Graduation of Tax on Capital Gains with Length of Holding Period

Statement by

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Norman B. Ture, Inc.

on behalf of

American Council on Capital Gains and Estate Taxation

Presented to

Subcommittee on Financial Markets
Committee on Finance
United States Senate

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Summary

In my statement before the Bentsen Committee, I proposed the elimination of the taxation of capital gains as one of a number of constructive revisions which would ameliorate, if not entirely eliminate, the present tax bias against saving and capital formation. As an interim, less drastic change, the proposal for graduating the tax on capital gains downwards with the length of the holding period warrants careful attention.

Enactment of this proposal for the treatment of individual capital gains, with all capital assets eligible, would present no compliance, enforcement, or administrative problems. To the extent that the average effective rate of tax under the graduated rate structure were less than at present, this revision would mitigate the heavy surcharge now imposed on the returns to saving and concomitantly reduce the cost of changing the composition of assets, thereby encouraging more efficient investment decisions and the unlocking of long-held capital assets. Implimentation of this proposal should not replace the existing "rollover" provision for personal residences.

The implications of a graduated tax proposal are quite different for the corporate taxpayer. Compliance problems would often be quite substantial, particularly in those cases where acquisitions, mergers, and reorganizations make the determination of holding periods difficult. Far more serious problems would arise on substantive gounds. Application of downward graduation to corporate taxpayers would differentiate the net-of-tax value

of large amounts of corporate assets on the basis of holding period and, therefore, distort the market's valuation of companies' equity capital, since these valuations would reflect not only the earning power of company assets but also their status under the downward graduated tax.

Additionally, since a substantial portion of the capital gains realized by corporations result from dispositions of property used in the company's trade or business rather than from portfolio transactions, a downward graduation of tax rates might impede the acquisition of more modern or productive capital assets, or otherwise distort the optimum holding period compared with the time of most economic disposition. To avoid imposing further tax deterrents to the timely replacement of uneconomical or obsolete plant and equipment, it is recommended that tax revision for the treatment of corporate capital gains be limited to an interim reduction to a flat rate of 25 percent, leaving unaltered the existing Section 1231 determinations of gain or loss.

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In testifying before the Subcommittee on Financial Markets of the Committee on Finance on September 24, 1973, I addressed the related questions of (1) the impact of the present tax structure on individual saving and investment and (2) the consequences of that tax impact on the efficiency of U.S. financial markets. There is no need to burden the record of the Subcommittee's hearings with a full restatement of my analysis and recommendations, but I should like to take the liberty of briefly summarizing the principal elements of that analysis in this testimony on behalf of the American Council on Capital Gains and Estate Taxation.

Well developed and efficiently operating financial markets are essential for the effective functioning of any advanced and diversified economy depending largely on private enterprises for the conduct of business in free markets. One of the major requirements for efficient performance by financial markets is widespread and active participation by individual savers-investors. For some time past, however, the major financial markets of the United States have been marked by thin and dwindling participation by individuals and by market results which disproportionately reflect the portfolio management activities of a relatively small number of large institutional

investors[1]. Since the investment requirements and strategies of these investors may well differ significantly from those of the vast majority of individual savers, the market results may also differ significantly from those required for efficient allocation and use of the economy's production capability and distort the consumption-saving choices of the private sector.

One of the factors contributing to the reluctance of individuals to invest directly in corporate equities and impeding their participation in financial markets is the anti-saving bias of the existing tax system. The nature and sources of this bias were described and illustrated in my testimony of September 24, 1973. I respectfully call the attention of the Subcommittee as well to my study Tax Policy, Capital Formation, and Productivity, prepared for the Committee on Taxation, National Association of Manufacturers (January 1973) and my testimony to the Committee on Ways and Means, U.S. House of Representatives, February 5, 1973, for further exposition and illustration of the anti-saving tax bias. In very summary terms, that bias derives principally from including in the current year's income tax base the amount saved in the current year and in subsequent years' tax base the returns to that saving. Since the amount saved is the capitalized value of the future returns on the saving, this income tax treatment taxes the same income flow twice. In contrast, income used for consumption is taxed only initially. This basic tax discrimination against saving is greatly increased by the separate taxation of corporate profits, by the taxation of capital gains,

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[1] In every year since 1961, individuals have, on balance, reduced their holdings of corporate equities. Cf. The 1974 Economic Report of the President, p. 273.

by State income taxes, by State and local property taxes, and by Federal estate and gift taxes and State inheritance taxes.

There is a large inventory of constructive tax revisions which would reduce, if not entirely eliminate, the present tax bias against saving and capital formation. (For a detailed inventory of such proposals, please refer to my NAM study cited above and to my White Paper on Long Range Tax Policy and Balanced Growth, prepared for the Special Committee on Long Range Tax Policy and Balanced Growth of the Chamber of Commerce of the United States, October 1972). One major item in that inventory is revision of the tax treatment of capital gains and losses.

The present tax treatment of capital gains and losses not only adds substantially to the differentially heavy tax burden on saving but also significantly impairs the efficient allocation of saving among alternative uses. In doing so, it represents a serious impediment to effective operation of financial markets.

A capital gain, by definition, is the market's capitalization of an anticipated increase in the earnings attributable to an asset or property. In the usual case, the income out of which the saving necessary for the acquisition of the property was made was taxed as it was accrued or realized, and the earnings of the property similarly were taxed as they materialized. So, too, will the increase in the future earnings of the asset be taxed as they are realized. Taxing currently the capitalized value of these additional future earnings obviously is to impose a surcharge on the taxes that will be paid

when the future earnings come along.

Coming on top of the disproportionately heavy load of individual and corporation income taxes on saving, the tax on capital gains significantly increases the cost of saving relative to consumption. And through the operation of the capital markets, the increase in the relative cost of saving which results from taxing capital gains leads to an across-the-board increase in the cost of saving and of capital formation.

The significance of this tax-imposed increase in the cost of saving should not be ignored. Had the tax system discriminated less harshly against saving and capital formation during the postwar period, the entire economy would have benefitted from a more rapid increase in total production capacity, greater real output, and a higher rate of advance in labor's productivity and real wage rate.

"If capital services had increased 50 percent more rapidly than the actual trend rate"...i.e., at an annual rate of 5.55 percent rather than 3.7 percent..."for example, gross output of the business sector would have increased 4.19 percent faster than its actual trend rate of growth and would have been 12.0 percent greater than its trend value for 1967. The marginal productivity of labor and the real wage rate would have increased at an average annual rate of 2.79 percent, compared with the trend rate of increase of 2.2 percent, and would have been 11.9 percent more than its trend value

in 1967."[1/] The anti-saving, anti-capital formation bias of our tax system, to which the present tax treatment of capital gains contributes significantly, costs us all dearly.

But this is not the sole adverse effect of taxing capital gains. The tax is imposed on gains not as they accrue but only when they are realized by sale or exchange of the assets. The occasion for the tax is not merely the increase in value but the transfer of the asset as well. Taxing capital gains not only increases the relative cost of saving but also increases the cost of changing the composition of the assets one owns. The interaction of these two effects of capital gains taxation is to increase the difference between the expected returns on alternative investments required to make a shift in asset holdings worthwhile.

Unless it could be established that people are utterly unresponsive to changes in transaction costs---a wholly unrealistic proposition, taxing capital gains must reduce the frequency of transfers and impede prompt changes in the composition of assets in response to changes in their relative values. In turn, this clearly impedes the efficient functioning of the financial markets in providing valuations of alternative uses of saving and in allocating saving optimumly.

Tax changes to ease the existing discrimination against saving will not necessarily, of themselves, reverse the trends of the past few years in the securities markets nor assure the financial climate most conducive to

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[1/] Ture, Tax Policy, Capital Formation, and Productivity, op.cit., p. 19.

vigorous, innovative private enterprise. But constructive changes in the tax laws would surely make an important contribution to a higher rate of private saving, particularly by individuals, to greater participation by them in the financial markets, and therefore to more efficient functioning of those markets.

Constructive tax revisions are those which will reduce tax interference in the choices of businesses and households as to how they obtain and use their income and wealth. Given the enormous demands for additional capital to be faced in virtually every sector and by every industry in the economy in the coming years, if the Nation is to maintain and advance productivity and living standards and to extend more fully the benefits of that advance to the poor, constructive tax policy will have to give top priority to reducing the present tax bias against saving.

A good place to begin is to eliminate entirely the taxation of capital gains. Few other advanced industrial nations apply their income taxes to capital gains. To be sure, in the context of U.S. income tax history, this would be a drastic step. But properly viewed, i.e., as a heavy tax surcharge on the returns to saving and as an excise on shifting the allocation of saving, the taxation of capital gains affords few benefits to justify the cost it entails in terms of the lost capital formation, lost productivity, and lost real output for the economy as a whole.

In the current climate of opinion, realism requires recognition of the fact that complete elimination of the present tax on capital gains must be

viewed as a long-range objective. In the interim, considerably less drastic changes can be made which would mitigate the adverse effects of capital gains taxation.

One such change which has received careful attention would graduate the tax on capital gains downwards with the length of time the capital assets had been held. I was happy to have had the opportunity to respond last fall to several inquiries from the Subcommittee concerning this proposal. The gist of my replies was that a downward graduated tax on capital gains would raise no significant compliance, enforcement, or administration problems and that it would in all likelihood result in a substantial unlocking of long-held capital assets. Moreover, implementation of the proposal would very likely generate substantial additional tax revenues, although this effect would be far more pronounced in the early period following adoption of the revised tax than subsequently.

To the extent that the average effective rate of tax under the downward graduated rate structure were less than at present, moreover, this revision would somewhat mitigate the existing tax bias against saving. It should also induce somewhat greater individual investment in corporation securities and such other capital assets of which an important attribute is the relative ease with which they may be sold or exchanged. Hence, enactment of this proposal should contribute to fuller participation by individuals in the financial markets and to improved efficiency in the operation of these markets. Considerations of tax neutrality, however, militate against confining the proposed tax treatment solely to securities. All capital assets owned by individuals should be eligible,

except that downward graduation should not replace the existing "roll over" treatment for gains on personal residences.

Quite different answers to the Subcommittee's questions are appropriate insofar as corporate income taxpayers are concerned. For the corporate taxpayer, compliance problems would often be substantial, particularly in cases in which acquisitions, mergers, and reorganizations have occurred and the determination of holding periods, other than more or less than six months as under present law, would be difficult.

On substantive grounds, a far more serious problem would arise. Application of downward graduation to corporate taxpayers would differentiate the net-of-tax value of the capital assets owned by corporations on the basis of holding period and accordingly it would distort the market's valuation of the corporation's equity. Thus, if two corporations, A and B, held identical portfolios of capital assets but A had held such assets much longer than B, the capitalized value of the potential tax on the liquidation of A's portfolio would be less than that with respect to B's. This difference in potential taxes would certainly be reflected, other things being equal, in the market's valuation of the two company's stocks. Yet these differing valuations would reflect no real difference between the companies' pretax earning capacities, but merely differences in their status under the downward graduated capital gains tax.

An additional substantive difficulty in applying the downward graduating system to corporations stems from the fact that a substantial portion of the

capital gains realized by corporations result from the disposition of property used in the corporation's trade or business and do not represent gains on portfolio transactions. Such property is generally disposed of when there is opportunity for replacing it with more modern and productive production facilities. Such replacements should not be impeded by tax considerations. Indeed, one of the principal justifications for the enactment of the tax treatment of gains and losses upon the disposition of such property detailed in Sec. 1231 of the Internal Revenue Code was to reduce tax barriers to such dispositions on a timely basis. In many cases, such dispositions would take place, apart from tax considerations, some considerable time before the elapse of the holding period at which a step down in the capital gains tax rate would occur under the proposal. And for a significant amount of such property, the typical holding period under the present tax provisions is short enough that the proposed downward graduation of the capital gains tax rate with holding period would be of little benefit, if, indeed, it did not increase tax. For some other types of property, e.g., timber and land, the optimum time for their disposition as determined by sound business considerations is likely to differ materially from the holding period at which a step down in the tax would be provided under the proposal. The downward graduation of rates, therefore, might well induce retention of such property beyond the time when it would be most economic to dispose of it.

A substantial argument, therefore, can be made for limiting the proposed downward graduated tax rate to capital gains realized by individuals.

For corporate taxpayers, the prime consideration should be to reduce existing tax deterrents to timely disposition and replacement of uneconomical or obsolete

production facilities and to avoid increasing tax barriers to modernization of plant and equipment. Given this consideration, a highly constructive interim revision would be to reduce the present rate of tax on all corporate capital gains, say to a flat rate of 25 percent. Moreover, any such interim change should not alter the existing Section 1231 determinations of gain or loss.

I should like to emphasize that these suggestions are offered as interim measures, not as ultimate solutions. A complete overhaul of the tax system to eliminate the tax discrimination against saving or to reduce it to a minimum would eliminate automatically many of the current problems arising in the tax treatment of capital gains. Pending any such thorough-going revision, intermediate measures to reduce the weight of existing taxes on capital gains warrant endorsement by the Congress.