Critique of Current Congressional Capital Gains Contentions

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CRITIQUE OF CURRENT CONGRESSIONAL CAPITAL GAINS CONTENTIONS

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I. INTRODUCTION

Current House Ways and Means Committee Chair Bill Archer, R-Tex., while a minority member of the House Ways and Means Committee, sponsored income tax cuts for capital gains in 1978 and 1989. These tax cuts would have been brought about by indexing the basis of capital assets for inflation, either in conjunction with, or in lieu of, an exclusion of part of the gain realized upon a sale or exchange. Both proposals were passed by the then Democratic-controlled House, but were not passed by the Senate, and the proposals died in Conference. Recent Senate Finance Committee Chair Bob Packwood, R-Ore., when Chair in 1986, ended the 60% exclusion for long-term capital gains to partially pay for bringing the top permanent individual tax rate down from 50% to 28%. A 28% rate was also adopted as the top individual rate for capital gains.

The Republican administration under President Bush attempted unsuccessfully from 1989 through 1992 to cut the individual capital gains rate without raising the individual rate on ordinary income. Congress held hearings on and debated capital gains in 1989 and 1990. Congress, with President George Bush's acquiescence, raised the top individual permanent rate on ordinary income to 31% in 1990, while maintaining the 28% ceiling on capital gains. This had the effect of restoring a capital gains preference at that rate, but limited only to individuals. In 1993, Congress, at the behest of

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1 See infra notes 7 and 8.
3 Jane Gravelle, Capital Gains Tax Issues and Proposals: An Overview, 95 Tax Notes Today 61-26 (Mar. 29, 1995). President George Bush proposed: a top individual capital gains rate of 15% on selected capital assets in 1989; in 1990, a 30% exclusion on all capital assets, except collectibles, resulting in a top rate of 19.6%; a 30% exclusion in 1991, on which no action was taken; and a 45% exclusion in 1992.
Democratic President Bill Clinton, in effect added additional individual ordinary income rates of 36% and 39.6%. This substantially increased the capital gains preference for individuals at the rates above the 28% capital gains rate, which again was not disturbed.

In 1994, Republican candidates in the House campaigned on the platform of a “Contract with America,” which called for cutting capital gains taxes in half. In the 1994 elections, Republicans gained control of the House for the first time since 1954, and of the Senate for the second time since 1954. House and Senate Committees held extensive hearings in January, February, and March of 1995, on capital gains rates, indexing the basis of capital assets for inflation, and related topics (the “1995 Hearings”). The Contract with America Tax Relief Act of 1995 (“CWATRA”), introduced as H.R. 1215, passed along partisan lines in the House of Representatives on April 5, 1995, as Title VI of H.R. 1327, the Tax Fairness and Deficit Reduction Act of 1995.

After sketching the CWATRA capital gains provisions, this article examines the arguments on capital gains cuts which emerged in these hearings and House floor debates, most of which had been aired in earlier hearings and debates. Except for the last two categories of arguments in favor of capital gains cuts discussed below, all of the arguments reappeared in the House Ways and Means

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Committee Report on CWATRA.

A principal underlying thesis of this article is that the proposed 50% exclusion of capital gains would produce inequitable results, because the annual capital gains realizations enjoyed by the top 1% of families are, on average, more than 50% real or economic gains. For these families, such an exclusion would lower their effective rate of Federal taxation on realized income to the level of the effective rates of moderate income families. The effective rate created by the exclusion would be considerably lower than other high income families without capital gains, thus violating the principles of horizontal and vertical equity.

Conversely, the capital gains reported by the bottom 95% of families are, on average, all inflationary gains; a 50% exclusion is therefore not generous enough for them. The proposed inflation adjustment would avoid these inequities, but would induce high income families to avoid realization to a greater degree than the practice under current law, thus reducing revenues. Moreover, the traditional interest groups supporting capital gains preferences do not advocate indexing, because they either have little or no basis or do much better than inflation. Thus, if indexing were adopted alone, political pressure would likely arise quickly to replace indexing with a 50% exclusion, which could be done after a few years with no revenue loss.

There are many solutions that avoid most or all of the above problems, but none has sufficient support for enactment in the current political climate. Consequently, the current 28% ceiling on individual capital gains should be maintained and no further preference should be given at the current time.

II. OVERVIEW OF CONTENTIONS OF CAPITAL GAINS PROONENTS

In the 1995 Hearings, proponents of the capital gains cuts in the Republican Contract with America steadfastly maintained that a generic capital gains cut (some added indexing) is necessary either to unlock frozen capital assets for investment in starting up or expanding young businesses, or to reward the entrepreneur and investors for the greater risk of new ventures. They also asserted that most capital gains, particularly in small businesses, farms, and residences, are due to inflation; fairness, they concluded, therefore requires indexing.

Proponents claimed that most capital gains are realized by mid-
Middle income taxpayers, some of whom are pushed into high income status in a single tax year by the once-in-a-lifetime realization of gain which has accrued over a number of years, as in the case of a retirement sale of a small business, farm, or residence. They also made the claim that studies of the distribution of benefits of a capital gain cut are misleading, since substantial economic mobility in the United States makes it possible for an individual classified as lower income to achieve higher income status in a decade. In any event, they contended that capital gains cuts leading to economic growth benefit all Americans.

Moreover, proponents argued that a generic capital gains cut would pay for itself by unblocking frozen sales, by building the economy through greater efficiency in investments, and by supplying additional investment capital through reductions in capital gains taxes. Proponents claimed that a reduction in capital gains taxation, by increasing the rate of return on savings, would increase savings. Some proponents reasoned that international competition made a capital gains cut necessary, since our trade competitors have little or no capital gains tax or, in rare instances, index for inflation. A minor theme was that a capital gains preference was necessary to offset double or greater taxation of investments, particularly in corporate equities.

This article concludes that all of these contentions are in error, in whole or in part. To the extent they are meritorious as a policy matter, the problems they address should be remedied by provisions other than those currently before Congress.

III. H.R. 1215: CONTRACT WITH AMERICA TAX REDUCTION ACT ("CWATRA")

A. 50% Capital Gains Deduction

As introduced, H.R. 9, the Job Creation and Wage Enhancement Act of 1995, would have allowed all taxpayers, both individual and corporate, a deduction equal to 50% of net capital gain for the taxable year. It would also have repealed the maximum rate of 28% for non-corporate taxpayers ("individuals") under present law.¹⁰

¹⁰ Staff of Joint Comm. on Taxation, 104th Cong., 1st Sess., Tax Treatment of Capital Gains and Losses (Comm. Print 1995) (hereinafter Capital Gains and Losses 1995); see also Joint Comm. on Taxation, 104th Cong., 1st Sess., Description of the “Contract With
Thus, the effective rate on the net capital gain of an individual in the highest rate bracket would be 19.8%, and the effective rate for a corporation in the 35% bracket would have been 17.5%. H.R. 1215's Contract With America Tax Reduction Act ("CWATRA") modifications would continue to provide this 50% exclusion for individuals,\(^{11}\) and would further provide an alternative tax of 25% on the net capital gain of a corporation, if that rate is less than the corporation's regular tax rate.\(^{12}\) The 50% individual exclusion would apply to taxable years ending after December 31, 1994.\(^{13}\)

CWATRA would repeal section 1202, enacted by the Omnibus Revenue Reconciliation Act of 1993, which provides a 50% capital gain exclusion (against the existing 28% maximum individual capital gains rate) for sales of certain small business stock held for at least five years.\(^{14}\) A taxpayer holding small business stock on the date of enactment could elect, within one year from such date, to have the current section 1202 apply, rather than the CWATRA provision, to any gain from the sale of such stock.\(^{16}\) The election could result in a lower rate: since the 50% exclusion after five years is against 28% rather than the top ordinary rate, half of such exclusion is a tax preference item.

In response to criticisms raised in the hearings over including collectibles in the 50% exclusion, CWATRA would make collectibles ineligible for the 50% net capital gain exclusion;\(^{18}\) however, an individual could elect to apply a maximum rate of 28% to the net capital gain attributable to collectibles, in which case "indexing" would not apply.\(^{17}\) Otherwise, the individual maximum

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12 CWATRA, supra note 11, at § 6311 (amending § 1201(a)).

13 Id. at § 6301(c)(1).

14 Id. at § 6301(d)(1)(A). Section 1202 is described infra note 50.

15 Id. at § 6301(d)(1)(B).

16 See Unofficial Transcript of W&M 'Contract' Hearing (Jan. 10, 1995), available in 95 Tax Notes Today 12-76 (Jan. 19, 1995) (hereinafter Ways & Means Hearing, Jan. 10, 1995). Rep. Charles Rangel, D-N.Y., in referring to the application of the H.R. 9 capital gains provisions to collectibles, which included baseball cards, stated that he was there to work with the majority to make the right corrections: "We don't want people to laugh at this contract."

17 CWATRA, supra note 11, at § 6301(a) (providing for new § 1202(d)).
28% capital gains rate would be repealed.

CWATRA would reinstate the rule applied prior to the Tax Reform Act of 1986, requiring that two dollars of an individual's long-term capital loss offset one dollar of ordinary income. This resurrected capital loss rule would not apply to losses arising in taxable years beginning before January 1, 1996. The $3,000 limitation for individual taxpayers under section 1211(b) on the deduction of capital losses against ordinary income would continue to apply. The capital gains deduction would not be treated as a tax preference item for purposes of the alternative minimum tax. (Historically, the capital gains exclusion accounted for 80% of individual tax preference items.) Moreover, unlike the 1989 provision passed by the House and both the 1990 and 1991 Bush proposals, real estate depreciation would not be recaptured.

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18 Id. at § 6301(d)(13)(A) (amending § 1211(b)(2)).
19 Id. at § 6301(f)(3).
22 In the past, depreciation recapture for improved real estate was limited to the excess of accelerated depreciation over straight line. I.R.C. § 1250. The stated rationale was that the longer (useful) life of real estate and, hence, the greater impact of inflation, required more liberal treatment than the recapture of all depreciation, as required for personal property under § 1245. S. Rep. No. 830, 88th Cong., 2d Sess. 132 (1964), reprinted in 1964 U.S.C.C.A.N. 22; H.R. Rep. No. 1447, 87th Cong., 2d Sess. 67 (1962). Were this valid, the current absence of accelerated depreciation for real estate under §§ 168(b)(3)(A) and (B) would justify no recapture, as is the case in CWATRA. The reality behind the 1964-1986 excess rule was, however, the political clout of the real estate lobby, especially with the
B. Indexing of Basis for Inflation

CWATRA also would provide for an inflation adjustment to (i.e., indexing of) the basis of certain assets ("indexed assets"), for purposes of determining gain upon a sale or other disposition of such assets held by individuals and pass-through entities, but not by C corporations. H.R. 9 had originally provided for indexing of corporate held assets, which could have created a deductible loss. At House Ways and Means Hearings, Rep. Sander Levin, D-Mich., queried whether the Republican majority was serious about this provision; apparently it was not, as evidenced by the deletion of the provision.

Democratic Party. Also, personal property interests (big manufacturers, etc.) went along with full recapture under § 1245 in 1962; in exchange, they got Bulletin F, shorter lives for personal property, and the investment tax credit also inapplicable to real estate. President's 1961 Tax Recommendations: Hearings before the House Comm. on Ways and Means, 87th Cong., 1st Sess., vol. 2, at 995, 997 (1961) (statement of Joel Barlow, representative of Chamber of Commerce of the United States). Real estate (developers more than plant owners) fought recapture in 1961 and got no break from Treasury on depreciation, or from Congress on the investment tax credit. The recaptured gain is due to ordinary depreciation deductions reducing basis; therefore, tax benefit principles call for ordinary gain to that extent for improved real estate, just as for personal property. Any 50% capital gains exclusion can rest only on the notion of a second-best offset for inflation. Therefore, an accelerated over straight-line recapture rule for real estate would amount to double-dipping. Real estate should be treated just like any other capital or § 1231 asset. Moreover, a no-recapture rule opens up the use of real estate as a tax shelter, although historically such conversion was a less important feature of shelters, compared to deferral and leverage. George Cooper, The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance, 85 Colum. L. Rev. 657, 679-680 (1985); Alvin C. Warren, Jr., Accelerated Capital Recovery, Debt, and Tax Arbitrage, 38 Tax Law. 549 (1985); John P. Steines, Income Tax Allowances for Cost Recovery, 40 Tax L. Rev. 483 (1985). See Joint Comm. Staff, Overview of Tax Shelters 1 (1975) for the classic discussion of these three elements of tax shelters. While § 469 would continue to stop the sheltering of salary and portfolio income by most individual, passive investors, sheltering is still available to real estate operators and most corporations. I.R.C. §§ 469(a)(2) and (c)(7).

CWATRA, supra note 11, at § 6302(a) (providing new § 1022). Such basis adjustments would not apply for purposes of depreciation or amortization, etc. Id. at new § 1022(a)(2). Assets held by, but not ownership interests in, trusts, estates, S corporations, regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and partnerships would be eligible for indexing, to the extent gain is taken into account by taxpayers other than C corporations. Id. at §§ 1022(e) and (g).

Former Under Secretary of the Treasury Ed Cohen, founder of the Virginia Tax Study Group, has described the issues that arise when indexing does not apply for loss purposes or to corporate assets. Edwin S. Cohen, The Pending Proposals to Index Capital Gains, 45 Tax Notes 103, 105 (Oct. 2, 1989).

H.R. 9 had originally covered assets acquired prior to 1995. The inflation adjustment would have been measured by increases in the gross domestic product ("GDP") deflator occurring after December 31, 1994, regardless of whether the asset was acquired by the taxpayer prior to that date. CWATRA would limit indexing to assets acquired after 1994, but would provide for a "mark-to-market" gain recognition election for indexed assets held on January 1, 1995 and not sold before the next business day. In the case of such assets, indexing would apply. Also, principal residences held and used as residences on January 1, 1995 would constitute indexed assets.

Under CWATRA, assets eligible for the inflation adjustment generally would include corporate stock and tangible property constituting either capital assets or property used in a trade or business, provided they are held by the taxpayer for more than three years. For this purpose, options, warrants, or other contract rights with respect to stock would not be considered stock. The inflation adjustment would not apply to stock in an S corporation or a partnership interest, or to stock in a foreign corporation, except for common stock regularly traded on an established securi-

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11 CWATRA, supra note 11, at § 6302(c)(1).
12 Id. at § 6302(d). In 1989, Ways and Means Chair Dan Rostenkowski, D-Ill., similarly proposed indexing for covered assets purchased after the effective date and held for 1 year, with a "mark-to-market" election for common stock already held and thus becoming eligible for indexing. Andrew Hoerner, Rumors and Opinions Fly on Competing Capital Gains Plans, 44 Tax Notes 839 (Aug. 21, 1989); Pat Jones, Stuck on Capital Gains, Ways and Means Action Slows to a Crawl, 44 Tax Notes 479 (July 31, 1989). This proposal was estimated to raise over $1 billion in revenue in the first year, apparently due to such election. Hoerner, supra. The dissenting House Ways and Means Democrats stated that the CWATRA mark-to-market for indexing results in a "one-time revenue pickup of $11.2 billion during the first two years." H.R. Rep. No. 84, 104th Cong., 1st Sess. 270 (1995), available in 95 Tax Notes Today 56-11 (Mar. 22, 1995). In 1989, a competing capital gain proposal supported by Rep. Bill Archer, R-Tex., was instead passed by a conservative coalition on the Ways and Means Committee and by a similar coalition in the House. 45 Cong. Q. Almanac 114 (1989); 135 Cong. Rec. H631-14 (daily ed. Sept. 28, 1989) (Roll No. 253). On the floor, Senate Majority Leader George Mitchell, D-Me., proposed that the deficit-reduction measure be stripped down of hundreds of extraneous provisions, including the House's capital gains cuts. 45 Cong. Q. Almanac 109, 111 (1989). Ultimately, the Senate agreed, 87 to 7, on October 13. Id. On November 2, 1989, Senator Bob Dole, R-Kan., agreed in Conference to drop capital gains from the Budget bill, with President George Bush concurring; on November 21, 1989, the Conferees reached an agreement that contained neither capital gains nor a rate increase. Id. at 112-13.
13 CWATRA, supra note 11, at § 6302(e).
14 Id. at § 6302(a) (providing new §§ 1022(a)(1) and (b)(1)).
ties market. Moreover, no inflation adjustment would be provided for non-participating preferred stock. Indexed assets would not include any mortgage or other creditor's interest in property; the basis of debt would similarly not be indexed. H.R. 9 had provided that a lessor's interest in property subject to a net lease would not be an indexed asset, but this was omitted in CWA TRA. No property using "neutral cost recovery" (as provided in Subtitle C, Part II of Title VI) would be an indexed asset.

C. Ordinary Loss Deduction for Sale of Principal Residence

CWA TRA also would provide that losses from the sale or exchange of a principal residence would be treated as a deductible capital loss rather than as a nondeductible personal loss.

IV. Analysis of the 1995 Congressional Contentions

A. Risk Capital

Capital gain proponents' most common argument in the 1995 Hearings on the provisions currently before Congress has been that a generic capital gains cut would make more capital available to an entrepreneur who wants to start or expand a small business. Proponents reasoned that start-ups are risky and that a capital gains preference is necessary to compensate for the high risk; they also contended that borrowing from financial institutions tends to be unavailable.
Opponents of a generic capital gains cut pointed out that very few of the benefits of a generic capital gains preference would go to venture capital or small business; rather, most capital gains realizations are from public stock or real estate. Historically, most investors who invest in venture capital funds have been tax exempt entities.

is limited. The Committee believes it is important to encourage risk taking and believes a reduction in the taxation of capital gains will have that effect.

Professors Cunningham and Schenk dispute this risk stifling premise and argue, as does the Joint Committee on Taxation Staff, that in any event, a capital gains preference is not well designed to remedy any such bias. Noel B. Cunningham & Deborah H. Schenk, The Case for a Capital Gains Preference, 48 Tax L. Rev. 319, 340-41 (1993) (citing Charles Walker & Marc A. Bloomfield, The Case for Restoration of a Capital Gains Tax Differential, 43 Tax Notes 1019, 1022 (May 22, 1989)); Capital Gains and Losses 1995, supra note 10, at 18-19. Professor Dodge suggests that general riskiness is far too broad; more appropriate targets would be the formation of new job-creating businesses by entrepreneurs and by new combinations of capital (as § 1202 was to do) or new technology. Joseph Dodge, Restoring Preferential Capital Gains Treatment Under a Flat Rate Income Tax: Panacea or Placebo?, 44 Tax Notes 1133, 1139-40 (Sept. 4, 1989). See also James Porteba, Capital Gains Policy Towards Entrepreneurship, 42 Nat'l Tax J. 375, 383 (1989) (advocating distinguishing by enterprise size or due to high failure rate — 62% in 6 years, and providing more substantial loss provisions, rather than a preference on gain realization). I agree. See infra note 71.

In 1983, venture capital investments amounted to only 0.1% of total net worth of all non-financial corporations, and less than 1% of the market value of their equity. Treas. Dep't Report to Congress on the Capital Gains Tax Reductions of 1978, 139 (Sept. 1985), available in 85 Tax Notes Today 187-27 (Sept. 16, 1985) (hereinafter Tax Reductions of 1978); see Porteba, supra note 34, at 382 (initial public offerings by venture backed firms averaged 1.1% of total capital gains realizations). Similarly, I estimate that the value of equities in small businesses are less than 15% of the equities in all corporations. In 1988, the 10,400 largest (and mostly public) corporations, out of a total of around 3.5 million corporations (including S corporations), held 84% of the corporate assets by adjusted basis; self-created goodwill would not be counted, and their stock trades much more frequently than stock in a close corporation. John Lee, President Clinton's Capital Gains Proposals, 59 Tax Notes 1399, 1416 (June 7, 1995). Thus, the amount of annual realizations of close corporation stock might not exceed 10% of total stock realizations. See infra note 101.


While one lobbyist during the 1995 Hearings argued for a generic capital gains preference for corporate taxpayers, on the grounds that banks were becoming major players (6% to 13%) in the venture capital field, banks have had such a low effective tax rate due to other preferences that they have been dubbed functionally tax exempt. Moreover, beginning businesses generally rely upon capital from the entrepreneur and, to a lesser extent, family and friends.


Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of John Chapoton, representative of Alliance for Business Investment). Historically, corporations other than in the timber and plywood industries realized only 5% of their income from capital gains. Joint Publication of House Comm. on Ways and Means and Senate Comm. on Finance, 91st Cong., 1st Sess., Tax Reform Studies and Proposals U.S. Treasury Dept., pts. 1 and 3, 102, 434-38 (Comm. Print 1969) (hereinafter 1968 Tax Reform Study) (stating that the 16 largest timber and plywood corporations in the 1960's had more than 50% of their income from timber royalties; the largest five garnered 50% of such royalties; the largest one garnered 25%). These patterns probably still hold true, as evidenced by the absence of any other witness calling for a preference for corporate held assets in the 1995 Hearings. In the House floor debate, one capital gains proponent sought to tie a drop in venture capital into the 1986 repeal of a corporate capital gains preference (not a big source of contributions to venture capital funds, see supra note 35), but her main concern was capital gains treatment for timber royalties received by firms. 141 Cong. Rec., supra note 9, at H4219 (remarks of Rep. Jennifer Dunn, R-Wash.). The corporate sector in general is much more interested in easing, if not repealing, the § 55 corporate alternative minimum tax. See Ways & Means Hearing, Jan. 24, 1995, supra note 34 (statement of William Sinclair, Senior Tax Counsel, U.S. Chamber of Commerce).

Michael Barker, Must We Burn Gilder? Or, Taxes and the Entrepreneur, 27 Tax Notes 541, 543 (Apr. 29, 1985). "This shifting of income inclusions to low-rate taxpayers while deductions are taken by taxpayers with higher effective marginal rates in a manner that reduces total taxes paid is known as 'tax arbitrage'". Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., Federal Income Tax Aspects of Corporate Financial Structures 78 (Comm. Print 1989) (hereinafter Corporate Financial Structures). Such arbitrage is reflected in the ownership patterns of corporate stock and debt: as of the end of 1987, household ownership of stock was down to 60% (from 82% in 1967) with the rest held by functionally tax-exempt taxpayers (such as pension funds, banks, insurance companies and foreigners). Whereas households held only 8% of corporate debt, pension funds, banks and life insurance companies held 57%, and foreigners held 13%. Id. The average effective rate on such interest income is 7%. Leveraged Buysouts and Corporate Debt: Hearing Before the Senate Comm. on Finance, 101st Cong., 1st Sess., pt. 2, at 27 (1989) (hereinafter 1989 Senate LBO Hearing) (statement of Dr. Lawrence Summers, Harvard Professor of Economics); accord Hugh Calkins, The Inflation Subsidy in Interest, 42 Tax Notes 1267 (Mar. 6, 1989) (stating that the average effective rate is 7.3%, broken down by class of creditor).

Proponents argued that a capital gains preference is necessary to unlock investments held by the entrepreneur, such as stock options in the public company currently employing the entrepreneur, or by friends contributing capital. Proponents also argued that a capital gains preference was necessary to increase the back-end reward to investors or the entrepreneur when he or she sells out, in order to compensate for the greater risk in a new venture. 42

The Joint Committee on Taxation pointed out that, in fact, increased entrepreneurial “activity has been a very small factor in previous market responses to changes in the taxation of income from capital.” 43 Representative Fortney “Pete” Stark, D-Cal., at a January 1995 House Ways and Means Hearing, speculated that:

For an entrepreneur or for someone who’s going to start up a business and get going, the last thing you think about is what you’re going to pay five or one or ten years in the future to capital gains . . . I always think that entrepreneurs are born, not made. I have a hunch that we’re going to see entrepreneurs continue regardless of what we do with the capital gains taxes. 44

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44 Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Rep. Pete Stark, D-Cal.). For the related point that, in choosing the tax entity for a new venture, the proprietor is not concerned about the tax treatment of a sale years down the road, see Staff Recommendations to Revise Subchapter C: Hearing Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance, 99th Cong., 1st Sess. 263, 273, 281 (1985) (statement of Peter Faber, former Chair of Tax Section of American Bar Association). But see id. at 328 (statement of Sam Thompson, tax practitioner and now Dean of University of Miami Law School); accord id. at 246-47 (statement of Ed Cohen, former Under Secretary of the Treasury); id. at 326-27 (statement of Professor Edward Roche). Rep. Pete Stark also believed that the availability of venture capital turned less on capital gains rates and more on the investment policies of major pension funds that have been “intrigued by diversifying
Stark laid the foundation for his assertion by asking members of a panel of entrepreneurs what the marginal capital gains rates were when they commenced their first start-up; they couldn’t remember.

For the rest of the hearing, witnesses who supported a capital gains cut addressed Stark’s question. Most asserted that a capital gains preference was important at the margin, particularly for the “friend” investors; however, two witnesses acknowledged the accuracy of Stark’s insight. “Sure, an entrepreneur will not be deterred, but it’s just not fair if he realizes at the end of the day that a great portion of his winnings, for which he risked so much, are going to be taxed away. There’s a breaking of a social contract there . . .” The recurring theme was that investment should not

. . . into venture capital.” Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Rep. Pete Stark, D-Cal.). In 1978, the Department of Labor redefined fiduciary responsibility to allow private pension fund managers to invest a relatively small amount of total plan assets in more risky venture investments. Barker, supra note 39, at 543 (other factors were inflation, the resurgent stock market, and the mergers and acquisition boom). State pension plans followed, with the result that private and public pension plans are the single largest source of new venture capital investments. Id. An economist commented on the issue of whether capital gains cuts were necessary to encourage investment in start ups:

The image we have here is that the innovator who is taken with an idea is somehow planning ahead for capital gains, but the hundreds of millions of dollars at stake for those who are sitting on accumulated wealth somehow do not take it into account. The key point here is that capital gains are already favored over ordinary income. The argument that somehow capital markets are failing to recognize these marvelous opportunities for investment, and capitalists flowing in to secure blue chip stocks, is a vicious criticism of capitalism, which hinges on —and, I believe, prospers on— the ability of capital markets to allocate funds to projects that have the best expected rates of return.


E.g., Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of James Hoak, representing American Business Conference: Responding to Mr. Stark’s statement, first. I think that he’s wrong in his conclusion. I think it is possible that entrepreneurs—or it is likely that entrepreneurs on average would still begin businesses, but we’re dealing at the margin. I think that it’s the extra investments that Bob talked about that can create a larger savings and larger capital formation group in this country. Also, he’s looking only at the entrepreneur. He’s forgetting the outside capital sources.) Accord id. (statements of Rep. Dick Zimmer, R-N.J., and James Mann, CEO of SunGard Data Systems). But see supra note 44 and accompanying text.

Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statements of James Morgan, president-elect, National Venture Capital Association, and Robert Johnson, CEO of Black Entertainment Television). “Every time you have a [capital gains] transaction, a part of capital savings that is already out there is vacuumed up by the giant vacuum cleaner,
be punished.47 Opponents of an increase in the preference for capital gains espoused the contrary view that capital gains, particularly from equities, were already taxed lightly, as evidenced by: the deferral of recognition of accrued gains until realization, the step up in basis at death (50% of accruals in public stock48), the 28% cap on individual capital gains, and the holding of a substantial portion of equities by tax exempt entities.49

brought into the Treasury, and then disbursed on consumption items . . . ." (statement of Chair Bill Archer, R-Tex.). But see id. (statement of Robert McIntyre, Director of Citizens for Tax Justice).

47 Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Chair Bill Archer, R-Tex.):

What's fair about a tax that punishes people who sacrifice and forego consumption, pay the income tax on their income, take the net and invest it, save it and then get punished by being taxed on the appreciation and value of those savings? And what's fair about a tax system that gets in the way of people who want to go out and create jobs?


One of the things that has always troubled me about the capital gains proposal is that, on equity grounds, it is a little hard for me to look somebody in the face that makes $30,000 a year of wage income, works hard, has a family and is paying at one rate. And to say that, on the other hand, there may be a wealthy individual, somebody who has inherited his or her wealth, never worked a day in their lives, on their capital gains income they would pay a rate that is a fraction of what somebody pays who goes to work every day, perhaps at a modest salary.


48 From 1949 to 1989, as much as two thirds of annual capital appreciation was not recognized prior to death. With adjustments for owner-occupied housing gains excluded under § 121, and corporate stock held by tax-exempts, taxable realizations were about 46% of accruals. Jane Gravelle, Limits to Capital Gains Feedback Effects, 51 Tax Notes 363, 364-65 (Apr. 22, 1991).

49 Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Dr. Henry Aaron, Director, Economic Studies Program, the Brookings Institute) (effective rate of 7.2%); Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Rep. Sander Levin, D-Mich.); id. (statement of Mr. Robert DeHaven, President and CEO of Quality Services, Inc., AEA) (existing preference estimated as a tax expenditure of $170 billion over the next 5 years); accord id. (statement of Robert McIntyre, Director of Citizens for Tax Justice) (existing flat rate is equivalent to a 30% exclusion at the 39.6% bracket). Mervyn A. King and Don Fullerton believe that the statutory rate should be reduced by half to account for the benefit of deferral, and by half again to account for the basis step up at death. Mervyn A. King & Don
As such, only a small portion of a generic capital gains preference would apply to equity in small business. If the true goal is investment in small or start-up business, a capital gains preference specifically targeted to small business, or a rollover provision limited to reinvestment in small business, would appear more appropriate. Most capital gains cut proponents, while advocating a capital gains preference to benefit small business, ignored the capital gains preference targeted to small business under existing section 1202, and the rollover of the proceeds of sales of public stock in specialized small business investment companies under existing section 1044.

A few proponents, however, did advocate that these provisions be liberalized, be retargeted to manufacturing business or start-


Section 1202 provides a 50% exclusion for gain from the sale or exchange of original issue “qualified small business stock” held for more than 5 years. I.R.C. §§ 1202(a) and (c)(1). Half of this exclusion constitutes a tax preference item for the alternate minimum tax under I.R.C. § 57(a)(7). There is a cap of the greater of $10,000,000 (lifetime cap) or 10 times basis. I.R.C. § 1202(b). Qualified small business stock has a size limit ($50,000,000 in aggregate gross assets), an active business requirement, and a qualified business requirement (excluding personal services, financial business, farming, natural resource business, and hospitality business); certain types of corporations are excluded as well (for example, S corporations, DISCs, mutual funds, REITs, etc.). I.R.C. §§ 1202(c)(2), (d) and (e).

Section 1044 provides for the tax-free rollover (in the form of non-recognition, substituted basis, and a tacked holding period) for the proceeds of the sale of public securities (stock or debt) reinvested within 60 days in a “specialized small business investment company” (“SSBIC”). I.R.C. § 1044(a). For individuals there is a $50,000 annual and a $500,000 lifetime cap; for corporations, the cap is $250,000 and $1,000,000, respectively. I.R.C. § 1044(b). A SSBIC is any partnership or corporation licensed by the Small Business Administration under § 301(d) of the Small Business Investment Act of 1958.

Professor Blum has argued for a universal non-recognition carryover basis rollover of the proceeds from dispositions of capital assets. Cynthia Blum, Rollover, An Alternative Treatment of Capital Gains, 41 Tax L. Rev. 383 (1986). Professor Johnson points out that complete tax-exemption of rolled-over proceeds is not on the current political agenda because it would lose revenue no matter how many additional sales were induced. Calvin H. Johnson, The Consumption of Capital Gains, 55 Tax Notes 957, 970 (May 18, 1992). This may partially underlie the opposition of Chair Bill Archer, infra note 52.

Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Rep. Ron Wyden, D-Ore.) (favoring 18-month tax-free rollover of proceeds of sale of stock into investment in small business in less burdensome manner than § 1044 SSBIC provision). Chair Bill Archer seemed to oppose expansion of such tax-free rollovers due to the burden of record keeping, and on the supposition that 95% of the proceeds of stock sales were reinvested anyway. Id. Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Mark Bloomfield).
ups in enterprise zones,\textsuperscript{54} be provided as a second-tier capital gains cut in addition to a generic capital gains cut,\textsuperscript{55} or be provided if a generic cut was not passed.\textsuperscript{56} Some proponents of a capital gains (stating that most sales proceeds are reinvested). The empirical data is to the contrary. See infra notes 298-301 and accompanying text. See also House Small Business Hearing, Jan. 26, 1995, supra note 42 (statement of Paul Pryde, President of Pryde and Company) (stating that §§ 1044 and 1202 should be perfected instead of cut); id. (statement of Craig Willet, CPA) (stating that "attaching a whole bunch of regulations to it and qualifications, will [not] help small business"; if generic cut is enacted, he advocated a second tier 100% exclusion for small business stock held 5 years); accord id. (statement of Pete Linsert, representative of Biotechnology Industry) (stating that "drastic" restrictions on § 1202 rendered it useless for raising capital for biotechnology industry); id. (statement of Alan Sklar, CPA, representative of small business) (stating that he advocated extension of § 1202 to S corporation stock and an additional upfront $50,000 deduction for investment in small business stock, which resembles provisions in rejected 1990 Budget Accord). The 1990 proposed 25% (or $25,000) deduction for investment in small business stock would have cost $7.3 billion between 1991 and 1995, or over 60% of the 5-year total of $11.5 billion of "growth incentives." Andrew Hoerner, Small Business Incentives: An Eight-Fold Path to Who Knows Where?, 49 Tax Notes 134 (Oct. 8, 1990); David Wessel & Jeffrey Birnbaum, Consolation Prize: Tax Shelters for Rich Could Return in Plan to Aid Small Business, Wall St. J., Oct. 2, 1990, at A1, A18. The 1990 Budget Accord was not accepted by the House, in large part because of its regressive nature and rhetoric on the failure of trickle down during the 1980's. See, e.g., 136 Cong. Rec. H8699-8700 (daily ed. Oct. 2, 1990) (statement of Rep. David Obey, D-Wis.); 136 Cong. Rec. H7792 (daily ed. Sept. 25, 1990) (statement of Rep. James Trafi­cant, D-Oh.) ("The poor pay more taxes than they did 10 years ago. The rich pay less, and the President wants another big tax cut."); 136 Cong. Rec. H8944-45 (daily ed. Oct. 4, 1990) (statement of Rep. Marty Russo, D-Ill.); 136 Cong. Rec. H8321 (daily ed. Sept. 28, 1990) (Rep. Tom Downey, D-N.Y.); 136 Cong. Rec. at H8699-7000 (daily ed. Oct. 2, 1990) (statement of Rep. David Obey, D-Wis.). One Member quipped that the 1980's "trickle-down" had been from the top 1% down to the top 5% only; the remaining 95% of individual taxpayers had not benefited. 136 Cong. Rec. H8927 (daily ed. Oct. 4, 1990) (extension of remarks of Rep. George Miller, D-Cal.). A metaphor frequently used by the 1990 Budget Accord opponents was that the rich were at the 1980s party, but now they won't have to pay. E.g., 136 Cong. Rec. H8829 (daily ed. Oct. 3, 1990) (remarks of Rep. Major Owens, D-N.Y.).


\textsuperscript{56} House Small Business Hearing, Jan. 26, 1995, supra note 42 (statement of Alan Sklar, CPA).
cut seeking to aid small business opposed a cut targeted just to small business on the ground that they did not want the government choosing favored investments. Proponents also, albeit less often, opposed a targeted cut on the ground that they could not trust the tax rules to remain constant. A telling response to the first ground by a member of Congress was that a capital gains cut in itself involves an incentive/Government intervention. The second ground has too often been true in the last two or three decades with regard to the top individual ordinary income and capital gains rates.

Assistant Secretary of Treasury for Tax Policy Leslie Samuels asserted that a generic capital gains cut and repeal of section 1202 would draw capital away from small business investments. The Administration believed that any “additional capital gains preferences for new investment . . . should likewise be targeted and should meet the test of fairness, simplicity, and efficiency.” The Administration believed that the CWATRA capital gains cuts failed all of these benchmarks. According to Samuels, the distribution of tax cuts under the Contract With America disproportionately benefited families with income over $100,000 and hence would not meet the fairness test; indexing would make the tax law more complex; and capital gains preferences would encourage tax

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68 House Small Business Hearing, Jan. 26, 1995, supra note 42 (statement of Rep. Ken Bentsen, D-Tex.) (stating that the Code “is full of incentives to direct investment”); accord id. (statement of Chuck Ludlam, representative of Biotechnology Industry Organization) (stating that we make choices in the Code all the time, and a targeted cut is not expensive); id. (statement of John Pryde, President John Pryde and Company) (stating that a targeted cut is not expensive).

69 Ways & Means Hearing, Jan. 10, 1995, supra note 16 (statement of Ass’t Sec’ty Leslie Samuels).

70 Id.
shelters. Proponents, however, argued that the proposed capital gains cuts were fair because they applied to all income brackets and sectors of the American economy; they argued that the cuts made economic sense because they reduced capital costs, prevented the taxation of inflationary gains, and encouraged entrepreneurship.

Practitioners who testified during the hearings pointed out that a substantial generic capital gains exclusion would increase complexities in tax planning. The New York City Bar has long held a similar view as to a capital gains preference. In the 1990 Congressional debate on capital gains, practitioners, economists, and committee members testified that the 1986 repeal of the then-generic capital gains preference had greatly simplified transactional tax planning.

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61 Id.
63 Ways & Means Hearing, Jan. 24, 1995, supra note 34 (statement of Sheldon Cohen, former Commissioner); Unofficial Transcript of W&M ‘Contract’ Hearing (Feb. 1, 1995), available in 95 Tax Notes Today 24-50 (Feb. 6, 1995) (hereinafter Ways & Means Hearing, Feb. 1, 1995) (statement of Thomas Terry, Chair of the Section of Taxation of the ABA); Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Ronald Pearlman, former Chief of Joint Committee Staff and Ass’t Sec’ty for Tax Policy); id. (statement of Dr. Henry Aaron); Revenue Raising Options Required Under the Fiscal Year 1988 Budget Resolution: Hearing Before the Senate Comm. on Finance, 100th Cong., 1st Sess., pt. 2, at 120 (1987) (hereinafter 1987 Senate Hearing) (colloquy between Dr. Joseph Minarik, Urban Institute, and Chair Lloyd Bentsen, D-Tex.). The Joint Committee has provided examples of “portfolio effect,” or the ability of taxpayers to convert ordinary income to capital gains. Methodology in Revenue Estimating 1995, supra note 43. See also Tax Reductions of 1978, supra note 35, at 27-28 (providing a list of planning complexities, some of which have been since remedied by statute). For references to past studies of conversion problems see Lee, supra note 35, at 1411 (studies by Randolph Paul and Stanley Surrey).
66 Id. at 112 (statement of Professor Alan Auerbach); id. at 171 (statement of Dr. Henry Aaron, Senior Fellow, The Brookings Institute).
67 E.g., id. at 206 (statement of Rep. (now Senator) Byron Dorgan, D-N.D.).
68 The old complexities of transactional tax planning for capital gains were roundly and soundly criticized by the New York City Bar Association. Proposed Capital Gains Tax Reduction, supra note 64. For an excellent discussion of the rule and transactional complexities arising from a substantial capital gains preference see Cunningham & Schenk, supra
The stated goal of encouraging investment in small business would be met much more effectively and cheaply by broadening sections 1202, 1244 or 1044. Modifying section 1202's ten-times-basis limitation on capital gains eligible for the 14% rate would probably be the most appealing change to entrepreneurs, given the pattern of sweat equity over capital investment. The $50,000,000 size limitation may also catch larger start-ups, particularly in the biotechnology industries. An increase from $50 to $100 million in aggregate gross assets would not result in much additional revenue loss, and would still be comparatively small. Section 1244's $100,000 joint return cap on ordinary losses from small business stock could be raised to a higher ceiling, say $500,000 or even $1,000,000, reflecting the riskiness of new ventures. Any opening up of section 1044 should lie more in broadening the categories of small businesses into which the proceeds of the sale of public stock could be rolled tax free, rather than broadening the category of capital assets qualifying for such roll over. Modifications along these lines, particularly as to section 1202, are much more likely to avoid a veto by President Bill Clinton, all other things being equal.

B. Inflation

The second most common argument in the 1995 Hearings in favor of either indexing or a generic capital gains preference was


*** See Porteba, supra note 34. I would provide higher ordinary loss ceilings for taxpayers who materially participate in the small business, partially on the rationale that they and their venture should not be treated conceptually as separate tax entities. John Lee, Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations and the Tax Legislative Process, 8 Va. Tax Rev. 57, 88-93 (1988). Of course, some or all of any gains upon the sale should be ordinary as well, to the extent they are attributable to such participation.
the unfairness of taxing "people on gains that are strictly due to inflation." Many claimed that taxpayers particularly resisted selling assets where the gain was largely due to inflation. The consensus of witnesses was that universal indexing was conceptually correct, but difficult (at least politically), as the 1984 Treasury experience shows. An economist pointed out, however, that universal indexing would reduce the constituency advocating low inflation.

72 Ways and Means Hearing, Jan. 25, 1995, supra note 33 (statement of Chair Bill Archer, R-Tex.); accord Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Senator Don Nickles, R-Okla.). Twice before, in 1978 and 1989, Chair Archer supported Ways and Means proposals that provided for the indexing of the basis of capital assets (while allowing a generic exclusion at the same time). A conservative coalition in the House passed the proposals over the objections of the Democratic Chair of the Ways and Means Committee, but the Senate and the Conference rejected them. See supra note 27 and infra note 98.

73 Ways & Means Hearing, Jan. 12, 1995, supra note 47 (statement of Dale Kettner, farmer) (noting a disincentive to sell farm equipment); Ways & Means Hearing, Jan. 24, 1995, supra note 34 (statement of William Sinclaire, representative of U.S. Chamber of Commerce); House Small Business Hearing, Jan. 26, 1995, supra note 42 (statement of Sidney Hoff-Hay). H.R. Rep. No. 84, supra note 27, at 38, reasoned that "taxation of these inflationary gains discourages new saving and investors from selling old investments even when better investment opportunities present themselves. This retards economic growth and leads to an inefficient allocation of capital by the capital markets."

74 Treasury I proposed a complete regime of indexing in lieu of various then-existing preferences, including the then-sixty-percent capital gains exclusion. 2 Treas. Dep't, Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, General Explanation of the Treats. Dep't Proposals 1, 181 (1984) (hereinafter Treasury I). Its overriding objective was to subject real economic income from all sources to the same tax treatment. Id. at 13; 138 Cong. Rec. 3957 (1992) (remarks of Senate Finance Chair Lloyd Bentsen, D-Tex.). One of the chief architects of Treasury I was then-Assistant Secretary of Treasury for Tax Policy Ronald Pearlman. Pearlman and economist Charles McLure were "allowed to design what they thought was a perfect tax system." Jeffrey H. Birnbaum & Alan S. Murray, Showdown at Gucci Gulch 46 (1987). "They called for a 'neutral' tax system, a system that does not influence private decisions." Id. There was much opposition to indexing in lieu of accelerated capital recovery. Joseph J. Minarik, How Tax Reform Came About, 37 Tax Notes 1359, 1367 (Dec. 27, 1987); Ways & Means Hearing, Jan. 11, 1995, supra note 54 (statement of Dr. Michael Boskin, Stanford Professor and former Chair of President Bush's Council of Economic Advisers); Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Dr. Henry Aaron). Treasury stated that the principal opposition to capital asset indexing came from individual entrepreneurs and the venture capital industry. See Impact of Tax Simplification Hearing, supra note 37, at 963 (statement of Ass't Sec'ty Charles McLure); 1989 Senate Hearings, supra note 70, at 50 (statement of Robert McIntyre, Citizens for Tax Justice) (stating that indexing would have required a much higher top individual rate, perhaps 40% or 45%, to meet the distributional equity requirement, and a series of very complex adjustments on both interest deductions and deferral of gains).

75 Ways & Means Hearing, Jan. 11, 1995, supra note 54 (statement of Professor Michael Boskin). In 1978, Secretary of the Treasury Michael Blumenthal, pointing to Brazilian experience, criticized the House-passed Archer indexing provision (in addition to the then-ex-
Tax professionals asserted that indexing is complicated.\(^7\) House Ways and Means Chair Bill Archer, R-Tex., argued that taxpayers already had to maintain detailed records as to cost and improvements.\(^7\) Assistant Secretary Leslie Samuels responded that, “adding the burden . . . of keeping track of cost-of-living adjustments, inflation adjustments over a long period of time” would be significant,\(^7\) giving the often cited example of mutual fund shares.\(^7\)

Significantly, the British indexing regime exempts almost $10,000 of gain a year and, hence, small taxpayers.\(^8\) After initial problems with losses, the British system does not currently allow them.\(^8\) The Clinton Administration criticized the allowance of losses arising from indexing basis.\(^8\) Not surprisingly, the ability to take losses from indexing basis was omitted by the CWATRA provisions.

Assistant Secretary Leslie Samuels believed that the allowance for losses on the sale of a personal residence was unwise tax policy; losses on personal use property are generally not allowed under the Code. Furthermore, in some instances, such losses reflected a de-

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\(^7\) An Interview with Ronald A. Pearlman: Tax Policy and Product, 29 Tax Notes 1288, 1290 (Dec. 30, 1985); Impact of Tax Simplification Hearings, supra note 37, at 1003 (statement of Charles McLure, Deputy Ass't Sec'ty for Tax Analysis); H.R. Rep. No. 84 (dissenting views), supra note 27, at 283.

cline in the local real estate market; in others, it reflected real deprecation and other deterioration in the residence.\textsuperscript{88} Additionally, the decline in the fair market value of residences is a regional phenomenon. This factor may lead Congress to drop the ordinary-loss-on-sale-of-residence rule from any capital gains provision enacted this term.

A wide range of witnesses criticized the nonindexing of debt, while indexing equities, on the grounds that it opens the door to tax abuse; these witnesses included tax professionals,\textsuperscript{84} economists\textsuperscript{85} and some members of Congress.\textsuperscript{86} The British system has avoided this problem, since investment interest is nondeductible.\textsuperscript{87} An economist claimed that the market makes sure that arbitrage opportunities do not exist,\textsuperscript{88} but historically, high income individuals did indeed incur large amounts of debt to acquire or carry equities.\textsuperscript{89} Chair Archer reasoned that indexing of debt would require both sides of the income-expense equation to be indexed.\textsuperscript{90} This

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\item \textsuperscript{84} Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Ron Pearlman, former Ass't Sec'y and former Joint Committee on Taxation Chief of Staff); id. (statement of Michael Schler, representative of New York State Bar Association); Ways & Means Hearing, Feb. 1, 1995, supra note 63 (statement of Deborah Walker, representative of AICPA).
\item \textsuperscript{85} Ways & Means Hearing, Jan. 11, 1995, supra note 54 (statement of Dr. Barry Bosworth, Senior Fellow at the Brookings Institute); Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Dr. Henry Aaron); see Reed Shuldinger, Indexing the Tax Code, 48 Tax L. Rev. 537, 641-43 (1993) (stating that the case for indexing debt is stronger than the case for indexing capital assets, but political pressure is for indexing the latter but not the former).
\item \textsuperscript{87} Senate Finance Hearing, Feb. 16, 1995, supra note 80 (statement of Christopher Dent).
\item \textsuperscript{88} Id. (statement of Alan Reynolds, Director of Economic Research, Hudson Institute).
\item \textsuperscript{89} 1968 Tax Reform Study, supra note 38, at 84-86, 142-45 (stating that the combination of interest deductions and a capital gains preference reduced the effective rate for high income taxpayers with both to 10%). This was the impetus for § 163(d), which undoubtedly has reduced this pattern.
\item \textsuperscript{90} Ways & Means Hearing, Feb. 1, 1995, supra note 63 (statement of Chair Bill Archer, R-
view overlooks the fact that most lenders are either legally tax exempt, such as pension funds and foreigners, or functionally tax exempt owing to other preferences, such as financial institutions. On the other hand, existing section 163(d) limitations on deduction of investment interest appear to substantially limit tax arbitrage opportunities from indexing capital assets. An individual's deduction of investment interest is limited to "investment income," which in this context includes "net gain attributable to the disposition of property held for investment." Thus, deduction of interest on indebtedness attributable to indexed stock would not be deductible until the stock was disposed of (assuming no other investment income, including dividends, etc.), and the otherwise taxable gain from such disposition, which serves as the measuring rod for the deduction, would be reduced by the inflation adjustments. At the same time, indexing equities but not debt investments held by individuals is particularly unfair to the moderate income taxpayers because they disproportionately invest in such instruments.

The Administration and others criticized the allowance of both a 50% exclusion (traditionally justified as a rough offset for

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*1 See Barker, supra note 39, at 543; Lee Sheppard, Fear of Financing —LBO Controversy, 42 Tax Notes 424, 426 (Jan. 23, 1989). See supra note 39. See Shuldinger, supra note 85, at 644-45 (stating that under the "clientele effect," low-bracket or effective rate taxpayers find it attractive to hold debt, while high bracket taxpayers find it attractive to borrow).

*2 I.R.C. § 163(d)(4)(B)(ii). One opponent of indexing posited tax arbitrage by assuming that the investment interest was currently offset against other investment income. Ways & Means Hearing, Jan. 11, 1995, supra note 54 (statement of Iris Lav, representative of Center on Budget and Policy Priorities); accord Shuldinger, supra note 85, at 647. But other investment income presumably would not be indexed.

*3 I wish to thank my class on Small Business Planning in which this insight came out in a discussion of the continued viability of § 1202. Note that to the extent capital gain is used to soak up investment interest, such gain cannot be offset by the 50% deduction. CWATRA, supra note 11, at § 6301(a) (adding new § 1202(c)). See Shuldinger, supra note 85, at 647 n.409 (discussing similar, existing-law provisions reducing capital gains subject to the top individual rate of 28%, where they are included in investment income for purposes of § 163(d)).

*4 Senate Finance Hearings, Feb. 16, 1995, supra note 80 (statement of Ed Cohen, former Under Secretary of Treasury); 1978 Senate Hearings, supra note 75, at 141 (statement of Sec'ty Michael Blumenthal).

*5 Ways & Means Hearing, Jan. 10, 1995, supra note 16 (statement of Ass't Sec'ty Leslie Samuels).

inflation\textsuperscript{97}) and indexing of basis for inflation "as too generous." Such "double dipping," in the words used by former Rep. (and subsequent Ways and Means Chair) Dan Rostenkowski, D-Ill., almost two decades ago to describe a similar Archer proposal,\textsuperscript{98} could create negative income and, hence, tax sheltering where an economic or real gain existed.\textsuperscript{99}

Different constituencies support a generic preference and indexing, with more support among the traditional interest groups for the former.\textsuperscript{100} Recent hard data as to the composition of annual realizations of capital gains is unavailable, but perhaps illogically is seemingly politically unimportant in an interest group analysis. Around 50\% of annual realizations consists of stock (both public and closely held\textsuperscript{101}). My guess\textsuperscript{102} is that gain from nonresidential
real estate amounts to around 25%-35%, and installment sales

estate assets were public stock; only 6% of the estimated tax cost of the Senate estate and gift tax provision (which did not include carryover basis) was attributable to closely-held stock and farms. See 122 Cong. Rec. 25954-55 (1976) (remarks of Sen. George Hathaway, D-Me., and Sen. Edward Kennedy, D-Mass.); Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Comm. on Ways and Means, 94th Cong., 2d Sess. 355 (1976) (statement of Robert Brandon, public interest group) (stating that untraded closely-held corporation stock totaled not more than $1.9 billion and marketable securities totaled not more than $14 billion, indicating at least a 10 to 1 ratio of public stock holdings to closely-held stock and farms). Second, the Small Business Administration estimates that only 10% of business finance resources currently goes to small business. Letter dated April 3, 1995, from Jere W. Glover, Chief Counsel for Advocacy, U.S. Small Business Administration to Rep. Zoe Lofgren, D-Cal., reprinted in 141 Cong. Rec. H4317-18 (daily ed. Apr. 5, 1995). Third, as of 1988, the top 10,000 corporations out of around 3.5 million corporations held over 80% of total corporate assets by adjusted basis. See supra note 35. Fourth, public stock trades much more frequently than stock in a close corporation. Lee, supra note 35, at 1416. Closely held small businesses appear more important to capital gains cut proponents than public stock based upon their rhetoric, but cloaking is at work here at least some of the time.

Prepared Statement of Jane G. Gravelle, Senior Specialist in Economic Policy Congressional Research Service Before the Senate Finance Comm., Feb. 15, 1995, available in 95 Tax Notes Today 32-38 (Feb. 16, 1995) (hereinafter Prepared Statement of Jane Gravelle) (stating that gains from equities range from about 20% to 50% of annual realizations, depending on the relative performance of the stock market; much of the remainder is gain on real estate); Revenue Act of 1963: Hearings on H.R. 8363 Before the Senate Comm. on Finance, 88th Cong., 1st Sess., pt. 1, at 197 (1963) (hereinafter 1963 Senate Hearings) (reporting that 41% of capital gains realizations in 1959 were from corporate stock); Congressional Budget Office, Effects of Lower Capital Gains Taxes on Economic Growth, 30 (Aug. 1990), available in 90 Tax Notes Today 181-1 (Aug. 31, 1990) (stating that “[i]n 1985, 46 percent of net capital gains was on corporate stock . . .”). During the period between 1985 and 1989, sales of stock, securities, and partnership interests comprised about half of reported capital gains. Michael Hallassos & Andrew Lyon, Progressivity of Capital Gains Taxation with Optimal Portfolio Selection, Paper Presented at University of Michigan Tax Conference on Sept. 11, 1992, available in 92 Tax Notes Today 190-28 (Sept. 18, 1992). During years when the stock market performs relatively poorly, for example in the early and mid-1970's, this percentage is much lower due to the combination of less capital gain from corporate stock and the recognition of much more capital losses from stock. Tax Reductions of 1978, supra note 35, at 20. For example, in 1973, corporate stock accounted for 53.8% of capital asset transactions; gross capital gains from stock constituted 26.1% of such gross gains. Gross capital losses from stock, however, constituted 51.9% of such losses, while net capital gains from stock constituted only 14.8% of net capital gains. Id. at 16. These figures were understated: the share of capital gain from partnerships and trusts (7.9% of net capital gains), and prior year installment proceeds (amounting to 14% of net capital gains), included a “large amount of sales of and/or gains from corporate stock [as well as from real estate].” Id. at 15. The figures for 1977 were essentially unchanged. Id. at 18-19.

Lee, supra note 35, at 1410-11.

Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Dr. Henry Aaron) (stating that real estate industry is the source of about half of all capital gains); see Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Dr. Jane Gravelle, Senior Specialist in Economic Policy Congressional Research Services); Prepared Statement of Jane
gain, largely from closely held stock and real estate, amounts to 10\% to 15\%. Timber and livestock, although politically important, amount to small percentages of total annual realizations.\textsuperscript{106} Due to rollovers and the $125,000 exclusion under section 121(b), annual realizations from the sales of residences may be ignored (except for coastal cities), although they are often mentioned by congressional proponents of preferential capital gains treatment.\textsuperscript{106} Despite the actual composition of annual realizations of capital gains, congressional hearings and floor debates disproportionately reflect the interests of narrow constituencies.

Over the last thirty years, the political base for increasing the capital gains preference, whether by a generic exclusion, or indexing, or both, has been a "conservative coalition" of Republicans and Southern Democrats.\textsuperscript{107} With the new Republican majorities in

\textsuperscript{106} In 1959, timber and other natural resource capital gains amounted to 2.1\% of total long-term capital gain; livestock amounted to 5.7\%. 1963 Senate Hearings, supra note 102, at 197 (statement of Sec'ty Douglas Dillon). In 1973, net gains from timber amounted to 0.6\% of net gains; gains from livestock and farmland with unharvested crops amounted to 0.4\%. Tax Reductions of 1978, supra note 35, at 16-17. For 1977, the comparable figures were 1.3\% and 0.5\%. Id. at 18-19.

\textsuperscript{107} Tax Reductions of 1978, supra note 35, at 98; 124 Cong. Rec. 25471 (1978) (remarks of Rep. Dan Rostenkowski, D-Ill.). The median purchase price of a new home in 1993 was $126,500, see infra note 213, just above the excluded gain ceiling.

\textsuperscript{108} For a discussion of this political-science concept, defined as a majority of Republicans and Southern Democrats opposed by a majority of other Democrats, see Lee, supra note 35, at 1402 and n.10. The first two decades of capital gains legislation, from 1921 through 1941, tell a somewhat different story. Rather than a coalition of Republican and Southern-Democratic special interests driving capital gains legislation, the income tax in the 1920's was intended to tax only the near rich and the rich. Marjorie Kornhauser, The Origins of Capital Gains Taxation: What's Law Got to Do With It?, 39 Sw. L.J. 869, 873 n.18, 908 n.235 (1985). Half or more of the very rich's income was from capital gains, where realizations clearly had been retarded by high rates at the end of WWI. The capital gains preference was enacted "to permit such transactions to go forward without fear of a prohibitive tax..." H.R. Rep. No. 350, 67th Cong., 1st Sess. (1921), reprinted in 1939-1 (Part 2) C.B. 168, 176; Revenue Revision: Hearings Before the House Comm. on Ways and Means, 66th Cong., 3d Sess. 10-11 (1920) (statement of Dr. Thomas S. Adams, Special Tax Adviser to Treasury, and father of the Revenue Act of 1921) (noting that from 1916 to 1918, during boom times, net income of individuals with over $300,000 in income dropped 60\%, from $992,000,000 to $392,000,000); 61 Cong. Rec. 5201 (1921) (remarks of Rep. Hawley, R-Ore.); id. at 5289 (remarks of Rep. Green, R-Iowa). Thus, increased revenues were the articulated policy for the initial enactment of the capital gains preference. In the 1930's, in addition to the notion that lower capital gains rates increased revenues, capital gains tax legislation was also motivated by the idea that "frozen capital," not invested in the stock market, perpetuated the
the House and Senate, the Democrats presumably are less important except in veto override situations. The hearings and floor debates of the past two decades reveal that the capital gains proponents explicitly championed timberlot owners, small business owners and venture capitalists, farmers of both livestock and farmland, homeowners, and occasionally small investors in the stock market, roughly in that order. Over the years, and in the 1995

Great Depression. S. Rep. No. 1567, 75th Cong., 3d Sess. 6 (1938), reprinted in 1939-1 C.B. 779, 783; accord Associated Press, Harrison Demands End of Profits Tax, N.Y. Times, Mar. 13, 1938, at 1 ("[I]f there is a sit-down strike upon the part of capital because of fear or the uncertainties of investment, . . . we should break it if possible, and . . . effective work should be done toward removing some of the barriers that are checking the flow of capital and credit into new investment and new industries."). (quotation attributed to Senate Finance, Chair Pat Harrison, D-Miss.). In fact, frozen credit from lenders not making loans (rather than frozen capital) was a cause of the Great Depression. Federal Reserve's Second Monetary Policy Report for 1992: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 102d Cong., 2d Sess. 70 (1992) (statement of Federal Reserve Board Chairman Alan Greenspan) (hereinafter 1992 Senate Banking Committee Hearing).


The 1989 capital gains debate in the House provides the most clear identification, in the legislative history of capital gains, of the interest groups favored by the Conservative Coalition. Timber was their preeminent special interest. 135 Cong. Rec. H6280 (daily ed. Sept. 28, 1989) (remarks of Rep. Lindsay Thomas, D-Ga.) ("[T]he people I have heard from have not been people in investments, or wealthy people, but the landowners who worked the forest land in my district."); id. at H6281 (remarks of Rep. Sonny Callahan, R-Ala.). See also id. at H6278 (remarks of Rep. Charles Rangel, D-N.Y.) ("[T]imber becomes the issue rather than the social needs of our country."). See Charles Krauthammer, Stealing from the Future, Wash. Post, Sept. 28, 1989, at A31; 1990 House Hearings on Fairness, supra note 65, at 164 (statement of Robert McIntyre, Citizens for Tax Justice) (stating that timber is the most popular capital asset to the Ways and Means Committee). Two representatives from timber-growing districts opposed the 1989 capital gains cut, primarily on distributional grounds. See 135 Cong. Rec. H6282 (daily ed. Sept. 28, 1989) (remarks of Rep. Tim Valentine, D-N.C.); id. at H6291 (Rep. Les AuCoin, D-Ore.).

Hearings and the House floor debate on CWATRA, small business was most important. Although seldom mentioned in the hearings
or debates on the floor, Republicans surely supported capital gains for public stock held by high income individuals, since such "enterprisers" constitute a key Republican constituent group. Rare but revealing exceptions to this silence emerged when members of Congress opposed targeted capital gains proposals that would not benefit high income individuals or public stock.

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118 See John Lee, "Death and Taxes" and Hypocrisy, 60 Tax Notes 1393, 1397 (Sept. 6, 1993), for a discussion of the L.A. Times/Gallup Poll dissection of the voting electorate into 11 factions, including "enterprisers" who were affluent, highly educated, 99% white, 60% male, mostly married, and concentrated in the suburbs, with strongly pro-business, anti-government, and anti-welfare spending attitudes. In the late 1980s, enterprisers made up 16% of all likely voters, and together with "moralists" (roughly equivalent to the Christian Right), composed the core of the Republican coalition. For a discussion of the alignment of the Christian Right with the Republican Party, see Laurie Goodstein, Mixing God and Politics Brings Out the Naysayers, Wash. Post, Mar. 27, 1995, at A1.

118 For criticism of a "progressive" provision providing no additional preference at the top, see 138 Cong. Rec. S3683 (daily ed. Mar. 13, 1992) (remarks of Sen. Connie Mack, R-Fla.) ("[I]t fails to reduce the tax rate for those individuals who have large pools of capital . . . ."); id. at S3682 (remarks of Sen. Bob Kasten, R-Wis.) ("[K]eeping the tax rate high keeps that capital locked up and out of the hands of businesses who can grow and produce jobs."); 138 Cong. Rec. S3279 (daily ed. Mar. 11, 1992) (remarks of Senator Steve Symms, R-Idaho) ("It seems to me once again we are going to soak the rich but this time they don't even get anything in return."). For criticisms of § 1202, see 138 Cong. Rec. H783 (daily ed. Feb. 27, 1992) (remarks of Rep. George Riggs, R-Cal.) (stating that § 1202 did not provide a significant capital gains reduction "to help entrepreneurs attract the private venture capital necessary to grow a business . . . ."); cf. 138 Cong. Rec. S3106 (daily ed. Mar. 10, 1992) (remarks of Sen. Pete Dominici, R-N.M.) (stating that every time Congress attempted to target a capital gains preference, it was wrong as often as it was right, and did as much harm as good); id. at S3633-34 (daily ed. Mar. 13, 1992) (remarks of Sen. Bob Kasten, R-Wis.) ("The capital gains tax provision in the Finance Committee package would make the Tax Code
Perhaps most revealing was the voice of the capital gains “wannabe,” illustrated by a House Member in the floor debate on the 1989 Archer-sponsored capital gains cut (including indexing): “We have found from talking to many constituents, who will not benefit immediately, that they do not want to preempt opportunity because they want to have this opportunity.” In the 1995 Hearings and House floor debate on CWATRA, Rep. Jim Ramstad, R-Minn., recounted a story of a 17-year old who said he liked a capital gains preference. When asked if he had any capital gains, the teenager answered “[n]o, not now, . . . but someday I hope to.”

Anecdotes in the 1995 Hearings focused almost exclusively on small business and the capital gains “wannabe’s” (and, to a lesser degree, real estate), although timber and farming were also more complex while doing, in my view, very little to help reincentivize the small business sector of our economy.”


115 141 Cong. Rec. H4215 (daily ed. Apr. 5, 1995) (remarks of Rep. Jim Ramstad, R-Minn.); Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Rep. Jim Ramstad, R-Minn.); id. (statement of Jim Hoak, representative of American Business Conference) (“Most Americans believe that they can improve themselves and their family’s economic position.”). Ranking member and former Chair Sam Gibbons, D-Fla., responded that a 17 year old would be better off playing the lottery because only 8% of Americans ever win anything on the capital gains tax cut. 141 Cong. Rec. H4215 (daily ed. Apr. 5, 1995). Chair Bill Archer, R-Tex., rejoined that over a five-year period studied by the Joint Committee, 16% of the taxpayers reported a capital gain, so that over a life time a very, very large percentage of Americans would have “some type of capital gain.” Id. at H4231. The catch is that the top 2% accounted for 70% of the gains reported. The large number of taxpayers changing every year accounted for less than 10% of the gains over the five year period. See infra note 155 and accompanying text. So the chances of winning a capital gains prize of a small amount over one’s lifetime may not be that bad. But to win a big capital gains prize you have to be in the top 2%. Furthermore, most Americans are probably aware by now of the decline in the standard of living of the bottom and part of the middle-income taxpayers over the past decade or two. See infra notes 173 and 192-7 and accompanying text. Nevertheless, the “wannabe” effect may underlie the results in public opinion polls described in Cunningham and Schenk, supra note 34, at 369 n.217, in which 44% to two-thirds of those polled favored a cut in the capital gains rate. The vocal students in my Small Business Planning course supported a generic capital gains preference in the hopes that some day they would have capital gains, as upon the sale of stock, to pay for their children’s education. They expressly did not care that high income individuals would reduce the rate on largely economic gains with such a preference. Also, one student volunteered that the more he heard the rhetoric of take from the poor and give to the rich, the less it mattered to him. It may be noteworthy that he regularly realized capital gains as a law student.
Residences constitute an old red herring. This time the more sophisticated anecdote involved an atypical, under-age-fifty-five taxpayer who chose not to reinvest in a more expensive house. If the problem is the $125,000 ceiling under section 121, Congress should raise it or vary it regionally. Economists claim residences already garner too much of a preference.

Owner-occupied housing is the most tax favored asset under current law. The income from this asset, imputed gross rent, is excluded from the tax base. Owners are nonetheless permitted to deduct two expenses of ownership normally permitted only for income-generating assets, interest expense and property taxes. Capital gains on sale of a principal residence are excluded from tax if the owner purchases another house within two years. In addition, current law excuses the first $125,000 of capital gains on sale of a principal residence for homeowners over age 55 who sell their houses. The result of all of these concessions is the allocation of an excessive share of the U.S. capital stock to housing and too little to less favored assets.

See also Congressional Budget Office, Deficit Reduction Options (Mar. 3, 1995), available in 1995 Tax Notes Today 44-74 (Mar. 6, 1995) (stating that one-third of net private investment goes into owner-occupied housing). On the other hand, Canada has the same rate of home ownership, with no deduction for mortgage interest, but with a capital gains preference for sales proceeds. Id. Ranking minority member and former Chair Daniel Patrick Moynihan, D-N.Y., when told this by Chair Bob Packwood, R-Ore, responded “Oh, damn.” Senate Finance Hearing, Mar. 2, 1995, supra note 8.
Small business owners typically capitalize their ventures with minimum equity. High-tech venture capitalists similarly invest more sweat than cash equity and historically have done better than inflation; timberlot owners and farmers usually deduct most of their growing costs up front. Improved real estate, never mentioned in the debate, annually loses basis with depreciation. In contrast, high income churners on the public market have basis, but do not hold investments long enough to experience much inflation. Thus, most, if not all, of the traditional interest groups prefer a generic percentage exclusion to indexing of basis for inflation.

Notwithstanding Chair Bill Archer’s long commitment to indexing and its strong equity appeal, I expect to see it drop out of any final capital gains provision enacted by Congress this term. If Congress approved the indexing of basis of capital assets for inflation, instead of a 50% individual capital gains exclusion, history indicates that the above factors would give rise to political pressure to replace indexing with the preferred exclusion (at no revenue loss after several years of inflation). It took the proponents of a flat rate and short holding period only four years to replace the four-step, ten-year, sliding-scale capital gains deduction of the Revenue Act of 1934 with a plan offering the better of a 50% deduction (for the small capital gains income taxpayer) or a 15% rate (for the big capital gains income taxpayer) after two years. It took some proponents only four more years to pass the Revenue Act of 1942, which

1985, venture capital representatives and entrepreneurs in general explicitly preferred a generic exclusion over indexing; this was one of the stated reasons for the Reagan Administration abandoning the indexing of the basis of capital assets proposed in Treasury I in favor of a 50% exclusion of capital gain. Impact of Tax Simplification Hearings, supra note 37, at 963, 1004, 1011 (statements of Ass’t Sec’ty Charles McLure and Donald Ackerman, representative of National Venture Capital Association, respectively).

Former Under Secretary of Treasury Ed Cohen pointed out at the Spring 1995 Tax Symposium that farmland and residences in expensive metropolitan areas, both of which tend to have long holding periods, would benefit from inflation adjustments. While supporters of these two interests have been very vocal in the Congressional debates, see supra note 110, the capital gain attributable to farmland is in the range of gains attributable to timber and in some years less. Tax Reductions of 1978, supra note 35, at 17-19. The amount attributable to residences is much larger, in the 15% range in the 1970’s, and probably more today, but only a very small percentage of such gains are not shielded by the rollover provisions of § 1034 or the § 121 $125,000 shield for taxpayers who have attained age 55. Id. See supra note 106 and accompanying text.
offered the better of a 50% deduction or 25% rate after a six month holding period. This Act, which continued unchanged for over twenty-five years, remained only slightly modified for almost another decade, until the Revenue Act of 1978.123

Several witnesses at the 1995 Hearings suggested a sliding-scale alternative to indexing, either because it is less complicated,124 or because it serves as compensation for a lack of basis, as in the cases of the timber industry and small business.125 Chair Archer objected that a sliding scale would not make the taxpayer whole in

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123 The broad contours of the 1934 capital gains tax legislation, Pub. L. 73-216, § 117, 48 Stat. 680, 714 (1934), were set by the Joint Committee’s 1929 proposal of a two- to fifteen-year sliding scale capital gains deduction, with a 100% deduction after fifteen years, bottomed on: (a) the policy of approximating the tax payable, had the capital gain been realized ratably over the holding period; and (b) the premise that a large part of capital gains “is derived from the taxation of appreciation in money value as distinct from actual value.” Joint Comm. on Internal Revenue Taxation, Supplemental Report on Capital Gains and Losses, vol. 1, pt. 7, at 2 (1929). The House Ways and Means Committee Bill dropped the later years’ exclusions (including the 100% deduction) due to revenue needs. Confidential Senate 1934 Hearings, supra note 97, at 102-03 (statement of L. H. Parker, Chief of Joint Comm. Staff); H.R. Rep. No. 704, 73d Cong., 2d Sess. 10, 31 (1934) (“[T]he theory is that the gain or loss should be somewhat reduced in proportion to the time for which the capital asset has been held.”). The Senate bill (adopted by the Conference) added a fourth 10% step at year 10, resulting in a maximum deduction of 70% and hence a maximum capital gains rate of 20.1% to closer approximate the 1921 Act’s flat 12.5%. Confidential Senate 1934 Hearings, supra note 97, at 107 (colloquy between Sen. Reed, R-Pa., Ranking Minority Member, and Dr. Roswell Magill). Under this sliding scale deduction, capital gains taxes were considerably less than if the gain were taxed each year as it accrued. Revenue Act of 1938: Confidential Hearings on H.R. 9682 Before the Senate Comm. on Finance, 75th Cong., 3d Sess. 11 (1938) (statement of Dr. Magill, Ass’t to Sec’ty of the Treasury). In 1938, Congress under the rationales previously discussed, see supra note 107, collapsed the sliding scale into only two steps: a thirty-three and one-third percent deduction, or a maximum effective rate of 20% at 18 months, and a deduction of 50%, or a maximum effective rate of 15% at 24 months. Pub. L. No. 75-554, § 117(b), 52 Stat. 447, 501 (1938). In 1942, Congress went to a 50% deduction, or maximum rate of 25% at a 6 month holding period. Pub. L. No. 753, § 150, 56 Stat. 798, 843-44 (1942). “It has been shown that too high a capital gains tax will result in a loss of revenue to the Government.” H.R. Rep. No. 2333, 77th Cong., 2d Sess. 29 (1942). The Report also asserted that too high a capital gains tax would “have the effect of discouraging taxpayers from investing in new or productive enterprises,” reasoning that too high capital gains rates would discourage sales and hence reinvestment (in new and hence non-public stock). Id. at 29. The Report noted that with a top ordinary rate of 88%, “it is not believed that a moderate increase in the capital-gain rate will retard capital transactions.” Id. at 30.


125 See Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Bill Stuckey, former member of Ways and Means, representative of Forest Farmers Association); id. (statement of Richard Herring, representative of National Small Business United).
high inflation years and that it would have a "cliff," or blocking effect. Under the sliding-scale capital gains deductions of the Revenue Act of 1934, substantial blocking did indeed occur, as high-income individuals tended to sell gain equities only at the last (ten year) step.

Capital gain proponents argued that all realized capital gains consisted of inflationary gains, which over the years is true on the average. But a radically different story, with strong design implications, emerges when the data is broken down into realizations by high and low income individuals. All empirical studies to date show that inflationary gains tend to be a larger component of total realized capital gains among lower- and middle-income taxpayers than among high-income taxpayers. For example, in 1981, the more the individual's adjusted gross income class exceeded $100,000, the greater was the percentage of real or positive capital gains to nominal capital gains; capital gains were more than 80% real at the $1,000,000 level. Conversely, the further the individual's adjusted gross income class fell below $100,000, the greater the real or economic loss per dollar of nominal gain. The following table illustrates this phenomenon:

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127 Lee, supra note 35, at 1403.


129 Lee, supra note 35, at 1402; Shulding, supra note 85, at 558 n.75 (stating that taxpayers of moderate income tend to dispose of capital assets at a real loss, while high income taxpayers tend to dispose of assets at a gain). Several Treasury studies of capital gains realizations in the early 1960s, the 1970s, and the early 1980s also concluded that the top half by income of these individuals realizing capital gains in most years have a real or economic gain of roughly 50% of the nominal gains reported. E.g., Tax Reductions of 1978, supra note 35, at 10, 11, 47 (stating that in 1977 only taxpayers with over $100,000 adjusted gross income realized any real gains as to stock sales; for those with over $200,000, real gains were two-thirds of nominal gains). In all these studies, the higher the income bracket, the better the individuals' rate of return as to realized capital gains was in comparison to the rate of inflation. The lower half (in annual income) of the individual taxpayers annually reporting capital gains actually incur economic losses on the average. Staff of Joint Comm. on Taxation, Tax Treatment of Capital Gains and Losses, JCS-7-89, 26 (Mar. 11, 1989), available in 1989 Tax Notes Today 58-7 (Mar. 14, 1989) (hereinafter Capital Gains and Losses 1989).

<table>
<thead>
<tr>
<th>Adjusted Gross Income Class</th>
<th>Percentage of Real Gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000-199,999</td>
<td>20%</td>
</tr>
<tr>
<td>200,000-499,999</td>
<td>50%</td>
</tr>
<tr>
<td>500,000-999,999</td>
<td>70%</td>
</tr>
<tr>
<td>1,000,000 or more</td>
<td>82%</td>
</tr>
</tbody>
</table>

Note that for taxpayers with less than $100,000 in income, the rate of inflation exceeded their nominal gain. Considered alone, they, on average, reported tax gains, but suffered economic losses. Often, their economic losses equal the economic gains of the rich. Thus, the middle loses, but with the rich getting richer, it all averages out in the long run.

This pattern of real capital gains and losses realizations may reflect, to a degree, a tendency of upper-income taxpayers to sell real estate and (gain) securities shortly after the long-term holding period, whatever it is at the time.¹⁸¹ Both real estate and (gain) securities tend to appreciate more than inflation.¹⁸² Individual taxpayers below that upper income level tend to have held securities for longer periods and to have less real estate gains. Thus, disparities by income class (in the distribution of capital gains realizations and percentage of realizations consisting of economic gain) in the early 1980's were aggravated by the tendency of taxpayers in the lower quintiles who realized capital gains to have longer holding periods (reflecting less frequent sales), including the stagflation of the 1970's (high inflation and stagnating economy and stock market). On the other hand, the top quintile had shorter holding periods, tending to include only the lower inflation booming mar-

¹⁸¹ In the 1930's, under the ten-year sliding scale, 70% of the capital gains of individuals with income over $100,000 were from assets held over ten years, whereas only 25% of gains were from such assets in the case of individuals with incomes not exceeding $25,000. H.R. Rep. No. 2333, 77th Cong., 2d Sess. 30 (1942). In more recent years, realizations by high income taxpayers also tend to cluster in the first month after the long-term holding period has been met. Eric Fredland, John Gray, & Emil Sunley, Jr., The Six Month Holding Period for Capital Gains: An Empirical Analysis of its Effect on the Timing of Gains, 21 Nat'l Tax J. 467, 469-70 (1968) ("[T]axpayers in higher tax brackets postpone their gain beyond the sixth month to a much greater extent than taxpayers in lower brackets [and the] proportion realized in the seventh month increases as AGI increases."). See H.R. Rep. No. 413, 91st Cong., 1st Sess., pt. 1, at 151-52 (1969), reprinted in 1969 U.S.C.C.A.N. 1645; James Repetti, The Use of the Tax Law to Stabilize the Stock Market: the Efficacy of Holding Period Requirements, 8 Va. Tax Rev. 591, 615 (1989) (citing academic studies for stock realizations which show clustering in seventh month when there is a six month holding period).

¹⁸² Lee, supra note 35, at 1402.
ket years of the mid 1980s.

The Joint Committee on Taxation has recently suggested that such difference in inflationary gains by income class may reflect the tendency of high income individuals to invest in more risky investments, which generate higher average returns to compensate for risk.\textsuperscript{138} It concluded that, "[a]ll else being equal, an exclusion might be expected to offer greater tax benefits to higher-income taxpayers (who invest in risky assets) than would indexing."\textsuperscript{134} A commentator has suggested that this pattern may reflect a tendency of moderate-income taxpayers to invest in dividend-paying stocks, while high income taxpayers invest in growth (income-retaining) stocks.\textsuperscript{135}

Under the CWATRA capital gains proposals, these different patterns of inflationary and real or economic capital gains at the different individual income levels would produce the following result: higher-income individuals would tend to benefit more from the 50%-of-gain exclusion feature, while lower- and moderate-income individuals would tend to benefit more from the indexing feature. This would create the mirror image of the Revenue Act of 1942 (and early 1954 Code), where Congress anticipated that high-income individuals would use the alternative 25% rate, while individuals with small capital gains would use the 50% deduction.\textsuperscript{138} As a matter of designing a capital gains preference, a case could be made for similarly giving individual taxpayers the greater of indexing or a percentage exclusion, but not both.

Due to the compounding nature of indexing the basis of capital assets for inflation, the revenue losses are estimated to be much greater in the out years (six through ten) than in the five-year budget window.\textsuperscript{137} Since indexing of capital assets for inflation has

\textsuperscript{138} Capital Gains and Losses 1995, supra note 10, at 31. There are many ways to structure relatively low risk investments so as to achieve capital gains treatment. An example is retained earnings by mature corporations. Tax Reductions of 1978, supra note 35, at 56. Therefore, a capital gains preference is poorly targeted to offset a bias against risk. Id. See supra note 34.

\textsuperscript{134} Capital Gains and Losses 1995, supra note 10, at 31.

\textsuperscript{135} Roger Brinner, Inflation and the Definition of Taxable Personal Income in Sunley and Pechman, Inflation and the Income Tax 121, 135-37 (Henry Aaron ed., 1976); Shuldinger, supra note 85, at 558 n.75.

\textsuperscript{137} Lee, supra note 112, at 1395-96.

\textsuperscript{137} Ways & Means Hearing, Jan. 10, 1995, supra note 16; Prepared Statement of Ass't Sec'ty Samuels, supra note 83.
never been enacted in the Code, CBO correctly notes that a comparison of the dynamic effects of indexing with those of an exclusion cannot be inferred from historical data. It is highly uncertain whether indexing would have more of an unlocking effect than would an exclusion of the same average magnitude. In 1989, Treasury officials believed that it would not. In 1992, the Joint Committee Staff also apparently assumed that, under indexing, high-income individuals would be less likely to realize economic gains greater than inflation. They would therefore hold on to their capital assets (public stock) until more of the real gain was swallowed by inflation, while selling all stock that failed to exceed inflation. These assumptions were based on a projected drop from 80% to 60% in tax benefits in the short run (three years assuming a 3% rate of inflation), comparing basis indexing with a fixed percentage of gain exclusion. Any such blocking tendency surely would be increased by CWATRA’s three-year holding period for indexing. Capital gains revenues would tend to be further reduced by fewer realizations, which would tend to offset the reduction in revenue losses during the five-year budget window attributable to: (1) no inflation adjustment losses in years two and three, and (2) deemed realizations in year 1 from mark-to-market elections made to obtain indexed asset status for capital assets held on January 1, 1995.

Conceptually better solutions than indexing, with its blocking effects and complexities, would slant the benefits of any capital gains preference more to the middle- and low-income taxpayers. The inflation gains for these taxpayers are greater and the preference would tend to contribute less to blocking. (As long as step up in basis at death continues, any rate other than a 100% exclusion or annual accrual of unrealized gains tends to block realizations.) A “progressive” capital gains rate, with the percentage pref-

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138 Indexing Capital Gains, supra note 130, at 31-32; see Capital Gains and Losses 1990, supra note 21, at 33. Professor Shuldinger believes that indexing will not create an incentive to sell appreciated assets; the continued value of deferral and the loss of a stepped up basis for indexing by failure to sell will be offset by the benefit of further deferral. Shuldinger, supra note 85, at 560-61.

139 1989 Senate Hearings, supra note 70, at 20 (statement of Deputy Ass’t Sec’ty Dennis Ross).

erence *decreasing* as the taxpayer’s income increased, would serve as a very good “second-best” alternative to indexing the basis of capital assets to account for the rate of inflation.\textsuperscript{141} This decreasing preference system would not result in taxpayers holding capital assets longer in order to obtain a greater exclusion from an inflation adjustment, yet at each income level, it could be designed to exclude an amount equal to the average inflation gain at that level.

A provision containing such a decreasing preference system was passed by Congress in early 1992, but vetoed by President George Bush. That progressive schedule was designed by Chief of Joint Committee Staff Hank Gutman and Staff Economist Alan Auerbach for then Senate Finance Chair Lloyd Bentsen, D-Tex., (recently Secretary of the Treasury). The schedule capped the capital gains “permanent” rate on capital assets, other than small business stock covered by a separate targeted preference (and “collectibles”), at 28% for taxpayers whose ordinary income would be in the proposed 36% and above rate. The schedule also provided for (in the Conference version) a 0% capital gains rate for individuals otherwise in the 15% ordinary-income bracket. These two polar capital gains brackets roughly approximate the inflation gain on the average amount of capital gains reported at these two extremes of the income tax brackets,\textsuperscript{142} namely 20% and 100%.

I would modify the 1992 Conference progressive capital gains provision to more closely reflect economic income. To accomplish this goal, I would grant a 50% deduction at the current 31% bracket, because at this level, about 50% of reported capital gains consist of economic gain. A greater-than-50% deduction or exclusion would be needed at the 28% bracket to mimic economic gain; I would use whatever appropriate fraction approximates the average inflation gain in capital gains reported at the 28% bracket.\textsuperscript{143} The average inflation gain at this level is probably close to 100%. Such a provision, however, has no political support among Republicans because it would not benefit high-income individuals,\textsuperscript{144} who generally realize the majority of capital gains.

Another surrogate approach compensating for inflation, better

\textsuperscript{141} Lee, supra note 35, at 1404-05.

\textsuperscript{142} See supra notes 129-30 and accompanying text.

\textsuperscript{143} Lee, supra note 35, at 1404-05.

\textsuperscript{144} See supra note 112.
than an across-the-board, 50% exclusion, would be to exempt annual realizations below a certain ceiling, for example, $2,500 or $3,500. This provision also could be phased out beginning at adjusted gross income above, for example, $100,000. The ceiling provision resembles, in either form or effect, proposals by Senator Gaylord Nelson, D-Wis, in the 1970's, President George Bush in 1989, and Chair Dan Rostenkowski, D-Ill., in 1990 (including the phase out), and a suggestion in the 1995 Hearings by Rep. Mel Hancock, R-Mo.146 This ceiling approximates the average capital gain of the infrequent capital gain realizer whose gain tends to be all inflationary.146 This approach would also lack political support by Republicans because it would not provide much benefit to the high-income individuals who realize the bulk of capital gains year after year.

C. Fairness and Bunching or King-For-a-Day

At the time of the 1995 Hearings, the Clinton Administration had looked at the aggregate distribution of the tax cuts under the 1995 Republican Contract: 50% were distributed to families with incomes over $100,000. This distribution reduces progressivity and, accordingly, failed the Administration's fairness test.147 In the 1995 Hearings, opponents of a substantial generic capital gains preference, looking back to a similar provision advocated by President George Bush, frequently maintained that 60% to 70% of the bene-

146 Ways & Means Hearing, Jan. 10, 1995, supra note 16 (colloquy with Ass't Sec'ty Leslie Samuels); Ways & Means Hearing, Jan. 24, 1995, supra note 34 (statement of Rep. Mel Hancock, R-Mo.) (supporting zero capital gains “[m]erely to get rid of this asinine statement that capital gains only benefit the rich.”). For precisely the same reason, the 1989 Bush proposals excluded capital gains entirely for an individual with less than $20,000 in income for the realization year, if he or she was not subject to the alternate minimum tax. 1989 Senate Hearings, supra note 70, at 17 (statement of Deputy Ass't Sec'ty Dennis Ross). Ross further rationalized that such taxpayers are less responsive to rate changes, so “in the search for a more substantial incentive we went all the way to 100 percent.” Id. at 182. Professor Dodge criticized the Bush provision because such lower income taxpayers will have little or nothing to invest. Dodge, supra note 34, at 1136. On the other hand, when such taxpayers (probably by-and-large retired) do dispose of capital assets, all of their reported gain on average is inflationary and thus should not be taxed. The Joint Committee Staff in 1989 criticized the “cliff effect” of the Bush Administration's proposal. Capital Gains and Losses 1989, supra note 129, at 95.

147 Lee, supra note 35, at 1405.

148 Ways & Means Hearing, Jan. 10, 1995, supra note 16 (statement of Ass't Sec'ty Leslie Samuels).
fits of an individual generic capital gains preference would go to such high-income taxpayers. This percentage reflects their share of capital gains realizations combined with their higher brackets. (For the reasons discussed above, only half of the benefits from indexing would go to such taxpayers.) Treasury scored 76.3% of the benefits from the individual CWATRA capital gains exclusion and indexing as benefitting taxpayers with "family economic income" of $100,000 and above. Treasury's distribution tables

148 Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Rep. Sander Levin, D-Mich.) (stating that in 1991, 65% of realized capital gains went to families reporting $100,000 or more in income). Citizens for Tax Justice estimates that "almost two-thirds of total capital gains reported on individual tax returns go to people whose incomes exceed $200,000. In contrast, three-quarters of tax filers earn incomes of $50,000 or less but report only 8.7% of total capital gains." Amy Hamilton, Tax Loopholes in Republican Contract Could Cost States Billions, Taxpayer Advocacy Group Charges, 95 Tax Notes Today 49-5 (Mar. 13, 1995). Due to their higher brackets, more than two-thirds of the tax benefits of the proposed cuts would go to such high income taxpayers. "According to [House Minority Leader Richard] Gephardt, 76% of the capital gains cut would go to those earning more than $100,000 per year." Barbara Kirchheimer, Democrats to Limit Their Amendments to Archer Tax Bill, 95 Tax Notes Today 50-28 (Mar. 14, 1995). The Joint Committee Staff had estimated that 62.2% of the benefits of the 1992 Bush proposed cut in the capital gains rate (from 28% to 14%) would have gone to taxpayers reporting more than $200,000, and that an additional 15.15% of the benefits would have gone to taxpayers reporting between $100,000 and $200,000. Preliminary Distributional Effect of the President's Budget Proposal for Capital Gains, as contained in H.R. 4200 (Feb. 13, 1992), available in 92 Tax Notes Today 63-22 (Mar. 23, 1992); 138 Cong. Rec. H405 (daily ed. Feb. 11, 1992) (remarks of Rep. Richard Gephardt, D-Mo.) ("Its most significant idea for jumpstarting the economy is the tired and discredited capital gains cut, a proposal which conveys 70% of the benefits to people earning over $100,000.); 136 Cong. Rec. H8322 (daily ed. Sept. 28, 1990) (remarks of Rep. (now Senator) Barbara Boxer, D-Cal.); id. at H8700 (remarks of Rep. David Obey, D-Wis.). This pattern should not be surprising since, as of 1983, the top 10% of families owned approximately 89.3% of all publicly traded stock held by individuals. Democratic Staff of the Joint Economic Comm., 99th Cong., 2d Sess., Trends in the Distribution of Wealth Among American Families 24 (Comm. Print 1986). Indeed, the top 1% of families owned 31% of household net worth in 1983 (and 36% in 1989). Anne Fisher, The New Debate over the Very Rich, Fortune, June 29, 1992, at 42, 43; 1992 Senate Banking Comm. Hearing, supra note 107, at 65 (statement of Sen. Jim Sasser, D-Tenn.). More recent data pegs the top 1% as owning 40% of all household wealth in 1989. Keith Bradsher, Gap in Wealth in U.S. Called Widest in West, N.Y. Times, Apr. 17, 1995, at A1. Currently, the top 1% hold 49% of publicly held stock, 62% of business assets, 78% of bonds and trusts, and 45% of nonresidential real estate. Sylvia Nasar, Fed Gives New Evidence of 80's Gains by Richest, N.Y. Times, Apr. 21, 1992, at A1, A17. This corresponds with the pattern of the top 1% annually realizing 50% or more of the capital gains reported by individuals. See infra note 231.


showed that the top 1% of families (700,000 families, beginning at $349,438) receive 45.9% of such tax benefits; the top 5% (2,300,000 families, beginning at $145,412) receive 66.5% of such benefits; and the top 10% (3,500,000 families, beginning at $108,704) receive 73.9%. Chair Bill Archer, R-Tex., claimed that Treasury's distributions “grossly overstate the number of families in the upper-income brackets benefitting from the proposed tax breaks.” This view reflects an article of faith held by many proponents of a capital gains preference, which is that the vast majority of capital gain realizations are “once-in-a-lifetime” events, so that bunching up makes middle-income taxpayers only appear to be wealthy, or “king-for-a-day”.

In 1990, then-Representative (now Senator) Byron Dorgan, D-N.D., asked the Joint Committee on Taxation Staff to make a timed series study of a sample of capital gains realizations in the early 1980's. This study demonstrated that taxpayers accounting for sales in just one out of the five years sampled, while amounting

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111 CWATRA Effects on Receipts, supra note 150.

112 Eric Pianin & Dan Morgan, Tax-Cut Passed by House Committee; Democrats Appear to Be Making Inroads With Charge That GOP Bill Favors Wealthy, Wash. Post, Mar. 15, 1995, at A4. This view is now incorporated into H.R. Rep. No. 84, supra note 27, at 36: The Committee rejects the narrow view that reductions in the taxation of capital gains benefit primarily higher-income Americans. Traditional attempts to measure the benefit of a tax reduction for capital gains are deficient. Typically, the classification of individuals in such studies measure the individuals' incomes including any capital gains realized. Many Americans realize only one or two capital gains during their lifetime, for example upon the sale of family business upon retirement. Including the gain on such a one-time sale in the income of the individual makes the individual appear, for that one year, to be a higher-income taxpayer when, in other years, the taxpayer would appear to be solidly middle class.

to 40% or so of the taxpayers with capital gains in the timed series, reported less than 10% of the capital gain over the period studied. Those individuals with multiple transactions, year-after-year, obtained more than 81% of the tax benefits of the capital gains preference. More specifically, the 43.7% of the individual taxpayers in the sample who realized capital gains only once in the five-year period (1979 to 1983) had an average capital gain of $2,000 and realized only 9.8% of all capital gains realized by individuals in the period. On the other hand, the 15.7% of the individuals who realized capital gains in all five years realized an average capital gain of $100,000 and 58.9% of total capital gains realized over the period. Those who realized such gains in at least four years out of the five-year period recognized 70.9% of the total dollar value of reported capital gains.

These findings were confirmed by other researchers using the same model. The same pattern obtained in subsequent years:

In 1995, the Staff of the Joint Committee on Taxation concluded that:

Higher-income taxpayers generally hold a larger proportion of corporate stock and other capital assets than do other taxpayers.

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196 See Haliasos & Lyon, supra note 102; see generally Andrew Hoerner, Economists Examine Whether Progressivity has Regressed, 56 Tax Notes 1520, 1521 (Sept. 21, 1992).

197 Capital Gains and Losses 1995, supra note 10, at 30; Methodology 1990, supra note 155, at 49.
Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, a larger proportion of the dollar value of any tax reduction will go to those higher-income taxpayers who realize the bulk of the dollar value of gains.\textsuperscript{158}

An economist supporting a capital gains preference acknowledged that "there is no doubt in my mind that capital gains reductions benefit higher-income families compared with lower-income families."\textsuperscript{159}

There may be a grain of truth in the one-time event rhetoric; namely, small businesses and real estate are often sold on an installment-sale basis with payments received over a number of years. Treasury data from the early and late 1970's\textsuperscript{160} indicates that installment-reported capital gain amounted to between 9% and 14% of net gains.\textsuperscript{161} Thus, some one-time realizations could push an otherwise middle-income taxpayer into high income for a number of years. Installment reporting under section 453, however, would serve as an income averaging function, tending to compensate for accrual over a number of years.

One witness in the 1995 Hearings concluded that 75% of taxpayers reporting capital gains had wage and salary income of less than $50,000 and that they reported 50% of the capital gains.\textsuperscript{162} Many capital gains cut proponents pointed to the fact that the large majority of individual returns showing capital gains (approximately


\textsuperscript{159} Ways & Means Hearing, Jan. 24, 1995, supra note 34 (statement of Dr. Alan Sinai, managing director and chief global economist, Lehman Brothers) (stating that growth and ability to compete internationally were more important to him than income distribution). Rep. Pete Stark, D-Cal., interjected that the capital gains cuts, if so important, could be paid for by budget cuts distributed more to upper income taxpayers, rather than to lower income groups as proposed. Id. See infra note 208.

\textsuperscript{160} During this period of "stagflation" (denoting inflation while the economy lags), the stock market performed relatively poorly, which tended to inflate the percentage of realized capital gain attributable to sources other than equities.

\textsuperscript{161} Tax Reductions of 1978, supra note 35, at 17, 19.

\textsuperscript{162} Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Mark Bloomfield). This approach has the flaw of treating as a low income taxpayer a taxpayer with high capital gains, but low ordinary income year after year. Andrew Hoerner, Class Conflict and the "Classifier," 47 Tax Notes 145, 146 (Apr. 9, 1990) (criticizing similar Treasury study); see Zodrow, supra note 37, at 488 (stating that such approach seriously understates the income of the wealthy, particularly at the very highest income levels); Methodology 1990, supra note 155, at 50-51. And this is a pattern at very high income ranges. See infra notes 218 and 231. See infra note 162.
70% to 75%) are filed by middle- and lower-income taxpayers. This analysis is misleading because it ignores the very low percentage of realized gains (approximately 10%) that such taxpayers reported. Some proponents, claiming that the Republican distribution numbers are better than the Democratic numbers, went on to say, albeit erroneously, that most of the capital assets are owned by people with $50,000 or less in income, or that they pay 70% of the capital gains taxes, or that 75% of the taxpayers in that income class reported an item of capital gain in their returns (a pre-


What that carefully crafted statement means is that of the 8 million tax returns annually [out of 110 million individual returns] which show any capital gains activity, roughly 70 percent --about 5.5 million— are filed by those with incomes below $50,000 . . . Using Joint Tax Committee figures—Bush uses Treasury figures—there were 4.4 million returns containing capital gains filed by those earning under $50,000 per year. Under Bush-Archer-Jenkins, they would save $1.2 billion in taxes for an average of $280 each. That's 8% of the tax break under Bush-Archer-Jenkins. In contrast, there are 376,000 tax returns with capital gains by those earning over $200,000 per year. Under Bush-Archer-Jenkins, they would save $9.4 billion in taxes for an average of $25,000 each.

Id. at H6283 (remarks of Rep. Donald Pease, D-Oh.). Professor Zodrow assumes that it is the dollar magnitude of capital gains realized and not the number of taxpayers who realize a capital gain, however small that is of primary importance in evaluating the distributional effects of a capital gains tax cut. Zodrow, supra note 37, at 485.

posterous claim). But as former Commissioner Sheldon Cohen pointed out: “If you looked at the dollars, it skews the other way.” The 44% who reported a gain in only one in five years, together with the above moderate income returns, accounted for less than 10% of the capital gains reported.

Moreover, inclusion of imputed income from owner-occupied housing in “income,” for purposes of determining distribution of the benefits of a capital gains cut, was sharply criticized by Ways and Means Chair Bill Archer, R-Tex., as not understandable by American families. Assistant Secretary Leslie Samuels re-

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166 Ways & Means Hearings, Jan. 25, 1995, supra note 33 (statement of Rep. Ron Wyden, D-Ore.). Cf. 1990 House Hearings on Fairness, supra note 65, at 263 (statement of Rep. Raymond McGrath, R-N.Y.) (“Now, we can argue whether or not there is a distributational problem with it. Some people say yes and some people say no.”); id. at 27-28 (statement of Rep. Bill Frenzel, R-Minn.); id. at 268 (statement of Rep. Don Sundquist, R-Tenn.). In 1995, Rep. Sander Levin, D-Mich., rejoined that it was no use obscuring the fact that distribution of the benefits of a capital gains preference went to high income individuals. Ways & Means Hearing, Jan. 25, 1995, supra note 33. Professor Dodge also believed that capital gains proponents were attempting to confuse the issue. Dodge, supra note 34, at 1136. They appear to have confused themselves. See supra note 164.


168 Ways & Means Hearing, Jan. 10, 1995, supra note 16 (colloquy of Ass't Sec'ty Leslie Samuels with Chair Bill Archer, R-Tex., and Rep. Andy Jacobs, D-Ind.).

Once again you use the —what I believe the public totally discredited— family economic income as a formula, which includes the so-called imputed rental value of your home if you own your own home to determine what income class you're in, that includes the imputed value of inside buildup of pension plans, life insurance, Keogh plans, IRAs and 401Ks to determine what your income is in a particular year; and includes what is labeled as a lump sum income that you did not report.

Now, how does the Treasury know how much income a family does not report? Can you look under their mattresses and into their bathrooms and all the other things that relate to their lives and be able to come up with some magic figure that “We know you didn't report this, therefore, we're going to include it to determine how, quote, rich you are.”

Id. (statement of Chair Bill Archer, R-Tex.). In the floor debate on CWATRA, Chair Archer pointed to such imputation as the reason Treasury distribution figures were not “credible.” 141 Cong. Rec. H4215, 4231 (daily ed. Apr. 5, 1995).

Mortimer Caplin, President John Kennedy's Commissioner of Internal Revenue and member of the Virginia Tax Study Group, recounts how Congressional leaders initially opposed Professor Surrey's appointment as Assistant Secretary for Tax Policy, due to his published statements on tax policy favoring, for example, imputed rental income to taxpayers occupying their personally owned residences (and, I suspect, “favoring” taxation of unrealized appreciation at death or at least “carryover basis” as well). Accordingly, Congressional leaders required a commitment that Secretary of the Treasury Douglas Dillon would present Treasury's tax proposals. This story may partially explain the House Ways and Means Chair Wilbur Mills’ compliments to Secretary Dillon on his 1963 presentations. 1963 House Hearings, supra note 110, at 688. See also id. at 1068 (statement of Harvard Business Pro-
sponded that imputed income is a very small part of "family economic income" (and not subject to tax). In a subsequent colloquy, Samuels pointed out that the practice commenced in the Ford Administration, two decades earlier. Archer also questioned why

fessor Dan Throop Smith) ("The idea of presumptive realization of gains at death is an old favorite among some writers on tax theory, along with inclusion of rental value of owner-occupied homes and employers' contributions to pension trusts in the individual tax base. It should be rejected, as these other theoretical proposals have been rejected.").

168 Treasury constructs "family economic income" by adding the following to AGI: unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC (food stamps); employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation. CWATRA Effects on Receipts, supra note 150; James Nunns, OTA's Methodology for Distributional Analysis (Dec. 16, 1993), available in 93 Tax Notes Today 259-27 (Dec. 22, 1993); Susan C. Nelson, Family Economic Income and Other Income Concepts Used in Analyzing Tax Reform, Office of Tax Analysis, Dep't of Treas., Compendium of Tax Research 1987 (G.F.O. 1987). The economic incomes of all members of a family, which generally operate as an economic unit, are added to arrive at the family's economic income used in the distributions. The Joint Committee on Taxation makes similar adjustments for "distribution" purposes in its annual income concept, called "expanded income," which include: (1) tax-exempt interest; (2) employer contributions for health plans and life insurance; (3) employer share of FICA tax; (4) workers' compensation; (5) nontaxable Social Security benefits; (6) the insurance value of Medicare benefits; (7) corporate income tax liability attributed to stockholders; (8) alternative minimum tax preference items; and (9) excluded income of U.S. citizens living abroad. Barthold, The JCT Distributional Analysis of OBRA 93 (Dec. 13, 1993), available in 93 Tax Notes Today 259-28 (Dec. 22, 1993). The Treasury adjustments more closely follow Haig-Simons precepts than does the JCT, particularly as to the accrual of capital gains and the imputation of rent. Joint Comm. on Taxation, Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens JCS-7-93, at 89 n.147 (June 14, 1993), available in 93 Tax Notes Today 133-21 (June 23, 1993) (hereinafter Measuring Changes in Distribution of Tax Benefits). See generally Jane Gravelle, Distributional Effects of Tax Provisions in the Contract With America As Reported by the Ways and Means Committee (Apr. 3, 1995), available in 95 Tax Notes Today 66-33 (Apr. 5, 1995)(hereinafter CRS Distributional Effects); Gene Steurle, The Distributional Effects of Tax Changes, 66 Tax Notes 2027, 2028 (Mar. 27, 1995). The Joint Committee on Taxation's figures show the middle class getting the largest percentage reduction in taxes under CWATRA, while Treasury's figures show the greatest reduction at the top, with an estimated benefit there three times greater than the JCT's. Martin Sullivan, Computer Bytes to Sound Bytes: JCT & Treasury Analysis of CWATRA, 95 Tax Notes Today 76-3 (Apr. 19, 1995) (stating that two-thirds of difference attributable to treatment of corporate taxes). In addition to criticizing imputation of rent, Chair Bill Archer criticized annual accrual of capital gain. 141 Cong. Rec. H4231 (daily ed. Apr. 5, 1995) ("[S]ome people start their business early in life and do not show a capital gain until later when they sell their business. It may be many years. The Treasury figures show them as accruing giant gains each year, and of course when they do finally sell in a one time in a lifetime sale, they are declared to be rich.").

169 Ways & Means Hearing, Jan. 10, 1995, supra note 16 (statement of Ass't Sec'ty Leslie Samuels).
the "burden tables" did not include the additional income taxes that high-income taxpayers would pay due to increased realizations induced by a capital gains tax cut.\textsuperscript{170} Samuels' response was that the distribution tables were based on static realizations, and therefore did not include "voluntary" induced realizations.\textsuperscript{171}

The CWATRA House Committee Report asserts that another deficiency in the distribution studies is their classification only by current economic condition. "Studies show that there is substantial economic mobility in the United States. An individual who might be counted as lower income now may in a decade be higher in-

\textsuperscript{170} Ways & Means Hearing, Jan. 10, 1995, supra note 16 (colloquy between Chair Bill Archer, R-Tex., and Ass't Sec'ty Leslie Samuels). Treasury, in 1990, measured the distribution of the benefits of a capital gains cut by a "dynamic distribution analysis," which took into account the increased capital gains taxes attributable to increased realizations induced by the tax cut. Fiscal Year 1991 Budget Proposals: Hearings Before the Senate Comm. on Finance, 101st Cong., 2d Sess. 22 (1990) (statement of Ass't Sec'ty Ken Gideon). Chair Archer used such an analysis to show that the top 1% and the top 10% will pay greater taxes under the Republican Contract. Archer Releases Data on Tax Burden of Contract Items (Mar. 31, 1995), available in 95 Tax Notes Today 64-57 (Apr. 3, 1995). The increase appears attributable to increased capital gains realizations. CRS Distributional Effects, supra note 168. Opponents of the CWATRA capital gains provisions argued that the increased taxes reflected that "[u]nder the Republican bill, the rich get richer so it is logical that they will pay additional taxes on the extra money they earn." 141 Cong. Rec. H4318 (daily ed. Apr. 5, 1995) (remarks of Rep. Jim McDermott, D-Wash.).

\textsuperscript{171} Ways & Means Hearing, Jan. 10, 1995, supra note 16 (statement of Ass't Sec'ty Leslie Samuels). The Joint Committee Staff explained:

\begin{quote}
In other words, this calculation measures only the benefit the taxpayer receives if he or she does not alter behavior. This is a conservative estimate of the actual benefit, because it does not assume a behavioral response. If taxpayers respond by realizing additional [capital] gains they will obtain even more benefit from the change, since taxpayers change their behavior only if the change makes them even better off. Thus, this calculation understates the benefit received by higher income taxpayers. In other words, Table 2 reports the distribution of the tax burden rather than the distribution of taxes paid. If a reduction in capital gains tax rates leads to greater realizations and tax revenue paid by high-income taxpayers, the distribution of taxes paid will have shifted more onto high-income taxpayers. However, an increase in the distribution of taxes paid does not imply that the tax burden on high-income taxpayers has increased, because, as noted above, any additional tax paid in response to a capital gains rate cut results only from changed behavior.
\end{quote}

Capital Gains and Losses 1990, supra note 21, at 31-32; see also Measuring Changes in Distribution of Tax Benefits, supra note 168, at 7; Zodrow, supra note 37, at 491 (stating that, since increased realizations are voluntary, the "marginal benefits of the increased realizations must exceed the associated marginal capital gains tax costs incurred."); Jane Gravelle & Lawrence Lindsey, Capital Gains, 38 Tax Notes 397, 404 (Jan. 25, 1988); Steurle, supra note 168. CRS Distributional Effects, supra note 168, strongly criticizes the current JCT practice of basing distributional effects on induced realizations.
come." Treasury in the Bush Administration, in response to arguments leveled by Democrats with increasing effectiveness in the early 1990's concerning the failure of "trickle down," reported that as much as one-third of the taxpayers who were at the bottom of the income scale in 1979 moved up the scale during the 1990's, and that, similarly, as many as one-third in the top 20% moved down the income scale during this period.

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179 1990 House Hearings on Fairness, supra note 65, at 275 (statement of Rep. Marty Russo, D-Ill.); accord, id. (statements of Rep. Richard Gephardt, D-Mo., and Sen. Bill Bradley, D-N.J.). Commencing in 1990, Democrats successfully used the argument that the tax cuts of 1981 (and capital gains cut of 1978) had benefitted only the rich; the benefits had not trickled down to the middle- and lower-income taxpayers. Majority Staff of House Comm. on Ways and Means, Tax Progressivity and Income Distribution, 101st Cong., 1st Sess. 2-4, 12-13 (Comm. Print 1990) (hereinafter Progressivity and Income Distribution); Staff of Joint Comm. on Taxation, Tax Policy and the Macroeconomy: Stabilization, Growth and Distribution, 102d Cong., 1st Sess. 5, 29-30, 55 (Comm. Print 1991) (hereinafter Tax Policy and the Macroeconomy); Paul Taylor, Tax Policy as Political Battleground, Wash. Post, Feb. 18, 1990, at A1. See generally Mickey Kaus, The End of Equality 29-32 (BasicBooks 1992); T. Edsall & M. Edsall, Chain Reaction 159-65, 219-20 (W.W. Norton & Co. 1991) (distributional effect by political affiliation). Some of this rhetoric appears supra note 52 and infra notes 192-98. The income at the top almost doubled, primarily due to speculative bubbles in the stock market and real estate. Michael Mandel, Who'll Get the Lion's Share of Wealth in the '90s? The Lions, Business Week, June 8, 1992, at 86. The increase in average income of the top quintile of households was due to the fact that the greatest changes overall were in the mix of incomes, with greatest increases in capital gains, dividend and interest incomes. The middle's share of these kinds of incomes remained low. The median after-tax income of the top 1% of households increased 94% to over $500,000 from 1978 to 1990; the telling statistics are that the rich's income from capital gains increased 171% and that their dollar increase in interest income approximated the dollar increase in capital gains. Matthew Cooper & Dorian Friedman, The Rich in America, U.S. News & World Rep., November 18, 1991, at 35 (212% increase in executive pay); Sylvia Nasar, Fed Gives New Evidence of 80's Gains for the Wealthiest, N.Y. Times, Apr. 21, 1992, at A1, A17. The decrease in average wage and increase in average hours reflects to a large degree, the increase in two working spouses households. Juliet Schor, The Overworked American 19-22, 25-6, 29-34, 39-41, 167-74 (BasicBooks 1991), concludes that over the past 20 years the average number of annual hours increased from 1,786 to 1,949, or 163 hours; as much as 12% of the workforce holds 2 jobs. In 1990, nearly 60% of mothers with pre-school children worked; 75% of mothers with school age children worked. Felicity Barringer, New Census Data Reveal Redistribution of Poverty, N.Y. Times, May 29, 1992, at A14. Only 46% of mothers with pre-schoolers worked in 1980. Barbara Vobejda, A Nation in Transition, Wash. Post, May 29, 1992, at A1, A19. Similarly, during this period per capita income paradoxically went up 23% from 1977 to 1989, but real family income went up only 8.6%, with 70% of the growth at the top 1%, and 95% at the top 5%. Paul Krugman, Disparity and Despair, U.S. News & World Rep., Mar. 23, 1992, at 54. 174 U.S. Dep't of the Tress. Office of Tax Analysis, Household Income Mobility During the 1980's: A Statistical Assessment Based on Tax Return Data (June 1, 1992) (hereinafter Treasury, Income Mobility); see 138 Cong. Rec. S9125 (daily ed. June 29, 1992) (remarks of
Thus, there was allegedly great income mobility during this period. These factual claims, however, while themselves accurate, present a distorted picture. An Urban Institute study on income class mobility released at about the same time concludes that there has been some income mobility decade by decade, but the degree of such mobility did not increase during the 1980's, and such mobility to a large degree reflected the life cycle of workers. The Urban Institute study concluded: "While the poor can 'make it' in America and the wealthy can 'fall from grace,' these events are neither very common nor more likely to occur today than in the 1970's." Many of the people in Treasury's bottom quintile in 1979 were in fact middle- or high-income taxpayers, such as business people or farmers with a bad year, and especially recent college graduates. Indeed, the average age of those in the bottom (first) quintile in 1979 who had risen to the top or fifth quintile ten years later was twenty-two; of those who had risen to the middle class, the average age was twenty-three. With ages twenty-two and twenty-three as starting points for workers who moved up substantially in income, the increase in income over the decade of the bottom quintile reflected not only the work cycle, but also status changes, i.e., marriage and a two-earner household. Similarly, a

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176 From this, some argue that income redistribution makes no sense because: (a) different players will benefit and suffer; (b) this shows some factor other than Republican policies, i.e., trickle down, was at work, and thus the tax cuts of the 1980s should not be reversed; or (c) in a repeat of social Darwinism well-suited to the 80s (both the 1880s and the 1980s), this is simply the "creative destruction" of Schumpeterian capitalism, Joseph A. Schumpeter, The Theory of Economic Development 131 (Harvard University Press 1934), at its best, tearing down to build anew. Furthermore, income disparity is necessary to fuel capitalistic competitiveness according to Kaus, supra note 173. This theme is ideologically woven into education and lifestyle choices of poor, etc., by R. McKenzie, The "Fortunate Fifth" Fallacy 28-9, 31 (Center for Study of American Business Policy Study No. 111, May 1992).


177 Id.

178 Steven Mufson, Treasury's Look at Income Mobility; Study Fuels Argument Over Who Benefitted from the Reagan Era, Wash. Post, June 3, 1992, at A17 (relying on Lee Price, a staff economist with the Joint Economic Committee).

179 See Sylvia Nasar, One Study's Riches, Another's Rags, N.Y. Times, June 17, 1992, at
lot of the short-term turnover at the top (each year about 25% were not in that income class the year before):

reflects reporting error, timing of income like capital gains, episodes of illness or unemployment and other transitory effects that have little to do with true mobility. In the 1980's, it became easier for those in the middle class to become rich but harder for the rich to fall out of the top 10 percent. The explosive growth of pay for top professionals and managers in the era propelled lots of people into the ranks of the rich. More troubling was the finding, based on the same data, that it became harder to climb out of poverty largely because of the stagnation and outright decline of real earnings among young, less-educated men.

Considering, for example, that the median age of the top 1% was fifty-three in 1981, looking ten years after 1979 at those who had been in the top 1% of taxpayers at that time, the median age would be at least sixty-three. In 1990, one would expect that a large percentage of this group had retired and therefore had lower incomes. "In other words, it is not a question of the poor getting poorer and the rich getting richer as much as the young getting older and the rich retiring."

Notwithstanding the distribution of the benefits of a capital gains cut primarily to high-income families, or the top 2% of families, and that 70% of the individual returns report no capital gains, there is still a political element beyond ideology. A large number of

D1, D19.


181 Id. at D5 (relying on study by Duncan, Smeeding, and Rogers that would be published in "Inequality at the Close of the 20th Century" by the Levy Institute).

182 Fisher, supra note 148, at 44.

183 Mufson, supra note 178. Even the Treasury "Assessment" itself concluded:

Taxpayers whose incomes rise in the income distribution over time tend to be younger at the beginning of the sample period than households whose incomes stay constant or fall in the income distribution over time. This pattern is consistent with intuition about life-cycle patterns in earnings.

Taxpayers falling into lower-income quintiles over time tend to be older . . . Taxpayers who were in the fifth quintile in 1979 and first quintile in 1988 had an average wage share of 37 percent, likely indicating partial or full retirement for many such taxpayers . . . [T]he wage share for individuals starting and remaining in the fifth quintile over time is approximately 80 percent in each year of the sample.

Treasury, Income Mobility, supra 174, at 1, 6, 7.
middle-income taxpayers see themselves as potential beneficiaries of capital gains cuts; they are the "wannabes." Members of Congress frequently claim to hear their voices.

Solutions more tightly focused on these classes of taxpayers include: (1) capital gains income averaging; (2) a lifetime gain of, for example, $200,000, exclusive of public stock and subject to a 50% deduction, as the House passed in 1990; or (3) liberalized sections 1044 and 1202, as discussed above. A 30% generic exclusion would also be more fair than the current flat 28%, which provides the equivalent of a 30% exclusion at the 39.6% rate (coincidentally, equal to the average inflation gain at that income level), but no exclusion for the 28% and 15% brackets (where, ironically, most or all of the gain is inflationary on the average). Again, some or all of these would not be that expensive, but have little or

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184 Andrew Hoerner, supra note 162, at 147 (asserting that 11 million returns with average annual incomes of less than $70,000 reported capital gains); see Ways & Means Hearing, Jan. 24, 1995, supra note 34 (statement of Mark Bloomfield) ("[T]here's a heck of a lot of middle-class people who have capital gains, too."); Ways and Means Hearing, Jan. 25, 1995, supra note 33 (statement of Rep. John Ensign, R-Nev.). Add the wannabes and you have a substantial number of voters, although not much of the realized capital gain.


187 In the 1990 House Hearings on Fairness, supra note 65, at 260-61, Rep. Tom Downey, D-N.Y., argued that due to the appeal of doing something for the once-in-a-lifetime sale, and the thread having been pulled on the fabric of the 1986 Act when the House passed a generic capital gains cut in 1989, the "Northern Democrats" would lose without an alternative to the Bush Administration's generic capital gains proposals. He suggested a lifetime exclusion of, for example, $60,000 of capital gain, with an income cap of, for example, $200,000 or $150,000. Others agreed with the concept and strategy. Id. at 249, 267, 270. This was the origin of Ways and Means Chair Dan Rostenkowski's 1990 Middle Class Capital Gain Proposal: a 50% capital gain deduction with a lifetime cap of $100,000 in deductions applicable to assets such as farms, typical small businesses, homes, and timber, but not to public stock. In addition to the lifetime cap, $1,000 in capital gain from all sources except "collectibles" would have been excluded annually, but this exclusion covering public stock was phased out over $100,000 to $150,000 in taxable joint return income. Ways & Means Democratic Alternative (Oct. 12, 1990), available in 90 Tax Notes Today 210-8 (Oct. 15, 1990). This provision passed the House on strictly partisan lines with 90% of the Democrats for, and 95% of the Republicans against. 136 Cong. Rec. H10296 (daily ed. Oct. 16, 1990) (Roll No. 474); 41 Cong. Q. Almanac 150-H (1990). The "Middle Class Capital Gains" provision died in Conference, as Chair Dan Rostenkowski, D-III., apparently intended. Rosty threatens Combat with Bush over Top Rate Increase, 90 Tax Notes Today 212-13 (Oct. 17, 1990).

188 Ways & Means Hearing, Jan. 25, 1995, supra note 33 (statement of Chair Bill Archer, R-Tex.); id. (statement of David Lietzke, representing Bay Networks) (stating that generic deduction a lot more fair and much more populist than 28% ceiling which only benefits top two brackets); Lee, supra note 35, at 1400.
no special interest constituency important to capital gains proponents. The history of prior analogous tax cuts targeted solely to small businesses and farmers, the special interest groups most often articulated by proponents of a generic cut as needing tax relief, suggests that they are not the true, or perhaps not even the primary, intended beneficiaries of a capital gains cut.

Capital gains proponents and the CWATRA Committee Report claim that a reduction in capital gains leads to increased investment, which in turn leads to greater productivity and higher wages, thus benefiting all individuals. The premise that substantially all of the tax savings from capital gains cuts will be reinvested is

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188 In 1976, the liberal coalition in the Senate proposed an estate and gift tax reform amendment strictly limited to closely-held businesses and farms. 122 Cong. Rec. 25950, 25953-54 (1976) (remarks of Sen. Edward Kennedy, D-Mass.). Despite the fact that rhetoric for the general Estate and Gift Tax “Reform,” greatly raising the exemption, focused almost exclusively on closely-held farms and businesses (which obtained only 2% of the benefits of the expansion), id., the Kennedy amendment was roundly defeated, 78 to 6. Id. at 25956 (Roll No. 490). Senator Edward Kennedy, again in 1981, sought to limit similarly the proposed increase in the unified estate and gift tax credit to estates and donors with interests in small farms and businesses. 127 Cong. Rec. 17124 (1981) (remarks of Sen. Edward Kennedy, D-Mass.) (“Only 15 percent of the relief [of the committee provision] goes to family farms, and approximately 15 percent more goes to small businesses.”). Ranking minority member of the Senate Finance Committee, Senator Russell Long, D-La., pointedly argued that Kennedy's amendment meant “that a person who dedicates his life to serving the public in public office is unworthy of equal tax treatment with a small businessman or farmer.” Id. at 17126. Senator Kennedy's amendment was defeated this time 87 to 9. Id. at 17127 (Roll No. 217). Similarly, a 1992 amendment sponsored by Senator Bob Kasten, R-Wis., allowing farmers alone a tax-free roll over of the proceeds of the sale of farm assets into an IRA (to be paid for by extension of customs user fees and elimination of the statute of limitations on collection of defaulted student loans) was opposed both on equity grounds, and on fairness grounds with relation to other business people”. 138 Cong. Rec. S3641. (daily ed. Mar. 13, 1992) (remarks of Sen. Bill Bradley, D-N.J.). This amendment more narrowly failed on a partisan vote, 53 to 45. Id. at S3643 (Roll No. 49); 50 Cong. Q. Wkly. Rep. 760 (Mar. 21, 1992) (Republicans favored 34 to 9, while Northern and Southern Democrats opposed, 30 to 8 and 14 to 3, respectively). Section 1202 constitutes a rare exception to this pattern and was not subject to a separate vote in 1993, although similar provisions had been in earlier years.

189 See Lee, supra note 112, at 1399 and n.38 (noting allegations by commentators and then Rep. (now Sen.) Barbara Boxer, D-Cal., that real Republican agenda in capital gains cuts is taking care of their core constituency of the wealthy). See supra note 112 and infra note 247.

highly questionable.\textsuperscript{191} The historical record is clear, however, that the 1978 and 1981 capital gains cuts did not translate into higher wages for moderate- and lower-income taxpayers. Indeed, wages adjusted for inflation have been falling at the middle and bottom income levels over the past two decades.\textsuperscript{192} This was the basis for the failure of trickle-down rhetoric of the Democrats in the early 1990's. During his 1992 presidential campaign, in television "debates" campaign speeches, and his book-program Putting People First: A National Economic Strategy for America,\textsuperscript{193} Democratic Governor Bill Clinton of Arkansas charged that the 1979 to 1990 stagnation in income of the middle 40% of households and the drop in income of the bottom 40%, while the income of the top 20% alone increased (doubling at the top 1% level), were due to a failed economic policy: trickle down economics. Governor Clinton described trickle down economics as "[t]he economic philosophy . . . 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

\textsuperscript{191} See infra notes 298-301 and accompanying text.

\textsuperscript{192} There is no agreement as to why inequality is rising faster in the United States than elsewhere. Explanations include falling wages for unskilled workers as automation spreads, low tax rates on the rich during the 1980's, relatively low minimum wages, the decline of trade unions and the rapid rise in the 1980's of the stock and bond markets in which rich people are heavily invested. . . . While incomes rose for the most affluent two-fifths of the nation's households as the economy expanded in 1993, the rest of the country suffered from falling incomes, after adjusting for inflation.

Bradsher, supra note 148, at D4. The pre-tax changes in income are apparently due in part to increased pay for skills (particularly those attained through education) and decreased pay for lack of skills, which in turn may reflect, to some degree, the globalization of the economy with the economic principle of "factor price equalization" coming into play. Lester Thurow, Head to Head 52-3 (William Murrow & Co. 1992); H.R. Doc. No. 177, 102d Cong., 2d Sess. 101-02, 112-13 (1992). See also supra note 173. The argument of capital gains proponents, "that wages have stagnated in large part because we have a Tax Code that penalizes people who invest, people who invest, people who save, people who take risks to create new jobs . . . .", 141 Cong. Rec. H4216 (daily ed. Apr. 5, 1995) (remarks of Rep. Dick Zimmer, R-N.J.), is just another variant of the trickle down argument. Wages at the bottom stagnated when capital gains taxes were cut before, in 1978 and 1981. The argument of a capital gains cut opponent comes closer to the mark: "Corporate America has exported our jobs overseas for cheap labor. As trade unions have been beaten back, hard-earned benefits like health coverage, pensions and family leave have eroded. . . . [I]n the 1980's, [payroll] taxes have increased on working class Americans." Id. at H4252-53 (remarks of Rep. Maxine Waters, D-Cal.).

\textsuperscript{193} Bill Clinton, Putting People First, 1-2 (1992).
decisions to invest and to create jobs." Clinton liked to encapsulate this aspect of the 1980's distribution of income in the following statistic derived from the New York Times:

During the 1980s the wealthiest one percent of Americans got 70 percent of income gains. By the end of the decade, American CEOs were paying themselves 100 times more than their workers. Washington stood by while quick-buck artists brought down the Savings and Loan industry, leaving the rest of us with a $500 billion bill.

While the rich cashed in, the forgotten middle class—those people who work hard and play by the rules—took it on the chin. They worked harder for less money and paid more taxes to a government that failed to produce what we need.


Secretary of the Treasury Andrew Mellon popularized trickle down economics the first time as he induced Congress to reduce the individual elite or "class" Federal income tax maximum rate from 73% to 25% in steps from 1921 to 1925. Pub. L. No. 67-98, §§ 210 (normal tax of 8%) and 211 (maximum surtax of 50% on net income over $200,000), 42 Stat. 227, 233, 237 (1921); Pub. L. No. 69-20 §§ 210 (maximum normal rate of 5%) and 211 (maximum surtax of 20% of net income in excess of $100,000), 44 Stat. 9, 21-23 (1926). Corporate taxes were reduced as well, and with the Mellon-added disparity at the shareholder level, between dividends taxed at ordinary rates and capital gains then taxed at 12.5%, corporations greatly reduced their dividend rate and increased by 50% the percentage of earnings retained (invested in mostly excess capacity, it turned out), while the rich engaged in orgies of speculations. In 1925, only 2.5 million individuals paid income taxes, and the top 10,000 (with incomes exceeding $100,000; or $700,000 today) paid almost half of the Federal income taxes; their capital gains income from sales of publicly traded stock equalled the ordinary income reported that year. Report of a Subcommittee of the Committee on Ways and Means, Proposed Revision of the Revenue Laws, 1938, 75th Cong., 3d Sess. 90 (1938) (hereinafter Vinson Report); Revenue Revision, 1938: Hearings Before the House Comm. on Ways and Means, 75th Cong., 3d Sess. 116-21 (1938). In contrast to this class tax, the masses paid regressive excise taxes on soft drinks, movies, cars, etc., producing far more revenue than the individual income tax. Revenue Act of 1932: Hearings Before the Senate Comm. on Finance, 72d Cong., 1st Sess. 3 (1932) (statement of Secretary of the Treasury Ogden Mills). See Kornhauser, supra note 47, at 149. Moreover, as in the 1980s, the wages for the working folk declined. Lee, supra note 112, at 1397 n. 22a. The deflationary period following the bursting of the those speculative bubbles is known as the Great Depression.

Clinton's statistic was Sylvia Nasar, The 1980's: A Very Good Time for the Very Rich, N.Y. Times, Mar. 5, 1992, at A11 (stating that the top 1% earned 60%; later CBO corrected unadjusted figure to 70%). See generally Sylvia Nasar, The Richest Getting Richer: Now It's a Top Political Issue, N.Y. Times, May 11, 1992, at D1 (quoting Dee Dee Myers as stating that Clinton "was reading the paper that morning and went crazy . . . . The story proved a point he had been trying to make for months, so he added the statistic to his repertoire"). For a critique of Clinton's numbers, see David Lauter & James Gerstenzang, Accuracy of Bush, Clinton Accusations Varies, L.A. Times, Oct. 11, 1992, at 36 ("One set of numbers show the top 1% absorbed 70% of the income gains of the 1980s. By another measure, the
Governor Clinton added that, "for the first time since the Roaring '20s, the top one percent of the American people now control more wealth than the bottom 90 percent." In the Third Debate Governor Clinton opened with this factual assertion: "middle-class Americans are basically the only group of Americans who've been taxed more in the 1980s and during the last 12 years, even though their incomes have gone down, the wealthiest Americans have been taxed much less, even though their incomes have gone up."

D. Revenue

The Joint Committee Staff has found that the capital gains relief in Republican Contract, as originally proposed, would cost $53.9 billion over five years and $170 billion over ten years. The Joint Committee Staff scored the capital gains proposals, as modified on March 9, 1995, as losing only $31.7 billion over the first five years, with most of the change attributable to a scaled-back corporate capital gains provision. Treasury put the capital gains top 1% took less — 44% of the total gains.

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1 Remarks by Governor Bill Clinton at Montgomery College, supra note 194.
2 The question asked was whether voters should be concerned whether Clinton's promises (such as to reform health care, reduce the deficit, and guarantee a college education) could be kept with financial pain only for the rich. Much later in the Debate, Gov. Clinton pledged not to raise taxes on the middle class to pay for investment incentives, if taxes on the rich and foreign subsidiaries would not pay for such incentives.
3 Clinton, supra note 193, at 2. Substitution of lower-income for middle-income Americans would render Gov. Clinton's statement in the Third Debate more factually accurate, but less politically sound. Since the 1970's, Republicans have wooed the (formerly) Democratic white, lower, middle, and working class (male voters) with the mantra that tax-and-spend Democrats exact higher taxes from them to give to the minorities. See Lee, supra note 112, at 1396-97.
4 Staff of the Joint Comm. on Taxation, Analysis of Estimated Effects on Fiscal Year Budget Receipts of the Revenue Provisions in the "Contract with America" (H.R. 6, H.R. 8, H.R. 9, H.R. 11), JCX-4-95 (Feb. 6, 1995), available in 95 Tax Notes Today 26-12 (Feb. 8, 1995) (hereinafter Estimated Effects). For 1995-2000, the estimated losses were: $21.7 billion for the 50% individual capital gains deduction; $15.1 billion for the corporate preference; $11.2 billion for indexing; $700 million for the capital loss deduction as to residences; and an offset of $5.2 billion when all of the capital gains provisions are estimated together as an entire package. For 2001-05, the breakdown was: $73.4 billion for the 50% individual capital gains deduction; $30.3 billion for the corporate preference; $45.2 billion for indexing; $1.6 billion for the capital loss deduction as to residences; and an offset of $19.8 billion when all of the capital gains provisions are estimated together as an entire package.
5 CWATRA Effects on Receipts, supra note 150.
costs of original proposals at $60.9 billion and $183.1 billion, respectively.\footnote{Prepared Statement of Ass't Sec'ty Samuels, supra note 83.} Treasury scored CWATRA's capital gains provisions considerably lower, however, losing only $11 billion over the five-year budget window and $91 billion over the ten-year window.\footnote{CWATRA Effects on Receipts, supra note 150.}

The significance of the above findings is that the "pay-as-you-go" or "paygo" procedures of OBRA 1990, as extended by OBRA 1993,\footnote{Barbara Kirchheimer, Reconciliation Perspective: A Look Back To See Where We're Headed, 59 Tax Notes 158 (Apr. 12, 1993); Alexander Polinsky, What is the Deficit Trust Fund?, 60 Tax Notes 1295, 1296 (Sept. 6, 1993).} require revenue decreases to be offset by: (1) increases in revenues, which is unlikely due to the Republican aversion to tax increases,\footnote{Senate Finance Committee Chair Bob Packwood, R-Ore., has suggested paying for a capital gains cut with a lower cap on the deductibility of home mortgage interest. See infra note 213.} or (2) decreases in spending, so there is no net increase in the deficit.\footnote{Senate Finance Hearings, Feb. 15, 1995, supra note 36 (statement of Senator John Breaux, D-La); Ways & Means Hearing, Jan. 24, 1995, supra note 34 (statement of Rep. Robert Matsui, D-Cal.).} In the former case, present indications are that, by and large, the congressional spending decreases will be targeted at lower- and middle-income taxpayers, not at a Republican constituency. This will resurrect the charges that the poor will be paying for a capital gains tax cut for the rich, otherwise termed "Robin Hood upside down".\footnote{141 Cong. Rec. H4240 (daily ed. Apr. 5, 1995) (remarks of Rep. Kweisi Mfume, D-Md.); accord id. at H4244 and H4253 (remarks of Rep. John Dingell, D-Mich.). See Peter Gosselin, House GOP seeks $188 Billion in Tax Cuts: Proposals are similar to those in party's election contract, The Boston Globe, March 10, 1995, at A1; Fred Stokeld, Gore Charges GOP Tax Cuts Would Help Rich, Increase Deficit, 95 Tax Notes Today 65-5 (April 4, 1995). The apex of the class warfare debate was reached in the floor debate on the failed October 1990 Budget Accord. See Lee, supra note 112 at 1399 n.39; supra note 52. The political base for this tactic may be reemerging. Richard Morin, Public Growing Wary of GOP Cuts, Wash. Post, March 21, 1995, at A1 ("Among the public's biggest worries: that the Republican majority in Congress will cut too deeply and too quickly into social programs to finance tax cuts and other benefits to wealthy Americans."). This rhetoric appears to lie in large part behind the initial (but not permanent) split among the House Republicans over lowering the ceiling on the CWATRA family tax credit. See Michael Wines, G.O.P. Dissidents Want Narrower Family Tax Credit, N.Y. Times, March 22, 1995, at A1; Eric Pianin, House Republicans Retreat on Tax Cut, Wash. Post, March 22, 1995, at A1; Kenneth Cooper and Helen Dewar, Unity Lags on Remaining Parts of "Contract", Wash. Post, March 28, 1995, at A4 (targeting child credit to families earning up to $95,000, rather than $200,000, "will be more effective in winning the equity argument", said Rep. Rick Lazio, R-N.Y.); Eric Pianin, Domenici to Attack Deficit and Ignore GOP Tax Cut, Wash-}
be bad public policy on any day, in any context. But because it is funded by taking food from the mouths of children and heat from the homes of senior citizens, it is a true affront to fairness and decency.\footnote{208}

Whether any tax cuts, including capital gains, will pass the Senate is dubious, since many Senate Republicans, in addition to Senate Democrats, are on record as preferring deficit reduction to tax cuts.\footnote{209} Similarly, a coalition of moderate Republicans and con-

\footnote{208} House Minority Leader Richard Gephardt, D-Mo., News from the House Democratic Leader (March 9, 1995), available in 95 Tax Notes Today 48-21 (March 10, 1995); accord 141 Cong. Rec H 2991 (daily ed. March 10, 1995) (remarks of Minority Leader Richard Gephardt, D-Mo.); see House Ways and Means Hearing, January 24, 1995, supra note 34 (statement of Rep. Pete Stark, D-Cal.). The Clinton Administration also has adopted this theme:

The president rejects the idea, rejects the idea of targeting the most vulnerable in our society — our children, needy families, the homeless — in order to pay for these tax cuts, especially for tax cuts that are benefiting the wealthiest. . . . [I]n the end I think we have one fundamental question to ask of the Republicans: How can they justify, how can they justify, providing almost a quarter of a trillion dollars in tax benefits to the most privileged in our society, by cutting the most vulnerable in our society — kids and school lunches?

\footnote{209} David Rosenbaum, A House G.O.P. Leader Sets $200 Billion in Tax Cuts, N.Y. Times, March 10, 1995, at A16; Tim Poor, Republicans Announce Tax-Cut Plan; Sponsors Pledge 'A New Day'; Democrats Promise a New Fray, St. Louis Post-Dispatch, March 10, 1995 at A1; Michael Wines, Republican Says Senators Put Deficit Over Tax Cut, N.Y. Times, March 20, 1995, at A11; Barbara Kirchheimer, Finance Majority Prefers Deficit Reduction to Tax Cuts, Packwood Says, 95 Tax Notes Today 55-1 (March 21, 1995). President Bill Clinton would likely veto the Act, under the “Robin Hood upside down” rhetoric, if it were a freestanding bill with payments from reduction in spending aimed at the bottom and middle. Jerry Gray, Republicans Push Their Plan Ahead with the Budget Cuts, N.Y. Times, March 17, 1995, at A1. His veto probably would be sustained, with the Southern Democratic component of the conservative coalition in the House largely replaced by Republicans. CWATRA is much more likely, however, to be included in a Budget Reconciliation Act (if for no other reason than to avoid the Senate filibuster provisions restricting debate to twenty hours for such acts). In that case, we would have the mirror image of 1990. 136 Cong. Rec. H10285 (daily ed. October 16, 1990) (remarks of Rep. Tom Downey, D-N.Y.) (“For 10 years we have attempted to get the public's attention about the basic unfairness of the Republican package, and George Bush has finally handed it to us. He has decided that he would rather shut down the Government of the United States than to tax the wealthy.”).
servative Democrats vowed early in the development of CWATRA to block it unless the tax cuts were linked to progress on reducing the deficit. This threat proved hollow, because House Leader Newt Gingrich, R-Ga., played the Republicans-go-back-on-a-prom­ise-as-to-taxes-at-their-peril card. The final compromise (the Upton-Castle-Martini-Solomon amendment), while prohibiting the tax cuts from taking effect until Congress first adopts a budget resolution projecting a balanced budget by the year 2002, did not contain any enforcement mechanism.

Another solution would be to pay for the capital gains cut with a revenue increase, particularly one aimed at high-income taxpayers. Former Chair Bob Packwood, R-Ore., had suggested paying for a capital gains cut with a cap on deductibility of interest on home mortgages above $250,000. This would raise around $10 billion

Would President Bill Clinton veto that act and shut down the Government to avoid giving a capital gains cut to the Rich, or, more accurately, to avoid giving a “middle class” tax cut that goes too high? I suspect not.

Eric Pianin, Bipartisan Group Challenges House's Gop's Tax Package, Wash. Post, March 25, 1995, at A13 (stating that tax cuts would take effect once OMB certified that Congress had approved a budget plan that would eliminate the deficit by 2002; if an annual target were missed, the tax cuts would be revoked the following January); Michael Wines, Gingrich Acknowledges That Tax-Cut Plan Is in Trouble, N.Y. Times, March 29, 1995, at A17; Eric Pianin, House GOP Leaders, Moderates Near Tax Cut Compromise, Wash. Post, March 31, 1995, at A28 (agreement on certification trigger, not on “more onerous require­ment” of revocation if target missed); Eric Pianin, GOP Claims Accord on Tax Cut, Wash. Post, April 4, 1995, at A1 (only watered down version of trigger agreed upon).

Rules Chair Gerald Solomon countered that the Upton-Castle-Martini-Solomon amendment required, pursuant to the budget resolution trigger to the tax cuts, that a recon­ciliation bill must be enacted which keeps the commitment to a balanced budget glide path with real spending cuts. Id. at H4193 and H4205; accord id. at H4238 (remarks of Rep. Fred Upton, R-Mich.); id. at H4208 (remarks of Rep. William Martini, R-N.J.); see id. at H4242 (remarks of Rep. Peter Thorkildsen, R-Mass.) (one of twenty-three members linking much needed tax cuts with the specific plan to eliminate the deficit in 7 years).

Kirchheimer, supra note 209; Senate Finance Hearing, March 2, 1995, supra note 8. The median price of new homes sold in the United States was $126,500 in 1993; only 9% of new home sales were in excess of $250,000. Bipartisan Commission on Entitlement and Tax Reform, Final Report with Reform Proposals and Additional Views of Commissioners (January 30, 1995), available in 95 Tax Notes Today 33-43 (February 17, 1995). Only 3% of existing mortgages exceed $250,000. Senate Finance Hearing, March 2, 1995, supra note 8 (statement of Chair Bob Packwood, R. Ore.). One member of the Virginia Tax Study Group with experience on the Senate Finance Committee Staff opined that Packwood was an “army of one” on this issue.
over the five-year window. Considering whether or not to implement this deductibility cap, Packwood argues, depends upon whether "you want to have bigger mansions or better machines?" Such an approach would probably remove the objection of those who want to use spending savings to reduce the deficit, and would answer the increasingly effective Robin-Hood-upside-down rhetoric. It probably would not result in a reduction in the effective rate at the top. Note that the decline in value of "mansions" would, on the average, balance the increase in value of other capital assets.

The proposed capital gains preferences, if paid for by spending cuts aimed at the middle and bottom, would lower the effective rate at the top. Prior to the Revenue Act of 1978, the top individual ordinary rate was 50% on earned income and 70% on investment income. The effective rate at the top, however, was around 35%, due to the use of tax preferences, principally the capital gains preference and tax shelters. The effective rate at the top in the early 1960's had also been in the 35% range, despite a nomi-

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114 General Accounting Office, Addressing the Deficit (March 15, 1995), available in 95 Tax Notes Today 52-44 (March 16, 1995) (stating that there would be $9.2 billion in revenue gains between 1996 and 2000 from limiting interest deductibility to the first $300,000 in mortgage indebtedness on principal and second residence); Congressional Budget Office, Deficit Reduction Options, supra note 119 (same); Joint Committee on Taxation, Issues Involved in Possible Revenue Options to Reduce the Federal Deficit 18 (JCs-20-92 June 4, 1992), available in 92 Tax Notes Today 118-11 (June 8, 1992) ($14.7 billion 1993-97 from $300,000 principal cap). A 50% generic capital gains cut (19.8% maximum rate) for individuals could probably be brought down close to this estimate with, for example, full recapture for § 1250 property and by subjecting part of the exclusion to the AMT. The Joint Committee on Taxation estimated that the full § 1250 recapture provision, proposed in 1990 as part of the Bush Administration's capital gains cut (19.6% top individual rate versus currently proposed 19.8% rate), would have raised revenues by $10.3 over the five-year budget window (1990 to 1995). Methodology 1990, supra note 155, at 10.

115 Kirchheimer, supra note 209 (quoting Packwood, speaking to the National Association of Manufacturers).

116 A member of the Virginia Tax Study Group believed that the decline in value of "mansions" down the line would depress the value of the housing stock below $250,000 mortgages, even though such residences would retain their preference.

117 Progressivity and Income Distribution, supra note 173, at 2 (top 1% of families paid 35.4% of their income in Federal taxes in 1977).

118 The effective rate on "amended taxable income" (narrower than family economic income, consisting of taxable income after personal deductions increased by excluded portion of capital gains, exempt interest and excess percentage depletion) of $100,000 to $200,000, was 37.8%; of $200,000 to $500,000, was 37.9%; of $500,000 to $1,000,000, was 35.8%; and of over $1,000,000, was 32.7%. 1968 Tax Reform Study, supra note 38, pt. 1, at 81-86, and pt. 2., at 142-45; 110 Cong. Rec. (Part 2) 1438 (1964) (remarks of Floor Manager Sen. Russell
nal top rate of 91% for the same reason. The 1980's opened with President Ronald Reagan's Economic Recovery Tax Act of 1981 ("ERTA"). As a practical matter, ERTA enacted the maximum capital gains tax rate under President John F. Kennedy's 1963 proposed capital gains tax cut from two decades earlier, but with none of Kennedy's equitable limitations. (Carryover basis, not even a second-best substitute for Kennedy's proposed taxation of unrealized appreciation at death, enacted by the Tax Reform Act of 1976 with a delayed effective date and then retroactively postponed, had been finally repealed by the Crude Oil Windfall Profit Tax Act of 1980.\textsuperscript{219} ) ERTA's reduction of the maximum, regular tax rate on investment income from 70% to 50%,\textsuperscript{220} with no adjustment to three-year-old, 60% capital gains deduction applicable to all capital assets, immediately reduced the maximum capital gains rate from 28% to 20%.\textsuperscript{221} Congress also enacted an across-the-board, 25% reduction in individual rates phased in over three years, as well as enacting indexing of tax brackets, exemptions and the standard deduction.\textsuperscript{222} At the same time, the 1981 Act altered capital recovery methods (ACRS), which now encompassed real estate depreciation, by accelerating rates and adopting much-shorter-than-true-economic

\textsuperscript{219} Pub. L. 96-223, § 401(a), 94 Stat. 229.
useful lives for depreciation purposes.\textsuperscript{223} This resulted in virtually complete sheltering of: (1) portfolio and business income by many more high- and even middle-income individuals,\textsuperscript{224} and (2) business income by big corporations.\textsuperscript{225} As a result, payment of income taxes by both high income individuals and big corporations became virtually voluntary. By 1985 (in an increase from the low point of 1982), the effective rate for the top 1% was 24.9%, when the maximum rate was 50%.\textsuperscript{226} From the 1960's to the early 1980's, one-

\textsuperscript{223} Id. at \S 201, 95 Stat. 172, 203-19 (1981); 37 Cong. Q. Almanac 91 (1981); 127 Cong. Rec. 15768 (1981) (remarks of Senate Finance Chair Bob Dole, R-Kan.).

\textsuperscript{224} Of 260,000 individual returns in 1983 with “positive income” in excess of $250,000, 11\% paid less than 5\% in Federal income taxes and 76.4\% paid less than 30\%. Sixty-four percent of these 260,000 returns showed partnership losses, a major, but not the only, cause of the low effective rates. While Treasury could not break out tax from economic losses, the largest sources of deductions in these loss partnerships were interest, depreciation and depletion. “For sheer magnitude of losses real estate operators and lessors of buildings dominate all other industries.” High-Income Taxpayers and Related Partnership Tax Issues: Hearings Before the Subcommittee on Oversight of the House Comm. on Ways and Means, 99th Cong., 1st Sess. 6-7, 12-13 (1985) (statement of Assistant Secretary for Tax Policy Ronald Pearlman).

\textsuperscript{225} “[I]n 1955, corporate income taxes represented 27.3 percent of total tax receipts. . . . In 1989, it was down to 10.5 percent.” Decline of Corporate Tax Revenues: Hearing Before the Senate Comm. on Finance, 101st Cong., 2d Sess. 2 (1990) (statement of Chair Lloyd Bentsen, D-Tex); id. at 4 (stating that by 1986, percentage of corporate taxes as a percentage of Federal total revenue receipts had dropped to 5.1\%; thereafter, the declining trend reversed) (statement of Deputy Assistant Secretary for Tax Analysis Harvey Rosen). See Lee, supra note 71, at 129 n.324 (noting that corporate taxes had declined from 27\% of total budget receipts in 1950 to 6\% in 1985). For a discussion of the causes, see Hearing on Decline of Corporate Revenues, supra, at 5-6 (showing that primarily corporate pre-tax profits were lower than estimated, due to higher wages, salaries, and interest payments than expected) (statement of Harvey Rosen), and id. at 11 (stating that 58\% of shortfall was due to CBO overestimating corporate profits — the overestimation being due to error in the model, increased debt financing, and underestimation of depreciation deductions; 42\% was attributable to other factors, such as ESOPs and increased use of S corporations) (statement of Director of Congressional Budget Office Robert Reischauer).

\textsuperscript{226} Progressivity and Income Distribution, supra note 173, at 29; Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990 47 (1987); see generally Lee, supra note 71, at 70-71 n.43 and 130 n.334. Former Senator Floyd Haskell, D-Col., pointed out that the policy/political principle of distributional equity under which upper income taxpayers could not receive a greater tax cut than middle- and lower-income taxpayers had the effect of freezing in place the erosion of effective rates at the top. Floyd Haskell, Tax Reform, 35 Tax Notes 301, 305 (April 30, 1987); see also Kies, supra note 2, at 183. Opponents of a renewed capital gains preference argued, in the 1990 House Hearings on Fairness, that the 1986 Act had only partially restored individual progressivity to the pre-1981 level. 1990 Hearings on Fairness, supra note 65, at 124 (statement of Dr. Henry Aaron, Senior Fellow, the Brookings Institution) (high-water mark of progressivity was in early 1960's); id. at 142 (written statement of late Joseph Pechman). A renewed capital gains preference with 80\% of the tax benefits going to taxpayers with over $100,000 in income, id. at 345 (state-
quarter of the high-income taxpayers paid an effective rate much closer to the nominal rates (e.g., 50% to 60% in the early 1960's), and three-quarters paid a much lower effective rate than the average effective rate.\textsuperscript{227} This constant pattern has strong implications for horizontal equity.\textsuperscript{228} By 1990, various provisions had raised the top effective rate back to 27%,\textsuperscript{229} primarily due to the repeal of the

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\item See supra note 218. At amended taxable income levels over $100,000, high tax individuals paid an effective rate of 60% to 65%, while low tax individuals paid an effective rate of between 20% and 30%. 1968 Tax Reform Study, supra note 38, pt. 1, at 82; 110 Cong. Rec. (Part 2) 1439 (1964) (remarks of Floor Manager Senator Long, D-La.) (stating that average effective rate for high capital gains income taxpayers with $1,000,000 or more in income was 20%, while effective rate for such taxpayers with low capital gains income was 50%).

\item 1969 House Hearings, supra note 20, pt. 4, at 1592 (statement of Ass't Secretary of the Treasury for Tax Policy Stanley Surrey) ("Fairness it seems to me comes down to two things—one, that as between people who have different levels of income, one higher and one lower, the person with higher income should pay a progressively greater tax [i.e., 'vertical equity']; and, second, as between people who are at the same level of income and who are similarly situated, they should pay the same tax [i.e., 'horizontal equity']."). Cunningham and Schenk, supra note 34, at 363-64, after summarizing the literature, conclude that horizontal equity is a corollary of vertical equity, which they would balance against efficiency; in effect, the conclusion is that tax rules should interfere as little as possible with economic decisions. Id. at 367. They also discuss perceptional equity, id. at 368, which clearly moved Senator Russell Long, D-La., in 1964. See also supra note 47. Cunningham and Schenk conclude that a strong factor is whether a proposal lessens the gap between the statutory rate and the effective rate on income. Cunningham and Schenk, supra note 34, at 372. I agree, at least as to realized income. Lee, supra note 35, at 1410. Cunningham and Schenk look at accrued but unrealized capital gains and conclude that a preference, by increasing realizations, raises the effective rate on all accrued capital gains, thus lessening the gap. Cunningham and Schenk, supra note 34, at 373 Their analysis parallels the results of the "dynamic distribution analysis" advocated by the Bush Administration in 1990, which takes account of the increase in capital gains taxes paid as a result of induced realizations. See supra note 170. Shaviro, supra note 68, at 408, maintains that horizontal equity can not be measured purely on tax payments and effective tax rates on (undertaxed) income. The initial violation of horizontal (and vertical) equity arose from not taxing accrued, but unrealized capital gains; a capital gains preference makes a taxpayer with capital gains even better off. "She voluntarily agrees to pay more tax than previously because she regards the added tax payments (and complexity costs) as worth the reduction of lock-in." Shaviro, supra note 68, at 408; accord supra note 171; Daniel Halperin, Commentary: A Capital Gains Preference is not EVEN a Second-Best Solution, 46 Tax L. Rev. 381, 387 (1993). A capital gains preference lowers the effective rate on realized income, with the inequitable results at the top income levels set forth in the text. Cf. Revenue Increase Options: Hearings Before the House Comm. on Ways and Means, 100th Cong., 1st Sess. 371 (1987) (colloquy between Mark Bloomfield, President of American Council for Capital Formation, and Rep. (now Sen.) Byron Dorgan, D-N.D.).

\item Progressivity and Income Distribution, supra note 173, at 2-4, 12-13; Tax Policy and
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capital gains preference and to the Passive Activity Loss limitations of section 469. The 1993 increases in rates at the top to 36% and 39.6% raised the top effective rate back to 33%. The proposed CW ATRA capital gains preference would probably lower that rate by two to four percentage points and reintroduce at the top the substantial horizontal disparities as to realized income of earlier decades.

Ways and Means Democrats, Highlights Republican Tax Package (March 9, 1995), available in 95 Tax Notes Today 50-52 (March 14, 1995) (hereinafter Highlight of GOP Tax Package). While this increased vertical equity (although not fully back to the 1960's through 1970's level), with the top capital gains rate at 28%, horizontal disparities at the top probably disappeared also. See Lee, supra note 35, at 1410.

President George Bush's reproposed 19% maximum rate on capital gains would have lowered the effective income tax rate of the wealthy by four percentage points. Cong. Rec. H7790 (daily ed. September 25, 1990) (remarks of Rep. Donald Pease, D-Oh., based on a report issued on September 24 by the Democratic Study Group). The Ways and Means Committee predicted only a 2% reduction in the effective rate. Progressivity and Income Distribution, supra note 173, at 56. The aggregate change under all of the CWATRA provisions is estimated to lower the effective rate at the $200,000 and up range (top 5%) from 30% to 25.7%. Highlight of GOP Tax Package, supra note 230. The Joint Committee on Taxation estimates that the aggregate effect of the CWATRA tax cuts will lower the effective tax rate at the $200,000 and over income level from 29.8% to 28% in 1996 (twice the percentage point reduction of most lower income levels). Distributional Effects of the Tax Provisions Contained in the Contract with America Tax Relief Act of 1995 (March 8, 1995), available in 95 Tax Notes Today 52-12 (March 16, 1995). Almost all of that reduction is from the capital gains cut (from 29.8% to 28.1%). Id. The reduction would be even higher at the top 1% range, due to the greater percentage of capital gains income the higher the income range, Allen Manvell, Basic Statistics on Capital Gains in The Capital Gains Controversy: A Tax Analysts Reader 13 (J. Andrew Hoerner ed., 1992) (stating that, at $100,000-$200,000 of adjusted gross income level, 9% of income consists of capital gains; at $200,000-$500,000 of AGI, the percentage is 14%; at $500,000 to $1,000,000 of AGI, the percentage is 20%; and at levels of AGI of $1,000,000 and above, the percentage is 34%). The top 1% of returns (by adjusted gross income) reported around 50% of the realized capital gains in the 1950's and 1960's, dropping to the 30% to 40% in the 1970's, and climbing back to 55% in 1982 through 1985. Congressional Budget Office, How Capital Gains Tax Rates Affect Revenues: The Historical Evidence 30-1 (1988), available in 88 Tax Notes Today 61-79 (March 18, 1988); see 141 Cong. Rec. H4208 (daily ed. April 5, 1995) (remarks of ranking minority member and former Chair Sam Gibbons, D-Fla.). The agenda of some of the supporters of CWATRA was to eliminate two-thirds of the 1993 increase in taxes at the top. Id. at H4219 (remarks of Rep. Jim McCrery, R-La.).
The political implications of scoring a capital gains cut as a revenue loser played a major role in stymieing President George Bush's proposed capital gains cut in 1990; some members of Congress are currently faced with the same problems. Then, Treasury's estimates showed a revenue gain, while the Joint Committee's showed a revenue loss of almost the same amount. Only the Joint Committee's estimates counted for scoring purposes under House rules. The House Republicans, like the proverbial elephant, have a long memory on this issue. House Speaker Newt Gingrich, R-Ga., fumigated about estimators who for ideological reasons fudge: "There are some people who have a passion for more money for Washington and less money for America." He asserted that the leadership could "reshape the bill to work within ... honest estimates."
The Democrats also have long memories about rosy "estimates" that were to pay for tax cuts through resultant growth in the economy, as in the Economic Recovery Tax Act of 1981, a "Riverboat Gamble," which gave birth to the flood of deficits. They are worried that "the sort of supply side extremist type of approach may come back and advocate that the whole problem will go away and the tax cut will pay for itself." In fact, however, the Staff estimates had not made macroeconomic assumptions in 1981; their error arose from projecting a continuation of high inflation and not foreseeing the severe 1981 to 1982 recession. Reagan Administration officials did, however, make macroeconomic or supply side assumptions in the 1981 Hearings. Administration witnesses in the hearings on the President's tax proposals argued that the resulting increased incentives, under "supply side economics," would lead to higher output in the economy, generating increased tax revenues making tax shelters relatively less attractive. Coupled with

Wallace, D-Ala., ranting against "pointy-headed bureaucrats" in his 1968 campaign for President.


189 Joint Budget Hearing (January 10, 1995), available in 95 Tax Notes Today 7-33 (January 10, 1995) (opening statement of Rep. Martin Sabo, D-Minn.). Cf. Ways & Means Hearing, January 5, 1995, supra note 8 (statement of Ranking minority member and former Chair Sam Gibbons, D-Fla.) ("I will not go down the road again, having made the mistake once, of voting for tax reductions and just taking an empty promise that we're going to get the spending cuts."); Barbara Kirchheimer, Finance Majority Prefers Deficit Reduction to Tax Cuts, 95 Tax Notes Today 55-1 (March 21, 1995) (same simile by Chair Bob Packwood, R-Ore.). See supra note 210 and accompanying text. President Ronald Reagan's first budget message to Congress contained "over optimistic" macroeconomic offsets to proposed tax cuts, projecting a $342 billion increase in Federal receipts over the period from 1981 to 1986. Methodology 1990, supra note 155, at 7 n.10. Instead, total receipts rose just $170 billion, and only after substantial revenue increases in 1982 and 1984. Id.

188 Ways & Means Hearing, January 11, 1995, supra note 54 (statement of Dr. Michael Bosworth).

189 Senate Finance Hearings, January 24, 1995, supra note 8 (colloquy between Chair Bob Packwood, R-Ore, and William Niaken, Chairman of the Cato Institute).


191 Id. at 14 (statement of Sec'ty Don Regan); see Reagan Tax Cuts Face Hungry Congress, 12 Tax Notes 422 (February 23, 1981); 127 Cong. Rec. (Part 12) 15768 (1981) (remarks
spending cuts, higher real economic growth, and lower inflation, such increases would allegedly permit balancing of the budget at a lower level of taxation. Such results, however, were not based on traditional econometric models but on an "economic scenario" instead. The floor debate echoed that the ERTA tax cuts would increase savings and lead to dynamic growth and greater productivity.

Many Democrats on the Ways and Means Committee and on the floor were quite skeptical of these assumptions in 1981, particularly the effects of the across-the-board cuts on savings rates. OMB Director David Stockman bragged that supply-side economics was merely a cover for the trickle-down theory, in order to bring down the top ordinary and capital gains rates.
Today, capital gains proponents again claim that the proposed capital gains cut will pay for itself through unblocking sales, thus promoting efficiency in the capital market. The record shows that from 1954 to 1988, capital gains realizations pretty well tracked both GNP and stock market activity, rather than rate changes. This has been the case for a number of years, going back to the 1920's. The most extensive modern discussions on whether a generic capital gains cut would increase or decrease rev-

designed to bring down the top rate”; CWATRA is a “Trojan elephant”); cf. id. at H4214 (remarks of Rep. Robert Matsui, D-Cal.). See supra note 189 and accompanying text.

Ways & Means Hearing, January 24, 1995, supra note 34 (statement of Mark Bloomfield); House Small Business Hearing, January 26, 1995, supra note 42 (statement of Rep. Roscoe Bartlett, R-Md.); H.R. Rep. No. 84, supra note 27, at 35 (noting that induced sales, but not macroeconomic effects, were accounted for by Congressional estimates). Some commentators maintain that the most serious argument in favor of a capital gains preference is its reduction of the “lock-in effect” arising from taxing capital gains only upon realization (as contrasted with the ideal of annual accrual) and from not taxing unrealized appreciation upon death (an alternate ideal rule). Cunningham and Schenk, supra note 34, at 344, 375 (stating that best approach would be annual accrual or such taxation at death; preference is “second best” solution provided it raises revenue); cf. Shuldinger, supra note 85, at 559 (indexing by reducing lock-in adds to economic efficiency). Professor Halperin argues, based upon the economic literature, that lock-in does not substantially affect the mix of societal investment. Halperin, supra note 228, at 386 and n.28. (As appears to be the case on all aspects of capital gains taxation), the economic literature is mixed on this point, according to Professor Zodrow, but interindustry effects on capital allocation are small in any event. Zodrow, supra note 37, at 467-69, 484-93. See also infra notes 288-96 and accompanying text.

1990 Senate Tax Incentives Hearings, supra note 155, at 63 (statement of Joint Committee on Taxation Chief of Staff Ronald Pearlman); Methodology 1990, supra note 155, at 24-28 (1954-1988); see also 1989 Senate Hearings, supra note 70, at 29 (statement of Joint Committee on Taxation Chief of Staff Ron Pearlman) (“The decision to sell a capital asset and to realize a gain or a loss is largely a discretionary decision on the part of an investor. In fact, we know very little about why investors choose to buy and sell assets. We do know, that taxes are only one of many factors that enter into their decision making process.”). See generally CBO, Historical Evidence of Capital Gains Cut Revenues, supra note 231, at xv, 24-30; 1987 Senate Hearing, supra note 63, at 92, 96-98, 107 (statement of Dr. Joseph Minarik, Urban Institute) (“Over the long haul, through tax increases and tax decreases, capital gains realizations have tended to follow the growth of the economy with further upward and downward swings propelled by the stock market.”). But see id. at 108 (statement of Mark Bloomfield, President American Council for Capital Formation) (stating that capital gains revenues increased 243% from 1978 to 1985, while the Dow only increased 92%, and the economy only increased 77%).

Confidential Senate 1934 Hearings, supra note 97, pt. 3, at 105-06, 110 (statement of Under Secretary Dr. Roswell Magill); House 1942 Hearings, supra note 97, at 256-57; id. at 1628-30, 1642-43, 1647 (charts) (statement of Assistant Secretary Randolph Paul) (historical fluctuations in revenues from capital transactions reflected market conditions rather than capital gains tax rates).
Capital gains contentions are the 1989 and 1990 Senate Hearings. In these hearings, the Treasury and the Joint Committee on Taxation disagreed as to the revenue effects of the Bush Administration's various capital gains proposals. Joint Committee Chief of Staff Ronald Pearlman's most telling point in the 1989 Senate Finance Committee Hearings was the historical record. For the Bush Administration's projections to have been borne out, realizations would have had to have doubled for the four-year revenue period (1991 to 1995) to the $1 trillion level of the period from 1978 to 1987. This period included the capital gains cuts in 1978 and 1981, the push in 1986 and 1987 to sell before the Tax Reform Act of 1986's scheduled rate increases, the 1980's stock market boom, the leveraged buyout mania, and a boom in the real estate market. A witness at the 1995 Hearings pointed out that "[i]f you are going to raise revenue by cutting the capital gains tax in half, you are going to have to double realizations. And this is going to be a change that certainly we have not experienced historically."

Capital gains cut proponents, on the other hand, pointed to the substantial increase in capital gains revenues from 1978 through 1985 as evidence of the unlocking effect of the capital gains cuts in 1978 and 1981. Indeed, the 1978 capital gains cut had been sold to Congress as a revenue raiser. House Speaker Newt Gingrich,

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381 Ways & Means Hearing, January 11, 1995, supra note 54 (statement of Dr. Michael Boskin, a Stanford University professor and former chairman of President Bush's Council of Economic Advisers) (stating that Treasury scored 30% exclusion as gaining $12 billion over five year window; the Joint Committee scored the exclusion as losing $12 billion). The actual numbers were $12.5 billion and $11.4 billion. Methodology 1990, supra note 155, at 2; Congressional Budget Office, Budget Estimates: Current Practices and Alternative Approaches (January 12, 1995), available in 95 Tax Notes Today 7-16 (January 11, 1995) (hereinafter CBO, Budget Estimates).

383 1989 Senate Hearings, supra note 70, at 30 (statement of Chief of Staff Ron Pearlman); Senate Finance Hearings, February 15, 1995, supra note 36 (statement of Dr. Henry Aaron) (one of the biggest bull markets and a real estate boom of very considerable proportions); Ways & Means Hearing, January 24, 1995, supra note 34 (statement of Dr. Allen Sinai) (effect of stock market boom on realizations). Professor Zodrow points also to dramatic reduction in brokerage fees, increased importance of mutual funds with faster turnover of portfolios, explosion of LBO's, and introduction of capital gains reporting requirements resulting in increased compliance. Zodrow, supra note 37, at 448.


386 The Finance Committee, in justifying the 1978 capital gains cut stated that:
for instance, believed that the 1978 capital gains cuts had in fact raised revenues, while the estimators had forecast losses. The Treasury and the Joint Committee, however, both found that the 1978 capital gains cut actually lost revenue when examined under a "timed-series" analysis. Moreover, the increased realizations of lower capital gains taxes will markedly increase sales of appreciated assets, which will offset much of the revenue loss from the tax cut, and potentially lead to an actual increase in revenues. In addition, the improved mobility of capital will stimulate investment, thereby generating more economic activity and more tax revenue. Six former Secretaries of the Treasury have informed the committee that they believe lower capital gains taxes will raise, not lower, revenues.


\[\text{\textsuperscript{266} Ways \& Means Hearing, January 5, 1995, supra note 8 (statement of House Speaker Newt Gingrich, R-Ga.) ("[A]ll government estimates were explicitly wrong on the Jimmy Carter capital gains tax cut, and literally wrong to such a degree that it wasn't a question of scale; they had a negative number for their estimate when it was a positive number. So they were saying it will cost us money if we cut capital gains under Jimmy Carter, and in fact we made money."). See supra note 235 (similar bias). One Member of Congress apparently confused this story with the story of the capital gains cut proposed by President John Kennedy in 1963. Ways \& Means Hearing, January 12, 1995, supra note 47 (statement of Rep. Jim Bunning, R-Ky.).}\]

\[\text{\textsuperscript{267} According to Chief of Staff of the Joint Committee on Taxation Ronald Pearlman, while the 1985 Treasury Report on the 1978 Capital Gains cuts showed revenue gains from the 1978 capital gains cut under the "cross-section" analysis now used by Treasury, the "time series" data, then used by Treasury and still used by the Joint Committee Staff, showed revenue losses after the first year or two. 1990 Senate Tax Incentives Hearings, supra note 155, at 67. Tax Reductions of 1978, supra note 35, at ix, 186, more ambiguously states that the time-series estimates indicate a revenue increase in the first year after the 1978 cut, "but significantly smaller increases or small reductions in federal revenue in subsequent years." More specifically, by the third year after the cut, revenues were estimated to be less than they would have been absent the cut. The 1981 cut under this analysis lost revenue from the gun. Id. at 179. The study did not assume macroeconomic effects. Id. at vii. In short, the evidence was mixed as to the effects of the 1978 and 1981 capital gains cuts, and the Treasury economists did not feel that there was justification for a firm conclusion that lowering the rate would raise revenue. Andrew Hoerner, Treasury's Capital Gains Estimates: Mr. Economist Goes to Washington, 44 Tax Notes 141, 142 (July 10, 1989). Treasury later redid its time series studies, concluding that they did not as strongly support the conclusion that the 1978 and 1981 capital gains cuts lost revenue over time. Michael Darby, Robert Gillingham, & John Greenlees, The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time-Series Evidence, Treasury Dep't, 2 Bulletin (June 1988).}\]

The cross section analysis looks at a large group of taxpayers horizontally across a single year, whereas the time series looks vertically through a period of time at aggregate taxpayer data. 1989 Senate Hearings, supra note 70, at 31 (statement of Thomas Barthold, Joint Committee Staff Economist). Since a capital gains tax cut generally spurs a one-time surge in realizations of capital gains that otherwise would be realized in future years, a "time series" approach appears preferable as a matter of theory. Professor Zodrow critiques both
1978 through 1985 coincided with the above-mentioned stock and real estate booms. Capital gains cut proponents have also pointed to the contrast between the post-1986 drop off in capital gains realizations and that of the early 1980’s, as evidence of the blocking effect of high capital gains rates. Rep. Glenn Poshard, D-Ill., objected to comparing 1985 and 1992 because they represented the peak and trough of an economic cycle. Economists prefer to measure from peak to peak, or from trough to trough, in order to achieve an accurate representation. Furthermore, the huge surge in realizations in 1987, which were taken to avoid the coming increase in the maximum individual capital gains rate (from 20% to 28%), reduced realizations that would otherwise have occurred in later years.

The Treasury and Joint Committee Staff, when estimating revenue effects of a capital gains cut, do take into account the behavioral effects or additional realizations induced by such a cut. For example, for President George Bush’s 1990 proposed 30% exclusion, the Joint Committee estimated that induced realizations methods, concluding that the conflicts in studies, as well as more recent studies separating permanent and temporary changes (lower than most for the former and higher than most for the latter), “should give pause to those who propose cuts in capital gains tax rates on the grounds that they are likely to result in long-term revenue increases.” Zodrow, supra note 37, at 452-54, 461; CBO, Historical Evidence of Capital Gains Cut Revenues, supra note 231, at 6 (stating that cross section analysis has many more observations, i.e., returns, but does not separate tax rate changes from other factors and does not separate permanent and transitory effects of rate changes). During the 1980s, both public stock and real estate values increased greatly during the speculative boom. Fisher, supra note 148, at 44; Sylvia Nasar, Even Among the Well-Off, the Richest Get Richer, N.Y. Times, March 5, 1992, at D1.


Methodology 1990, supra note 155, at 28 n.27; Gravelle, Limits to Feedback Effects, supra note 48; Prepared Statement of Jane Gravelle, supra note 102.

Ways & Means Hearing, January 10, 1995, supra note 16 (statement of Asst Sec’ty Leslie Samuels). Chair Bill Archer, R-Tex., is reported to have thought that the Joint Committee on Taxation used a static methodology, while Treasury used a dynamic methodology. Barbara Kirchheimer, Archer Wants Mini-reconciliation for Contract’s Taxes, Spending, 95 Tax Notes Today 3-2 (January 5, 1995). Both use microeconomic assumptions (induced realizations); neither use macroeconomic assumptions.
would offset 78% of the loss.\textsuperscript{264} (The chief difference in the Joint Committee and Treasury estimations for the Bush proposals was in the rate of elasticity, defined as the percentage change in realizations divided by the percentage change in tax rates.) Induced realizations under the Republican Contract's proposed 50% exclusion are estimated to lower the "static" loss in the five-year budget window by 60%.\textsuperscript{265} The catch is that the Joint Committee believes that after an initial surge in realizations (50% of the baseline during the initial five-year budget window\textsuperscript{266}), most taxpayers will settle into a permanent level of lower realizations, although at a rate still higher than would be expected in the absence of a rate reduction.\textsuperscript{267} But the proposed generic capital gains rate cut would still lose revenue over the five-year budget window and beyond.\textsuperscript{268} Ironically, while the Republican Bush Administration tried to enact a capital gains cut resisted by a Democratic Congress, now a Republican Congress is pushing a cut equally resisted by the Democratic Clinton Administration. These actions, coupled with the hope of a capital gains cut in the near future, have been dampening realizations.\textsuperscript{269} Some opponents of an increased capital gains preference believe that Joint Committee on Taxation estimates are assuming too high a rate of induced realizations, with the result that revenue losses for a 50% generic exclusion may be twice as high as the Committee estimates.\textsuperscript{270}

Capital gains proponents have argued that both the Joint Committee on Taxation and the Congressional Budget Office have historically erred in calculating capital gains revenues.\textsuperscript{271} Opponents

\textsuperscript{264} Methodology 1990, supra note 155, at 10 (noting that $78.4 billion was generated from induced realizations, compared with a $100.2 billion static loss from 1990 to 1995); CBO, Budget Estimates, supra note 251.

\textsuperscript{265} Senate Finance Hearings, February 15, 1995, supra note 36 (statement of Dr. Jane Gravelle, Senior Specialist in Economic Policy CRS).

\textsuperscript{266} Methodology in Revenue Estimating 1995, supra note 43.

\textsuperscript{267} Id.

\textsuperscript{268} See supra notes 199-203 and accompanying text.

\textsuperscript{269} Senate Finance Hearings, February 15, 1995, supra note 36 (statement of Dr. Henry Aaron); Ways & Means Hearing, January 24, 1995, supra note 34 (statement of Rep. Mel Hancock, R-Mo.).

\textsuperscript{270} Senate Finance Hearings, February 15, 1995, supra note 36 (statement of Dr. Jane Gravelle, Director Senior Specialist in Economic Policy CRS).

of dynamic scoring, on the other hand, argue that CBO estimates of revenue gains from new tax provisions have tended to err on the high side, so that increasing the estimates for feedback effects would likely aggravate this tendency and worsen the deficit.\textsuperscript{272} Other opponents argued that the Joint Committee estimations were high because they did not take sufficiently into account the effect of temporary surges on the permanent level of realizations. The consequences of this defect were that overestimation of induced realizations would considerably understate revenue losses.\textsuperscript{273}

As has been the case for almost two decades, many capital gains cut proponents have maintained that macroeconomic or feedback effects under dynamic scoring would generate revenue gains rather than losses.\textsuperscript{274} Treasury does not take into account macroeconomic feedback effects or induced growth in the economy because “there is not a consensus among the economists about what the effects will be with respect to any proposal, including the reaction of the Federal Reserve Bank to various proposals that would potentially have an effect on the economy.”\textsuperscript{275} Similarly, the Joint Committee does not take into account macroeconomic or feedback effects, assuming instead that tax law changes will have no overall effect on economic aggregates such as gross domestic product.\textsuperscript{276} The Joint Committee has noted that, if growth in productivity were to result

\textsuperscript{272} Senate Finance Hearing, February 16, 1995, supra note 80 (statement of Professor Alan Auerbach). As a matter of logic, it is not so clear that this undercuts dynamic scoring. One could argue that the tax increases fell short because they failed to take account of the negative impact on the economy, just as tax cut estimates fail to take account of the positive impact upon the economy.


\textsuperscript{274} Ways & Means, January 24, 1995, supra note 34 (statement of Dr. Allen Sinai).

\textsuperscript{275} Ways & Means Hearing, January 10, 1995, supra note 16 (statement of Ass't Sec'ty Leslie Samuels); Ways & Means Hearing, January 11, 1995, supra note 54 (statement of Dr. Barry Bosworth, Senior Fellow at the Brookings Institution) (“[E]ven among academics there is a wide disagreement on exactly how big these incentive effects will be.”).

\textsuperscript{276} Methodology in Revenue Estimating 1995, supra note 43.
from changes in the capital stock due to a capital gains tax cut, "it would occur slowly at first, with most of the effects outside the five-year budget window." While changes in entrepreneurship would be more likely to occur within this budget window, "[s]uch activity had been a very small factor in previous market responses to changes in the taxation of income from capital." Many economists testifying in 1990 found surprisingly little effect one way or the other from elimination of the capital gains preference in the 1986 Code. Their findings cut against the argument of capital gains proponents that a generic capital gains cut would stimulate the economy. Most economists and some members of Congress believe that it would be more effective to reduce the deficit and hence serve to decrease the long-term interest rate. As in the past, some pointed to the minuscule role of venture capital investments in the context of total capital assets. Note that the 1978 capital gains cut, which timed-series studies show to have lost revenue, was justified in part on dynamic-feedback forecasts predicting that it would raise revenue.

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277 Id.
278 Id.; Ways & Means Hearing, January 11, 1995, supra note 54 (statement of Dr. Michael Boskin) (believing that capital gains cut will increase supply of entrepreneurs, but "it is the thing economists have the most difficulty quantifying").
279 1990 House Hearings on Fairness, supra note 65, at 166 (testimony of Dr. Henry Aaron). Professor Alan Auerbach pointed out the minuscule role of venture capital, etc. in the context of total capital gains realizations. Id. at 166. See also id. at 247, 254 (statements of Sen. Bill Bradley, D-N.J., and Rep. Richard Gephardt, D-Mo.). Cf. id. at 26 (debate between Reps. Bill Archer, R-Tex. and Byron Dorgan, D-N.D., over complexity).
282 Senate Finance Hearings, February 15, 1995, supra note 36 (statement of Dr. Henry Aaron); 1990 House Hearings on Fairness, supra note 65, at 166 (statement of Dr. Alan Auerbach).
283 In 1978, the Senate Finance Committee believed that the combined level of direct and indirect capital gains taxes contributed to a slower rate of economic growth with fewer realizations and a shortage of investment funds. This was an oblique reference to the intense debate on use of "feedback effects" in revenue estimates. See 1978 Senate Hearings, supra note 75, at 179 and 197 (statement of Sec'y Michael Blumenthal); id. at 211 (statement of Chair Russell Long, D-La.); id. at 452 (statement of former Treasury Secretary Henry Fowler); id. at 495 (statement of Samuel Cohn, Committee for Capital Formation through Dividend Reinvestment); id. at 688 and 697 (statement of Martin Feldstein, National Bureau of Research and Economics, Harvard University).
While initially there appeared a move among the writers of the Republican Contract to force dynamic scoring,\textsuperscript{284} it appears now that scoring by Joint Committee (and Treasury), albeit more open, will continue to take into account microeconomic effects while ignoring macroeconomic effects.\textsuperscript{286} The major barrier to a macroeconomic look was the lack of consensus as to its effects. In the words of Former Finance Chair Bob Packwood: “at some stage, [the overall revenue effect] is almost Greek. I have heard enough economists and enough people testify.”\textsuperscript{288} The concern over the effect of optimistic assumptions on market interest rates (and the Federal Reserve) which, if incorrect, would cause an increase in the deficit,\textsuperscript{287} was probably the determinative reason for not addressing macroeconomic considerations.

The Ways and Means Report states that reduction in the capital gains tax should improve the efficiency of the capital markets; all economists agreed that a capital gains cut would reduce “lock-in” and increase realizations. The Report concludes that such unlocking would permit monies to flow to new, more highly valued uses, thus improving the efficiency of the capital market.\textsuperscript{288} For more than fifty years, capital gains cut proponents have claimed that unblocking would permit capital to flow from sales of public stock to new companies.\textsuperscript{289} That case has never been made. Despite claims of capital gains cuts proponents that the CWATRA 50% generic capital gains cut “would free up capital for small business

\textsuperscript{284} Barbara Kirchheimer, “Contract” Hearing Foreshadows Partisan Debate on Estimates, 95 Tax Notes Today 4-1 (January 6, 1995).
\textsuperscript{286} Chair Bob Packwood, R-Ore., has indicated that the CBO and JCT are not going to change to macroeconomic scoring now. John Godfrey, Packwood Embraces Status Quo After More Warnings on “Dynamic” Estimates, 66 Tax Notes 638 (January 30, 1995); Ways & Means Hearing, January 11, 1995, supra note 54 (statement of Dr. J.D. Foster, Tax Foundation) (stating that it is going to take a while to get dynamic scoring).
\textsuperscript{287} Senate Finance Hearings, February 15, 1995, supra note 36.
\textsuperscript{288} Ways & Means Hearing, January 10, 1995, supra note 16 (statement of Rep. Charles Rangel, D-N.Y.); Ways & Means Hearing, January 24, 1995, supra note 34 (statement of Rep. Charles Rangel); John Godfrey, Economists Discourage GOP from Adopting “Dynamic Scoring,” 66 Tax Notes 303 (January 16, 1995) (quoting Greenspan saying, “[s]hould financial markets lose confidence in the integrity of our budget scoring procedures, the rise in inflation premiums and interest rates could more than offset any statistical difference between so-called static and more dynamic scoring”).
\textsuperscript{289} H.R. Rep. No. 84, supra note 27, at 35.
and entrepreneurs, providing the economy with seed corn. . . .”

realizations from public stock do not flow to new venture capital or to closely held businesses (unless they are from public stock held by the entrepreneur herself). As Senator Dale Bumpers, D-Ark., father of the section 1202 targeted small business stock preference slated for repeal by CWATRA, stated in the aftermath of the House’s passage of CWATRA: “I have never understood what economic benefit this country derives when somebody sells General Electric and uses the money and buys DuPont stock.” The Small Business Administration also regards a generic capital gains cut as “rewarding non-productive speculation in real estate or the stock market. . . .” The facts behind this rhetoric are that most mature corporations raise outside capital these days through debt, not through common stock offerings. Not surprisingly, therefore, less

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291 See supra note 41 and accompanying text.
292 141 Cong. Rec. S5297 (daily ed. April 6, 1995) (remarks of Sen. Dale Bumpers, D-Ark.); accord 1989 Senate Hearings, supra note 70 at 132 (statement of Senator Dale Bumpers, D-Ark.) (asking, why give investors in public stock a tax break for something they are already doing without any tax break?); 141 Cong. Rec. at H4209 (daily ed. April 5, 1995) (remarks of ranking minority member and former Chair Sam Gibbons, D-Fla.) (“They are just swapping their equities around between each other. . . . There is no creation of additional capital. It is just a game there. So it is bad economic justice, it is bad social justice.”); Harold Pepperell, “Rush” Exposes the Capital Gains Tax Cut Hoax, 66 Tax Notes 1200 (February 20, 1995). These “speculation” criticisms do not apply to original issue stock. From 1984-1990, however, net corporate equity issues were negative (with the bulk due to debt-financed acquisitions). Treas. Dep’t, Integration of Individual and Corporate Tax Systems—Taxing Business Income Once 8-9 (January 1992) (hereinafter Integration of Individual and Corporate Tax).
294 Before 1986, publicly traded corporate debt and common stock were issued in roughly equal amounts; in 1987, new corporate debt issues were ten times new stock issues. Statement of Professor Calvin Johnson, Three Errors in the “Neutral Cost Recovery System” Proposal, for the House Ways and Means Committee Hearing on January 24, 1995 and authorities cited at n. 32 (January 26, 1995), available in 95 Tax Notes Today 20-39 (January 31, 1995). The same ratio of ten-to-one debt to equity new issues holds true today. Monthly Roundup; Some Improvement, Investment Dealer’s Digest 30 (March 20, 1995) (stating that February debt offerings raised $38.9 billion, down 51% from a year ago; new equity issues raised $4.2 billion, down from $8.8 billion a year ago). Initial public offerings range from one-third to one-half of total common stock underwriting. Anita Raghavan, Slack Underwriting Activity Takes Its Toll on Wall Street, Chicago Sun-Times, April 4, 1995, at 50 (stating that, according to Securities Data in the first quarter of 1995, initial public offerings plunged to $3.8 billion, a 54% drop from a year ago, while total common stock underwriting slid 35% to $12.3 billion). Thus, only a small fraction of new offerings of debt and stock consist of common stock of mature companies.
than 3% of the action on Wall Street consists of public offerings of new common stock. Initial public offerings make up one-third to one-half of total new common stock offerings, most of which probably could qualify under section 1202 as to non-corporate purchasers and thus obtain a preference under current law. To the extent this is not so, the remedy is to amend section 1202, not to repeal it and replacement it with a wasteful generic capital gains preference.

Economists agreed that capital gains cuts would increase the value of existing capital assets, but they could not agree on the effect that this increase would have on savings. Proponents of course argued that it would lead to increased savings, others, however, did not believe that a persuasive case had been made in the literature. In the leveraged buy-out mania, 40% to 59% of the proceeds were invested in consumer durables; therefore, some economists reasoned that a cut in the capital gains rate, which would result in an increase in the value of capital assets,
could lead to more consumption.\textsuperscript{200} The benefit of an increased savings rate from a tax reduction at the top, claimed by the Reagan Administration in 1981, had not panned out.\textsuperscript{201} Total net private personal saving, as a percentage of Gross Domestic Product, declined from the 1960's and 1970's historically high averages of 4.7% and 5.5%, respectively, to 4.5% for the 1980's, and 3.4% for 1990 to 1994.\textsuperscript{202} This decline in savings might be attributable to such demographic factors as the bulge of baby boomers during their consumption/child raising years\textsuperscript{203} (which could reverse as they enter middle age and begin to save for retirement\textsuperscript{204}). The recent decline in savings, however, is in savings by the older Americans,\textsuperscript{205} which may be attributable to an increase in the availability of insurance and Social Security benefits, reducing the necessity

\textsuperscript{200} Senate Finance Hearings, February 15, 1995, supra note 36 (statement of Dr. Henry Aaron); accord Ways & Means Hearing, January 24, 1995, supra note 34 (statement of Dr. Alan Auerbach). Similarly, with current full production, an individual tax cut would probably lead to more consumption. Senate Finance Hearing, January 24, 1995, supra note 8 (statement of Dr. Alan Auerbach). Capital Gains and Losses 1995, supra note 10, at 17, cites a study indicating that taxpayers use accrued gains on personal residences (at least through refinancing and home equity loans) to finance increased consumption more often than reinvestment.

\textsuperscript{201} Staff of House Comm. on Ways and Means, 101st Cong., 2d Sess., Background and Materials on Federal Budget and Tax Policy for Fiscal Year 1991 and Beyond 100 (Comm. Print 1990); Eric Toder, Comments on Proposals for Fundamental Tax Reform, 66 Tax Notes 2003, 2008 (Table 2) (March 27, 1995) (hereinafter Proposals for Fundamental Tax Reform); note 244 supra.

\textsuperscript{202} Proposals for Fundamental Tax Reform, supra note 301 at 2008; Joint Committee on Taxation, Description and Analysis of Tax Proposals Relating to Individual Saving Scheduled for a Hearing before the Senate Committee on Finance 72 (JCS-3-95) (February 8, 1995), available in 95 Tax Notes Today 27-38 (February 9, 1995) (hereinafter Individual Saving 1995) (noting that decline in U.S. savings rate greater than decline in Japan and Germany, but comparable to decline in savings rates in France and Italy).

\textsuperscript{203} Ways & Means Hearing, January 24, 1995, supra note 34 (statement of Rep. Mac Collins, R-Ga.) (stating that he just went through 15 years of raising children with expenses for toys and now tuition); Savings and Investment Incentives, supra note 298, at 59.

\textsuperscript{204} Proposals for Fundamental Tax Reform, supra note 301, at 2008; Individual Saving 1995, supra note 302, at 72 (cautioning that others note that in the past demographic changes have not been successful in predicting changes in savings). Many pin their hopes on boomers beginning to reach traditionally peak savings years. Lowell Bryan and Diana Ferrel, The Savings Surge, Wall St. J., November 7, 1994, at A14; Susan Scherreik, Goodbye Cyclicals, Hello Growth Stocks, Or so the Analysts Say, N.Y. Times, June 18, 1994, at A36.

\textsuperscript{205} Congressional Budget Office, Baby Boomers in Retirement 30 (September 1993) (hereinafter Boomers); Sylvia Nasar, Older Americans Cited in Studies of National Savings Slump, N.Y. Times, February 21, 1995, at A1 (noting a decline in savings by those age 55 and older).
for private savings;\textsuperscript{306} the decline may also perhaps be attributed to the flattening of real incomes.\textsuperscript{307} Also, the sharp decline in interest rates in 1993 and 1994 may have caused the elderly to dip deeper into savings to maintain their standard of living. These demographic factors indicate the CWATRA savings provisions are likely to have little effect on the personal savings rate.\textsuperscript{308} The most direct way to increase savings is likely to be to reduce the federal budget deficit.\textsuperscript{309}

The more effective, policy-based solution to revenue losses and blocking is either taxation of unrealized appreciation at death,\textsuperscript{310} or taxation of annual accrual of appreciation in public equities.\textsuperscript{311} History disclose[s] that the special interests under whose name a capital gains preference is currently sought would bitterly oppose either rule. A combination of a traditional Republican "cut-taxes-to-spur-the-economy" leg and a traditional Democratic "equity" leg ran through the 1963 tax proposals of President John F. Kennedy; this combination was no doubt motivated, at least in part, by a desire to broaden the support base for tax reform. Kennedy's proposed capital gains rate cuts (a 70% capital gains deduction not

\textsuperscript{306} Proposals for Fundamental Tax Reform, supra note 301, at 208; Individual Savings 1995, supra note 302, at 72; Nasar, supra note 305. Boomers, supra note 305, at 30, reasons that in addition to anticipating relatively generous transfers from public and private pensions, older Americans may have seen capital gains on housing as a substitute for financial wealth during the housing boom of the 1970's when borrowing costs (particularly from earlier mortgages) were low. Moreover, they could foresee indexed Social Security benefits, so fear of inflation was lessened, and Medicare was seen as lessening the burden of medical costs.

\textsuperscript{307} Jane Bryant Quinn, Debt's Dangers Again Become Clear, Wash. Post, May 15, 1994, at H2. While the high inflation of the late 1970's might be thought to lessen the incentive to save in fixed income accounts, the significant drop in savings among older Americans began in the mid-1980's, when such inflation years were over. Boomers, supra note 305.

\textsuperscript{308} Nasar, supra note 305.

\textsuperscript{309} Proposals for Fundamental Tax Reform, supra note 301, at 208.


seen since the “sliding-scale” deductions in President Franklin Roosevelt’s Revenue Act of 1934, with a resulting maximum rate of 19.5%) ran contrary, however, to the 1950’s reformers’ consensus of raising, not cutting, the capital gains rate. Moreover, the benefit of the Democratic quid (an increased capital gains preference) was outweighed by the burden of the Republican quo (the taxation of unrealized capital appreciation at death, which would have more than paid for the capital gains cuts through increased realizations) from the point of view of both wealthy individual taxpayers (a long-time Republican constituency) and special inter-

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811 In 1955, soon to be Chairman of the House Ways and Means Committee Representative Wilbur Mills, D-Ark., commenced a series of tax policy hearings with papers submitted from invited witnesses who included academics in addition to the public witnesses who appeared in prior tax hearings; these hearings culminated in the well-known 1959 Tax Revision Compendium and accompanying Panel Discussions. The consensus conclusion of the Mills Hearings witnesses as to capital gains was the notion propounded by Harvard Law Professor Stanley Surrey; the excessively high nominal individual ordinary income rates coupled with the excessively large individual capital gains preference created politically irresistible pressure to expand the categories of capital gains, which continued to be concentrated at the top. The consensus solutions in turn were to lower individual ordinary income rates, raise capital gains rates, repeal the 1940s and 1950s accretions to capital gains treatment, “recapture” depreciation deductions to correct the Crane character mischaracterization, and tax unrealized capital gains at death and upon gifts. Staff of Joint Comm. on the Economic Report, 84th Cong., 1st Sess., Federal Tax Policy for Economic Growth and Stability: Papers Submitted by Panelists Appearing before the Subcomm. on Tax Policy 406-15 (Comm. Print 1955); 2 Tax Revision Compendium, supra note 110, at 1203-32; see Staff of Joint Comm. on Economic Report, 84th Cong., 1st Sess., The Federal Revenue System: Facts and Problems 16 (Comm. Print 1956) (stating the results of the accretion process).


813 The Kennedy Administration believed that the reduction in capital gains rate would be “somewhat more than offset by the increased revenue from the change in holding period, the taxation of capital gains at death and the changes in definitions. . . . “ 1963 House Hearings, supra note 110, at 26. The anticipated increase in revenue would have arisen primarily from the elimination of the ability to avoid all capital gains by holding assets until death. The resulting increased volume of realizations were to yield approximately $700,000 per year in additional revenues for a net increase of $100,000 per year. Id. Between one half and two thirds of annually accrued capital gains are not realized prior to the owner’s death. See Gravelle, Limits to Feedback Effects, supra note 48, at 354-55; 1990 Senate Tax Incentives Hearings, supra note 155, at 82 (written statement of Dr. Henry Aaron, Senior Fellow at Brookings Institute and University of Maryland Economics Professor). At the time of the owner’s death, the estate or heirs take a date of death (or alternate valuation date) fair market value as their basis in the capital asset, with no income tax being paid on the appreciation in value. I.R.C. § 1014.

814 1963 House Hearings, supra note 110, at 1419 (statement of Keith Funston, representing the New York Stock Exchange). See also 1963 Senate Hearings, supra note 102, at 496 (statement of Joel Barlow, representing the Chamber of Commerce of the United States).
ests, such as farmers, ranchers, and, especially, small business owners. Thus, the best capital gains reform proposals to that date (namely, definitional purification and taxation of unrealized appreciation at death) united the interest groups in opposition, thereby dooming the Kennedy capital gains proposals. When the House rejected the taxation-of-unrealized-appreciation part of the package, the Kennedy Administration opposed the enactment of the capital gains cut alone. Consequently, the Senate, and then the Conference Committee, rejected the flawed House capital gains provision containing a quid without the corresponding quo. Thus, the view that President Kennedy supported a bipartisan capital gains cut is only half the story.

816 See supra note 112.
818 1963 House Hearings, supra note 110, at 1327 (statement of Henry Bison, National Association of Retail Grocers); id. at 1344 (statement of Donald Alexander, Association of Institutional Distributors) (citing 1959 Panel Discussions and stating that the heaviest burden would fall on small and medium sized businesses); id. at 1364 (statement of Samuel Foosaner, New Jersey Manufacturer’s Association) (stating that the burden is on small business, particularly from “goodwill” based upon capitalized earnings); id. at 1412 (statement of Keith Funston).
819 1963 Senate Hearings, supra note 102, at 286 (statement of Sen. Paul Douglas, D-Ill.). The date of death taxation of unrealized appreciation was the critical issue. See, e.g., 1963 House Hearings, supra note 110, at 591 (ranking Minority Ways and Means Member Rep. John Byrnes, R-Wis.); id. at 1380 (Rep. Howard Baker, R-Tenn.); id. at 1381 (Reps. Cecil King, D-Cal., and Thomas Curtis, R-Mo.). The fact that organized labor favored taxation of unrealized appreciation was to no avail. Id. at 1961 (statement of George Meany, AF of L, CIO). Mills himself was receptive to definitional reforms, but he and other Representatives were cool as to taxation at death. 1959 Panel Discussions, supra note 110, at 703-04, 711-13.
820 In January 1964, in the debate on what was now the Revenue Act of 1964, floor Manager Russell Long, D-La., with his famous “down home” oratory, announced to the Senate floor that the vast majority of top bracket individuals used the capital gains preference to obtain “surprisingly” low effective rates of income taxation (i.e. 22%). Long successfully argued against a capital gains cut uncoupled with some treatment of unrealized capital appreciation at death. The super rich enjoyed a lower effective rate than the merely wealthy, or at least well to do. In Long’s words the “tax on this capital gains income is low enough already. In a long run, capital gains clearly represents an ability to pay taxes. . . . Because this income is bunched, we tax it at lower rates; but is not 25 percent low enough?” 110 Cong. Rec. 1438 (1964).
E. Competing Developed Countries and Capital Gains

Some capital gains proponents argue that a capital gains preference is necessary because our international competitors tax capital gains lightly or not at all, the consequence being that the cost of capital necessary for growth is higher here. While it is true that either capital gains are exempt or capital assets are indexed in most Western European countries, as usual, that is only part of the story. Some have broader definitions of business transactions; more importantly, many have higher costs of capital, due to monetary policies or an overall tax burden heavier than the combined Federal, state and local burden in the United States. The consensus of economists as to the competitive tax advantage of these other countries is that they tend to rely on consumption tax systems, which some believe encourages savings and investment.
This suggests that the solution may be a consumption tax rather than a generic cut in the capital gains tax. Moreover, some view the capital gains tax as a very small part of the capital structure.  

F. Double and Greater Taxation

Some capital gains proponents argue that the capital gains tax is a tax on retained earnings (which fund a large part of corporate investment) and, therefore, the higher the capital gains tax, the more difficult it is for management to retain earnings. The existing capital gains preference, however, equivalent to a 30% exclusion at the top income bracket, encourages investment by high-bracket individuals in growth or income retaining corporations. In reality, in close corporations, there is often less income taxation of corporate earnings on a present value basis than would result under direct taxation a single time at the entrepreneur's level. This is due to splitting the venture's profits between compensation to the entrepreneur and retained earnings. The retained earnings

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826 Prepared Statement of Jane Gravelle, supra note 10: This information does not reveal very much about the causes of countries' different economic performances, however. First, the capital gains tax is a relatively small part of the capital income tax structures even in the United States; many other taxes apply and a full comparison of tax systems across countries would require some complex calculations. Secondly, the evidence does not support the notion that capital gains taxes are likely to influence growth rates. Recall that the simulation above suggests that the large percentage reductions in capital gains tax rates (over two-thirds) would increase output by only about 1/100 of one percent a year in the initial years (and less in later years). Thus, our ability to identify any links between capital gains taxes and growth rates would be severely constrained even if such a link existed, simply because it would be too small.

827 Senate Finance Hearings, February 15, 1995, supra note 36 (statement of Dr. Norman Ture, President of the Institute for Research on the Economics of Taxation). In fact, non-financial corporations relied on internal funds (in the form of retained earnings) for 94.1% of their additional funds in 1990, with debt largely used to repurchase shares. Integration of Individual and Corporate Tax, supra note 292.

828 Professor Zodrow reasons that a capital gains preference instead tends to encourage growth companies (retaining income) with less dividend payout, and consequently less funds available for investment by their shareholders in start-ups. Zodrow, supra note 37, at 482.

are taxed at a lesser rate due to the interplay of: (1) graduated inside rates on the first $75,000 to $100,000 of retained earnings, which are lower than the entrepreneur's top marginal rate; and (2) a long-deferred capital gain tax (or no income tax at all if held until the entrepreneur's death) on the realization of such earnings through a sale of the stock or retirement redemption.

In public corporations, the lessons from the recent leveraged buy-out experience suggest that the market discounts the price of public stock (below the asset value) for the corporate level tax. Thus, when a high income individual chucks on the market, holding public stock for just over a year, he or she is not suffering from double taxation. His or her short-term investment is, in effect, net of the corporate level tax.

To the extent that double taxation exists with respect to public firms, a capital gains exclusion is a very poor remedy. As much as 40% of the stock in public companies is held by legally, or functionally, tax-exempt shareholders. Around half of all capital gains realizations are derived from sources other than equities. Thus, at a maximum, double taxation extends to only 30% of capital gains realizations; taking account of realizations of close corporations and public stock held for only a year or so would reduce this percentage much more. Moreover, the greater problem is double taxation of dividends, for which a capital gains preference provides no relief. To the extent double taxation is truly a problem (it clearly encourages debt over equity financing), integration of corporate and shareholder taxation is the answer, not a capital

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330 The usual LBO premium (excess of tender offer above pre-offer price) ranged from 30% to 50% (in RJR-Nabisco it was 100%). "It should come as no surprise that removing the burden of the 34 percent tax rate from a corporation's income stream can arithmetically increase the value of a corporation's capitalization. The substitution of interest charges for pre-tax income is the mill in which the grist of takeover premium is ground." 1989 Senate LBO Hearings, supra note 39, pt. 1, at 6 (statement of Sec'ty James Brady); see also id. at 16, 18, 20 (statement of Sec'ty James Brady); Tax Aspects of Acquisitions and Mergers: Hearings Before the House Subcomms. on Oversight and on Select Revenue Measures of the House Comm. on Ways and Means, 99th Cong. 1st Sess. 20 (1985) (statement of Sec'ty James Brady); Tax Policy Aspects of Mergers and Acquisitions: Hearings Before the House Comm. on Ways and Means, 101st Cong. 1st Sess. 69 (1989) (statement of Subcommittee Chairman J.J. Pickle, D-Tex.).

331 See supra note 39.

gains preference at the shareholder level.

The more extreme rhetoric speaks of double or even quintuple taxation, an example of this rhetoric being:

I invest my saved dollar instead of enjoying that instant gratification, invest in a public corporation. When they make a profit, it gets taxed a second time; dividend distribution, it gets hit a third time; I sell my stock, enjoy a capital gain, and it gets hit a fourth time; and the ultimate obscenity in our Code, in my estimation, is when you have the audacity to die, they come in and bash your bereaved spouse and loved ones.

I personally think we have one of the most reprehensible tax codes on the face of this earth that does violence to the values that I was brought up to believe in, and one of these involves this question of taxing interest, dividends or capital gains at all.

The fact of the matter is, if you have denied yourself that gratification, why can’t you put that dollar to work for the rest of that dollar's life and let it grow and develop interest and hopefully be in a position at some point you can pass it on to a loved one when you die.\footnote{Ways & Means Hearing, January 24, 1995, supra note 34 (statement of Rep. Philip Crane, R-Ill.); Ways & Means Hearing, January 25, 1995, supra note 33 (statement of Dr. Norman Ture, President Institute for Research of the Economics of Taxation).}

The view that the inside corporate tax is a second level of tax apparently rests on the notion that income generated by capital is not income, a notion discredited in this country for almost seventy-five years.\footnote{See Kornhauser, supra note 107; Walter Blum, A Handy Summary of the Capital Gains Arguments, 36 Taxes 247, 248 (1957).} The third and fourth hits are double counting. Corporate income is either paid out as a dividend or is retained, in which case it may be realized in a stock sale (or may be held until death). While the dividend is clearly a second tax on the corporate earnings if received by a taxable shareholder, share repurchases grew to be 34% of dividends by 1990, peaking at 47% of dividends at the end of the leveraged buy-out wave in 1989.\footnote{Integration of the Individual and Corporate Tax, supra note 292, at 11.} Moreover, sales of stock may not really be equivalent to double taxation as outlined above, or, if so, the gain may be sufficiently deferred so that the present value of the tax is half or less than half of what a tax would have been on the gain as it accrued. The fifth tax, the “obscene” estate tax, is often the first shareholder level tax, levied...
on the corporate earnings which were retained in stock held until death with substantial deferral.

V. Conclusion

Some Congressional supporters of the current capital gains proposals might actually believe that the primary beneficiaries of the cuts would be the small business folks, farmers, and home owners in whose interest they are claiming the need for additional capital gains preferences. They are deluded. Small business people and farmers together probably account for at best 10% of annual capital gains realizations; the overwhelming sales of personal residences are not taxed due to rollovers, the $125,000, age-fifty-five exclusion, and a step up in basis at death. (Venture capital is probably less than 1% of such realizations.) Moreover, for most entrepreneurs, a capital gains preference is a subsidy rewarding them for what they would have done anyway, rather than an incentive to do what they otherwise would not have done. Other proponents probably realize that the interests that they champion garner only a fraction of the benefits (as a reward), but succumb to the influence of small-business and timber interests because they are vocal constituents of that member of Congress as well as local opinion leaders who do want the benefits of a capital gain preference. Following the adage of the late Speaker of the House Tip O’Neill, that “[a]ll politics is local,”337 they support the preference in order for their constituents to obtain their small piece of the overall pie. Others really want the preference for their wealthy constituents who realize the bulk of capital gains year after year,338 mostly from public stock and real estate investments, and they are cloaking those interests in the mantle of the small business, farm and residence.

The rationale that on the average capital gains are all inflationary has much more merit; it is true on average. But it is only half

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338 Chair Bill Archer, R-Tex., represents “one of the half-dozen most affluent [districts] in Congress.” David Rosenbaum, A Zeal for Tax Cuts Now Has Power, Too, N.Y. Times, April 4, 1995, at A1 ("[A]ffluent taxpayers must receive tax breaks because they are mainly the ones who invest money and create jobs for others." Accord 141 Cong. Rec. H4213 (daily ed. April 5, 1995) (remarks of Chair Bill Archer, R-Tex.) (“[W]e provide fuel for the engine that pulls the train of economic growth by cutting capital gains.” This is the trickle down philosophy.)
the truth: at levels of adjusted gross income below $100,000 all gains are on average inflationary; at a level of $200,000, only 50% are inflationary; and at a level of $500,000 only 30% are inflationary. This pattern renders the 50% exclusion a very poor, regressive, and unfair remedy. The economic losses at the bottom average out the economic gains at the top. Indexing as proposed is too complex and too narrow; above all, indexing has no logical support from either the stated small business and timber interest groups, or from the perhaps-real interest groups of big hitters churning on the stock market or selling improved real estate investments.

The proponents' answer to the distribution charges of opponents is also a myth: most sales are not once-in-a-lifetime sales bunching into one year gains actually accrued over many years. Although some may believe the unreasonable claims that 70% of capital assets are held by taxpayers with no more than $50,000 of AGI, and that such taxpayers pay most of the capital gains taxes, they are mistaken both as to the facts and as to patterns of wealth in this country. The opposite is more true: 70% of the benefits of a capital gains preference are realized year after year by the same top 10% of families; 50% of the capital gains realizations are enjoyed by the top 1% of families, with the bulk of their gains being real and not inflationary. It could be no other way, taking into account the sources of capital gains realizations (mostly public stock and investment real estate) and concentration of ownership of such assets at the top. The claim that there is substantial income mobility is misleading: much of the apparent upward mobility in income reflects the young growing older and becoming part of a two-working-spouse household or reaching peak earning years; much of the downward mobility reflects taxpayers growing older and retiring. Similarly, the decline in wages at the middle and bottom over the past two decades indicates that the benefits of the capital gains cuts of 1978 and 1981 did not trickle down. Nor did the 1978 and 1981 capital gains cuts increase the individual savings rate; in fact, it fell in the period following such cuts.

The claim that increased realizations due to the proposed rate cut will increase efficiency in the economy appears unlikely. Part of the gains will be consumed; a large part of the remainder will most likely be put into other, already-traded public stock. Therefore, new money will not go to the corporate issuer, which raises its funds by and large through internal generation and debt issuance
Whether the proposed preferences would raise revenue is harder to predict, since this is an economic question on which economists disagree both in theory and in their empirical studies. The consensus is that increased realizations alone will offset most, but not all, of the otherwise occurring revenue loss. Clearly, more realizations, and hence more revenue, would result either from taxation at death of unrealized appreciation (many more realizations would occur prior to death), or from annual accrual of unrealized appreciation in public stock. Those who support additional capital gains preferences would give them up rather than be faced with income taxation at death, as the rejection of President John F. Kennedy’s proposed package in 1963 by capital gains cut proponents makes clear. Their opposition to annual accrual would be even more intense, unless perhaps it was coupled with pass-through corporate shareholder integration, which would be the ideal answer to a host of current law policy problems. The macroeconomic effect, particularly during the five-year budget window of the CWATRA proposals, seems much more problematic. There is no clear consensus as to how to estimate such effects.

The flawed international competitors and double taxation arguments are raised less often these days by members of Congress and less frequently by witnesses, compared to other contentions. The overall tax burden of most of these competitors is heavier. Double taxation in practice does not reach that much of capital gains realization; integration of the taxation of corporations and their shareholders is the better answer.