. . . . And to give these across-the-board cuts to people who've got — look at this, that's who's going to benefit from the across-the-board capital gains, the people that have got 60 percent of the wealth in the last decade, and it did not make us a richer country." Transcript of Democratic Candidates Debate: Gov. Bill Clinton, Sen. Paul Tsongas, and Jerry Brown, Chicago, Ill., Monday, March 16, 1992.

2She was summimg up her previous more complete rationale for higher rates but a 28-percent maximum capital gains rate. “Dr. Tyson: . . . [F]irst, it brings us back full circle back to the first question of the chairman, which is in a way, when you try to . . . we’re in a situation where we want to use a . . . we need to use revenues as part of deficit reduction, to get — first of all, to get a credible amount of deficit reduction, it really requires some revenues. Secondly, we want to do this in a balanced way. But once we get to that, we — and then we also have, incidentally, the goal of trying to restore some of the progressivity into the tax system, which really was reduced during the 1980s.” Unofficial Transcript of March 9, 1993 Ways & Means Hearing on Clinton Economic Plan, electronically reproduced, 93 Tax Notes Today 59-93.
which can be a political as well as economic virtue. Secretary Bentsen addressed the 28-percent rate query with two rationales: (1) that 28 percent was the revenue maximizing rate because above that blocking resulted, and (2) "to encourage to some degree people moving into equities to try to help start new ventures and to try to build new companies." As to the second point of reinvestment of funds from public market sales in new ventures, Congress bought that argument moving into equities to try to help start new ventures.

maximizing rate 4 because above that blocking with two rationales: (1) that 28 percent was the revenue which can be a political as well as economic virtue. 3

3The economic virtue is economic efficiency if a rate above 28 percent reduces realizations that historically have followed the market more than rates. That is not to say that rates may not have had an effect on the market; witness the 1920s and 1980s speculative booms. The political virtue of a 28-percent maximum rate is that without it a majority of conservatives, mostly southern, Democrats likely would rejoin the Republicans in forming a "conservative coalition" in either blocking the proposed rate increases or more probably, and even worse, restoring a much lower generic capital gains preference, possibly just half of the 28-percent rate. My guess is that this would more likely occur in the Senate than in the House.

4Joint Committee Chief of Staff Ron Pearlman had offered 28.6 percent as a possible revenue-maximizing rate in the 1990 Senate hearings on tax incentives, 101st Cong., 2d Sess. 65; accord JCS-19-90, p. 41.

5Since already 50 percent of annual appreciation in public stock held by individuals is not realized prior to the shareholder's death, increasing the rate on capital gains to 36 or 41 percent is likely to reduce (a) realizations, at least among nontraders, and (b) revenues from this sector.

6Official Transcript of Senate's Clinton Economic Proposal Hearing, February 24, 1993, electronically reproduced 93 Tax Notes Today 48-79. At the March 10, 1993 House Ways and Means hearing, Secretary Bentsen explained to Rep. Matsui, D-Calif., that the 13-point differential "was done with intent and an understanding that it would probably encourage a shift toward investment. That's the purpose of it, that it will cause an increased interest in equity investments that would help start businesses and create jobs. That is fully understood. There's another point that economists argue, that at some point you get the locked in feature more, and some would argue that you're near that breaking point at 28 percent. So that is another thing under consideration, that you lose revenue if you get it too high; assets get locked in. But there is an absolute and full intent to try to encourage investment."


from the entrepreneur, family, and friends. 8 The revenue estimators seem, however, to assume substantial movement of funds, probably from the public stock sector, to qualified small business corporations via pooled investment funds. Except for foregone trades due to funds tied up for five years in small business corporation holdings, where would they get revenue losses during the first five years of the provision? Foregone sales of the small businesses themselves during the first five years after creation surely constitute a small source for such estimated revenue losses, given the minimal likelihood of sales of such businesses during the first five years of operation anyway.

4. Why reward churning as a way of life? Combining the CBO and JCT studies discussed at 1.A.5 and 1.A.6 below, the apparent pattern is that, year after year, the same high-income individuals, say the top 2 percent, realize the bulk of capital gains reported. Most of that gain is from public stock, and most is economic. Also, data from the 1960s and earlier decades shows that the higher up the income scale, the greater the percentage of the taxpayers in that class who annually realize capital gains and the greater percentage of total income that their capital gains amount to on the average. Thus, the populist charge, during the 1920s and 1930s and again during the past 10 years, that a generic capital gains preference mostly rewards churning on the secondary public stock market by high-income individuals for whom such regular gains are a major if not the principal source of their income, is basically true.

That being the case, why do I support a 28-percent cap on generic capital gains? First, I surmise that the package of "ideal" rules described in V. below is not now politically obtainable and, worse, that attempts to enact them could instead trigger enactment by the conservative coalition of less equitable provisions than the current rules. Second, taxing generic capital gains at ordinary rates (a) is equally unobtainable politically while retaining, or even harder, reconstituting, high ordinary rates, as evidenced by President Carter's 1978 failed attempt to repeal capital gains; and (b) based on the high rates without a capital gains preference experience of 1916-1920, and assuming the 28.5-percent revenue maximizing capital gains rate estimated by the

8Hearings on Economic Growth and the President's Budget Proposals Before the Senate Finance Committee (Part 1), 102d Cong., 2d Sess. 56, 60 (1992) (Statement of Robert Gilbertson, representing American Electronics Association) (Venture Economics data indicates 96 percent of equity financing in small start-up companies comes from "the owner/entrepreneur himself, his relatives, friends, or groups of small businessmen... who will take some of their money and put it into a risk pool together") (the latter pattern is strong in some immigrant groups); accord id. at 61 (Statement of John J. Motley, representing National Federation of Independent Business) (NFIB study reached same conclusion); Hearings on Impact, Effectiveness, and Fairness of the Tax Reform Act of 1986 before the House Ways and Means Committee, 101st Cong., 2d Sess. 118 (1990) (statement of Professor Auerbach); id. at 130 (statement of Henry Aaron).
Joint Committee on Taxation Staff, would reduce revenues (unless coupled with taxation of unrealized capital appreciation at death, in which case the “conservative coalition” on capital gains would surely demand and get a generic capital gains cut as a trade-off). The 28-percent cap, coupled with a substantial ordinary rate increase, is the remaining alternative for restoring some of the eroded progressivity of the late 1970s and early 1980s, when effective rates at the top fell from 36 percent to 22 percent (subsequently to rise back to 28 percent). Thirdly, I conclude in II.D. and E. below that the PAL changes and a generic 28-percent capital gains rate would not revive 1976-1986 style tax shelters (but I would recommend total real estate depreciation recapture, at least for taxpayers not subject to PAL due to the proposed real estate business exception). And under the implicit “rule of 28,” discussed at II.E. below, the old progressivity/horizontal equity effective rate disparities at the top individual brackets should not reappear.

B. Analysis

This section assumes that the top permanent rate on individual capital gains will not be above 28 percent in the final legislation for revenue and political reasons. It focuses, therefore, on the question of whether some deduction or exclusion should be provided for capital gains of taxpayers below the top rates, or perhaps at the top rate. This question is addressed first from an equity perspective focusing on (a) the inverse relationship between income level of individual taxpayers reporting capital gains and inflation component of realized capital gains, and (b) the direct relationship between income level and the percentage of capital gains regularly reported. The article then sketches the historical experience of flat rate capital gains in the Revenue Act of 1921 and the botched remedies over the following decades that resulted in great vertical and horizontal inequities from around 1976 to 1986, which were exacerbated by the tax shelter boom. In conclusion, this section advocates, much like the 1992 Senate and Conference versions of H.R. 4210, an individual schedule of “progressive” rates on capital gain, ranging from a zero rate at the 15-percent ordinary income bracket to 28 percent at the 36-percent bracket on policy (rough mimicking of percentage of gain equal to rate of inflation while held) and distributional or fairness grounds. A simpler alternative with much the same effect would be an exclusion of the first $3,500 in annual capital gains, perhaps phased out across the 31-percent bracket much like the proposals by Senator Gaylord Nelson, D-Wis., in the 1970s, the Bush administration in 1989, and House Ways and Means Chairman Dan Rostenkowski, D-Ill., in 1990.

1. Inflation element. Perversely, the proposed flat 28-percent maximum individual capital gains rate constitutes the mirror image of the percentage of realized capital gains equal to the rate of inflation while held, by income classes. In all published government studies the percentage of economic income, if any, increases with income level and, conversely, the percentage of gain equal to the rate of inflation increases with decreasing income levels. Thus in 1980, according to a 1985 CBO study, Indexing Capital Gains, individual taxpayers with adjusted gross income above $100,000 enjoyed, on the average, a 50-percent “real” or economic gain as to capital gains reported that year. As the income level rose above $100,000, the percentage of economic gain on the average rose as well, reaching 82 percent at the $1 million AGI level and accounting for 18 percent of realized gains that year. Below the $100,000 AGI level, on the average, all reported capital gains as a percentage of basis were less than the rate of inflation while held, i.e., all “inflationary” gain. These extremes may have been skewed in 1980 with a beginning stock market boom following a period of stagflation, but the same general pattern is consistent across the recent decades. Former JCT Chief of Staff Ron Pearlman once told me that this pattern reflects that many high-income individuals sell public stock after relatively short holding periods and dispose of improved real estate, which until the late 1980s bust did better than the rate of inflation. Conversely, middle-income individuals realizing capital gains tend to have longer holding periods and hence fail to keep up with inflation.

2. Recurring capital gains. The Joint Committee, through “timed series” studies of capital gains realizations by a sample of the CBO study’s taxpayers from 1978-83, demonstrated that the same high-income individuals with multiple transactions year after year accounted for 80 percent of the tax benefits of a generic capital gains preference with an average capital gain of about $100,000. Conversely, while taxpayers realizing capital gain in only one of the five years sampled amounted to over 60 percent of the taxpayers in the five-year sample, their gains in the aggregate

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9Hearings on Tax Incentives for Increasing Savings and Investments before the Senate Finance Committee, 101st Cong., 2d Sess. 65 (1990) (Statement of Ronald Pearlman, Chief of Staff, Joint Committee on Taxation.)

10The votes on capital gains in the House in 1989 reveal a pattern of all but one or two House Republicans plus a majority of conservative, mostly Southern, Democrats (less than 25 percent of all Democrats) voting one way while the remaining House Democrats voted the other way. Such a voting pattern gives rise to the conservative coalition so defined by the Congressional Quarterly.


12Almost 60 percent of the capital gains realized in the sample went to the 15.7 percent of the individuals who reported capital gains in all five years surveyed, with an average gain of $100,000; over 70 percent went to those with gains in four out of the five years. Joint Committee Staff, Explanation of Methodology Used to Estimate Proposals Affecting the Taxation of Income from Capital Gains 48-9 (JCX-19-90); Hearings on Tax Incentives for Increasing Savings and Investments Before the Senate Finance Committee, 101st Cong., 2d Sess. 770 (1990); Hearings on Impact, Effectiveness, and Fairness of the Tax Reform Act of 1986 before the House Ways and Means Committee, 101st Cong., 1st Sess. 216-17, 248-49, 273 (1990). This study (Footnote continued on next page.)
amounted to only 10 percent of the capital gains reported with an average capital gain of $2,000,13 or about $3,500 in today’s dollars.

3. Flat rate capital gains before. In 1921, Congress enacted a flat 12½-percent individual capital gains rate for gains from capital assets held two years or longer. Congressional tax writers were familiar with the 60-percent drop-off in revenues at the highest brackets despite a general boom during the period 1916-18, when capital gains were subject to full ordinary rates rising to above 70 percent.14 Accordingly, they enacted the flat rate to unlock blocked transactions and thus increase revenues.15 With this move, progressivity became a farce, as was the entire income tax.16 For example, in the boom year 1925, only 70,000 out of 2.5 million taxpaying individuals were at brackets higher than 12½ percent (those earning more than $30,000, today’s $210,000), and the less than 10,000 earning $100,000 or more garnered almost 90 percent of the benefits from the flat capital gains rate.17 These same individuals paid almost 50 percent of the income taxes.18

In 1934, Congress’s first attempt to reform the capital gains preference attempted too much: a capital gains deduction for middle-income taxpayers, an “unblocking” rate for high-income taxpayers with most of the capital gains, and a rough offset for inflation (which would not return until after World War II). The result was a “confusing” sliding scale deduction format reaching a maximum 70-percent deduction (with maximum rate of 20.1 percent at the top bracket) at 10 years. In fact, as Treasury had warned, this sliding scale or “step rate” resulted in blocking, as high-income taxpayers clustered at the 10-year mark, while middle-income taxpayers with capital gains clustered at the first steps with smaller deductions and hence higher rates.19 This blocking charge carried the day as the Depression “double-dipped” in 1938 following the lesser known stock market crash of 1937, resulting in shorter holding periods for the lowest rates and in the final compromise in 1942 of a 50-percent long-term (six-month holding period) capital gains deduction for the individual with a small income and an alternative [25-percent flat] capital gains rate for the high-income taxpayer.20 By this time, 70 million taxpayers were covered by the income tax and the top ordinary rates were climbing back up to soon reach 90 percent. This alternative flat rate continued unchanged until the Tax Reform Act of 1969, which partially limited it with a $50,000-per-year ceiling (probably then the average realized capital gain at the top). After repeated failed attempts by tax liberals to repeal this remaining flat rate preference for the rich, Congress eliminated it in 1978 as a weak tradeoff, along with lengthening the holding period from the 1942-established six months to one year, for enacting at the same time the conservative coalition’s increase in the basic exclusion from the 50-percent established by the 1942 Act to a 60-percent deduction. President Carter had campaigned on repeal of the capital gains preference, arousing the special interests, which then united to force Carter to back down on repeal, although the president still called for tightening up the capital gains rules for high-income individuals. Once the capital gains lobby geared up to fight the repeal prevailed, it shifted to the offensive and sought a greater preference (double-dipping indexing in the House).21

The result of high nominal rates, coupled with a substantial capital gains preference, was a pattern from at least the 1950s through the mid 1980s of two-thirds to three-fourths of high-income taxpayers achieving an effective income tax rate far below the maximum nominal rate, while the remaining high-income individuals were taxed at effective rates closer to the nominal progressive rates. For example, in the 1960s and 1970s, the general pattern was that the average effective rate for high-income individuals was 35 percent. Those taxpayers with heavy capital gains (higher average income) had an effective rate of 22 percent, while the others had an effective rate in the high 40s

(Footnote 12 continued.)

was requested by then Rep. (now Senator) Byron Dorgan, D-N.D. The high-income taxpayers’ share of the tax benefit of the capital gains preference is even greater than their share of realized capital gains, due to the added gear of a higher ordinary rate avoided by the capital gain. And their share of economic gain is highest of all.

13Methodology, supra note 12 at 48-9.


16Due to generous personal and family exemptions, only 2½ million taxpayers (out of 30 to 40 million workers) were subject to the income tax while more federal revenues were raised from regressive excise taxes, as the taxwriting committees knew in the 1930s. Hearings on the Revenue Act of 1932 before the Senate Finance Committee, 72d Cong., 1st Sess. 3 (1932) (Statement of Sec’ty of Treasury Ogden Mills). This same pattern actually intensified under President Franklin Roosevelt. See Leff, The Limits of Symbolic Reform (Cambridge University Press 1984).


18Hearings on Revenue Revision, 1938, before the House Committee on Ways and Means, 75th Cong., 3d Sess. 116-21 (1938).


20The explicit aiming of the 50-percent deduction at the taxpayer with small capital gains and the flat rate at the taxpayer with a large capital gains income is revealed in the legislative history to the two-step capital gains provision adopted in the Revenue Act of 1938. Confidential Senate Hearings on H.R. 9682 (Revenue Act of 1938) before the Senate Finance Committee (Part 1), 75th Cong., 3d Sess. 11, 15-16 (1938) (statement of Dr. Roswell Magill, Under Secretary of Treasury).

and even 50s, when the maximum rate ranged from the 70s all the way to the 90s.  

As Stanley Surrey pointed out in the 1950s tax policy hearings led by House Ways and Means Chairman Wilbur Mills, D-Ark., the extreme disparity between top ordinary rates and the alternative 25-percent capital gains rates after the Revenue Act of 1942 first led seemingly inexorably to Congress incrementally bestowing capital gains on additional special interests, starting with timber and then coal and iron royalties, livestock, improved real estate, patents, etc., in the 1940s and 1950s. The political basis for such legislation was the conservative coalition on capital gains, which also defeated or watered down direct and indirect capital gains reforms in the 1960s and 1970s. This coalition consisted of almost all the Republicans and a majority of Southern Democrats, who squared off against the rest of the Democrats. Simplified, perhaps to the point of caricature, the Southern Democrats, particularly in the House, supported a generic preference to take care of timber, livestock, and small business, while Republicans supported it to take care of public stock held by high-income individuals and perhaps some of the Democratic-favored interest groups as well, particularly timber, in the case of southern Republicans.

4. Suggested capital gains preference for the small income. Given that, on the average, capital gains realized by taxpayers below the 31-percent bracket are less than the rate of inflation for the period the capital asset was held, and that, on the average, perhaps 50 percent of the gain realized by taxpayers above the 28-percent rate exceeds the rate of inflation (rising to 80 percent at the top brackets), a flat 28-percent rate providing no capital gains preference at all to those taxed below that rate is inequitable, just as the Democrats acknowledged in 1934. A flat exclusion, say 30 percent, still benefits high-income individuals with 60 percent to 70 percent of the gains inequitably, because lower-rate taxpayers who realize a capital gain (a) by virtue of such rate receive a lesser benefit, and (b) on the average, are taxed totally on inflation gain with no economic gain while higher income taxpayers, on the average, enjoy a 50-percent economic gain (rising to 80 percent at the very top, some years).

On the average, in contrast, a “progressive” formula, as the Senate and House passed in 1992 but President Bush vetoed, providing an increasing capital gains rate from zero percent to 28 percent move from the lowest to the highest individual bracket works rough justice at the top and bottom, but less so in the middle. I therefore recommend that Congress pass it again. Rather than the 14-percent and 21-percent rates at the 28-percent and 31-percent brackets, however, I would use the average percentage of inflation gain at these levels as the exclusion percentage. This percentage probably would be 50 percent at the 31-percent bracket and considerably higher at the 28-percent bracket. A progressive formula is preferable to indexing, apart from the distributional effects and out year costs of indexing, because indexing probably would lead to high-income individuals making considerably fewer trades (as they held on to an investment with an economic gain waiting for inflation to catch up), thus at least reducing revenue and possibly a decrease in economic efficiency.

A substantial disadvantage of the progressive rate is its cost — perhaps $8 billion over a five-year window.

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24. President John F. Kennedy and Stanley Surrey unsuccessfully attempted in 1963 to couple an increase in the capital gains exclusion from 50 percent to 70 percent with elimination of the 1940s/50s statutory capital gains add-ons and taxation of unrealized capital appreciation at death. Next the 1969 minimum tax on individual tax preferences, although mostly directed at capital gains (80 percent of the preferences consisted of the then-50-percent long-term capital gains exclusion), was never very effective as long as capital gains were subject to it due to low rates and offsets. The role of the conservative coalition in capital gains legislation and the interest groups represented became evident in the 1970s, with numerous separate votes and debates on capital gains, the impact of the mini-tax's (antece dent to the AMT) on capital gains, and the tax treatment of unrealized capital appreciation at death.
Also, it still provides about one-third of its benefits to individuals at or above the 31-percent bracket, but less than 10 percent to higher brackets. Since the progressive capital gains rate would be so generous at the lower income tax brackets, I would make it elective and carry a toll charge — give up the inflation element of any investment interest incurred while holding the asset or of mortgage interest if gain on a residence were subject to the progressive rate.

Anticipating that Congress will not be too interested in a progressive schedule due to its cost and failure to provide benefits to interest groups sponsored by the Democratic elements of the conservative coalition on capital gains, except for the small woodlot owner and farmer with recurring livestock sales, I would suggest, alternatively, simply excluding the first $3,500 or so of annual capital gain. Similar approaches were proposed by Senator Gaylord Nelson, D-Wis., in the 1970s, the Bush administration in 1989, and Rep. Rostenkowski in 1990 in his middle-income capital gains package. This amount probably does not exceed the average capital gain of the small capital gains realizer. Such gain is likely to be all inflation gain and be nonrecurring at the bottom income tax brackets. This ceiling probably would cover 60 percent of the individuals reporting capital gains, but less than 20 percent of the annual realized gains. This flat exclusion could be phased out across the 31-percent bracket at the cost of simplicity, but would improve distributional aspects even more.

II. SHELTERS, PROGRESSIVITY, COMPLEXITY

A. Congressional Concerns

In the March 17, 1993 continuing House Ways and Means hearing on President Clinton’s economic plan, ABA Section of Taxation Chairman Albert O’Neill testified that “[t]he American Bar Association has strongly supported the fundamental objectives of the 1986 act, and we continue to believe in the benefits to our tax system that flow from the simplicity, efficiency and fairness created by a broad base with lower rates.” He raised the specter of transactional complexity. House Ways and Means Chairman Rostenkowski displayed his true concern by asking O’Neill a different follow-

(Footnote 27 continued.)

Nasar, “Who Paid the Most Taxes in the 80s? The Superrich,” New York Times, Section 3, page 4, col. 1, at col. 2 (Sunday May 31, 1992) (“They paid an average of just 27 percent of their incomes to the Internal Revenue in 1988. In 1977, the earliest year for which Congressional Budget Office data are available, they paid a much heavier 36 percent.”). Moreover, due to depreciation recapture being taxed at 31 percent, twice as many taxpayers earning $200,000 and above would have an increase in income taxes as would have a decrease, and the aggregate increase would be about 150 percent of the aggregate decrease. See Preliminary Distributional Effect, supra. The outyear costs of indexing are reportedly enormous. 138 Cong. Rec. H607 (House Feb. 26, 1992 Daily Ed.) (Remarks of Rep. David Obey, D-Wis.) (“[A]fter five years the long-term costs of that capital gains gift, half of which goes to the super wealthy, will total $300 billion.”); id. at H 615 (House Feb. 26, 1992 Daily Ed.) (Remarks of Rep. Anthony Belenson, D-Cal.) (likely cost about $300 billion over next 20 years).

29The proposed increase in ordinary income rates will create over 12-percent disparity in rates between capital gains and ordinary income at the top end. We believe that this spread will be sufficient to cause high-income taxpayers to spend considerable time once again planning their transactions so as to convert ordinary income into capital gains. The targeted capital gains proposals will obviously exacerbate the situation even more.”

30Chairman Rostenkowski: . . . I just remember the ’86 Act, when we got rid of a lot of these so-called incentives, and I’m not totally against it but I worry about whether or not we’re starting on the road of another — the possibility of us having another run on tax incentives that many of us consider loopholes unnecessary.” March 10, 1993 House Hearings, supra (speaking of proposed temporary investment credit).

The administration shared some of this concern with tax shelters:

Secretary Bentsen: The package includes both tax incentives and public investment expenditures. The tax side of the investment package includes two important provisions for small business, since small businesses are a major source of new jobs.

First, small business will continue to enjoy the permanent investment tax credit that’s introduced in the stimulus package, and second, we propose that investors in small corporations be able to exclude 50 percent of the gain in stocks held more than five years.

This exclusion is carefully targeted to small growth companies and to avoid abuse. Those were cited by the chairman a moment ago. The one concern is we’re not trying to build up a bunch of tax loopholes or shelters in the process.

Id. March 10, 1993. The conservatives opposed the incentives-cum-rate increases as well:

Mr. Crane: Well, the Lord giveth and the Lord taketh away. What happens is you have a tax increase which sucks out money from the system, reduces savings, reduces spending, therefore, reduces unemployment; and therefore, you have military reductions, which in turn reduce the employment in the military, which again increases unemployment. Then on the other hand, to offset that, you have tax incentives for a variety of different businesses, particularly the high-tech businesses on the west coast, and also you have spending programs.

Why don’t you just leave it alone so that you don’t offset one problem with another, which is originally created when you increase the taxes and reduce the military?

Id. March 9, 1993.
up question: what is the effect of the 13-point spread on tax shelter activities?\textsuperscript{31} The response was: not that much, given the continued barrier of the passive activity loss limitations (PAL) of section 469.\textsuperscript{32} President-elect Gordon of the New York State Society of CPAs observed at the same hearing that the bitter aftertaste of the 1980s shelter binge has eliminated much of the demand from passive investors for classic shelters. All of this calls for, however, steadiness on the part of the administration and the tax-writing committee chairs in retaining (a) the narrowness of the new PAL exceptions for real estate people, (b) the limitations on the small-business corporation capital gains preference (particularly subject to one-half of the 50-percent exclusion to the AMT), and (c) increasing individual AMT progressive rates to 26 percent and 28 percent. While some witnesses and Ways and Means members hauled out the hoary chestnut that high rates would cause a run on tax-exempts,\textsuperscript{33} there is a perhaps more real potential for abuse of income conversion through growth corporations, as evidenced by recent anecdotal evidence and hard evidence from the 1960s.\textsuperscript{34}

Also during the March 31, 1993 House Ways and Means hearing on Clinton's economic plan, witnesses representing various small business interests generally spoke in favor of uniform tax increases to be used solely for deficit reduction\textsuperscript{35} and generally in opposition to restoration of preferences and high rates\textsuperscript{36} and, in particular, nickel-and-dime increases on specific industries.\textsuperscript{37} But clearly, their most politically powerful argument was that imposition of high individual rates on income of passthrough entities, such as subchapter S corporations and partnerships, otherwise retained for expansion, would cost jobs,\textsuperscript{38} and the resulting disequilibrium between top C corporation inside rates and top individual rates imposed on passthroughs would recreate transactional complexity in the choice of tax entity for small businesses as well as in financing.\textsuperscript{39} A workable compromise, for passthrough entities at

\textsuperscript{31}"Chairman Rostenkowski. . . You're all aware, of course, that the president vetoed what was incorporated as a tax simplification measure. Are any of you opposed to anything in the tax simplification measure that was introduced and that the president vetoed on the last two occasions? I gathered from most of your testimony that you're interested in tax simplification.

"Mr. O'Neill, you point out in your testimony that the Tax Reform Act of '86 attempted to reduce economic distortions and to eliminate tax sheltering opportunities. As you also recognize, the administration's plan raises individual tax rates but leaves the maximum rate on capital gain at 28 percent, thus creating a significant differential.

"What effect do you really think this will have on tax shelter activities?"

March 17, 1993 House Ways & Means Hearings.

"Well, in the traditional sense of tax shelters, with the other limitations that have already been imposed, including the passive loss limitations, I'm not sure in and of themselves that there will be that much of an impact on what I will call the traditional tax shelters. I think it's very clear that with a spread that we are looking at, that there will be a clear intent and for many taxpayers, complexity will be reintroduced about dealing with transactions, because people will want and will plan their affairs and try to come within the lower capital gains rates. So to the extent you consider a capital gains rate as a shelter, yes, obviously it will have an impact there." See also Emory, "Clinton Tax Plan Will Not Lead to Tax Shelter Mania," 59 Tax Notes 431 (April 19, 1993).

"Treasury Secretary Andrew Mellon raised this argument in favor of a flat 121/2-percent individual capital gains rate in 1921, even though he knew that wasn't all of the story for the fall-off in realizations at the top over the previous five years.

\textsuperscript{34}Rep. Robert Matsui, D-Calif., pointed out that the substantial capital gains rate differential will have other consequences, "for example . . . an effect on the issue of accumulated earnings, because it might be better for public corporations not to issue . . . [dividends] but instead keep the earnings so that it will inflate the value of stocks, so one would get capital gains treatment. . . . I received a call just the other day from an investment banker — an investment counselor from California, who indicated to me that he may. . .[start advising clients to] shift assets from taxable bonds to nontaxable bonds and also high risk, high growth stocks. . . ." March 9, 1993 House Ways and Means Hearing. See also March 31 House Ways and Means Hearing testimony of George Sydnor (High-yield tax-free fund); colloquy between Harry Sullivan and Rep. Nancy Johnson, R-Conn. Rostenkowski's studies indicated that high-income individuals held on the average much lower than average dividend paying stocks. This fits also with the pattern of many high-income individuals churning on the public market.

\textsuperscript{35}March 31 House Ways and Means hearing testimony of Darryl Hartley-Leonard.

\textsuperscript{36}March 31 House Ways and Means hearing testimony of George Sydnor and Harry Sullivan.


\textsuperscript{38}March 31 House Ways and Means hearing testimony of George Sydnor (1.4 million S corporations); Harry Sullivan (sketches 1980s to present equilibrium between corporate and individual top income tax rates); Rep. Mel Hancock, R-Mo. (adopting [without attribution] Mark Mann's 34-percent cap on retained in expansion S corporation earnings with 5.6-percent spread imposed at distribution); March 31 House Ways and Means hearing testimony of Mark Mann. See also March 25 Senate Finance Committee hearing testimony of Michael Boskin, Ph.D.

\textsuperscript{39}March 31 House Ways and Means hearing statements of Rep. Hancock in colloquy with George Sydnor and especially in colloquy with Mark Mann ("[W]ouldn't the incentive be to take all of the money out [of a passthrough entity] . . . even to the extent of borrowing money within the company [with deductible interest] to get his earnings out of there and invest that money in tax-frees and other potential capital gains like the stock market. . .?").
least, derived from the Mann-Hancock proposal is discussed at III.D. below.

B. 1950s-1980s Vertical and Horizontal Disparities

From the 1950s through the 1960s, according to Stanley Surrey, then-assistant secretary of Treasury for tax policy, the principal means by which high-income taxpayers achieved effective rates much lower than the nominal top rates was through the 50-percent capital gains exclusion, or more precisely, the maximum 25-percent alternate rate, followed by interest.\textsuperscript{30} The same pattern held through the early 1970s. By 1983, however, the mix of sheltering deductions had changed, at least for high-income individuals with the lowest effective rates. In 1983, 11 percent of 260,000 high-income taxpayers ($250,000 or more in total positive income (TPI)) achieved effective rates of less than 5 percent of TPI (after 15 years of Congress attempting to curb shelters and assure that high-income individuals paid some minimum tax).\textsuperscript{41} High-income taxpayers with below 5-percent effective rates used the capital gains exclusion and capital losses to offset only 46 percent of TPI. In contrast, they offset 67 percent of TPI with “business losses,” and one-third of those losses were passed through from partnerships principally attributable to improved real estate.\textsuperscript{42} Sixty-four percent of these high-income taxpayers used tax shelters.\textsuperscript{43} This shift was due in part to the backdoor consumption tax ACRS deduction for real estate depreciation, deregulation of lending institutions funding acquisition of real estate and overbuilding driven by speculation, and probably publicity about tax shelters as Congress enacted a series of ineffectual restrictions on tax shelters. I suspect that higher effective rate high-income individuals, say 5-percent to 20-percent effective rate, used the capital gains preference more and tax shelter preferences less.

During the 1980s boom, the greatest increase in source of income among high-income individuals overall was capital gains — a 171-percent increase in capital gains\textsuperscript{44} (largely a consequence of the boom stock market trebling and leveraged buyouts, but also the real estate boom), but only a 100-percent increase in before-tax income overall.\textsuperscript{15} Couple that increase with a cut in their effective rate from 35 percent on the average to the mid to high 20s on the average, while the average income at the lower brackets stagnated or declined even though average hours worked increased and effective rates, taking into account payroll taxes, stayed the same or increased, and you have the major justification in the Clinton campaign for restoration of some progressivity in the code.\textsuperscript{46}

C. 1986 Code: Low Rates and Broad Base

Tax shelters were classically defined in 1975 by the JCT as consisting of (a) deferral of income through

\textsuperscript{40}Hearings on the Subject of Tax Reform (Tax Reform, 1969) before the House Ways and Means Committee (Part 4), 91st Cong., 1st Sess. 1592, 1598-9 (1969) (statement of Assistant Secretary Surrey); United States Treasury Department, Tax Reform Studies and Proposals (Parts 1 and 2), 91st Cong., 1st Sess. 84-6 and 142-5, respectively (Comm. Print 1969).

\textsuperscript{41}By 1983, the effective rate of high-income individuals as a whole was down to 22 percent or so, which was the level only the taxpayers with $1 million income and large capital gains had achieved 20 years earlier when high-income individuals as a class had a 35-percent effective rate. Shelters, lowering the capital gains rate to 20 percent, and the top ordinary rate to 50 percent, thus dropped the effective rate at the top from 35 to 22 percent or so.

\textsuperscript{42}Hearing on High-Income Taxpayers and Related Partnership Tax Issues Before the House Ways and Means Subcommittee on Oversight, 99th Cong., 1st Sess. 7-13 (1985) (Statement of Ronald Pearlman, Assistant Secretary of Treasury for Tax Policy). “In 1983, 51 percent of all losses and only 14 percent of gains . . . came from limited partnerships. . . . [T]hree categories of deductions, namely, interest, depreciation, and mineral exploration expenses, accounted for over 40 percent of all deductions — . . . which include wages and salaries, rents, and taxes . . . . For the sheer magnitude of losses, real estate operators and lessors of buildings dominate all other industries. Although their gross income is about one-third of the total for all partnerships, they account for one-half of the depreciation deductions and 55 percent of the interest expense.” Id. Chicago Law Professor Shaviro makes the interesting and plausible point that the late 1970s had the top of shelters may have been encouraged by the widespread publicity in 1969 and then in 1976 about tax shelters.

\textsuperscript{43}Id. at 7.


\textsuperscript{46}The economic philosophy of this administration is that you make the economy grow by putting more and more wealth into the hands of fewer and fewer people at the top, getting government out of the way, and trusting them to make the right decisions to invest and to create jobs. I believe the way to make our economy grow is to invest in our people — our children's education, our workers' skills, our families' health care — (applause) — our plant and equipment, our best ideas in research and development. They believe that you make an economy grow by putting money first; I believe you make an economy grow in a global economy by putting people first. (Cheers, applause.) You can chart the differences between us by seeing who has won and who has lost, who has been helped and who has gotten hurt while this crowed has run our government over the last twelve years. For 12 years they have rewarded people who cut deals and cut corners, who make money by pushing paper, who make money by investing in new plants, new equipment, new businesses — those who work hard, play by the rules, and pay their taxes. And for the first time since the Roaring '20s, the top 1 percent of the American people now control more wealth than the bottom 90 percent. But while the rich have been winners, no American would have beegrudged them that since we all want in this free enterprise system to at least believe our children might grow up to be rich. No one would have begrudged that if the rest of us had been helped. But in 1980 we had the highest wages in the world. Now we're 13th. The census document itself shows that most Americans are working longer work weeks for lower wages, paying higher taxes on lower income, paying (Footnote continued on next page.)
accelerated deductions based on total cost, (b) leverage or deduction of interest paid in financing the business, and (c) conversion or realization of gain attributable to such ordinary deductions at capital gains rates. Early attempts to curb tax shelters, such as section 1250 recapture of “excess” depreciation as to real estate improvements enacted in 1964, the minitax antecedent to the individual side, and enactment of the PAL limitation on tax-shelter deductions and the “bubble” 33-percent rate on the near rich for distributional equity.

As House Ways and Means Committee member Charles Rangel, D-N.Y., pointed out in the March 31 House Ways and Means hearings, the 1986 code froze in place the late-1970s to early-1980s erosion of progressivity. Senate Finance Committee member Bill Bradley, D-N.J., admitted this earlier and would agree

(Footnote 46 continued.)

a bigger percentage of their income for housing and for health care, and yes, for education. Today the United States Commerce Department issued its report on adjusted figures for 1991 in which it says that in 1991 there was a 2 percent real drop in the incomes of the American people, the first drop since 1982, the worst drop in over 30 years. I will say that again. Inflation was 4.4 percent, incomes went up 2.2 percent, there was a 2 percent decline in the workings — in the earnings of the American people even though they worked more hours than the year before or the decade before. And the average family is actually spending more hours on the job than they were 20 years ago."


Joint Comm. Staff, Overview of Tax Shelters 1 (1975).


"Before 1986, the tax system had grown grossly unfair. The numerous preferences which complicated the code created very wide disparities in the effective tax rates paid by various industries. NAW considers the Tax Reform Act of 1986 to be the most important piece of tax legislation passed in the 47-year history of our organization, because market forces, rather than public policy no matter how skillfully crafted, can best determine investment decisions. ... [T]ax preferences are like drugs, sir. From 1986 to 1991 we had withdrawal trauma. Now, we have learned to live with this, and we have learned to play on a level playing field. If we reintroduce tax preferences, that takes away the underpinnings of the '86 Act and what it was founded upon — and this was low rates with few breaks." and Harry Sullivan ("The Tax Reform Action Coalition was formed in June of 1985 by business associations and corporations which were committed to enacting federal tax reform which would substantially reduce the then existing high statutory individual and corporate tax rates in return for the reduction of preferences in the code. ... The Tax Reform Act of 1986 represented much more than a revamping of the tax code. It represented a victory of principle over special interest, and demonstrated that American policies can work to the benefit of all of the people, not just the chosen few. ... TRAC's unifying glue that holds this together, is that all of these businesses and individuals using their after-tax dollars will make the best market decisions. ... ")

President Clinton's remarks to the U.S. Chamber of Commerce's 1993 National Business Action Rally, Feb. 23, 1993 ("I have offered a plan ... that cuts spending with real specific cuts, not rhetoric about overall caps, with tax increases that I believe are progressive, although none are free of pain. And with targeted, specific investments to grow this economy.").


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with raising the top rates so long as he could agree with the use of the resulting revenues. Therefore, if Congress can now raise the ordinary income tax rates at the top without restoring that much of the old preferences, the liberal element of the bipartisan coalition will rejoin partisan Democrats. Remember, the bipartisan coalition of conservatives favoring low rates, and liberals favoring lower preferences, passed the Tax Reform Act of 1986 for different reasons. The case for increasing the income tax rates at the top without really restoring that much of the old preferences rests on the case for restoring part of the late 1970s to early 1980s erosion of progressivity at the top from 35 percent to the 20s. Essentially that case is that Congress cut the rates at the top in a trickledown experiment that failed; therefore, the old effective rate at the top should be restored. Bill Clinton campaigned for the presidency in part on this argument.

D. Revival of Old-Time Tax Sheltering Unlikely

With a generic capital gains rate of 28 percent and PAL relaxed only as to real estate professionals (with the revenue losses being offset by lengthening the depreciable “life” of commercial real estate improvements — I would prefer using full section 1250 recapture first as discussed below), and the bitter aftertaste of the 1980s tax shelter implosion still lingering, traditional tax shelters will not likely come back in force as the chairman of the ABA Section of Taxation testified in the March 17, 1993 House Ways and Means hearing. I would add, as well, the factors of a 20-percent nationwide vacancy rate in office space and bust in real estate values following the 1980s bubble and attendant inability to obtain bank financing for real estate purchases and construction.

I understand, based on anecdotal evidence from practitioners and government officials, that PAL has effectively curbed the use of tax shelters by passive investors. The proposed loosening of the PAL provisions affects only “real estate professionals,” i.e., “more than half of the personal services the taxpayer performs in a trade or business during the taxable year are in real property trades or businesses in which he materially participates.” The stated reason was the “disadvantage” that real estate professionals under current section 469 may not use “losses arising from the rental of real property . . . to offset income from other aspects of the taxpayer’s real estate business. . . . [O]ther business professionals . . . are allowed to deduct losses from activities in which they materially participate.” I understand from further anecdotal evidence that IRS field agents looking for adjustments under section 469 must perforce focus on real estate professionals or quasi-professionals, since the true passive investors had long ago dropped out, particularly if their capital contributions were called for in annual stages. In any event, Congress passed this provision last year in the vetoed H.R. 4210. Its cost, while not that cheap at $2.2 billion over the five-year revenue window, is to be paid for by lengthening the “depreciable” life for real estate to 40 or so years, which would raise $2.4 billion over the window. This reduces the annual section 168 deduction for real estate from around 3 percent to 2.5 percent per year on a straightline basis. When one considers that the first 1984 Treasury report would have provided under its indexed system a 3-percent deduction for 63 years, this seems unfair. Of course, this Treasury report would at the same time have reduced a real estate owner’s interest deduction by the rate of inflation while increasing the owner’s depreciable basis for inflation (which is why 3 percent for 60 odd years works as long as inflation averages 3 percent or more).

A fairer policy answer, assuming the revenue is there or in conjunction with a less harsh useful life for real estate improvements, would be to tax all real estate section 1231 and perhaps section 1221 “capital gains” of real estate professionals as full ordinary income, at least to the extent of losses so exempted under PAL, i.e., a real estate recapture rule that really works. The logic supporting this linkage of PAL exception and ordinary income upon disposition is manifested by a comparison of (a) the definition in the legislative history of the 1986 act of “material participation,” viz., involvement on a “regular, continuous and substantial basis” with (b) a classic definition of trade or business status barring capital gains treatment contained in Fahren v. Crawford, 161 F.2d 315, 317 (5th Cir. 1947), viz., “Carrying on a business . . . implies an occupational undertaking to which one habitually devotes time, attention, or effort with substantial regularity.”

Alternatively, full recapture under section 1250 of all prior depreciation up to gain should be enacted. The original reason stated in 1964 for limiting depreciation recapture under section 1250 as to improved real estate to the excess of accelerated depreciation over straightline was that real estate was held longer than, for example, machinery, and hence, was more subject to inflation. The truth was the real estate lobby chose this 1964 slap on the wrist while giving up (a) ration-


58 "In Search of Borrowers," The Economist 71 (April 3, 1993) (since peak in 1987, commercial property values have probably halved and so banks have been refusing to accept commercial property as collateral).


alization of useful lives, and (b) the investment tax credit, which personal property had obtained in 1962 as part of a package including full recapture under section 1245 for depreciation taken up to gain realized. Now that an investment tax credit for personal property will not be enacted, real estate and personal property will be treated more alike if a shorter life than proposed by the administration for real estate is obtained. In that event, full recapture under section 1250 on the model of section 1245 with no offsets should apply to all disposals of improved real estate up to depreciation taken even by nonprofessionals if a generic 28-percent capital gains rate applies to section 1231 assets. Compare the 1992 administration proposals. A compromise might be to limit the rate increase to the 36 percent or even the 39.6-percent rate rather than the 41-percent rate at the top with PEP and Pease. Someone active enough in real estate activities to escape PAL should not be able to obtain capital gains treatment (including section 1231) as to improved real estate used in those activities.

E. Implicit Rule of 28

A member of Congress once said that the best thing to come out of the Tax Reform Act of 1986 was the individual AMT rate of then 21 percent, now 24 percent, and hopefully soon a graduated 26 percent to 28 percent. If one doesn't regard it as the single best thing, but as part of a troika, with PAL and repeal of the capital gains preference, that worked to assure that most high-income individual taxpayers would be taxed at much the same effective rate. All other income groups clustered around the mean. High-income taxpayers alone manifested a range from a zero effective rate to just below the top nominal rate, as discussed in II.B. above.

In short, the '86 act effected horizontal equity, not a change in vertical equity. Thus, with an average effective rate at the top in the high 20s, a maximum capital gains rate of 28 percent, a top rate at 28 percent (actually 33 percent with the original bubble rate), and an AMT of 21 percent, most taxpayers at the top would be taxed in the high 20s one way or another. Raising the AMT rate to a two-step graduated rate with a top rate of 28 percent and keeping the generic capital gains rate at 28 percent are further steps towards horizontal equity. The 42-percent or so top ordinary rate, however, will result in some gain in vertical equity, but a cost of some, but perhaps not a major, loss in horizontal equity. This horizontal inequity is an inevitable byproduct of the administration's avowed policy of using the code to implement industrial policy, i.e., growing the economy through marginal incentives.

In this context, the proposed targeted small-business preference must maintain its proposed limitations as well (particularly subjecting one-half of the 50-percent preference to the AMT) or both vertical and horizontal equity will be gravely at risk. If the net proposals increase the high-income effective rate and do not create that much deviation from that effective rate from renewed preferences, liberals in Congress should support the proposed rate increase cum limited preferences. After all, Clinton won a mandate on higher rates at the top, and he always plugged targeted small-business preferences on the stump.

F. Increased Complexity, but Only at the Margin

Complexity in transactional tax planning, i.e., converting services or portfolio income into capital gains, undoubtedly will increase with the reintroduction of a substantial capital gains preference. This seems to be the tax bar's main concern, which is not surprising, since this is the corner of capital transactions on which tax planners are called to provide advice. But transformation of income, perhaps other than through growth stocks, is at the margins in terms of revenue, as Treasury was surprised to discover in the 1960s. My estimates, derived from early 1960s and late 1970s Treasury data, of the likely breakdown of types of capital gains annual income show the reasons why: 45 percent

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public stock, 5 percent close corporations, 25 percent real estate, 15 percent installment sales (mostly businesses and land), 1 or 2 percent livestock, 1 or 2 percent timber and coal royalties, etc. Transactional costs from complexity, in theory, would reduce aggressive capital substantial audit, technical advice, litigation, and ultimately “substantial authority” attention to the conversion areas, should they redevelop rather than focus almost exclusively on real estate as in the past. Section 14206 of H.R. 2141, OBRA 1993, which treats gains from certain ostensible sales of capital assets as ordinary income where the economic substance is indistinguishable from a loan in terms of risk and return, is narrower than the traditional conversion transactions encouraged by a significant differential between top capital and ordinary rates. Such opportunities were first described by then-Special Tax Adviser to Treasury Randolph Paul in 1942 in 1942 Hearings on Revenue Revision Before the House Ways and Means Committee (Part 2), 77th Cong., 2d Sess. 1630-31 (1942), and closely examined by Professor Stanley S. Perr. first in the 1955 Joint Economic Committee Hearings held by Tax Policy Subcommittee Chairman Rep. Wilbur Mills, D-Ark., and then in “Definitional Problems in Capital Gains Taxation,” 69 Harv. L. Rev. 985 (1956), and in the 1959 Tax Revision Compendium.

G. Do Tax Incentives Really Work Anyway?

Chairman Rostenkowski: Well, Dr. Tyson, we wrote a tax bill here that was in the minds of many of us a simplification bill. Do you fill out your own income tax?

Dr. Tyson: No, I have an accountant fill out my income tax.

Chairman Rostenkowski: Well, I read all your suggestions and I’m not suggesting that I disagree with this. But, the fact of the matter is, investment tax credits, capital gains, enterprise zones, are we going to muck up the code at all?

Dr. Tyson: I think what we’re trying to do here is to find a way to use the tax system to encourage those kinds of economic activities which the country most needs right now.

Now, using the tax system in a targeted way does indeed make the tax system more complicated. So, my answer to that would be that we’re trying to strike a balance here between more simplification, which would of course make it easier, and incentives that are targeted.

Chairman Rostenkowski: I don’t want to disagree with that. I think that if we can target areas where we have a slump in the economy or a problem in the industry that we ought to do something like.

But, as I’ve been sitting on this committee, it almost comes into focus that once you give business or the taxpayer a break in an area — like an incentive — there’s no way you can rescind that incentive. I mean, it’s like a sick patient. You know, once you give them all the medicine and they get cured and you send them out of the hospital, they don’t take the medicine anymore.

But, American business starts making this a part of doing business. That’s what I always worry about. I, for one, feel I’d like the private sector to do a lot more. If government, in this committee, we can create an atmosphere where they’re going to do more, once they’re well and active, we can take that away.

It’s always been here, whenever you recommend you’re going to do something for a five-year period, about in the second year, the business community is sitting down there saying, “Well, can you give us another extension for four more years.” Now it’s not five years, it’s nine years.

That’s what worries me about this. I think that it is a bold package. I’ve endorsed it. I just hope that when we eliminate the deficit or curtail our spending, that we’re broad enough to understand that good business, in my opinion, makes investment when the time and climate is right and not because we give them incentives.

March 9, 1993 House Ways and Means Hearing. A witness at the March 25, 1993 Senate hearings pointed out that studies indicate that incentives are not the determinative factor in capital expenditures anyway.

Corporate interest groups rejected a narrow investment tax credit that would give back only a fraction of


66“Muck?” I think the — my experience and some of the studies, particularly some current studies by Professor Kasari at the Washington University of St. Louis, point out that the cost of capital is ordinarily not as big a factor in determining investment as is generally believed.

I think the bigger factors are cash flow or profitability and sales growth.”

Unofficial Transcript of Finance Hearing on Deficit Reduction March 25, 1993 (Statement of S.J. Levy, Chairman, the Jerome Levy Institute, Bard College). Senate Finance Committee Chairman Moynihan, D-N.Y., added anecdotal evidence.

The Chairman. We have respectable anecdotal evidence. . . . When you ask a group of business men what makes them decide to build a plant. . . . The only thing Ira asks is, “Can I sell the damned stuff?” Id.
the revenues from a two-point increase for the top 2,700 corporations with over $10 million in profits.\textsuperscript{67}

III. PROGRESSIVE RATES AND SMALL BUSINESSES

A. The Imbalance Between Inside and Outside Rates

Beginning in the mid-1930s, when Congress enacted (a) the graduated "inside" corporate income tax rate, thereby decoupling the rate for small businesses from the rate for large corporations, and (b) a soon-to-be-repealed tax on undistributed corporate profits, the small-business inside corporate rate was far below the maximum outside rate on individuals. Double taxation was largely a myth, since dividends were rarely paid by close corporations and retained earnings were realized at the shareholder level (if the business was sold before death) in the form of capital gains. These rules, together with the codified General Utilities doctrine (under which a liquidating corporation was not taxed on unrealized capital appreciation as to assets distributed pursuant to the liquidation or sold pursuant to a "timely" liquidation) resulted in less taxation than if the business were conducted directly, as Congress was repeatedly told in hearings.\textsuperscript{68}

In short, the close C corporation has long obtained preferential rates for small (currently up to $50,000 to $75,000) annual profits reinvested in the business. Until 1981, a smaller preference (around 50 percent inside versus 70 percent outside) even was provided for larger incomes. But the Tax Reform Act of 1986 established a new "equilibrium" at higher levels of retained earnings with a maximum permanent inside corporate rate of 34 percent and a maximum permanent outside individual rate of 28 percent.\textsuperscript{69} Actually, it mostly reversed the prior disequilibrium between top corporate and individual rates. With this new imbalance favoring direct taxation of the owner at annual retained income in excess of $100,000, the number of S corporations grew from around 500,000 to 1,500,000 or more\textsuperscript{70} out of 3,500,000 or so active corporations. The proposed increase in individual rates to 36 percent and around 41 percent while the top corporate rate for all but the biggest corporations (2,700 with $10 million in profits) remains at 34 percent would shift the balance back to "growth" C corporations for larger retained earnings.\textsuperscript{71}

B. Politics

The impact of the proposed rate increases on small-business owners is an important political issue. In the 1992 congressional debate on similar rate increases (although starting at considerably higher break points for the 36-percent bracket and millionaire's surtax), Treasury and conservatives claimed that they would bear as much as 70 percent of the burden of the rate increase.\textsuperscript{72}

\textsuperscript{67}Publication 16, Statistics of Income, 1989 Corporate Income Tax Returns, pp. 4, 9, indicates that for 1989 there were 1,422,967 S corporation returns out of 3,627,863 corporate returns, up from 1,257,191 in 1988, 1,127,905 in 1987, and 826,216 in 1986. Thus, by now, there may well be 2 million S corporations.

\textsuperscript{68}March 31 House Ways and Means hearing testimony of Harry Sullivan. "One of the things that we talked about in this double taxation — we start today from a snapshot where there is the top corporate rate is 34; the individual rate is 31. So the corporate rate is three points higher. For many people in the public, as well as some people in the Congress they think it has always been that way. It has only been since 1988 and '87 that the corporate rate was higher than the individual rate. That is how you got away from a little bit of the double taxation. The rate right now, the three-point negative spread, with the corporate higher — it was six — when we did the transition after the '86 Act, it was 1.5 points. The corporate rate was 40; the maximum individual was 38. Pre '86 that differential was four points; where the corporate rate was four points lower. So there has been an equilibrium between Ss and subchapter C corporations and individual rates. We have lived now for six years with that equilibrium or with the new equilibrium — the only time since 1909 that the corporate rate was higher than the individual rate — 1987 on."

\textsuperscript{69}See authorities cited in Lee, supra note 54, at 95 note 141. At the same time, Congress in the Tax Reform Act of 1986 increased the base for the lowest corporate rates (15 percent) from $25,000 to $50,000 in retained income, apparently in response to the complaint of small businesses as to the first 1984 Treasury Report's elimination of the graduated corporate rate. See Birnbaum & Murray, Showdown at Gucci Gulch 80 (1987).

\textsuperscript{70}On the House floor in Winter 1992, members of Congress opposing the House Democrats' proposed rate increase to 35 percent, distorting statistics, argued that 90 percent of the impact of the new high-income rates would fall on small businesses conducted as pass-through entities, i.e., a farm, sole proprietorship, partnership, or a subchapter S corporation. E.g., 138 Cong. Reg. H 449 (House Feb. 19, 1992 Daily Ed.) (Remarks of Rep. McCollum, R-Fla.). This number was far too high, reflecting the percentage of all business enterprises that pass-through entities constituted on a per capita basis, rather than the percentage of total annual reported income of all high-income individuals that small-business people reported (and even then at higher income levels small-business taxpayers may have substantial amounts of investment income). The Senate debate in March 1992 delineated the issue. Treasury (Footnote continued on next page.)
disputed the accuracy of such estimates, and now as Clinton’s Secretary of Treasury, has come up with his own statistics — only 4.2 percent of small-business people will see an ordinary income rate increase. Based on

(footnote 72 continued)

and Senate Republicans claimed that “approximately 70 percent of those who would have been affected by the tax rate increases proposed by Congress in the failed tax reform package are farmers and those in sole proprietorships, S corporations, and partnerships. More than $40 billion in revenue would have come from higher taxation of S corporations alone . . .” Speech by Assistant Treasury Secretary for Tax Policy Fred T. Goldberg Jr., former Commissioner, speaking at the Tax Executives Institute’s midyear conference March 30, 1991, in Washington, D.C., quoted in Zeidner, “Goldberg Says Tax Increases Hurt Small Businesses, Stall Job Creation,” 92 Tax Notes Today 69-1; accord, 138 Cong. Rec. S3270 (Senate March 11, 1992 Daily Ed.) (Remarks of Senator Dominici, R-N.M.) (60 to 65 percent of the tax increase will be added to returns with small-business income). The S corporation “share” thus would have constituted about 42 percent of the total increase.

Chairman Bentsen correctly criticized Treasury’s 70 percent as counting every partner in 1985 as a small-business person (as contrasted with professionals whom many members of Congress no longer regard as favored small businesses) and profitable partnerships probably are concentrated in the professions as well (accountants and attorneys) and in stock brokerage houses — and very few solo proprietors or individual farmers come within the high income categories. Similarly, S corporations, particularly those formed after 1987, include many professional corporations. See 138 Cong. Rec. S3281 (Senate March 11, 1992 Daily Ed.) (Remarks of Chairman Bentsen) (“What the administration has done is most misleading. Roughly two-thirds of those affected by the new fourth bracket are small business. What they did is include all taxpayers who reported income from sole proprietorships, S corporations, farms, and partnerships. The last two categories contain many taxpayers with net business losses, including many tax shelters. So I do not believe that is a representative statement. The way the administration put the numbers together I think brings about a situation which is not representative.”); id. at S3652 (Senate March 13, 1992 Daily Ed.) (Remarks of Chairman Bentsen); id. at S 4009, S 4020 (Senate March 20, 1992 (Remarks of Chairman Bentsen in Conference Debate).

Mr. Bentsen. Well, this plan is definitely pro-small business. We heard some arguments last year. And I pointed out to many Senators who were inaccurately using numbers. I am even more familiar with these numbers now for this last year. We have them for the last year from Treasury. So let’s present the data.

First of all, it is unreasonable to assume that every person with more than one dollar of business income on their return is a small-business person. Second, only a small percentage of small-business owners are affected.

To determine if the taxpayer is a bona fide small-business person, it is reasonable to look only at those taxpayers who had active business income that exceeded their wage income.

And of the nearly seven million taxpayers with business income in excess of their wages, only 300,000 or 4.2 percent would face higher marginal rates.

February 24, 1993 Senate Finance Committee Hearing. These computations apparently underestimate small-business taxpayers who draw out most of the corporate profit as compensation in either a C or S corporation.

widely cited unofficial estimates by a private firm providing financial planning for high-income taxpayers, it seems that small-business people make up approximately 16 percent of taxpayers at the 31-percent bracket, 20 percent or so at the $250,000 surtax level, and somewhere in between for the 36-percent bracket. I suspect that these percentages are close to the actual burden of the individual rate increases on small-business people. Moreover, at the higher income levels, half of the income is from passive sources — interest, dividends, and capital gains.

Footnote 72 continued

"Although the article states that the top 1 percent are retired, they would not have to be. At the $1 million level, medical professionals accounted for 9 percent and attorneys for 8 percent. Id. And regarding households in 1991 with incomes over $75,000 or net worth over $300,000 including primary residence: 26 percent were corporate executives or managers; 16 percent were business owners; 9 percent were technical specialists; 4 percent were physicians; 3 percent were accountants; and 3 percent were attorneys. Cooper and Friedman, ‘The Rich in America,’ U.S. News & World Report 34, 35 (Nov. 18, 1991). A New York Times article reprinted in the Congressional Record during this debate stated that most of the top high-income taxpayers probably were small-business people and CEOs of large corporations, but half of their income came from investment income including capital gains. Nasar, "Even Among the Well-Off, the Richest Get Richer," The New York Times, D-1, col. 2, at D-24, cols. 3-4 (Thursday March 5, 1992) (majority of top 20 percent probably own closely held businesses or manage Fortune 500 companies; wealthy get half of their income from investments which surged in the 1980s; "the early 1990s have already clipped the wings of a lot of high-fliers as corporations have shed executives, law firms have down-sized, businesses have failed, and real estate values have collapsed."); reprinted in 138 Cong. Rec. S3276, S3918 (Senate March 11 and 19, 1992, respectively Daily Ed.). And I might add the LBO mania had abated. In short, the speculative boom has collapsed. The average family income of the top 1 percent declined to roughly $350,000 in 1991 from $410,000 in 1989. Fisher, supra at 42-3. Indeed, the top 1 percent had peaked at average income of $617,000 earlier in 1988, Cooper and Friedman, supra at 34-5, before the leveraged buyout wave had ebbed. This post-boom trend at the top income level probably bodes ill for the revenue projections from the individual rate increases at the top."

TAX NOTES, June 7, 1993
C. Inside and Outside Disparities Before

In the 1930s and again in the 1960s, populist members of Congress criticized the lower inside subchapter C rates on smaller amounts of retained income in comparison to the higher individual rates applicable to partnership earnings. Both times, the answer from Treasury was the same: such small-business people should incorporate. And they did so under the 1954 code, as the number of close corporations grew from several hundred thousand to several million, almost half of which are S corporations under the 1986 code.

D. The Mann-Hancock Proposal

Mark Mann, a Chicago tax accountant representing closely held businesses, proposed at the March 31, 1993 House Ways and Means hearings that a “materially participating” entrepreneur’s annual share of income retained by a passthrough entity (partnership or S corporation), otherwise taxable at higher than the 31-percent rate, be currently taxed instead of at the entrepreneur’s level at the maximum corporate rate of 34 percent (up to $10 million of income) with an additional (deferred) tax of 5.6 percent (39.6 percent — 34 percent) triggered by distribution of this previously taxed but not distributed income. Obviously, having read Mann’s hearing statement beforehand, Rep. Mel Hancock, R-Mo., who “happen[s] to have a subchapter S corporation in the private world,” questioned several witnesses at the March 21, 1993 House hearing as to the advisability of taxing an S corporation shareholder on his share of income left in the company “at the corporate rate until such time as he takes it out, maybe five years later. Then he would pay the higher individual tax rate. [in excess of the 34 percent already paid].” Rep. Hancock explained that “the tax code should be an incentive for him to leave money in the company and expand his company.”

The Mann/Hancock proposal certainly would be an answer to the rhetoric that the proposed individual rate increases at the top would bear too heavily on small business. It also would clearly tax “capital” reinvested in the passthrough entity lighter than labor (although at the $140,000 taxable family income level and certainly at the $250,000 level, that fact begins to lose its populist appeal). The Mann/Hancock proposal is, in my eyes, therefore, preferable only to (a) scrapping the individual rate increases at the top altogether, or (b) more likely winning over the conservative coalition (particularly on the Senate side) by coupling with the rate increases a substantial individual generic capital gains cut. It thus may be a “second best” solution.

Serious consideration of this next logical step in schedular income\(^76\) would require addressing a number of issues. Would amounts taxed at 34 percent be subject to the higher tax at the shareholder/partner’s death? If so, Congress might want to forgive the deferred tax if the family member inheriting the interest continues in the business for a specified period of, say, five or eight years. And, by the way, what would the deferred tax be? The rate that would have applied in the year deferred? (With PEP and Pease?) Or simply the maximum rates at the time of distribution notwithstanding bunching? I lean toward the latter, for ease of administration and as a little toll charge for the deferral. Also, it is likely that the deferred amounts won’t be withdrawn but, rather, the business will be sold first. At least the deferred amounts should be “recaptured” at 39.6 percent, etc., upon a sale. Indeed, arguably, none of the gain on the sale should be afforded generic capital gains treatment as a further toll charge for deferral. Should nonrecognition transfers of the stock or partnership interest as by gift or merger continue the deferral? I think not, since the assignment of income doctrine would be vitiated as to such transfers. Congress chose, however, the opposite path in 1962 in section 1250, despite Treasury’s desire for gifts to trigger recapture.

Even more difficult would be fashioning the rules for which subchapter S or partnership small businesses should qualify, and especially what the retained entity income must be invested in. The first cut as to qualifying businesses would be to adopt the standards of excluded businesses and corporations under the proposed targeted small business capital gain. Similarly, investments of retained passthrough entity income in stock or in real estate should be limited. But the more difficult areas would be avoiding the trouble spots of the current accumulated earnings tax. For example, reserves for future expansion should not qualify. An alternative would be to allow the deferral in year one for amounts “held” in such a reserve, but reopen year one if expansion does not occur (or perhaps begin) within a specified period such as three years. Loans to the shareholder/partner or related parties should be treated as distributions.

Mann asked in his hearing statement, but not in his actual testimony, for both the “corporate rate” on retained passthrough earnings and targeted small business capital gains for S corporations. This front end and back end preference is not justified.

If Congress continues to provide graduated inside taxation of close C corporations, targeted capital gains might be defensible (although there is both a front and back end preference). But the ideal would be mandatory passthrough of close C corporation income for taxation purposes coupled with a 34-percent rate on retained income reinvested in expansion with the deferred tax upon distribution/sale, etc. The billion or so dollar annual subsidy in the graduated close C corporation rates would go a long way to paying for the lost/deferred revenues from using the 34-percent rate rather than the 36-percent/millionaire’s surtax, PEP, and Pease as to qualified accumulations. This would favor the larger small-business owner at the expense of the smaller owner, but there is no sound tax policy for the graduated inside close C corporation rate when the owners materially participate. See my testimony at the Tax Treatment of Master Limited Partnerships Hearing before the House Ways and Means Subcommittee on Select Revenue Measures, 100th Cong., 1st

\(^76\) I am not in principle opposed to schedular income; in theory, it should facilitate dividing and conquering special interest groups.

IV. SMALL-BUSINESS CAPITAL GAINS CUT

President Clinton campaigned on, among numerous other promises, a targeted small business tax cut. The proposed targeted small business capital gains cut of a 50-percent exclusion (maximum income tax rate of 14 percent) of gain realized upon the sale or exchange of qualified small business stock held for five years or more constitutes a paradigm Clinton tax provision: (1) it is relatively inexpensive even assuming that it does attract outside capital so that it is a “leveraged” provision; (2) if it works, more jobs will be created since most new jobs currently are provided by small businesses; (3) favoring small businesses over big businesses is consistent with Clinton’s populism; and (4) consistent with the president’s pattern of promoting the ideas of others, the provision was originated by Senator Dale Bumpers, D-Ark., a long-time political ally of the president.

A. ‘Sunset’ Provision

Distributionally, the proposed targeted capital gains cut to a 14-percent maximum rate after a five-year holding period for sales of qualified small business

corporation stock would be the worst of any recent capital gains proposal, since the average income of small-business people is much higher than the average income of those realizing capital gains in general and virtually no low-income individuals own stock in small business corporations. But the proposal probably would have minimal effect on the effective rate at the top unless it succeeded beyond the wildest dreams of Senator Bumpers to attract outside capital. If it did, the benefits probably would trickle down in the form of new jobs. So, like then-Senate, now Finance Committee Chairman, Moynihan in the 1978 debate over increasing the generic preference to open up capital for start-ups, I might be willing to try a targeted small business gain. But I suspect it would most likely turn out to be a subsidy to people starting new mom and pop high-techs (more machine tool companies than Silicon Valley start-ups) anyway, rather than an incentive that actually attracts outside capital (now any noncommercial financing is from the “entrepreneur,” family, and friends). My guess is the primary effect of the small business provision would be psychological — see how the administration likes small businesses — and in the real world, easing the credit crunch as the president is doing will have much more effect. Therefore, this time the experiment should have a sunset provision. Only such a provision will answer Chairman Rostenkowski’s fear (expressed in the context of the investment tax credit) that Clinton’s tax proposal will result in a subsidy after the need for a remedial incentive has passed and the plea of John White, Ph.D., testifying at the March 25, 1993 Senate

B. How Big Is Small?

As far as size goes, the real dividing line between large and small corporations is probably $100 million adjusted basis in assets (at least when the economy is booming). In 1988, the 5,000 corporations with assets of $250 million or more held 80 percent of corporate assets and earned 74 percent of corporate income after NOL deductions. Adding the next set of 5,000 corporations (assets from $100 million to $250 million) raised the asset totals only to 84 percent and income to 79 percent after NOLs. The numbers for 1989 are similar. Already, the administration has raised the threshold from $25 to $50 million in assets.

C. Coverage of S Corporations

The more important issue is whether to cover S corporations. Currently, they constitute almost half of all small or close corporations and earn probably half of the income at this level. Not covering them would make the choice of tax entity for new ventures very complex. Reversal of the trend to passthrough entities would increase substantially since most of the corporate tax problems in operation arise from small businesses conducted as C corporations closely audited, and are unlikely to turn that decision on the potential costs would increase substantially since most of the corporate tax problems in operation arise from small businesses carried on as C corporations: constructive dividends, unreasonable compensation, redemptions, accumulated earnings, etc. See my testimony at the Tax Treatment of Master Limited Partnerships Hearings before the House Ways and Means Subcommittee on Select Revenue Measures, 100th Cong., 1st Sess. 343-50 (1987). See also Va. Tax Rev. 57, 107-08 (1988).

On the other hand, due to the preclusion of partnerships owning S corporation stock as well as the ceiling on number of owners, it is unlikely that outside high-income individuals will invest heavily in S corporations (particularly when its income will be taxed at as high as the low 40s to them). Thus, extension of a capital gains preference to S corporations would be even more of a subsidy to entrepreneurs who likely would have gone into business for themselves anyway and are unlikely to turn that decision on the potential of a pot of gold capital gains reward 10 to 20 years down the road. Cutting against this assumption are the comments by members of Congress across the 1970s through the early 1990s that most of their small business constituents are most interested in a capital gains preference for their closely held stock. If the individual shareholder's share of S corporation income is subjected to the highest individual rates, allowing a back end small business capital gain politically strengthens the rate increase.

D. Thwarting the Conservative Coalition

Former Commissioner of Internal Revenue Mortimer Caplin and the former Assistant Treasury Secretary for Tax Policy, Roger Metz, observed at the November 1992 Virginia Tax Study Group meeting at the University of Virginia School of Law that President Clinton might propose a targeted small business capital preference (as he has), but Congress would likely pass a generic preference. This conventional wisdom roughly reflects the experience in the House of Presidents Kennedy and Carter in 1963 and 1978, respectively, and Chairman Rostenkowski in 1989. Once a limited capital proposal was on the table, conservative (primarily Southern) Democrats joined with Republicans to vote for a generic preference. Until the filibuster by Senate Republicans against President Clinton's economic plan, I predicted that the conservative coalition on capital gains would not arise this time, primarily due to high lost revenue cost of a generic capital gains preference over a five-year budget period, which must be paid for under the OBRA 1990 operating rules. In the 1989/1992 debate, the projected revenue loss of the various generic cuts proposed by the Bush administration ranged over five years from about $12 billion to $24 billion using JCT figures. The proposed small business capital gains cut would cost only $700 million and change over the five-year window. Second, President Clinton campaigned hard against a generic capital gains cut and there already has been growing party solidarity on capital gains and rate increases from 1990 on, particularly in the House. This partisanship is reflected in the recent administration victory in the House on the budget resolution. For comparable party solidarity in tax matters, you have to go back to the first part of the Roosevelt Era, when FDR could more or less obtain party solidarity until 1937, but wasn't really serious about federal income taxation until this power had begun to fray. President Clinton clearly does not have the same majority in the Senate

My estimate is based on the 1988 Corporate Statistics of Income data showing that S corporations earned almost 10 percent of corporate income and the big 10,000 corporations earned almost 80 percent, adjusted upward for the continued growth in the number of S corporations.

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as in the House, but almost the same party solidarity. This party solidarity more recently has more than frayed at the edges.

Notwithstanding President Clinton's probable ability to obtain enactment of a freestanding small-business capital gains cut, I recommend steps to thwart a future expansion to a generic capital gains cut.

Notwithstanding President Clinton's probable ability to obtain enactment of a freestanding small-business capital gains cut, I recommend steps to thwart a future expansion of this provision into a generic capital gains cut. In 1992, some Republicans talked of coming back another day to fashion a generic cut if a targeted small-business cut were enacted. Coupling with a targeted small-business provision a progressive generic cut, as the Senate and the Conference Committee did in 1992, just might attract enough Southern Democrats, due to the benefits under a progressive rate for recurring livestock sales by farmers as well as some of the timber royalty taxpayers with low cash income, if such benefits were so explained to the Southern Democrats (and if the interests they champion are truly the only ones they really want to champion). I would advocate a progressive capital gains rate structure for the reasons stated at I.B.4. above. Indeed, it and the annual $3,500 exclusion are the only capital gains provisions I personally would support in the abstract and, of course, in the alternative. To really split the current conservative coalition and keep it split, couple those measures with a small-business provision and a capital gains preference for timber and livestock only.

E. Section 1244 Deductions

Some of the small business corporations invested in by a pooled fund for high-income individuals might qualify under section 1244 so that $100,000 in losses will be ordinary. Since the cap on "smallness" here is $1 million, section 1244(c)(3)(A), the overlap may not be substantial. Nevertheless, the question arises as to whether such a pooled fund partnership should be able to pass through its section 1244 ordinary losses.

F. Sale of Mom-and-Pop Businesses

I understand from repeated conversations with Virginia tax practitioners at local tax conferences over the past five years or so that the almost universal pattern of sales of closely held corporate businesses is an asset sale by the target corporation (often on the installment basis) followed by a liquidation of the target. While the Bumpers bill spoke of a sale or exchange and a section 331 liquidation is treated as a sale at the shareholder level, the legislative history should provide that the active business test is applied immediately prior to the sale where the liquidation timely occurs thereafter. Congress might use the 1954 code section 337 12-month test.

G. Passive and Tainted Business Exceptions

The legislative history should spell out the rationales for the exclusion of service, financial, real estate, farming, mineral extraction, and hospitality businesses from the proposed targeted capital gains. At first blush, the approach seems by-and-large a rationalization or perhaps mechanization of the old passive income tests for personal holding companies. More likely, the common element is upfront preferences, primarily in the form of accelerated depreciation/amortization (real estate, mineral extraction, hospitality and, perhaps, farming), simplified accounting rules (small farms and service businesses), or low effective rates in general due to various preferences (financial institutions, particularly banks and insurance companies). Under the latter rationale, a targeted capital gains preference upon disposition plus up-front preferences would constitute a "double hit" in the words of then-Senate Finance Committee Chairman Bentsen (commenting on the exclusion of depreciable assets from the Bush administration's 1989 proposed capital gains preference).

H. Size of Preference Limitations

The 10:1 and $1 million gain restrictions, together with the inclusion of half the small business preference in the AMT base (for a 21-percent maximum gain), are all necessary to prevent horizontal disparity from arising should pooled fund investments in small business flourish. In other words, without these limitations, a substantial number of high-income individuals might be able to achieve effective rates in the high teens, far below the proposed 28-percent AMT rate. This would bring back part of the horizontal and vertical inequities of the 1954 code. These limitations should be sticking points for the administration. AMT is particularly vulnerable to a small-business carve-out, as demonstrated by the House conservative coalition in 1978 and House Republicans in 1992. But if the preference is not subject

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85In the late 1950s, only livestock and, to a lesser degree, timber were heavily realized by then-middle-income families. Hearings on the Revenue Act of 1963 Before the Senate Finance Committee (Part 1), 88th Cong., 1st Sess. 197 (1963). And such types of capital gains made up less than 9 percent of all capital gains — mostly livestock rather than royalties. In 1973 and 1977, timber gains amounted to .6 percent and 1.2 percent, and livestock amounted to .4 percent and .5 percent of all capital gains realizations, respectively (but no distributional effects were provided). Treasury, Report to Congress on the Capital Gains Tax Reductions of 1978 (Sept. 1985). Obviously, we need more recent data on this and many other factual statements or assumptions in text and footnotes.
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to the AMT, old vertical and horizontal disparities would reappear if the pooled funds/outside capital approach is successful.

V. DEATHTIME TAXATION OF APPRECIATION

I believe (and judging from the literature, it is probably the majority academic view) that ideal tax rules would provide for annual accrual of public stock gain and loss, preferably coupled with some sort of passthrough integration of corporate and shareholder taxes, and taxation at death of other unrealized capital appreciation and perhaps carryover basis for closely held businesses and farms with a step up if the enterprise is continued by the family for five years. Indexing of the basis of capital and depreciable assets and of debt completes the ideal package. History suggests, however, that enactment of these rules is not politically feasible. Moreover, I fear that a serious attempt to institute taxation at death of unrealized capital appreciation would result at least in the conservative coalition broadening the capital gains preference to a generic one. It appears that half of the appreciation in public stock obtains a stepped up basis at death. A taxation at death rule would probably raise revenue more by unblocking those sales by older taxpayers than by deemed sales at death. My further guess is that the conservative coalition could block a combination of both the proposed rate increases and taxation of capital gains at death. The likely result would be generic capital gains linked with one or the other. The net result would probably be the same progressivity as at present, say 28 percent at the top. The proposed rate increase with only a targeted capital gain preference and a largely intact PAL should raise the effective rate two or three points. Therefore, I would not open that Pandora's box. But if I did, I would adapt Senator Kennedy's 1976 and 1981 proposals to carve out small businesses and farms (with a $1 million or so cap) to deflect the inevitable arguments that taxation of unrealized capital appreciation at death would fall heaviest on holders of public stock. The best approach here, and which I would favor beyond tongue-in-cheek, would be carryover basis for family owned enterprises with step up to date of death value if a member of the family materially participates in the enterprise for a specified period after the decedent's death, much like the special farm use valuation provisions of section 2032A.