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A STUDY OF THE LOCK-IN EFFECTS OF FEDERAL INCOME TAXATION OF CAPITAL GAINS ON SECURITIES OF INDIVIDUALS

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CHAPTER I

INTRODUCTION

The history of the federal income tax laws is replete with controversy regarding the taxation of income derived from transactions involving capital assets. One area of controversy concerns arguments that the provisions of the income tax laws pertaining to capital gains and losses (referred to as the capital gains tax) create a situation referred to as "lock-in." The term "lock-in" is defined, for purposes of the study, as a situation which exists if a taxpayer is reluctant to dispose of a capital asset because of federal income tax consequences of the disposition. The basic problem considered in this study is a determination of the magnitude of the alleged lock-in effects of capital gains taxation on individual investors.

Areas of the Laws Allegedly Creating Investor Lock-In

Three aspects of the present federal income tax structure pertaining to capital gains and losses are said to create lock-in of investors. These are: (1) the imposition of a tax on realization, (2) the treatment of transfers at death, and (3) the holding period distinction.

Imposition of a Tax on Realization

Capital gains and losses are recognized, for income tax purposes, when realization (generally sale or exchange of a capital asset) occurs. A taxpayer may defer payment of income taxes on capital gains by postponing realization of the gain. Thus, a taxpayer may be influenced to hold rather than sell an appreciated asset simply to postpone payment of income tax on the appreciation.

The imposition of a tax on realization creates a more complex situation when an investor is considering the sale of an appreciated capital asset and reinvestment of the proceeds. The income tax reduces the amount of proceeds from the sale available for reinvestment. Consequently, the differential in the expected return from an asset to be purchased over the expected return from an asset held must be sufficient to justify a transfer and to offset payment of income taxes on the transaction. The capital gains tax may thus create an impediment to the exchange of earning assets.

Alleged investor lock-in, attributable to the imposition of a tax on realization, is often referred to as lock-in from the "capital gains tax rate."

Treatment of Transfers at Death

A taxpayer may completely avoid payment of income taxes on appreciated capital assets included in his estate. For income tax purposes, such gains are not considered to be realized at the time of the taxpayer's death, and no income tax is imposed on the amount of appreciation up to that point. In addition, the tax basis for computing gain or loss on such assets, in the hands of a beneficiary, is the fair market value of the asset at date of death or alternative estate valuation date. Appreciation on a capital asset transferred through an estate is thus never subject to income tax. A taxpayer may be influenced to hold rather than sell an appreciated asset because the opportunity to completely avoid payment of income taxes is available. Such influence is referred to as lock-in from "avoidance at death provisions" or "step-up in basis provisions."

Assets included in estates are subject to various taxes that must be paid on estates, but these taxes are imposed regardless of the form of assets in the estate. Therefore, they do not affect the validity of the statement that income taxes may be completely avoided on appreciated capital assets transferred through an estate, or allegations that the avoidance provisions create investor lock-in.

Holding Period Distinction

The income tax laws distinguish between gains from capital assets held more than six months (long-term capital gains) and gains from capital assets held six months or less (short-term capital gains). Short-term capital gains are taxed at basically the same rates as ordinary income, while long-term capital gains receive preferential treatment. A taxpayer may be influenced to hold an appreciated capital asset for a period longer than six months before selling it, in order to reduce the income tax that must be paid on the sale of the asset. Such influence is referred to as "holding period lock-in."

Significance of the Alleged Lock-in Problem

It is claimed that capital gains taxation tends to lock-in investors owning appreciated capital assets, impeding the free flow of capital and creating serious economic consequences. Among the undesirable effects attributed to investor lock-in are accentuation of fluctuations in the stock market and fluctuations in specific asset prices thereby distorting the process of resource allocation and reducing economic growth and efficiency.

As stated by Jonathan A. Brown, former director of the Research Department of the New York Stock Exchange,

> As of this moment, [1955] American investors are locked in with over $200 billion of unrealized capital gains. We know that, in stocks listed on the New York Stock Exchange alone, there is over $100 billion of unrealized appreciation just since 1949. That these investors continue to be locked in by the restrictive effects of the capital-gains tax constitutes one of the country's most serious obstacles to economic growth.[1]

Neil Jacoby, in a report presented to the Committee on Ways and Means of the Congress, expressed a similar opinion.

> The current treatment of capital gains does tend to "freeze" capital assets in the hands of investors who are reluctant to sell appreciated assets and pay up to 25 percent of their gain to the Federal Government. Thus, it does in some measure impede the mobility of investment funds, with adverse consequences for the productivity of capital.[2]

The significance of these arguments and the magnitude of economic consequences depend to a large degree on the strength of the alleged lock-in effects of capital gains taxation on investors, and there is considerable disagreement on this point. The preceding quotations contain implications that capital gains taxation exerts a substantial lock-in influence on investors. Economist Walter Heller questioned the strength of investor lock-in,

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[1]Jonathan A. Brown, "The Locked-in Problem," Federal Tax Policy for Economic Growth and Stability. Papers submitted by panelists appearing before the Subcommittee on Tax Policy, Joint Committee on the Economic Report. 84th Congress, 1st Session, November 9, 1955 (Washington, D.C.: U.S. Government Printing Office, 1955), p. 367.

[2]Neil H. Jacoby, "Guidelines of Income Tax Reforms for the 1960's," Tax Revision Compendium. Compendium of papers on Broadening the Tax Base submitted to the Committee on Ways and Means (Washington, D.C.: U.S. Government Printing Office, 1959), p. 165.

> . . . how much scope is left for its [the capital gains tax] lock-in effect? Far less, certainly, than our worst fears (ably translated by the officials of the New York Stock Exchange) would suggest. . . .
> The extent, severity, and economic impact of the lock-in effect have been seriously overrated.[3]

Professors Holt and Shelton expressed a similar view,

> There is only the slightest empirical evidence relating to the lock-in effect, but what exists tends to support the conclusion derived from the theoretical analysis . . . that the lock-in effect of the capital gains tax is not great.[4]

There is little agreement among authorities concerning the extent or significance of lock-in effects of capital gains taxation. Yet, there has been little empirical research conducted to provide support for the various positions.

Hypothesis and Objectives

The central hypothesis of the study is that federal income tax implications influence investors to hold appreciated securities that might otherwise be sold, and therefore, lock-in of investors exists.

A primary objective of the investigation was to obtain evidence to support or refute the hypothesis and to

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[3]Walter W. Heller, "Investors' Decisions, Equity, and the Capital Gains Tax," Federal Tax Policy for Economic Growth and Stability. Papers submitted by panelists appearing before the Subcommittee on Tax Policy, Joint Committee on the Economic Report. 84th Congress, 1st Session, November 9, 1955 (Washington, D.C.: U.S. Government Printing Office, 1955), pp. 386, 394.

[4]Charles C. Holt, and John P. Shelton, "The Lock-in Effect of the Capital Gains Tax," The National Tax Journal, Vol. XV (December, 1962), p. 351.

provide an indication of the extent of investor lock-in created by capital gains taxation. This study of the lock-in effects of capital gains taxation also includes:

(1) an examination of the relevant provisions of the laws of federal income taxation and a delineation of those provisions that may create a lock-in situation for investors,

(2) a discussion of possible undesirable economic consequences resulting from alleged investor lock-in, and

(3) an evaluation of proposals for income tax reform designed to alleviate the alleged lock-in problem, and recommendations for reform based on information derived from the project.

A summary review of each of these areas is presented in order to provide the necessary background for a comprehensive investigation of the lock-in effects of capital gains taxation.

Approach Followed in the Study

The research for the project was conducted in two separate phases. The first phase was a thorough review of literature concerning lock-in effects of capital gains taxation. Such a review was necessary in order to determine that a controversial issue exists, to define the problem and areas of the federal income tax laws that may create investor lock-in, to delineate the study within relevant and practical limits, and to obtain information about previous research and analyses. This phase of the research provided the basis for much of the discussion which follows, particularly that concerning present federal income tax laws, economic consequences of investor lock-in, and proposals for alleviation of investor lock-in.

The second phase of the research consisted of collecting and analyzing data gathered from a mail survey of a group of taxpayers. The primary purpose of the survey was to obtain information to be utilized in an evaluation of the existence and significance of lock-in effects on investor decisions. A detailed discussion of the methodology, results, and conclusions of the survey is presented in subsequent chapters.

Scope of the Study

Although lock-in has been defined as a situation which exists if a taxpayer is reluctant to dispose of a capital asset because of federal income tax consequences of the disposition, the terms "taxpayer" and "capital assets" refer to a large number of heterogeneous items. The scope of the study was restricted to exclude unnecessary complexity from the presentation and to allow for development of meaningful conclusions. The investigation was, therefore, limited to lock-in effects of capital gains taxation on individual taxpayers and their investments in stocks and bonds.

In addition, individuals in business or professional occupations were selected for the survey, and a disproportionately large number of high-income persons were included. Members of these groups were chosen because of the high degree of concentration of security ownership by such individuals. The responses of high-income business and professional people would represent opinions and attitudes of members of a significant group of investors. This contention obviously influenced the collection, presentation, and analysis of empirical data, and consequently, results and conclusions of the study. The validity of the conclusions, therefore, are dependent, to some extent, on the validity of this assumption. Appendix A contains a more detailed discussion of these restrictions on the scope of the study.

Significance of the Study

The lack of empirical evidence on the subject of investor lock-in provided one justification for conducting this investigation. Data collected from the survey, combined with results of previous research, were used to support or provide a basis for disagreement with currently held positions regarding the lock-in effects of capital gains taxation.

The response rate to the survey was relatively low, a common occurrence for mail questionnaires of this nature. In spite of efforts to protect the research from bias or error, nonresponse could have affected the representativeness of the data. Therefore, statistically verifiable statements could not be made about the population of high-income business and professional investors or investors as a whole; although conclusions derived from the data may be completely valid and representative of either or both.

Also, at the time this study was initiated, the 91st Congress was considering a major reform of the federal income tax laws, and The Tax Reform Act of 1969 was the product of their efforts. The act contained several modifications of the income tax treatment of capital gains and losses, and additional modifications are currently being studied. As a result, an increasing amount of attention has been directed toward the whole area of income taxation, and the capital gains controversy has received new fuel. The significance of this project was partially attributable to its timeliness.

In summary, the project was initiated to provide original, meaningful, and timely information that might be utilized to reduce the controversy over lock-in effects of capital gains taxation.

Organization of the Study

Chapter I contains an introduction to the subject of the lock-in effects of capital gains taxation. The hypothesis, objectives, approach, and organization of the study are presented, and the significance of the alleged lock-in problem and the study is discussed. In addition, the areas of the laws allegedly creating lock-in are delineated, and the constraints on the scope of the study are explained.

Chapter II summarizes the major provisions of present income tax laws that are relevant to individual investors in securities. In addition, those provisions of the laws purportedly creating lock-in are isolated and discussed.

Chapter III discusses some of the economic aspects of federal taxation of capital gains. A review of arguments for and against preferential treatment and alleged economic consequences of lock-in are presented.

Chapter IV contains a detailed description of survey methodology utilized to obtain information about investor lock-in and presents some of the pertinent findings.

Chapter V evaluates the degree of lock-in created by various aspects of capital gains taxation based on information obtained in this project and previous research.

Chapter VI examines some alternative methods of taxing capital gains that have been proposed to eliminate or alleviate the alleged lock-in problem. In addition, the effects of the 1969 income tax reform on provisions pertaining to capital gains and losses and investor lock-in are discussed.

Chapter VII presents a recommendation, based on conclusions derived from the study, for income tax reform that would alleviate lock-in effects of capital gains taxation.

Chapter VIII provides a summary of major findings of the research and indicates some areas where additional research might be beneficial.

CHAPTER II

SUMMARY OF THE RELEVANT PROVISIONS OF THE LAWS OF FEDERAL INCOME TAXATION PERTAINING TO CAPITAL GAINS AND LOSSES

A comprehensive investigation of the lock-in effects of capital gains taxation requires a basic understanding of the relevant provisions and subsequent amendments and interpretations of the Internal Revenue Code of 1954.[1] The purpose of this chapter is to provide a review of the provisions of the laws of federal income taxation that are pertinent to the lock-in controversy. The provisions concerning capital gains and losses are complex, and numerous technical aspects, not directly related to the subject of this project, are omitted. In accordance with limitations on the scope of the study, the review includes primarily those provisions affecting individual taxpayers and their transactions involving securities. The "temporary" income tax surcharge generally is ignored in the discussion, since

[1]References to the Code and Regulations are taken from Internal Revenue Code of 1954 and Income Tax Regulations, July, 1969, Editions, published by Prentice-Hall, Inc.

it affects the magnitude of the current effective rates but not the basic structure of the federal income tax, allegedly creating investor lock-in. Also, federal income tax laws as they existed prior to the 1969 reform are the basis of the project and are the laws relevant to the study. Modifications of the provisions resulting from the reform are noted, and a discussion of the changes is presented in Chapter VI.

Definition of a Capital Asset

The exact nature of a capital asset is not specified in the Code; rather, the definition states that all property, except items specifically excluded, are capital assets. The exclusions apply to a substantial group of assets. Specifically, the Code states:

> . . . the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
>
> (2) property, used in his trade or business, (of a character) which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;
>
> (3) a copyright, a literary, musical, or artistic composition, or similar property, held by--
>
> (A) a taxpayer whose personal efforts created such property, or
>
> (B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.[2]

This definition of a capital asset includes a number of diverse types of assets. Securities held by a taxpayer who is not a dealer in securities are included, and these are the assets of particular interest in the study.

Gains on Capital Assets as Income

Accountants, economists, and tax experts have had very little success in formulating a universal definition for the word "income." The term "income" is not defined specifically in the Internal Revenue Code of 1954. The Code does, however, provide a basis for distinguishing between items considered income to a taxpayer and items not considered income. As stated in the Code, the term "gross income":

> . . . means all income from whatever source derived, including (but not limited to) the following items:
> (1) Compensation for services, including fees, commissions, and similar items;
> (2) Gross income derived from business;
> (3) Gains derived from dealings in property;
> (4) Interest;
> (5) Rents;

---

[2]Internal Revenue Code, Section 1221.

(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.[3]

The federal tax regulations interpreting this section specify:

> Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. . . .[4]

Thus, gross income is defined very broadly for income tax purposes. Realized "gains derived from dealings in property" (including capital assets) are included in the gross income of a taxpayer and are subject to the income tax.

Determination of Point of Recognition and Amount of Capital Gains and Losses

A capital gain or loss is recognized for tax purposes when realization occurs (generally a sale or exchange of a capital asset). Realization is not deemed to have occurred when a capital asset is transferred by gift or at death.

---

[3]Internal Revenue Code, Section 61.

[4]Regulations, 1.61-1 (a).

The determination of the amount of a realized gain or loss is provided for in the Code.

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.[5]

There are two terms, "amount realized" and "adjusted basis," that require clarification.

> The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. . . .[6]

The rules for determination of "adjusted basis" are complex and depend on the type and the method of acquisition of property. Two situations are particularly important to this study; these are securities acquired by purchase or securities acquired from a decedent.

Securities Acquired by Purchase

The original basis of a security purchased by a taxpayer is the amount paid for the security, including brokerage fees, transfer taxes, and other acquisition costs.[7]

---

[5]Internal Revenue Code, Section 1001 (a).

[6]Internal Revenue Code, Section 1001 (b).

[7]Internal Revenue Code, Section 1012.

Securities Acquired from a Decedent

Securities may be acquired from a decedent, and, subject to a few minor exceptions,

> . . . the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811 (j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections.[8]

The basis of securities acquired from a decedent is, therefore, the fair market value of the security at the date of death, or, if estate valuation at an alternative date is elected, the fair market value at the valuation date.

Implications of the Sections for This Study

The preceding provisions contain several aspects of the income tax laws of particular interest to a study of investor lock-in. These provisions are concerned with the point of recognition of capital gains and losses and the determination of basis for computing gain or loss.

Major changes in the value of capital assets, such as securities and real estate, frequently occur over a period of years. In spite of this characteristic, no capital gain or loss is recognized for income tax purposes

[8]Internal Revenue Code, Section 1014 (a).

until realization occurs. Consequently, the taxpayer, by deciding the time of realization, determines the taxable year in which a capital gain or loss will be included in his income. As a result of the taxpayer's control over the timing of recognition of capital gains, he may postpone the payment of income taxes on a capital gain simply by continuing to hold the asset.

Also, realization is not considered to have occurred, and, therefore, no capital gain or loss is recognized on transfers of capital assets by gift or at death. The amount of gain is not recognized for income tax purposes at the time of death or transfer to the heir. In addition, the basis of an asset in the hands of a person acquiring property from a decedent is the fair market value at the estate valuation date. Consequently, any amount of accrued appreciation to the date of estate valuation is never subject to the income tax; such tax is completely avoided.

These factors prove to be significant considerations in later discussions of lock-in effects of capital gains taxes.

Distinction between Short-Term and Long-Term Capital Gains and Losses

The present law distinguishes between short-term and long-term capital transactions based on the length of time the asset has been held. A gain or loss resulting from the sale or exchange of a capital asset held for more than six months is referred to as a long-term capital gain or loss. A gain or loss resulting from the sale or exchange of a capital asset held for six months or less is referred to as a short-term capital gain or loss. The distinction between long-term and short-term gains is of utmost importance, since the effective rate at which the gain will be taxed is determined by the classification of the gain.

Terminology Related to Short-Term and Long-Term Capital Gains and Losses

An understanding of the following terms should facilitate comprehension of the discussion concerning the treatment of short-term and long-term capital gains and losses that is presented in a subsequent section.

> (1) Short-term capital gain.--The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than six months, if and to the extent such gain is taken into account in computing gross income.
> (2) Short-term capital loss.--The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than six months, if and to the extent that such loss is taken into account in computing taxable income.
> (3) Long-term capital gain.--The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than six months, if and to the extent such gain is taken into account in computing gross income.
> (4) Long-term capital loss.--The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than six months, if and to the extent that such loss is taken into account in computing taxable income.
> (5) Net short-term capital gain.--The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

> (6) Net short-term capital loss.--The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.
> (7) Net long-term capital gain.--The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.
> (8) Net long-term capital loss.--The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year. . . .[9]

Short-Term Capital Gains

Net short-term capital gains are included in a taxpayer's gross income and receive the same income tax treatment as ordinary income. There are no special provisions for realized gains from capital assets held six months or less. Consequently, such short-term capital gains may be taxed at ordinary income rates, ranging from 14 to 70 percent, depending on the total amount of the taxable income of the taxpayer.

Long-Term Capital Gains

The excess of net long-term capital gains over net short-term capital losses for a particular taxable year[10] is included in a taxpayer's gross income for that year, but two provisions afford preferential treatment for the excess of net long-term capital gains over net short-term capital losses.

---

[9]Internal Revenue Code, Section 1222.

[10]This excess is termed "net section 1201 gains" by the Tax Reform Act of 1969.

First, an amount equal to 50 percent of the excess is deducted from gross income in computing "adjusted gross income" for the taxable year. As stated in the Code,

> In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. . . .[11]

This provision has the effect of reducing effective tax rates applied to long-term capital gains by one-half, and such gains may be taxed at effective rates ranging from seven to 35 percent.

Secondly, an alternative computation of the income tax is allowed, limiting to 25 percent the maximum income tax applicable to long-term capital gains.[12] As stated in the Code,

> If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of--
>
> (1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

---

[11] Internal Revenue Code, Section 1202.

[12] The alternative tax computation is modified by the Tax Reform Act of 1969. The maximum rate remains 25 percent for up to $50,000 of long-term capital gains. The maximum rate applicable to such gains in excess of $50,000 is raised to 29.5 percent in 1970, 32.5 percent in 1971, and, effectively, 35 percent thereafter.

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.[13]

As a result of these two provisions, effective income tax rates on long-term capital gains of individuals are generally one-half the corresponding rates applicable to ordinary income and short-term capital gains, with a limit of a 25 percent maximum rate.

Table 1 compares effective rates applicable to ordinary income and net short-term capital gains with effective rates applicable to long-term capital gains.

TABLE 1

COMPARISON OF EFFECTIVE TAX RATES FOR A MARRIED INDIVIDUAL FILING A JOINT TAX RETURN

Amount of Taxable Income		Marginal Tax Rate Applicable to an Additional Dollar of:	
More Than	But Less Than	Ordinary Income and Short-Term Capital Gains	Long-Term Capital Gains
$ 3,000	$ 4,000	17%	8.5%
8,000	12,000	22	11.0
16,000	20,000	28	14.0
20,000	24,000	32	16.0
24,000	28,000	36	18.0
36,000	40,000	45	22.5
40,000	44,000	48	24.0
44,000	52,000	50	25.0
76,000	88,000	58	25.0
100,000	120,000	62	25.0
200,000	and over	70	25.0

[13]Internal Revenue Code, Section 1201 (b).

The preferential treatment afforded long-term capital gains thus comes from two provisions: (1) the 50 percent deduction, and (2) the alternate tax computation. It is apparent from Table 1 that effective rates on marginal income in the form of long-term capital gains are substantially below effective rates applicable to ordinary income and short-term capital gains.

Capital Losses

Capital losses, like capital gains, receive special treatment under federal laws of income taxation. The provisions concerning capital losses, unlike those applicable to capital gains, are generally disadvantageous to the taxpayer.

The general treatment of losses is set forth in the Code, as follows,

> (a) General Rule.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> (b) Amount of Deduction.--For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.
>
> (c) Limitation on Losses of Individuals.--In the case of an individual, the deduction under subsection (a) shall be limited to--
>
> (1) losses incurred in a trade or business;
>
> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
>
> (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. . . .[14]

---

[14]Internal Revenue Code, Section 165 (a-c).

In general then, losses are deductible in a taxable year, with certain limitations, if they arise from a business, from transactions entered into for profit, or from theft or casualty. Purchases and sales of capital assets are transactions entered into for profit; therefore, losses from such transactions are deductible under this provision.

The amount of a capital loss, as mentioned previously, is the excess of adjusted basis over the value of cash and other property received. There are limitations, however, on the amount that may be deducted in a taxable year. According to the Code,

> In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or $1,000, whichever is smaller. . . .[15]

Thus, capital losses are first offset in full against capital gains, and any excess is then deducted from other income,[16] limited by the lesser of the amount of the taxable income or $1,000. Any amount of capital loss not used in a taxable year may be carried over to succeeding years.

> In general.--If a taxpayer other than a corporation has a net capital loss for any taxable year beginning after December 31, 1963--
> (A) the excess of the net short-term capital loss over the net long-term capital gain for such year

[15]Internal Revenue Code, Section 1211 (b).

[16]As a result of the tax reform, only 50 percent of a long-term capital loss may be deducted from income; therefore, $2 of such losses are required to offset $1 of ordinary income. Long-term losses may still be offset in full against capital gains.

> shall be a short-term capital loss in the succeeding taxable year, and
>
> (B) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year. . . .[17]

The Code, therefore, provides for the carry-over of unused capital losses for an indefinite period of time, with retention of their original character.

Primary Areas of the Laws of Federal Income Taxation Allegedly Creating Investor Lock-in

The preceding sections have reviewed some of the relevant provisions of the federal income tax laws applicable to investments in securities by individual taxpayers. There are three aspects of the laws concerning capital gains that allegedly provide the major sources of lock-in for investors.

Holding Period

As mentioned in the previous section, capital gains from assets held six months or less are referred to as short-term capital gains. Such gains are included in the gross income of a taxpayer, receive no preferential treatment, and are subject to the same rates as ordinary income.

On the other hand, gains from the sale or exchange of capital assets held more than six months (referred to as long-term capital gains) are allowed preferential treatment,

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[17]Internal Revenue Code, Section 1212 (b) (1).

compared to ordinary income. A taxpayer is allowed to deduct 50 percent of the excess of net long-term capital gains over short-term capital losses from his gross income. As a result of this deduction, the effective tax rates applicable to such gains are 50 percent less than the rates applicable to ordinary income. In addition, the maximum tax rate on long-term capital gains is limited to 25 percent as compared to a maximum tax rate of 70 percent for ordinary income and short-term capital gains.

In view of these provisions, a taxpayer may substantially reduce the amount of income taxes he would otherwise pay, by waiting until the six months holding period has elapsed before selling an appreciated capital asset. Many authorities have expressed the opinion that the significant tax savings obtainable by postponing realization until the holding period has elapsed create a very significant lock-in effect on investors.

Imposition of a Tax on Realization

Capital gains and losses are generally recognized for tax purposes when realization (sale or exchange) occurs. As long as an investor continues to hold an appreciated capital asset, no income is recognized, and no income tax on the gain must be paid. These criteria for recognition of capital gains allegedly create investor lock-in.

An investor may, by deferring payment of income tax on appreciation in capital assets, retain and earn a return on money that would otherwise be paid in income taxes. The tax deferral is in the nature of an interest-free loan from the federal government in the amount of postponed tax payments. Imposition of a tax on realization is especially important to an investor considering the sale of an earning asset and the purchase of another. An income tax on realized gains has the effect of a transfer tax on the exchange. The amount of tax that must be paid reduces the proceeds from the disposition available for reinvestment by the taxpayer. The differential in the return expected from an asset to be purchased, over the return expected from an asset held, must be sufficiently great to offset the amount of capital paid in tax and still induce an investor to make the exchange.

As a result of these considerations, many authorities feel that tax consequences may deter investors from making sales or exchanges they might otherwise transact.

Avoidance of the Capital Gains Tax at Death

The tax laws do not consider the transfer of an asset through an estate as a point of realization for capital gains. Therefore, such gains are not included in a decedent's final income tax return. In addition, the basis for gain or loss to a taxpayer who receives an asset from a decedent is the fair market value at the estate valuation date. As a consequence, appreciation on capital assets transferred through an estate is never subject to the income tax; such tax is completely avoided.

It seems likely that investors might be hesitant in selling appreciated capital assets and paying income taxes when an option to completely avoid the income tax is available. It is the opinion of many authorities that the ability to completely avoid the income tax by transfer at death exerts a substantial lock-in pressure on investors.

Summary

This chapter has presented a brief review of the present income tax provisions that prescribe the general treatment for capital gains and losses. No attempt was made to include all the detailed exceptions and special provisions of this area of taxation, but rather the purpose was to provide sufficient background for an understanding of the current treatment and an appreciation of the ramifications of this treatment. In addition, those aspects of the federal income tax laws that allegedly create investor lock-in were isolated and discussed.

CHAPTER III

SOME ECONOMIC ASPECTS OF FEDERAL INCOME TAXATION OF CAPITAL GAINS

Federal laws of income taxation have provided some form of preferential treatment for capital gains since 1921. This chapter briefly explores some of the main arguments for and against preferential treatment of capital gains, and the alleged economic consequences of investor lock-in created by capital gains taxation.

The Principles of Taxation

Several "principles" reappear throughout the literature on taxation. These principles are not in the nature of scientific laws that can be precisely stated or proven. Rather, they represent opinions of authorities concerning desirable attributes of a tax system. In this regard, Norman Ture recently testified,

> There can be, of course, no scientific, definitive delineation of the objectives or characteristics of a good tax system, since, like all social institutions, the tax system is a reflection of preferences.[1]

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[1] Tax Reform, 1969. Hearings before the Committee on Ways and Means, House of Representatives, 91st Congress,

The most frequently mentioned principles of taxation are (1) adequacy of revenue, (2) equity, (3) neutrality, (4) simplicity of compliance and collection, and (5) promotion of desirable economic goals. These principles are subject to varying interpretations and emphasis by different authorities and, in addition, often prove to be interrelated and conflicting.[2]

Adequacy of Revenue

One necessary characteristic of a good tax system is the generation of adequate revenues. In explaining this principle, Ture stated,

> First a good tax structure should over a reasonable period of time generate the revenues required to defray any given proportion of Government outlays during that period without the necessity for frequent upward and downward revisions of tax rates.[3]

This principle requires only that a system of taxation produces sufficient revenues in a particular time period to finance desired government services. No criteria are provided concerning appropriate methods or structures to be utilized, except to note that frequent changes in the tax laws are undesirable.

1st Session, February 18-April 24, 1969 (Washington, D.C.: U.S. Government Printing Office, 1969), part 12, p. 4245.

[2]Dan Throop Smith provides one of the many excellent discussions of objectives of taxation and the problems involved, in his book, Federal Tax Reform (New York: McGraw-Hill Book Company, Inc., 1961), especially pages 9-32.

[3]Tax Reform, 1969, p. 4246.

Equity

The equity principle is a vague concept, connoting that a good tax system should treat all taxpayers fairly. John Due, describing the equity principle, wrote,

> The distribution of burden of the tax must conform with the pattern of income distribution regarded as the optimum by the consensus of opinion in contemporary society.[4]

The concept of equity contains horizontal and vertical dimensions. Horizontal equity requires that taxpayers in similar economic circumstances be taxed equally. As stated by Harvey E. Brazer,

> . . . horizontal equity may be said to be achieved when the tax liabilities of all persons receiving any given amount of income are equal, after adjustments have been made for number of dependents and other obligations which we choose to honor by permitting their deduction from income for tax purposes. . . .[5]

Vertical equity concerns treatment of taxpayers in unequal circumstances and has been interpreted by Ture as follows:

> . . . a good tax system should conform with society's preferences about how tax liabilities should be distributed by level of income or wealth of the taxpayer.[6]

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[4]John F. Due, <u>Government Finance</u> (Homewood, Illinois: Richard D. Irwin, Inc., 1954), p. 115.

[5]Harvey E. Brazer, <u>A Program for Federal Tax Revision</u> (Ann Arbor, Michigan: Institute of Public Administration, The University of Michigan, 1960), Michigan Pamphlets No. 28, p. 2.

[6]<u>Tax Reform, 1969</u>, p. 4247.

Under the concept of equity, two general approaches may be followed in determining the amount of tax a particular individual should pay.

Proponents of the benefits received approach would consider it equitable to tax an individual based on the benefits he derives from government. It is argued, however, that this basis is inappropriate, because it conflicts with our society's views on welfare and income redistribution. The benefits approach is also generally conceded to be impracticable because of difficulties in precisely measuring benefits received.

Our income tax system is based on the concept of ability-to-pay, and it is assumed throughout this discussion that ability-to-pay is an acceptable basis of taxation.[7]

As a corollary, the measure of ability-to-pay utilized by our income tax system, is the amount of income received by a taxpayer in a specified period. This unit of measurement is also considered valid. In addition, our society has accepted progressive taxation as a means of obtaining vertical equity in the income tax. Progressive taxation is assumed to be in conformity with the principle of vertical equity in this presentation.

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[7]See The Theory of Public Finance by Richard A. Musgrave for an elaboration on the concepts of benefits received and ability-to-pay, pp. 61-115.

Nevertheless, the concept of equity or fairness in a tax system remains a vague and uncertain guide for tax policy. Commenting on this, Dan Throop Smith wrote,

> What may seem fair to one person will seem grossly unfair to another. The concept of "ability to pay" is widely used as setting a standard of fairness in taxation; actually it is little more than a phrase. The concept has not been reduced to objective or scientific standards, and there does not seem to be any basis for so reducing it. Comparisons of relative "abilities" to pay taxes involve measurements of psychological units of pleasure and displeasure, and as yet, psychologists have not provided a standard or means for such calculations.[8]

Neutrality

In the opinion of some authorities, a tax system should be neutral in its influence on taxpayer behavior. Ture indicated that a good tax system,

> . . . should aim at minimizing the impact of taxes on decisions by private businesses and households concerning how income is to be earned or wealth is to be accumulated, and how income and wealth are to be used.[9]

Others feel neutrality is desirable but argue that the tax system may be used to encourage socially or economically desirable behavior. In this regard, Brazer stated,

> The rule of neutrality in taxation requires that our tax laws should be so drawn as to minimize the extent to which they influence choices in the private sector of the economy.
>
> . . . There may, however, be circumstances under which social or economic objectives of national

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[8]Smith, Federal Tax Reform, p. 13.

[9]Tax Reform, 1969, p. 4246.

> policy are of such overriding importance as to require the use of every possible means of achieving them, including deliberately, unneutral tax measures. . . .[10]

Simplicity of Compliance and Collection

Simplicity of compliance and collection is another frequently expressed principle of taxation. John Due explained the meaning of this principle as follows:

> This rule requires that taxes be established in such a manner as to minimize the real costs of collection, in terms of resources required to collect the taxes and to comply with the tax laws on the part of the taxpayers, as well as in terms of the direct inconvenience caused the taxpayers in the payment of the tax.[11]

Thus, a tax system should be as simple as possible, consistent with other objectives, for ease of administration, collection, enforcement, compliance, and convenience.

Promotion of Desirable Economic Goals

The tax system is becoming an increasingly important means of attaining the economic environment desired by society. Among the economic goals often mentioned are price stability, economic growth, full employment, economic development, and wealth redistribution.[12] Evaluating a particular system of taxation's effectiveness in performing

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[10] Brazer, Federal Tax Revision, p. 3.

[11] Due, Government Finance, p. 115.

[12] Ray M. Sommerfeld, Hershel M. Anderson, and Horace R. Brock, An Introduction to Taxation (New York: Harcourt, Brace and World, Inc., 1969), pp. 11-15.

this function is difficult, because desired objectives and the means of attaining them may change as social preferences and the economic climate change. A tax structure should, however, be flexible enough to allow for modifications required by changes in these conditions.

Exceptions to the Principles

The preceding discussion indicates the existence of differing interpretations and emphasis on the various principles of taxation. Exceptions to the general principles are frequently found in the tax laws, as noted by Harold Groves:

> Our tradition requires that the rules of taxation shall be general rules. It is true that there may be exceptions--indeed, it is often said that taxation is the classic example of a case where the exceptions are more important than the general rule. But the exceptions themselves must be general to a degree and moreover they must carry a positive burden of proof. A tax exception is first cousin to a subsidy and even more suspect because it is less conspicuous and aboveboard.[13]

The dangers of such exceptions were also noted by Brazer:

> Extremely close scrutiny is required in the case of each feature of the tax system which, in favoring selected kinds of income or expenditure, tends, by slicing large pieces off the tax base, to make high

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[13]Harold Groves, "Special Tax Provisions and the Economy," Federal Tax Policy for Economic Growth and Stability. Papers submitted by panelists appearing before the Subcommittee on Tax Policy, Joint Committee on the Economic Report. 84th Congress, 1st Session, November 9, 1955 (Washington, D.C.: U.S. Government Printing Office, 1955), p. 286.

> tax rates necessary, to distribute subsidies [through tax savings] outside the appropriation process, and to treat very differently taxpayers in essentially similar circumstances.[14]

The provisions of the income tax laws pertaining to capital gains are often criticized on grounds that they do not conform to established principles of taxation. The primary argument is that capital gains represent income to a taxpayer, and thus, special provisions applicable to this form of income are in contradiction to the concept of horizontal equity. It is also argued that preferential treatment afforded such gains conflicts with the neutrality principle and that the complex provisions required do not comply with the simplicity principle.

The preceding quotations express the opinion that there must be convincing evidence to provide justification for exceptions to the principles. The purpose of the following section is to indicate circumstances that provide a basis for arguments for preferentialism in the treatment of capital gains.

Taxation of Income and Capital Gains

It has been noted that our tax system regards the amount of income received by a taxpayer as a measure of ability-to-pay and uses this amount as a basis for computation of income tax liability. Some authorities feel that

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[14] Brazer, Federal Tax Revision, pp. 3-4.

the definition of income for tax purposes should coincide, as closely as possible, to concepts of income commonly held in other fields. As expressed by Robert M. Haig, in his early work, The Federal Income Tax,

> It goes without saying that taxable income under an income tax law should approximate as nearly as practicable the true net income as defined by the analysis of the economist and the accountant. How close an approximation is possible depends upon the perfection of the environment in which the tax must live.[15]

This criterion does not provide a very reliable guide; however, as economists, accountants, and other interested persons have found, the concept of income is nebulous and difficult to define and quantify.

Generally, economists have adhered to an "accretion" concept of income similar to the following, provided by Henry Simons,

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.[16]

The accretion definition of income would include changes in the value of wealth and, as a result, would

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[15]Robert Murray Haig, "The Concept of Income--Economic and Legal Aspects," The Federal Income Tax (New York: Columbia University Press, 1921), p. 15.

[16]Henry C. Simons, Personal Income Taxation (Chicago: The University of Chicago Press, 1938), p. 50.

include capital gains as they accrue. It has been argued, however, that capital gains are not income and that such gains should not be subject to a tax on income.

Capital Gains Considered as Additions to Capital

Some economists contend that capital gains represent capital not income to a taxpayer. Smith reiterated the analogy of the tree and the fruit to emphasize the difference between capital and income:

> The analogy of the tree and the fruit is often used in distinguishing capital and income. The crop of apples is clearly income, but the growth in the size of the tree is not; it cannot be eaten or sold, nor can a branch be cut off to be eaten or sold, except as firewood. The growth of the tree does not seem to be income as it occurs.[17]

If capital gains are regarded by an investor as additions to capital, then a tax on capital gains would be considered by the taxpayer to be a capital levy rather than a tax on his income. Smith explained it in the following way,

> As a matter of equity, a capital gains tax may be resented as a special form of capital levy. If one rejects the idea that appreciation in value itself constitutes income, one thinks of his capital as consisting at any time of the total of his investments. A tax which must be paid from capital, when an investment is switched, is a selective capital levy. This is also a defensible reaction to capital gains taxation. It is widely held by investors and is not merely a rationalization against the capital gains tax.[18]

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[17]Smith, Federal Tax Reform, p. 122.

[18]*Ibid.*, pp. 122-123.

Capital Gains Resulting from Changes in the Price Level

Another argument for preferential treatment of capital gains is that portions of such gains that accrue over a period of time result from changes in the price level. According to some authorities, such gains do not improve the real economic position of the taxpayer or represent real income to him. This situation was noted by Pigou,[19] George O. May,[20] and others. George C. Williams expressed doubt that creators of the income tax laws could have intended to tax gains reflecting price level changes, when he wrote the following:

> It is erroneous to assume that income in the true and substantial sense is received merely as the result of receiving a larger number of dollars as the selling price than the number of dollars paid as the purchase price, and ignoring the real value of the dollar at the dates of purchase and sale. It seems incredible that Congress intended to tax or that the sixteenth amendment permits taxation of a sale of an asset which clearly only returned the real capital cost and produced no gain, no profit, and hence no income.[21]

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[19] A. C. Pigou, _A Study in Public Finance_ (London: Macmillan & Co., Ltd., 1921), pp. 159-160.

[20] George O. May, "The Taxation of Capital Gains," _Harvard Business Review_, I (October, 1922), 11.

[21] George C. Williams, "Are Capital Gains and Losses Largely Fictitious?", _The Tax Magazine_, XII (May, 1934), 234.

Shoup,[22] Vickrey,[23] and Smith recognized the problem of illusory gains, but conclude that they must be taxed. The following quotation by Smith is indicative of their reasoning.

> It is often said that capital gains in many instances merely offset or partially offset the results of inflation. On equity grounds, it is then argued that a monetary gain which does not represent a gain in real value should not be taxed. This argument is appealing and, if inflation had no other effects, might be persuasive. But there are many other respects in which money measures and real values depart from each other because of inflation. A general revision in the law to adjust for the effects of inflation would be impossibly complicated, . . . Though inflation gives some additional justification for special tax treatment of capital gains, it should not be relied on as a major reason in the absence of general adjustments throughout the law to offset the inequities of inflation.[24]

Walter Heller argued that an individual, by hedging against price level changes through investment in capital assets, improves his relative economic position and should be taxed.

> . . . the entire emphasis of modern income taxation is, quite properly, on relative economic positions. The taxpayer who protects himself from inflation by holding common stocks or real estate is certainly better off than the one who holds fixed-income securities or no securities at all. To exempt inflationary gains would be to ignore significant changes in the relative taxpaying capacity of individuals.[25]

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[22]Carl S. Shoup, Federal Estate and Gift Taxes (Washington, D.C.: The Brookings Institution, 1966), p. 488.

[23]William Vickrey, Agenda for Progressive Taxation (New York: The Ronald Press, 1947), p. 149.

[24]Smith, Federal Tax Reform, p. 123.

[25]Heller, Federal Tax Policy, p. 393.

Irving Goffman pointed out that the income tax is based on ability-to-pay determined by money rather than real income; and therefore, he believes arguments concerning illusory gains are irrelevant.

> The income tax is a tax on money income and not on real income, so the measure of ability to pay is based on the number of dollars received by the taxpayer. The problem of changes in the value of money is an index number problem and not a tax problem.[26]

Lawrence H. Seltzer questioned the validity of taxing illusory gains and indicated that preferential treatment might be justified on these grounds.

> Granting that it is not feasible to isolate spurious [illusory] from real capital gains and losses with anything like precision, the question remains whether even a crude and limited attempt to make special provisions for the former may not produce a net improvement in equity. Occasionally, when the value of a currency depreciates drastically, the resulting fictitious capital gains may be so tremendous as to dictate special provisions for excluding the increase in value between specified dates from income tax. . . . Even a gradual rise in the price level, if long continued, raises serious questions respecting both the equity and the practical effects of taxing all capital gains in full as ordinary income. In general it can be argued that the preferential tax treatment of capital gains and the limited allowances for capital losses in force in the United States since the 1920's constitute one means, however crude, of recognizing the illusory character of many capital gains and losses.[27]

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[26]Irving J. Goffman, "The Taxation of Capital Gains: An Economic Analysis," The Canadian Journal of Economics and Political Science, XXVIII (May, 1962), 241.

[27]Lawrence H. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses (New York: National Bureau of Economic Research, Inc., 1951), pp. 102-103.

Capital Gains Resulting from Changes in the Interest or Capitalization Rates

Capital gains may arise from changes in the market rate of interest. When this occurs the potential receipts from the asset do not change, and it is argued that gains resulting from interest rate changes do not represent income to the investor. Pigou classified gains from changes in the market rate of interest as increments in value which are "apparent, not real."

> The other class [in addition to gains reflecting price level changes] of apparent increment arises when the general rate of money interest on long-period investments falls. This kind of change means that an investment yielding exactly the same annual return must rise in capital value. Such a rise is of no advantage to the owner of the investment--unless, indeed, he intends to turn the proceeds into consumable income--because, even if he sells it, he will not be able to invest the proceeds in anything that will yield, on equal security, a higher annual return than he was obtaining before.[28]

Franklin Cole viewed the taxation of such gains as an impairment of capital.

> The income of an individual for any stated period of time is the value of that part of his gross income which can be used up--by taxing or otherwise--without impairing the prospects of equivalent gross receipts in any subsequent similar period. Income being a flow from a fund of capital, it follows that capital gains are not income, and that capital gains and losses are additions to or subtractions from capital.[29]

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[28]Pigou, A Study in Public Finance, pp. 160-161.

[29]Franklin Cole, "What's Wrong with the Tax Law?--From the Viewpoint of Investors," New York Certified Public Accountant, XIX (January, 1949), 17.

Seltzer expressed the argument that such gains are real, not illusory, because the relative economic position of the investor has been improved.

> Capital gains and losses caused solely by changes in interest rates are not illusory in the same sense as those arising from changes in the general price level, it is argued. An investor who realizes a profit of $20,000 by selling his bonds after interest rates have fallen is in a position to command $20,000 more of the world's real goods. Relative to other individuals, he has gained in net worth, even though his interest income may remain unchanged.[30]

It is also argued that gains resulting from changes in the capitalization rate for securities are illusory, and Henry C. Wallich commented on this situation as follows:

> If the rate at which future corporate earnings are capitalized falls from 10 per cent to 5 per cent, the value of equities doubles. The current income of stockholders, in terms of earnings and dividends, does not change. Many stockholders will feel "richer," no doubt. But if more than a very small number of them try to consume the increment, its illusory character would quickly become apparent. . . .
>
> As it happens, we have had, in the post-war period, a change of capitalization rates for the current earnings of common stocks, and in part perhaps also of real estate, from roughly 10 per cent to roughly 5 per cent.[31]

Nonrecurring Nature of Capital Gains

The unexpected, uncertain, or nonrecurring nature of capital gains is sometimes used as a basis for arguments

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[30]Lawrence H. Seltzer, "Capital Gains and the Income Tax," American Economic Review, Vol. XL (May, 1950), pp. 375.

[31]Henry C. Wallich, "Taxation of Capital Gains in the Light of Recent Economic Developments," National Tax Journal, XVIII (June, 1965), 138.

for preferential treatment of such gains. Vickrey considered the primary characteristic of capital gains to be their unexpected or uncertain nature.

> If one is looking for a criterion of what is or is not a capital gain that refers to the substance of the situation and not the mere form, I think about the only thing . . . that distinguishes a capital gain is that the recipient is more or less surprised to get it, or at least was uncertain in some greater or less degree as to whether it was going to eventuate or not. The capital gain is thus something to which there is attached an element of risk.[32]

Carl C. Plehn argued that true income has three characteristics: receipt, spendability, and recurrence.

> It will, I think, be readily admitted that those particular gains and profits which are recurrent, expendable receipts are the ones about whose income character there is seldom any doubt. . . . But it is when gains and profits lack one or two of the three characteristics of income, or have them in less than complete form, that a question arises. The one that is most lacking is recurrence. Thus gains and profits from transactions outside of one's regular vocation or line of business, like the profit from the sale of a home, are of doubtful income character.[33]

Seltzer noted that the qualities of instability and nonrecurrence may reduce the usefulness of capital gains as a measure of taxable capacity.

> . . . capital gains, unlike wages, interests, rents, or ordinary profits, lack a continuing source such as a job, a farm, or a business enterprise. Instead, they arise out of discrete transactions that may occur only a few times in an individual's

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[32]William Vickrey, a discussion in a symposium on Income Tax Differentials (Princeton: Tax Institute, Inc., 1958), p. 174.

[33]Carl C. Plehn, "The Concept of Income, as Recurrent, Consumable Receipts," The American Economic Review, XIV (March, 1924), p. 10.

> life. Hence they lack the relative stability and recurring character of ordinary income. For these reasons many believe that a capital gain represents less taxpaying capacity than ordinary income.
>
> For the same reasons capital gains are usually excluded from what we might term the prudent consumption concept of income, a concept widely used to govern an individual's or a family's consumption expenditures. It distinguishes between sporadic and regularly recurring receipts on the ground that only the latter may prudently be spent. Sporadic gains are often followed by sporadic losses. A prudent man conserves much or all of the former to meet the latter. The implication is that he should not have to pay income taxes on receipts he cannot prudently spend. . . . An income tax that does not distinguish between recurring and nonrecurring types of income might be said to ignore the fact that a man's capacity to pay taxes depends not only upon his income in any single year but upon the average income he has been receiving and to which he may reasonably look forward.[34]

He also noted that the qualities of instability and nonrecurrence might lead to an argument that capital gains should be subjected to heavier taxes than ordinary income.

> The recipient of an unexpected gain can afford to pay more of it in taxes precisely because it is a windfall. He has not counted upon it for his ordinary expenditures. Since his gain was unsought, or at least was won without a commensurate service on his part, it is a fitting object for especially heavy taxation.[35]

Reinvested Capital Gains

The preceding arguments have been concerned with various aspects of capital gains that make them questionable components of income, regardless of their disposition. One additional position distinguishes between capital gains and

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[34]Seltzer, Tax Treatment, pp. 83-84.

[35]*Ibid.*, p. 84.

income, based on whether the increment is reinvested or used for other purposes. Irving Fisher defined income in the following way,

> Money income is all money received which is not obviously, and in the nature of the case, to be devoted to reinvestment--or, as the expression is, "earmarked" for reinvestment. In other words, all money received and readily available and intended to be used for spending is money income.[36]

Smith made a similar distinction between the concepts of capital and income.

> A distinction should be drawn . . . between a capital gains tax on a shift in an investment portfolio and a capital gains tax on realized gains which are used for consumption. In the first case the tax is regarded as a capital levy and is likely to have the effect of reducing a nation's supply of capital. . . . By contrast, the capital gains tax on gains which are realized to secure funds for consumption is much more likely to be regarded as a form of income tax, at a favorable rate on a special form of income.[37]

Goffman rejected this line of reasoning with the following comment,

> What a recipient does with his income--whether he spends it or saves it--reflects a pattern of behavior and not a lack of taxpaying ability. A reduction in one's "capital" (that is savings) is not in conflict with a tax on income.[38]

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[36]Irving Fisher, The Theory of Interest as Determined by Impatience to Spend Money and the Opportunity to Invest It, Monograph (New York, 1930), pp. 10, 25.

[37]Dan Throop Smith, "Capital Formation and the Use of Capital," The American Economic Review, LIII (May, 1963), 314-322.

[38]Goffman, "Taxation of Capital Gains," p. 240.

Technical Problems in the Taxation of Capital Gains

The preceding discussions provide a brief review of major arguments concerning preferential treatment of capital gains on the grounds that they are not properly includable as elements of income. There are additional arguments for preferential treatment of capital gains that are based on technical problems involved in the taxation of such gains.

As previously mentioned, capital gains are not recognized as income, for tax purposes, until they are realized (generally the point of sale or exchange of the asset). This treatment is in accord with the accounting field's realization criteria. The precedent for this practice was set in several court cases early in the history of the income tax. In one of these cases, Eisner v. Macomber, the Supreme Court's decision was that funds to pay the tax and severance from capital came from realization, and both were essential elements in their interpretation of the word "income." The Court declared,

> . . . without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay on income tax. . . .
>
> . . . secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term.

The Court explained why it did not consider accrued gains to be income. In their words, income derived from property is:

> . . . not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being "derived," that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;--that is income derived from property.[39]

William H. Anderson expressed the opinion that realization strengthens the case for taxation of capital gains.

> When capital gains are tested against the concept of income as an accretion of economic power, there is little doubt but that they can be classified as income even before they are realized. When we combine economic power and realization, a very strong case can be made out for designating them as income for tax purposes. They clearly represent ability to pay taxes. . . . Our conclusion is that it is only logical and fair that capital gains when realized be dealt with as income.[40]

This interpretation, for tax purposes, of the meaning of the term "income" has been questioned. Speaking for the minority in another Supreme Court case, Mr. Justice Douglas stated,

> The wealth of stockholders normally increases as a result of the earnings of the corporation in which they hold shares. I see no reason why Congress should not treat that increase in wealth as "income" to them. . . . The notion that there can be no "income" to the shareholders in such a case within the meaning of the Sixteenth Amendment unless the gain is "severed from" capital and made available to the recipient for his

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[39]Eisner v. Macomber, 252 U.S. 189, 40 Sup. Ct. 189 (1920).

[40]William H. Anderson, Taxation and the American Economy (New York: Prentice-Hall, Inc., 1951), p. 212.

"separate use, benefit and disposal" . . . will not stand analysis. . . .[41]

The realization criteria for recognition of capital gains creates a situation referred to as "bunching" of income that many feel requires preferential treatment for these gains. Capital gains may accrue over a period of years, but the entire gain is recognized for tax purposes and is included in a taxpayer's income in the year it is realized. This fact combined with progressive income tax rates can result in a greater tax burden on capital gains than would be imposed on more stable forms of income.[42]

Vickrey noted the inequitable nature of this treatment of fluctuating income.

> It is an obvious extension of the principle of taxation according to ability to pay that no taxpayer should bear a heavier or lighter burden merely because certain items of his income happen to be earned or realized in one year or another, regardless of whether this be by chance or by design of the taxpayer and regardless of any fluctuations in the needs of the government for revenue or the rates of tax in effect at various times.[43]

Dan Throop Smith saw the bunching problem as a primary reason for preferential treatment of capital gains.

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[41] Helvering v. Griffiths, 318 U.S. 371, 63 Sup. Ct. 636 (1943).

[42] The following comments were made prior to the Tax Reform Act of 1969. Capital gains are now subject to income averaging provisions, as a result of the tax reform. The averaging provisions alleviate but do not completely eliminate the bunching problem, as discussed in Chapter VII.

[43] William Vickrey, "Averaging of Income for Income-Tax Purposes," The Journal of Political Economy, XLVII (June, 1939), 381.

> On grounds of fairness, a gain which has developed over many years, if taxed on realization, may put a taxpayer in a much higher bracket than he would have been in if he could have been taxed on the gains as they accrued. It is thus considered equitable to give a lower rate of tax on gains developing over long periods in order to avoid the effects of having income bunched in the single year of realization. This point of equity was probably the principal argument for the original differential taxation of capital gains in this country and is still regarded by many as the most significant one.[44]

He later pointed out, however, that the present treatment may provide a degree of relief not justified by the bunching problem.

> . . . if the purpose [of special treatment] is simply to give relief from undue progression through bunching of income in a single year, there is no reason to give a bottom rate of tax on capital gains lower than the bottom rate of the regular income tax. If taxation at regular rates does not involve any progression, bunching cannot create any artificial increase in progression requiring relief. On this basis, the present method of including only half of net long-term gains at all income levels is not justified, . . .[45]

Smith and others also question the six months holding period as a criteria for determining gains that should be afforded relief from bunching.

> To the extent that special treatment of capital gains is based on avoidance of unfair progression in the taxation of bunched income . . . it should be applied only on gains which might be subject to unfair progression because of bunching. This means that a special tax rate should be applied only to gains on property held for more than a year. On property held up to a year, there is no artificial increase in progression and hence no equitable need for relief. The

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[44]Smith, Federal Tax Reform, p. 123.

[45]*Ibid.*, p. 124.

> present six months' holding period is too short by this standard, and the frequent proposals to reduce it are quite unjustified.[46]

Reuben Clark mentioned other problems of providing relief for the bunching effect.

> However, the validity of this argument [bunching] in order to justify the preferential rate of tax for capital gains has long been open to doubt. Manifestly, there may be no relationship whatsoever between the time an asset is held and the time in which gain accrues; even assuming such correlation exists, there may be no relationship between the tax paid under the preferential rate and the total tax that would have been paid if such gains had been paid as they had previously accrued; and, in any event, extension of a preferential rate of tax to capital gains as an averaging device ignores the plain fact that the taxpayer, who allegedly suffers because gains accruing over many years are lumped into one year, has had the use of his tax money through all the previous years.[47]

The concensus seems to be that the bunching effect does require some form of relief in the income tax laws, but the appropriateness of the present provisions for this purpose is often questioned.

Economic Grounds for Preferential Treatment

Many authorities contend that, regardless of the conclusions derived from the foregoing arguments, preferential treatment of capital gains is warranted because of

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[46] *Ibid.*, pp. 123-24.

[47] Reuben Clark, "The Paradox of Capital Gains: Taxable Income That Ought Not to be Currently Taxed," *Tax Revision Compendium*, Compendium of Papers on Broadening the Tax Base Submitted to the Committee on Ways and Means (Washington, D.C.: U.S. Government Printing Office, 1959), Vol. II, pp. 1244-1245.

the adverse economic consequences that would result from taxing capital gains as ordinary income.

Goffman considered capital gains a taxable form of income but recognized their possible economic significance.

> The method of taxing these [capital] gains presents economic problems which may far outweigh in importance the arguments presented above [that capital gains are income]. In fact among professional economists, most of the controversy over capital gains deals with the immediate consequences of taxing these and not with the problem of whether or not they are income. The latter question is usually answered rather quickly (and often inadequately) in the affirmative.[48]

Goode expressed a similar regard for the importance of economic consequences of taxing capital gains.

> However strong the case in equity for taxing capital gains at the same rates as other income, this will not be acceptable if there is reason to believe that the economic consequences would be highly detrimental.[49]

Accentuation of Stock Market Fluctuations

One alleged economic effect is that capital gains taxation tends to accentuate fluctuations in the stock market. Harold Somers provided one of the early investigations on the subject[50] and based his conclusions on an analysis of supply and demand for securities. His analysis begins with (Figure 1) a positively sloping supply curve

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[48]Goffman, "Taxation of Capital Gains," pp. 241-242.

[49]Richard Goode, The Individual Income Tax (Washington, D.C.: The Brookings Institution, 1964), p. 204.

[50]Harold M. Somers, "An Economic Analysis of the Capital Gains Tax," National Tax Journal, I (September, 1948), 226-232.

(SS) and a negatively sloping demand curve (DD) for a particular asset, assuming no capital gains tax. The imposition of a capital gains tax on sales would shift the supply curve upward (S'S') by the amount of the "weighted average of the tax" (QR) of the prospective sellers. They would require a higher price to offset the income tax to be paid on the sale.

The prospect of having to pay a tax on an expected gain may also reduce, to some extent, the demand for an asset, shifting the demand curve downward to D'D'.

These shifts in the supply and demand curves would reduce the volume of sales (from OM to ON), but the effect on price would depend on the relative size of the shifts. Somers reasoned that the tax liability of the seller is "real, definite, and calculable," while the prospective tax on the buyers is "something very vague and indefinite." He concluded that the shift in the supply curve will be greater than the shift in the demand curve, in a period of rising prices when profit-taking is predominant, and that the price of the asset would rise from OP to OQ.

The ability of taxpayers to offset losses against gains and income would tend to have an opposite effect. In this analysis (Figure 2), the tax savings from such loss offsets would shift the supply curve downward (S'S'). The new demand curve (D'D') is not significantly different from the old; because, in Somers' words,

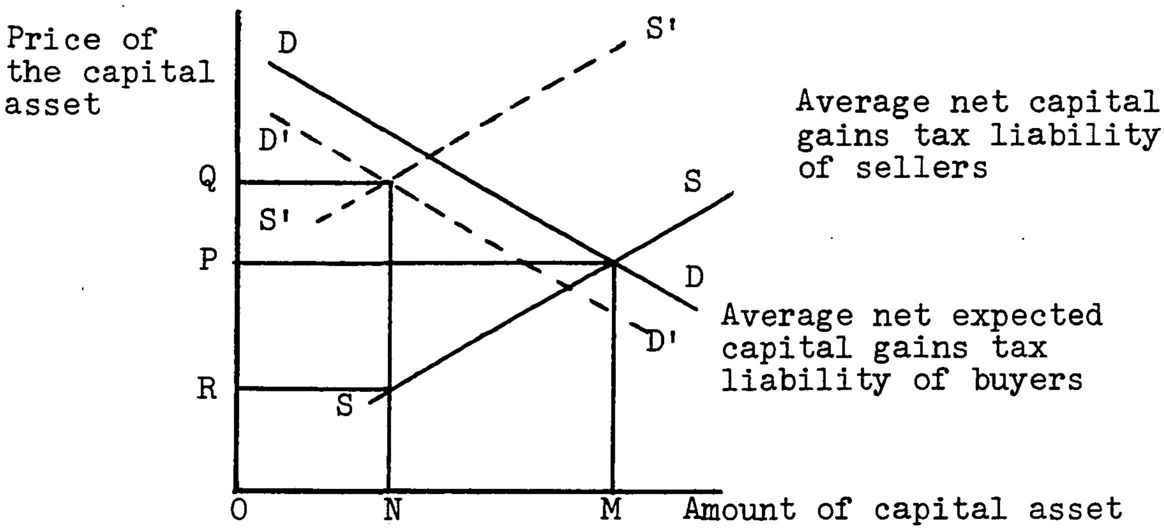

Fig. 1.--Shifting of capital gains tax when profit-taking predominates.

Source: Somers, Ibid., p. 227.

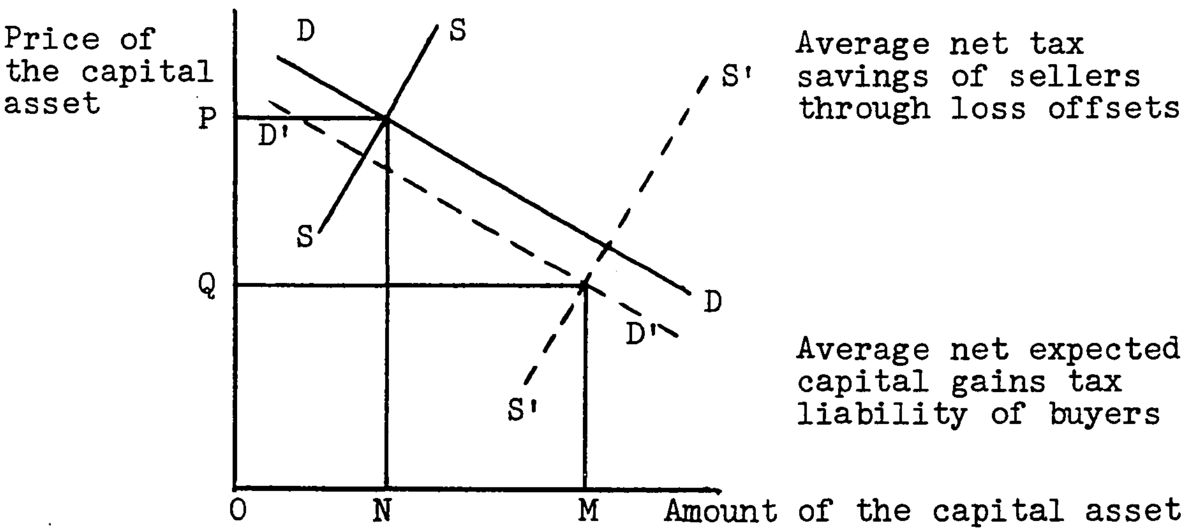

Fig. 2.--Shifting of capital gains tax when loss-taking predominates.

Source: Somers, Ibid., p. 228.

> The tax-saving effect on the demand curve is probably slight if it exists at all. Since people seldom, if ever, buy with the expectation of a loss, the prospect of tax-saving must be very small and its influence on the demand curve may be considered negligible.[51]

In a period of falling prices, where loss-taking predominates, Somers concluded the capital gains tax would influence the price to fall (from OP to OQ). As a result of the preceding analyses, Somers stated,

> The general conclusion to be derived from the tax shifting analysis . . . is that the capital gains tax aggravates price rises and price falls.[52]

In a later article, Robert F. Gemmill questioned part of Somers' analysis but reached similar conclusions. Concerning the general level of asset prices, he stated,

> If the tax prevents an investor from selling one asset and buying another, it has reduced the supply of the first asset and the demand for the second. These shifts may affect the relative prices of the assets, but they could be expected to offset each other in their effect on the overall level of asset prices.[53]

Gemmill, in his analysis, assumed (1) that the investor is unable to reduce or avoid the tax liability at death, and (2) that there is a single tax rate with no holding period. Gemmill first questioned the size of the shift of the supply curve, calculated by Somers, and concluded,

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[51] Ibid., p. 228.

[52] Ibid., p. 230.

[53] Robert F. Gemmill, "The Effect of the Capital Gains Tax on Asset Prices," National Tax Journal, IX (December, 1956), 292.

> . . . at any given time there may be relatively few investors who have increased their reservation prices by more than enough to cover their tax liabilities, and the average increase could be significantly less than this amount.[54]

The modification does not refute the position of Somers, that the capital gains tax accentuates price fluctuations; however, it would imply a smaller "price effect."

Gemmill also recognized a "capital effect" of the capital gains tax. The capital effect results from the loss of capital paid in tax on realization of a gain or the addition to capital from tax saving on realization of a loss. He argued that, in a time of rising prices,

> . . . a reduction in the investor's capital will act to restrict the rise, if the investor had intended to purchase other assets with the proceeds from the sale. . . .
>
> Conversely, an increase in the investor's capital (from loss offsets) in a period in which prices are falling will enable him to provide more support to the market, and will lead to greater price stability.
>
> In general, therefore, we might expect that the capital effect would contribute to price stability.[55]

In spite of his arguments of a smaller price effect and the possible stabilizing influence of the capital effect on the general level of prices, Gemmill concluded;

> The capital gains tax does tend to increase fluctuations in the general level of asset prices, as has often been charged. . . .
>
> The adverse effects of the capital gains tax upon the general level of asset prices . . . appear to be overstated in Professor Somers' analysis, . . .[56]

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[54] Ibid., p. 297.

[55] Ibid., p. 298.

[56] Ibid., p. 299.

Walter Heller questioned the degree of influence of capital gains tax on investor decisions and the emphasis of Somers' analysis. In his words,

> First, in focusing on the incentives to enter or leave the market rather than the flow of funds within the market, it seems to lose sight of the "Say's law of the stock market": Especially in a rising market, supply largely creates its own demand in that most of the proceeds of security sales reenter the market as demand for other securities.[57]

He pointed out that ". . . the gains tax drives a sizeable wedge between the amounts realized on the sale of appreciated assets and the amounts that go back into the market as a demand factor."[58]

He concluded that ". . . the tax on capital gains exerts opposing influences--some bullish, others bearish . . ."[59] but that the influence of the tax on market instability has probably been overstated.

Somers attempted to answer some of these criticisms in his article, "Reconsideration of the Capital Gains Tax." He noted that Gemmill assumed away two of the principal reasons for investor lock-in (avoidance at death and the holding period).

> Even if we grant the full validity of his [Gemmill's] argument and ignore the unreal assumptions mentioned above, we are left with some degree of accentuation of price increases. . . . the dampening effect on

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[57]Heller, Federal Tax Policy, p. 387.

[58]Ibid., p. 387.

[59]Ibid., p. 388.

> price increases of the considerations advanced by Gemmill is not so great as might at first appear. In any case, the direction of change is as indicated in the basic supply-and-demand analysis.[60]

Somers disagreed with Heller's implications that tax consequences are insignificant to the rational investor. In answer to Heller's position based on "Say's law of the stock market," Somers conceded the net effect of the capital gains tax would be nil on persons who are on both the supply and the demand side to an equal extent in a time period. In a shorter period, however, a seller is on the supply side and at the time of sale may become a purchaser. He concluded that,

> Since prices do fluctuate, however, there must be those who are suppliers but not demanders at a given price level, and vice versa. It is these who determine price fluctuations and the price consequences of the capital gains tax.[61]

The same basic argument is used as a basis of attacking the "capital effect" of Gemmill.

An additional discussion of the accentuation of stock market prices by the capital gains tax is contained in a doctoral dissertation by Robert C. Vowels. Using a supply and demand analysis, he attempted to explain the effect on prices of the three primary areas of lock-in compared to a zero tax rate. Vowels concluded that each area would contribute to higher asset prices than would occur if there

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[60] Harold M. Somers, "Reconsideration of the Capital Gains Tax," National Tax Journal, XIII (December, 1960), 296.

[61] Ibid., p. 298.

were no tax. In relative amounts, the avoidance at death provisions would produce the greatest increase. The holding period would produce a smaller increase, and the capital gains tax rate would produce the smallest increase. Although the capital effect and the circular flow of funds tend to offset the amount of accentuation, his conclusion was,

> . . . that the capital gains tax provisions accentuate prices by delaying sales in a rising market.[62]

Other authorities have agreed that capital gains taxation does accentuate stock market fluctuations to some extent. Elmer Fagan commented,

> . . . it is reasonable to argue that the capital gains tax will, if levied on a realization basis, cause an increase in the reservation prices of some types of capital assets. And in a rising market, this will cause a greater increase in stock prices than would otherwise have taken place, unless, of course, the tax also causes an offsetting decrease in the demand for stocks. . . . It is the writer's opinion, however, that the capital gains tax even when levied on a realization basis, is a factor of minor importance in stock market fluctuations.[63]

Jonathan A. Brown, formerly Director of the New York Stock Exchange Research Department, considered the capital gains tax a significant influence in the bull market of the mid-1950's.

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[62]Robert C. Vowels, An Evaluation of Equity and Economic Effects in Capital Gains Taxation. Unpublished doctoral dissertation, p. 50.

[63]Elmer D. Fagan, "The Economics of Capital Gains Taxation," Proceedings of the Thirty-Second Annual Conference on Taxation, National Tax Association, 1940, pp. 119-120.

> From September 1, 1953, to September 1, 1955, the market value of all stocks listed on the New York Stock Exchange increased from $111 billion to $198 billion. There were many reasons for this increase of $87 billion.
>
> Certainly one of the most important was the reluctance of thousands of investors to add to the supply of stock because it did not make sense--it was not economically justified--to sell and pay the present capital-gains-tax penalty.[64]

The study of investors, published by the Harvard Business School, found empirical support for the argument that capital gains taxation accentuates fluctuations in the stock market.

> The evidence from our field interviews is consistent with the charge that the capital gains tax tends to accentuate the severity of fluctuations in the security markets, especially on the up side; in fact, it indicates that tax effects may have been a fairly significant influence in this respect.[65]

A summary conclusion might be that the present capital gains tax accentuates stock market fluctuations, but the capital effect and the circular flow of funds reduce the extent of the magnitude of such accentuations. The strength of the lock-in effects of the capital gains tax is of major importance to the validity of this conclusion.

Resource Allocation and Efficiency

Our economic system depends, to a large degree, on capital markets to determine the proper allocation of

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[64]Brown, Federal Tax Policy, pp. 369-370.

[65]J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, Effects of Taxation: Investments by Individuals (Boston: Harvard University, Graduate School of Business Administration, Division of Research, 1953), p. 45.

productive resources. This process is achieved by directing funds to more profitable businesses and away from less profitable businesses. Irwin Friend described the system as follows:

> Allocational efficiency, which may be regarded as the most important economic service provided by the capital markets, relates to the ability of these markets to maintain equivalent rates of return or costs of financing on comparable investments. This quality of the market would ensure that funds are channeled from savers to those users who will apply them most profitably and that portfolio shifts can be made to the mutual advantage of different investors. Comparable investment opportunities would find equal access to new funds at comparable costs, and the most profitable investments would be able to bid funds away from investments offering lower rates of return. The efficiency of this allocation process can be measured, at least in theory, by the extent to which variations in return on various types of assets can be explained by differentials in risks, and whether these differentials in turn seem reasonable in the light of experience.[66]

One factor that may distort the flow of funds and, consequently, the efficiency of the economic system is the system of taxation. As stated by Earl R. Rolph,

> Of the various differences which taxes may make in the operation of an economic system, there is the obvious one that a tax, by imposing an obstacle to some course of action, induces a different course of action. . . . Taxation may by virtue of such effect induce a better or worse pattern of resource allocation, judged from the point of view of some norm of ideal allocation. This is one efficiency test of a tax system.[67]

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[66]Irwin Friend, "Economic Function of Capital Markets," <u>Conference on Securities Regulation</u> held at Duke University School of Law (Chicago, Illinois: Robert H. Mundheim (ed) Commerce Clearing House, Inc., 1965), p. 120.

[67]Earl R. Rolph, "Equity Versus Efficiency in Federal Tax Policy," <u>American Economic Review</u>, XL (May, 1950), 391.

A tax on realized gains may inhibit the sale of appreciated assets and thereby affect the value of specific securities. Arguments concerning the lock-in effects of capital gains taxation on relative security prices are similar to arguments concerning overall market fluctuations, that is, the tax may increase the reservation price of holders of appreciated securities and inhibit the sale of such securities. If this is the case, the supply of these securities will be reduced, and their market price will be higher than if no tax were imposed. But, the circular flow of funds effect and the capital effect do not produce any offsetting influences in the case of a specific security. Therefore, a stronger case can be made that the capital gains tax affects the price of individual securities in contrast to overall market prices.

If lock-in does occur, the investor's free choice of investment would be impaired and a less than optimal allocation of resources would result. The lock-in effect contributes to a higher or lower price of a specific security than would otherwise prevail. Accentuation of the price of a specific security affects the cost of purchasing, the proceeds from selling, and the rate of return from the security. The tax may thus impair the functioning of the capital market and affect the allocation of resources.

Other Alleged Economic Effects

The preceding alleged economic effects of the capital gains tax are attributable, in part, to the existence of a lock-in situation. There are many additional arguments concerning economic advantages and disadvantages of extending preferential treatment to capital gains. Such arguments are concerned with various methods of taxing capital gains and the resulting influences of each on accumulation and supply of capital, rate of economic growth, risk-taking, new ventures, small businesses, earnings retention, and other economic matters. The controversy in these areas centers on the desirability and effects of special treatment of income from capital assets, rather than economic aspects of investor lock-in, and is not a logical consideration for the project. It must be noted, however, that conclusions concerning these questions are of utmost importance for economic and political policies regarding taxation of income from capital assets and should be considered in any proposed solution to the alleged lock-in problem.

Summary

This chapter provides a summary review of the principles of taxation and notes that special treatment of capital gains and losses is in conflict with several of the principles. Arguments for and against preferential treatment of capital gains are presented. The arguments that taxation of capital gains results in undesirable economic consequences are discussed. Conclusions of the presentation are that if investor lock-in exists, it would accentuate stock market fluctuations and distort the process of resource allocation.

CHAPTER IV

SURVEY METHODOLOGY AND RESPONDENTS

One of the primary objectives of this project was to obtain empirical evidence regarding the significance of the lock-in effects of capital gains taxation on individual investors. The purpose of this chapter is to explain the methodology utilized in obtaining this evidence. Included are descriptions of the survey, the sample selection process, and a brief discussion of the types of responses received.

Description of the Survey

The scope of this investigation was limited to the lock-in effects of capital gains taxation on individual investors in securities, as stated in Chapter I. In order to derive as meaningful conclusions as possible, it was felt that information should be obtained from a nationwide survey of investors. Temporal and financial limitations made a mail questionnaire the most feasible approach. Additional constraints, also stated in Chapter I, were that the persons surveyed were to be business and professional people and that a disproportionately large number of high-income individuals should be included. In spite of these restrictions on the population to be studied, finding a satisfactory mailing list presented a substantial obstacle. Such a list was obtained, however, from a commercial research company.

Description of the Primary List

The primary list contained the names and addresses of some 360,000 individuals in the 50 states and the District of Columbia. The persons included on the list are or have been employed in business or professional occupations with average incomes of $25,000 or more. Utilization of this mailing list, therefore, provided a means of contacting business and professional people across the nation, including a large number of high-income individuals.

The primary list is divided into five main geographical regions. Table 2 indicates the number of persons in each of these regions, by state.

The 360,000 individuals in the primary list were considered to be the population of interest in this investigation. If responses from the survey were indicative of the opinions of persons in this population, they might also be reasonably representative of the opinions of all such persons across the nation.

TABLE 2

GEOGRAPHICAL DISTRIBUTION OF PERSONS IN THE PRIMARY LIST

West	
Alaska	400
Arizona	2,900
California	45,200
Colorado	3,300
Hawaii	1,400
Idaho	700
Montana	800
Nevada	800
New Mexico	1,400
Oregon	3,500
Utah	1,200
Washington	5,000
Wyoming	500
	67,100
North Central	
Iowa	4,000
Kansas	3,900
Minnesota	5,300
Missouri	7,800
Nebraska	1,800
North Dakota	400
South Dakota	500
Wisconsin	6,800
	30,500
South Central	
Arkansas	1,400
Louisiana	4,900
Oklahoma	3,900
Texas	18,100
	28,300
Southeast	
Alabama	3,000
Florida	10,600
Georgia	4,800
Kentucky	3,800
Mississippi	1,300
North Carolina	4,800
South Carolina	2,000
Tennessee	4,500
Virginia	6,000
	40,800
Northeast	
Connecticut	9,100
Delaware	1,300
Illinois	27,700
Indiana	6,800
Maine	700
Maryland	7,200
Massachusetts	11,400
Michigan	14,700
New Hampshire	900
New Jersey	16,900
New York	51,900
Ohio	18,600
Pennsylvania	20,100
Rhode Island	1,400
Vermont	400
Washington, D.C.	2,500
West Virginia	1,700
	193,300
TOTAL	360,000

Selection of the Sample

The names and addresses of a total of 2,122 persons to be contacted were selected from the 360,000 persons in the population. The list was stratified into the five geographical regions. The percentage of persons included in the sample from a region was approximately the same as the percentage of the population in the region. Table 3 compares the geographical distribution of the persons in the population and the sample. The persons to be surveyed were chosen randomly (selection at fixed intervals) from states located in each region.

Questionnaire Design and Testing

The questionnaire used in this survey was two pages in length and contained 18 basic questions. Copies of the questionnaire and accompanying cover letter used in the survey are included in Appendix B. The questionnaire was designed to obtain information about some general characteristics of the respondent, his security holdings, income, investment knowledge, awareness of taxes, and attitudes toward various aspects of the capital gains tax.

One hundred preliminary questionnaires were mailed to selected persons in Norman, Oklahoma. Based on the results of this test mailing, a final revision of the questionnaire was made. The final revision was reproduced and mailed to the 2,122 persons in the sample on October 31, 1969.

TABLE 3

COMPARISON OF THE GEOGRAPHICAL DISTRIBUTIONS
OF THE SAMPLE TO THE POPULATION

Region	Number of Persons in Population	Percent of Total	Number of Persons Included in Sample	Percent of Total
West	67,100	19	427	20
North Central	30,500	8	210	10
South Central	28,300	8	210	10
Southeast	40,800	11	216	10
Northeast	193,300	54	1,059	50
TOTALS	360,000	100	2,122	100

Survey Response

The persons in the survey were allowed two months to receive, complete, and return the questionnaire. The cut-off date was December 31, 1969, although no questionnaires were returned between December 23, and December 31.

Of the 2,122 questionnaires mailed, 49 (approximately two percent) were returned with incorrect addresses and were not forwardable. Of the remaining 2,073, a total of 310 (approximately 15 percent) were returned with varying amounts of information.

The regional distribution of the mail-out and the response is presented in Table 4. As indicated in the table, the geographical distribution of the responses did not differ greatly from the distribution of questionnaires mailed. A total of 23 were returned without postmarks, and the point of origin of these could not be determined.

Of the 310 questionnaires received, 19 were returned with answers to few or no questions and contained no information useful to the project. Of the remaining 291, a total of 242 indicated they (or their immediate families) currently owned securities, while 49 indicated they did not own any securities. The majority of the questions on the questionnaire were concerned with securities and security holders' attitudes, and it is likely that many persons who owned no securities, having little useful information to

TABLE 4

COMPARISON OF THE GEOGRAPHICAL DISTRIBUTION
OF SURVEY MAIL-OUT AND RESPONSE

Region	Original Mailing	Percent of Total	Incorrect Address	Responses	Percent of Total Responses by Region
West	427	20	12	74	26
North Central	210	10	3	29	10
South Central	210	10	7	26	9
Southeast	216	10	7	22	8
Northeast	1,059	50	20	136	47
Location not Determinable	---	--	--	23	--
TOTALS	2,122	100	49	310	100

provide, simply did not respond. A breakdown of the responses is presented in Table 5.

TABLE 5

CLASSIFICATION OF RESPONSES

	With Useful Information	No Useful Information	Total
Respondent-Owned Securities	229	13	242
Respondent-Owned No Securities	18	31	49
Respondent-No Indication	0	19	19
	247	63	310

Characteristics of the Respondents

Personal Characteristics

Of the 247 respondents providing useful information, 241 were married, and 222 had at least one child. The majority (59 percent) of those who were parents had either two or three children. The persons surveyed were or had been employed in a business or professional occupation. A total of 241 of the respondents were male, three were female, and three did not indicate their sex. The average and median age of the respondents were 46; the range was from 23 to 85 years of age.

Income

The questionnaire asked for the amount of the respondent's 1968 adjusted gross income and requested the information be obtained from his 1968 federal income tax return. A total of 204 (83 percent of the respondents) provided this information. Of the 204 who responded to the question, 139 (68 percent) indicated that the information had been obtained from their tax return, and 65 had estimated the amount.

Table 6 presents the income distribution of the respondents. The average income, of the respondents to the question concerning income, was approximately $24,000, and the median income was approximately $19,000. The range was from $0 (because of extraordinary tax losses) to $91,780.

Security Holdings

As mentioned previously, 242 of the respondents, or members of their immediate families, owned securities at the time the survey was taken. Thirteen of the security owners provided no other information and were not included in the tabulation of responses. Table 7 presents the distribution of the amounts of securities owned by the respondents. The average amount of securities owned by the respondents and their families was approximately $73,000, and the median amount was approximately $20,000. The amount of securities owned ranged from $75 to $1,150,000.

TABLE 6

DISTRIBUTION OF RESPONDENTS BY ADJUSTED GROSS INCOME CLASS

Adjusted Gross Income	Obtained from 1968 Income Tax Return	Estimated	Total
$0 but less than $10,000	14	9	23
$10,000 but less than $20,000	60	26	86
$20,000 but less than $30,000	24	15	39
$30,000 but less than $40,000	17	9	26
$40,000 but less than $50,000	11	2	13
$50,000 and over	13	4	17
	139	65	204
No Response to Income Question			43
Total Respondents			247

TABLE 7

DISTRIBUTION OF THE AMOUNTS OF SECURITIES OWNED BY RESPONDENTS

Current Market Value of Securities	Number	Percent
$1 but less than $10,000	78	34
$10,000 but less than $25,000	47	21
$25,000 but less than $50,000	29	13
$50,000 but less than $100,000	27	12
$100,000 but less than $200,000	24	10
$200,000 and over	22	10
Total Estimating Market Value	227	99*
No Response to Amount	2	1
Total Security Owners	229	100

*Detail does not add to total because of rounding.

Management of Securities

Each respondent was asked to indicate the percent of his portfolio that he managed personally. Of the 229 persons owning securities, 173 made all the decisions concerning their portfolios. Investors owning large amounts of securities appeared to delegate fewer portfolio decisions than investors owning smaller amounts of securities. A total of 84 percent of the respondents owning $50,000 or more of securities made all their portfolio decisions, while 73 percent of the respondents owning less than $25,000 of securities made all their own decisions. Only four percent of those respondents with $50,000 or more worth of securities managed less than 25 percent of their portfolios, while 14 percent of the group owning less than $25,000 managed less than 25 percent. Other recent studies have indicated that high-income persons delegate very little authority over their investment decisions.[1]

Relationship Between Income and Amount of Securities Owned

As indicated in Appendix A, most studies concerning the financial characteristics of individuals have found a direct relationship between the income of an individual and the amount of securities owned by the individual. A strong

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[1]Robin Barlow, Harvey E. Brazer, and James N. Morgan, Economic Behavior of the Affluent (Washington, D.C.: The Brookings Institution, 1966), pp. 25-28; and George Katona and John B. Lansing, "The Wealth of the Wealthy," Review of Economics and Statistics (February, 1964), pp. 1-13.

relationship between income and security ownership was also noted in the survey. This relationship is presented in Table 8.

Table 8 indicates that large holdings were concentrated in the upper income classes. Approximately 35 percent of the persons in the $25,000 to $49,999 income class and 53 percent of those in the $50,000 and over income classes owned securities worth $100,000 or more. On the other hand, 87 percent of the persons in the $0 to $10,000 income class compared to only 12 percent of those in the $50,000 to $99,999 income class owned less than $10,000 worth of securities.

TABLE 8

AMOUNT OF SECURITIES OWNED BY INCOME CLASS

Value of Securities Owned	Percent of Persons in Income Class			
	$0- $9,999	$10,000- $24,999	$25,000- $49,999	$50,000 $99,999
None	35	8	3	
$1-$9,999	52	42	10	12
$10,000-$24,999	4	22	18	16
$25,000-$49,999	4	13	18	6
$50,000-$99,999		9	13	13
$100,000-$199,999		3	22	24
$200,000 and over	4	3	13	29
No response			2	
TOTALS*	100	100	100	100

*Details may not add to totals because of rounding.

Several respondents in the high-income classes, who held a relatively small amount of securities, commented on their greater interest and holdings of other types of investment assets, such as real estate. However, the questionnaire referred only to investments in securities because of the previously discussed limitation on the scope of the study.

The information in Table 9 provides another indication of the concentration of large security holdings in the high-income classes.

The total value of securities owned by the 185 respondents to questions concerning income and investment was estimated to be approximately $12,000,000. Of this amount, persons in the $25,000 and over income classes (approximately 40 percent of the individuals) held some 77 percent of the total value of securities. Persons in the $50,000 to $99,999 income class (approximately 9 percent of the individuals) held approximately 34 percent of the securities owned by the respondents.

Environmental Climate of the Survey

During the time the survey was taken two unrelated events were occurring that may have affected the results of the study. These events were a decline of the stock market and the passage of federal income tax reforms.

TABLE 9

ANALYSIS OF SECURITY HOLDINGS BY INCOME CLASS

Income Class	Number of Respondents	Percent of Total	Total Amount of Securities	Percent of Total	Average Amount of Securities
$ 0- 9,999	15	8	$ 73,100	1	$ 4,806
$10,000- 24,999	96	52	2,762,391	22	28,774
$25,000- 49,999	57	31	5,360,800	43	94,049
$50,000- 99,999	17	9	4,148,500	34	244,029
TOTALS	185	100	$12,344,791	100	
No response on income	42		4,286,575		102,061
TOTALS	227		$16,631,366		

The Decline of the Stock Market

The survey was conducted during November and December, 1969, while the stock market was in the midst of a rather substantial decline. In December, 1968, the market, as measured by the Dow-Jones Industrial Index, reached a high of near 990, and thereafter fell rather steadily. By December, 1969, the market reached a low near 760, representing a decrease of over 20 percent in the value of stocks. In early November, 1969, the market completed a temporary rally, reaching the 860-870 range, and then steadily declined to the 760-770 range in late December.

This situation almost certainly had an influence on the value of stocks held by many stockholders and the respondents to the survey. Of the 229 persons owning securities, a total of 60 (about 26 percent of the group) indicated that they owned no securities which were worth "considerably more" than when they acquired them. In addition, several respondents commented that they had substantially reduced their holdings of stocks, either in anticipation of or during the decline. Thus, it is likely that the market decline had an influence on the value of securities reported by the respondents.

The decline may also have affected the results of the survey in less obvious ways. It is possible that some of the respondents had "paper profits" that had declined by a substantial amount, thereby reducing the income tax that would have to be paid on the sale of the securities. The income tax, perhaps once considered very important, might seem less important and be less influential on a smaller gain. There might also be a reduction in the importance and influence of capital gains taxes as an investor accumulates losses in a market decline. Income taxes are not paid on capital gains that are offset by capital losses. The tax effect of realizing capital gains is negligible if there are capital losses to be absorbed. Both of these possibilities are speculations, but if correct, either would have an influence on the results of the survey.

Tax Reform Legislation

There was considerable discussion of federal income taxes during 1968 and 1969. In 1968, a 10 percent income tax surcharge was enacted. In 1969, tax inequities became a main topic of conversation, and there was much talk of a major tax reform. Throughout the year, various committees of Congress proposed and discussed new tax legislation. In late December, 1969, a tax reform bill was passed by the Congress and was signed into law by the President.

The effect, if any, of these events on the results of the survey is not known. It is possible that the well-publicized statements about income taxes made people in general, and the respondents in particular, more aware of income taxes. However, there is some evidence, although not conclusive, that public discussions of taxes have little, or no effect on most persons' awareness of taxes.[2]

Summary

This chapter explained, in some detail, the methodology used in obtaining empirical evidence for this investigation. In addition, there is a brief analysis of some of the responses to the survey and of factors having a possible effect on the results of the survey.

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[2]Norbert Lloyd Enrick, "A Further Study of Income Tax Consciousness," National Tax Journal, XVII (September, 1964), 319.

CHAPTER V

EVALUATION OF THE SIGNIFICANCE OF THE LOCK-IN EFFECTS OF THE CAPITAL GAINS TAX

This chapter provides an evaluation of the significance of the lock-in effects of capital gains taxation. In accordance with limitations on the scope of the study, the investigation is directed toward lock-in effects on individual taxpayers investing in stocks and bonds. The chapter examines the three primary areas of federal income tax laws that allegedly create lock-in--the holding period, the avoidance of tax at death provisions, and the imposition of a tax on realizations of capital gains. Analyses and conclusions of previous research are discussed, and evidence obtained from the survey conducted for this project is presented.[1] From this, conclusions are made regarding the

[1] In presenting information concerning the influence of the capital gains tax on respondents to the survey, only those investors having appreciated securities were considered. The capital gains tax could be expected to have little or no lock-in effect on investors who do not own appreciated securities, or persons with no investment in securities. In addition, the survey was conducted prior to the 1969 tax reform; consequently, the evaluation of lock-in effects is based on the laws as they existed prior to the reform.

significance of the three separate areas, and the combined effects of the capital gains tax are evaluated.

Holding Period Lock-in

Short-term capital gains are treated as ordinary income for income tax purposes. Such gains are subject to tax rates ranging from 14 to 70 percent, depending on the amount of the taxpayer's other taxable income.

Long-term capital gains receive preferential treatment as compared to that afforded short-term gains and ordinary income. The effect of this preferentialism is to reduce the effective tax rate applicable to long-term capital gains by one-half, with a maximum rate of 25 percent. The effective rates on long-term capital gains thus range from seven to 25 percent.

Because of the preferential treatment afforded long-term capital gains, a taxpayer may reduce the income tax that must be paid upon realization of an appreciated capital asset by a minimum of 50 percent and a maximum of 62 percent, by postponing realization of the gain until the six months holding period has elapsed. At least four observations might be made concerning the holding period distinction between short-term and long-term capital gains.

First, it seems likely that the ability to reduce the tax liability by such a substantial percentage would strongly influence many investors to wait until six months had elapsed before selling or exchanging an appreciated capital asset. If this is correct, then lock-in, defined as reluctance to dispose of an asset because of tax consequences, does exist.

Secondly, higher income taxpayers may be influenced to a greater degree than lower income taxpayers as a result of two factors. Higher income persons, generally being subject to higher marginal tax rates, would have a larger amount of tax savings (by postponing realization) on each dollar of gain than persons with a lower income. Also, persons in tax brackets greater than 50 percent may reduce the potential tax liability by more than one-half. Higher income persons thus have an opportunity to save more tax dollars and therefore might have a greater incentive, than persons with lower incomes, to defer sales until the holding period has elapsed.

Thirdly, the strength of lock-in from the holding period might be expected to vary indirectly with the length of time that must expire before the gain reaches long-term status. That is, if an asset had been held for a period of time and the six months requirement would soon be met, the influence of holding period lock-in might be considerably stronger than if the asset were recently acquired.

The last observation about holding period lock-in is the obvious fact that, regardless of its effects during the first six months of ownership, it has no influence after that period of time. Thus, it can only result in a temporary lock-in situation for any specific security.

Results of Previous Research

The evidence compiled by previous investigators tends to support the above observations. In fact, most authorities agree that the holding period does create a significant lock-in effect on investors who have not held their appreciated securities for six months.

Walter Heller, who argues that the significance of lock-in from the capital gains tax is generally overestimated, concedes the effects of the holding period,

> . . . it is abundantly clear that such a large tax differential--whether it occurs after 6 months, 3 months, or 2 years--will have a significant effect on the timing of investment transactions.[2]

Professor John P. Shelton, using a mathematical approach, concluded that a very significant lock-in effect is created by the holding period. He analyzed the situation of an investor with a short-term capital gain who expects the price of the asset to decline before the end of the six months period. Shelton computed the percent of a short-term gain a taxpayer may lose awaiting long-term status, and still be no worse off financially, than if he had paid taxes on the gain at short-term rates. The percentages varied, of course, with the taxpayer's marginal tax rate but were substantial enough that Shelton concluded:

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[2]Heller, Federal Tax Policy, p. 382.

> . . . there is strong reason to be locked-in to securities with a short-term profit until the six months holding period has passed. Most investors cannot predict changes in stock prices over a short period of time; and so it would take a clear presumption of a price slump to justify the expectation of a 20% or 30% shrinkage in gain over a few months.[3]

The Harvard Business School study of investors provided some empirical evidence of holding period lock-in. In the study, approximately 21 percent of the 746 investors surveyed and 41 percent of those in the $100,000 or more income category indicated that the six months requirement had affected the timing of their investment transactions. The researchers in the study considered this a minimum estimate, and ". . . the frequency of timing effects for individuals in the top income and wealth groups probably was greater . . ."[4] than indicated.

By postponing realization of a capital gain for more than six months, a taxpayer subjects the gain to a lower effective rate. Seltzer concluded that higher income taxpayers are more responsive to differentials in tax rates than taxpayers with lower incomes.

> The disposition of the top income groups to realize or to defer taking capital gains has been clearly and markedly sensitive to the tax treatment. The degree of responsiveness of the middle and lower income groups is less clearly revealed by the

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[3]John P. Shelton, "Influence of the Six-Month Capital Gains Rule on Short Term Transactions," <u>Financial Analysts Journal</u>, XVIII (September-October, 1962), 100.

[4]Butters, Thompson, and Bollinger, <u>Effects of Taxation</u>, p. 339.

> figures . . . [but] . . . the responsiveness of the lower and middle income groups seems to have been less than that of the top income groups.[5]

Harley H. Hinrichs explained, by income classes, the data for short-term and long-term sales of capital assets in 1959. Regarding investors' practice of deferring sales to have gains taxed at lower, long-term rates, he stated:

> Short-term realizations of capital gains as a percentage of total realized security gains are inversely related to tax rate differentials: investors appear responsive to differences in tax rates . . . [and] . . . elasticities of investor reaction to capital gain tax rate differentials tend to rise with income.[6]

The Brookings Institution study, Economic Behavior of the Affluent, reported evidence of investor reaction to the holding period. In analyzing answers to a question concerning the length of time the most recently sold capital asset had been held, the researchers stated:

> The relative number of replies indicating short-term capital gains differed radically among income groups. It was more than three times as common at income levels below $75,000 as above, . . . Moreover, the frequency with which the latest capital gain had been realized on an asset held between six months and one year was 50 percent higher at incomes over $75,000 than it was in the $10,000-$75,000 range. At least at the margin, therefore, it appears that the timing of the realization of capital gains is influenced by tax considerations.[7]

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[5]Seltzer, Tax Treatment, p. 179.

[6]Harley H. Hinrichs, "An Empirical Measure of Investors' Responsiveness to Differentials in Capital Gains Tax Rates Among Income Groups," National Tax Journal, XVI (September, 1963), 227.

[7]Barlow, Brazer, and Morgan, Economic Behavior of the Affluent, p. 123.

In another study[8] of the effect of the six months holding period, the most recent data on sales of capital assets were examined. The researchers analyzed, by months, the value of corporate stocks sold at a gain and held for one year or less.

The analysis showed that a large dollar amount of the sales in the first year of ownership occurred within the first month after purchase. The amounts sold in the second through the sixth months were considerably lower. In the seventh month, amounts sold increased substantially. Sales in the eighth through the twelfth months were lower than the seventh; however, they remained above the levels for the second through the sixth months.

Each adjusted gross income class exhibited a similar pattern, although ". . . taxpayers in higher tax brackets postpone their gain beyond the sixth month to a much greater extent than taxpayers in lower brackets."[9] From their analysis, the researchers concluded,

> . . . the monthly distribution of gains suggests that investors respond to the difference in marginal tax rates between short and long term capital gains. We conclude that a six month locked-in effect for corporate stock transactions does exist, and that this lock-in is stronger for higher income taxpayers.[10]

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[8]J. Eric Fredland, John A. Gray, and Emil M. Sunley, Jr., "The Six Month Holding Period for Capital Gains: An Empirical Analysis of Its Effect on the Timing of Gains," National Tax Journal, XXI (December, 1968), 467-478.

[9]*Ibid*., p. 470.

[10]*Ibid*., p. 470.

Results of the Survey

Several questions in the survey were concerned with holding period lock-in.

The first of these questions asked the investor if he generally tries to hold securities at least six months. Approximately 95 percent of the respondents answered in the affirmative. This large percentage could be expected, because there are probably numerous factors influencing investors to hold securities longer than six months.

The second question asked the investor to estimate the degree of influence of the capital gains tax on his desire to hold securities at least six months. Almost 80 percent of all respondents were influenced by tax considerations to some extent. About 32 percent of the respondents indicated that influence of the capital gains tax on their short-term decisions was significant, and another 27 percent stated that the tax was a dominant factor. A total of 20 percent said that the capital gains tax exerted little influence, and 16 percent felt no influence from tax considerations. The remaining five percent of the respondents did not answer the question.

When the data were analyzed by income class, the holding period requirement appeared to have a greater effect on investors with higher incomes than those with lower incomes. Seventy-one percent of those with incomes of $60,000 and over indicated that the capital gains tax was a dominant influence. All respondents in this group indicated the tax had influenced, to some extent, their decisions to hold appreciated securities for six months. The amount of influence on the lower and middle income groups was mixed, but a progression in the degree of the influence of the holding period requirement was noted, beginning at the $10,000 income class.

Another question isolated investors indicating that tax considerations had influenced their decisions to hold their currently owned appreciated securities. These persons were asked which aspects of federal taxes had influenced them. Often, more than one aspect was mentioned, but some 12 percent indicated their decisions had been influenced by the fact that the security had not been held for six months. As a measure of the number of persons affected by the holding period requirement, the 12 percent is a minimum. It represents only the respondents whose portfolio decisions were affected by the holding period at the time of the survey. Any persons who had held their appreciated securities for more than six months at the time of the survey would not be affected by the holding period requirement.

Summary of Research Concerning Holding Period Lock-in

As a summarization of this section on the significance of investor lock-in from the holding period requirement, the following conclusions seem appropriate.

It would appear logical that the ability to achieve rather substantial tax savings by deferring a sale until the six months period had elapsed, would make many investors hesitant to sell a capital asset at a gain until the holding period requirement had been met. Most authorities agree that the holding period does create a significant lock-in effect. The evidence obtained from the survey in this investigation would seem to support the same position.

Lock-in from Avoidance by Transfer at Death

As explained in Chapter II, the federal income tax laws do not recognize any gain or loss on capital assets transferred to a beneficiary through an estate. Gains accumulated on capital assets included in an estate are not reported in the decedent's final income tax return. In addition, the basis for computation of gain or loss, to the person acquiring the asset from a decedent, is the fair market value at the valuation date of the estate. Therefore, accumulated gains on capital assets at the valuation date are never subjected to income tax. This provides a taxpayer owning an appreciated capital asset the opportunity of holding the asset until death and completely avoiding income tax on the gain.

Two observations can be made concerning the ability to avoid the capital gains tax by a transfer at death. First, a substantial income tax savings may be achieved, since the transfer at death reduces the marginal income tax rate applicable to a long-term capital gain from a maximum of 25 percent to zero. Secondly, this ability to avoid the income tax completely might be expected to become more important and exert greater influence as an investor grows older.

Results of Previous Research

As in the case regarding holding period lock-in, most authorities are in agreement that significant investor lock-in results from the ability of the taxpayer to avoid the capital gains tax completely, by a transfer at death. As a result of the agreement, very little has been written, and almost no empirical evidence has been accumulated, regarding this area of investor lock-in. In general, the feeling is that the lock-in effect is extremely influential on elderly investors but of little consequence to younger investors. A comment by economist Henry Wallich typifies the attitude of authorities when he stated: "That the lock-in increases inversely with life expectancy is obvious."[11]

The authors of Economic Behavior of the Affluent indicated that as long as the avoidance option exists, efforts to unlock investors may be unsuccessful.

> It may be the ultimate availability of a zero tax rate that matters . . . It is therefore questionable that even a substantial reduction in the capital gains tax

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[11]Wallich, "Taxation of Capital Gains," p. 145.

> rate would make much difference in asset mobility, as long as the tax-free alternative remained.[12]

The Standard and Poor's publication, Outlook, noted that the wealthy are generally older persons and that these people often cannot afford to sell appreciated securities, subjecting the gain to the capital gains tax, when provisions allowing avoidance are available.

> The age of wealthy investors ranges principally from 50 to 75 years. Selling advices to such clients must give full consideration to the tax factor. The combination of a 25% capital gains tax liability and an ultimate estate tax liability is too great a penalty on profit-taking, as viewed by most well-to-do investors.[13]

William Vickrey has criticized the avoidance provisions and conceded their effects on taxpayers as follows:

> This disappearance [through avoidance] of capital gains in probate is one of the most clearly illogical of all our income tax provisions. Moreover, it has fairly serious effects. In the hope of taking advantage of this loophole, taxpayers tend to hold on to appreciated stocks and other assets when they might otherwise shift their funds . . .[14]

Robert Vowels concluded that the avoidance provision probably creates a greater lock-in effect than any other aspect of the capital gains tax.

> The holding period and the step-up-in basis provision probably encourage investors to hold assets. . . . the step-up-in basis at death provision causes a

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[12]Barlow, Brazer, and Morgan, Economic Behavior of the Affluent, p. 120.

[13]Outlook, Standard and Poor's Corporation, XXVII, No. 3 (January 17, 1955), 180.

[14]Vickrey, Agenda for Progressive Taxation, p. 139.

> decrease in the willingness to sell present assets relative to the short- and long-term situation, and consequently also to the other situations.[15]

Dan Throop Smith stated that the avoidance provisions increase the lock-in effect of the capital gains tax, and ". . . will influence investment decisions for many years before one expects to die."[16]

Holt and Shelton have attempted to quantify decisions involving the avoidance at death option.[17] They assume that an investor desires to maximize his income and estate value and that he is concerned with his heirs. They also assume an investor will be willing to switch investments only if the exchange will maintain or increase his current income and restore the market value of the estate lost in payment of capital gains tax. In their computations, the authors used mortality tables to determine the probability that the income tax would be avoided by death. From this, they computed the additional return required from a prospective investment in order to offset the probable avoidance opportunity.

The size of the differential and the implied strength of investor lock-in depend on the taxpayer's marginal tax

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[15]Vowels, "An Evaluation," pp. 40, 49.

[16]Smith, Federal Tax Reform, p. 148.

[17]Holt and Shelton, "The Lock-in Effect," pp. 337-352; and Charles C. Holt and John P. Shelton, "The Implications of the Capital Gains Tax for Investment Decisions," Journal of Finance, XVI (December, 1961), 559-80.

rate, the amount of the gain, the expected future yield of the security owned, the age of the investor, the estate motivation of the investor, and the length of time he normally holds securities.

As a result of their computations, Holt and Shelton conclude that the magnitude of the lock-in effect is not great for most investors, except the elderly. They recognize, however, that their assumptions of rational behavior and optimization on the part of the investor may not be realistic. In addition, they make no attempt to allow for uncertainty in estimating future yields of securities. They admit the shortcomings of this omission and concede that "when other factors seem imponderable and difficult to forecast" the certainty of payment of the capital gains tax could dominate the decision and prevent a sale.[18]

In the final analysis of lock-in from the avoidance option, Holt and Shelton concluded,

> By granting the additional (a.i.) privilege of completely forgiving this tax at death, the taxpayer is encouraged by the government to postpone still further the realization of his capital gains. Thus the tax operates as if the government were trying to encourage investors who own securities with capital gains to hold them instead of selling them. . . . The result is to produce large (a.i.) lock-in differentials for aged investors in high tax brackets who have large capital gains and are interested in their heirs.[19]

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[18]Holt and Shelton, "The Lock-in Effect," pp. 337-352.

[19]*Ibid.*, p. 352.

Results of the Survey

The survey conducted in this project contained several questions related to the avoidance provisions and their effects on investor decisions to hold or sell assets. The first question asked the investor if he was aware of the provisions allowing complete avoidance of the income tax at death. A total of 63 percent indicated they were aware of the provisions.

The number of persons aware of the option varied considerably between age groups. Only 44 percent of the persons less than 35 years of age were aware of the option, while 74 percent of those individuals 55 or over were aware of it.

A second question asked the respondent if the ability to avoid the tax at death had affected any of his decisions to hold rather than sell an appreciated security. A total of 31 percent of the investors who were aware of the alternative (representing almost 20 percent of all respondents) indicated that it had affected their decisions.

The frequency of influence increased with the age group considered. Only 11 percent of those persons under 50 years of age indicated that the option had affected their decisions. This is compared with 30 percent of the 50 to 64 age group and 41 percent of the 65 and over age group.

A third question asked the respondent the degree of influence the avoidance provisions had exerted on his investment decisions. Of the persons whose decisions had been affected, 61 percent indicated the influence had been a significant influence, and another 18 percent said it had been a dominant influence on their decisions. The remaining 21 percent were aware of the provisions but had felt little influence from them.

In answer to the question asking the respondent which aspects of federal income taxes had affected his decisions to hold rather than sell his currently appreciated securities, some 16 percent mentioned the desire to completely avoid the tax on the appreciation by including the security in his estate at death. About 41 percent of the respondents 65 years of age or over mentioned the desire to avoid the tax. Again, this was a minimum estimate, representing only the influence of the avoidance provisions on current holdings.

Summary of the Research on Lock-in from Avoidance by Transfer at Death

Authorities are in substantial agreement that the ability to avoid the capital gains tax at death exerts considerable influence on elderly investors and little influence on younger investors. The results of the survey appear to support these opinions. Almost 63 percent of the respondents were aware of the provisions for avoidance by transfer at death, and, as might be expected, older persons exhibited a greater frequency of awareness than younger persons. Some 20 percent of all respondents owning appreciated securities indicated the avoidance at death provisions had, at some time, influenced their decisions to hold appreciated securities. Almost 16 percent of all respondents, and 41 percent of those 65 and over, mentioned it as a reason for holding rather than selling their currently appreciated securities. About 25 percent of the persons who were aware of the avoidance provisions felt that it had exerted a significant or dominant influence on their decisions.

These results would tend to support the arguments that lock-in influence from the avoidance provisions varies inversely with the age of the investor and that it has a substantial lock-in effect on a large percentage of the elderly investors.[20]

Lock-in from the Imposition of a Tax on Realization

As explained in Chapter II, capital gains and losses are generally recognized for tax purposes when realization occurs. A taxpayer may indefinitely postpone recognition of a capital gain and, thus, payment of the income tax, by delaying the time of realization. This ability to defer the tax has the effect of an interest-free loan from the

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[20]Research on national wealth, discussed in Appendix A and included in the bibliography, indicates that older persons are a significant group of investors. There is considerable evidence of concentration of ownership of securities by this group. The findings of the survey provided another indication of this concentration. The 55 and over age group, representing about 28 percent of the security owners, held nearly 65 percent of the dollar amount of securities owned by all respondents.

government in the amount of income tax not paid and may make investors reluctant to sell their appreciated assets. Also the amount of income tax that must be paid at the point of realization reduces the amount of the proceeds from the disposition available for use by a taxpayer. This factor becomes extremely important in the transfer of capital from one earning asset to another. For an exchange to occur, the differential in returns must be great enough to offset the amount of taxes paid and still induce the taxpayer to make the exchange. It is possible, therefore, that the imposition of a tax on realization causes investors to be reluctant to make sales they might otherwise transact because of the tax consequences involved. The strength and significance of lock-in from this aspect of the income tax laws, referred to as lock-in from the capital gains tax rate, are difficult to isolate and are the subject of considerable controversy.

Differential Returns

Previous research on differential returns

A number of authorities have attempted quantitative analyses of investor lock-in from the capital gains tax rate. A primary objective of these analyses has been to determine the necessary differential between the expected returns of a prospective investment and a presently held appreciated investment to justify an exchange. The significance of the income tax on the exchange is inferred from the size of the differential. Many of these analyses have been subject to rather severe, and sometimes unstated, restrictions and assumptions that simplify the computations, but reduce the realism of the situations. Among these assumptions are a one-year investment horizon, no reinvestment of returns, expected returns in only one form (dividends, interest, or appreciation, but not a combination), certainty of returns, and no portfolio complications. One of the most comprehensive analyses, that of William F. Beazer, is presented as an illustration.

Beazer allows for an investment time horizon of more than one year and reinvestment of returns from the investment. He first considers the case where all returns are expected to be in the form of appreciation, and the taxpayer does not expect to avoid the capital gains tax by dying. The following table was extracted from Beazer's article.

To illustrate the interpretation of this table, consider an investor in the 25 percent tax bracket owning a stock on which 70 percent of the current market value is appreciation. The value of the stock is expected to increase at the rate of 10 percent a year for 10 years. From the table, the annual expected rate of gain on the prospective investment must be 13.5 percent greater than that of the old investment or 11.35 percent per year. The differential required is relatively small for most of the situations contained in the table, and from this Beazer concludes the lock-in effect is not significant. In regard to more general situations, he explained,

> For shorter holding periods and lower expected annual rates of gain on the old asset the required ratio between annual rates of gain on the new and old securities is greater. For longer periods and higher rates, the ratio is smaller.[21]

TABLE 10

RATIOS BETWEEN RETURNS ON A NEW INVESTMENT AND AN OLD INVESTMENT REQUIRED TO MAKE A SWITCH ADVANTAGEOUS

Marginal Tax Rate on Capital Gains (Percent)	Gain on Old Asset as a Fraction of Its Market Value				
	1/10	3/10	5/10	7/10	9/10
10	1.006	1.021	1.035	1.050	1.065
25	1.017	1.054	1.095	1.135	1.182
35	1.025	1.076	1.135	1.201	1.275
50	1.035	1.114	1.206	1.319	1.457

The amounts are the ratio between annual rates of return if the expected holding period is 10 years and r_1 = 10%. The required ratio between annual rates of return varies with the actual level of the rates.

Source: William F. Beazer, "Expected Income Changes and the Lock-in Effect of the Capital Gains Tax," National Tax Journal, XIX (September, 1966), 310.

Beazer also notes that if returns expected from the investments are dividends, and if these are reinvested in the assets, then the same calculations would be appropriate.

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[21]William F. Beazer, "Expected Income Changes and the Lock-in Effect of the Capital Gains Tax," National Tax Journal, XIX (September, 1966), p. 310.

However, if the dividends are assumed to be invested in the highest yielding investment (probably a more realistic assumption), the calculations would be more complex and the required differential would be greater.

When both dividends and appreciation are expected from an investment, a more complicated decision confronts the investor. According to Beazer,

> A much more complicated situation arises when the old and the new securities have both capital gains potential and a dividend yield. . . .
> Just about the only generalizations that can be made in this situation are (1) that for any given expected dividend and gain combination on an old security there could be an infinity of combinations on the new security that would make it equivalent to the old and (2) that capital gains will weigh more heavily in the trade-off--particularly at higher tax rates.[22]

Other authors also have concluded that only a relatively small differential is generally necessary to offset the tax paid on an exchange.

Heller concluded from his calculations, that,

> . . . it is apparent that only where the accrued gain is large and the expected differentials in yields or price movements are small does the tax on long-term capital gains make switching financially unattractive.[23]

Holt and Shelton agreed that, mathematically, the required differential is relatively small; however, they noted,

> . . . one must be cautious when assuming that rational behavior as indicated by an optimizing

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[22]*Ibid.*, p. 311.

[23]Heller, *Federal Tax Policy*, p. 385.

> analysis will be approximated in actual decision practice. . . . [and] . . . if investors generally feel that any forecasts about the future yields of securities are quite uncertain, then the definite certainty or loss arising from a sale which incurs a capital gains tax may be a significant deterrent to switching.[24]

Regarding investor uncertainty and frequency of exchange of earning assets, Wallich argued,

> . . . I question whether the rational investor ordinarily has much reason to believe that he can improve his investment results either by switching or by trying to sell at peaks and buy at bottoms. . . .
> Under these conditions rational investor behavior would seem to be to switch only when a particular holding has become demonstrably unsuitable for his purposes . . . The only sure thing he ordinarily knows is that if his chances of improving his position by selling or switching are even, taxes and commissions make them less than even. . . . This view argues for a generally strong lock-in effect.[25]

Along these lines, Sprinkel and West felt that,

> . . . investors frequently overestimate the extent of the "lock-in" effect. . . . The impact of capital gains taxes on investment decisions has been exaggerated in the minds of many investors.[26]

Results of the survey concerning differential returns

A hypothetical problem, using the figures in the example explaining the Beazer table, was included in the survey to obtain an indication of the respondents' ability

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[24]Holt and Shelton, "The Lock-in Effect," pp. 350-351.

[25]Wallich, "Taxation of Capital Gains," pp. 145-146.

[26]Beryl W. Sprinkel and B. Kenneth West, "Effects of Capital Gains Taxes on Investment Decisions," Journal of Business, XXXV (April, 1962), 133-134.

to calculate the required differential. The question involved a simple stock exchange situation with no dividends or uncertainty. In addition, the after-tax proceeds of the sale were given, so no estimate of the marginal tax rate, or computation of the amount of the income tax on the sale was required. As explained earlier, the minimum required annual appreciation on the security to be purchased is 11.35 percent. The answers to the hypothetical problem were expressed in whole numbers, and 12 percent was the proper response. A respondent could overestimate the required percentage by over one-half percent, and still be considered correct.

The responses of persons not owning securities were not tabulated, and some 15 percent of the security holders did not respond to the question. The following table presents the distribution of answers provided by the security holders responding to the question.

Only 17 percent of responding security holders answered the question correctly, while 23 percent indicated that they were unable to compute the answer. A total of 50 percent of those responding answered the question, but overestimated the required rate. The mean response was 14 percent.

Many respondents had difficulty deriving the correct answer to the hypothetical security exchange problem. Although the evidence was not conclusive, almost 75 percent of

TABLE 11

RESPONSES TO THE HYPOTHETICAL INVESTMENT PROBLEM

Answer	Percent of Respondents	Cumulative Percent
10 percent	2	2
11 percent	5	7
12 percent	17	24
13 percent	20	44
14 percent	5	49
15 percent	10	59
16 percent	1	60
17 percent	0	60
18 percent	4	64
19 percent	1	65
20 percent	9	74
Unable to compute	23	97
Other	3	100
	100	

the respondents were either unable to compute the answer, or overstated the effect of the capital gains tax on the transfer. Certainly a real portfolio decision would be viewed more seriously and carefully and this may explain some of the inaccuracy. However, this is partially offset by the simplicity of the situation in the hypothetical problem. The results seem to support the allegation that investors tend to exaggerate the effect of the capital gains tax on security exchange decisions.

"Anti-Lock-In" Effects

Previous research on "anti-lock-in" effects

Beazer, in addition to his analysis of required differentials, theorized that the capital gains tax may produce "anti-lock-in" effects. Anti-lock-in might affect an investor who (1) owns an appreciated asset, (2) is subject to less than the maximum 25 percent capital gains tax rate, (3) does not expect to escape the tax by dying, and (4) expects an increase in his marginal capital gains tax rate in the future. Such an investor might be induced by the capital gains tax to sell rather than hold an appreciated asset. If he sells, the gain would be taxed at the present tax rate, and only future appreciation would be taxed at the expected higher rates (assuming he does not expect to offset the gain with losses). The investor might even find it profitable to sell and reinvest in the same asset. The relevant factors are the expected return from the asset held, and current and expected future capital gains tax rates.

Again, "for simplicity," Beazer assumed expected returns in the form of capital appreciation, in computing Table 12.

The values in the table are the minimum expected amounts of appreciation, for various current and anticipated capital gains tax rates, that are necessary to warrant holding an appreciated asset. If the expected amount of appreciation is less than the value in the table, the investor should realize his gain and reinvest in the best available investment. The expected increase in taxpayer's marginal tax rate offsets the value of postponing payment of taxes.

TABLE 12

MINIMUM AMOUNT OF APPRECIATION REQUIRED TO WARRANT HOLDING AN APPRECIATED ASSET

Difference Between Current & Expected Capital Gains Tax Rate	Current Tax Rate on Capital Gains							
	.07	.10	.15	.20	.25	.35	.50	.60
-.015	.23	.17	.12	.10	.09	.07	.06	.06
-.03	.47	.34	.22	.19	.17	.14	.13	.14
-.05	.81	.59	.42	.33	.29	.24	.22	.24
-.10	1.72	1.25	.88	.71	.61	.52	.50	.56
-.15	2.74	2.00	1.43	1.15	1.00	.86	.86	1.00

Source: Beazer, "Income Changes and Lock-in Effect," p. 312.

As an example, an investor in a 10 percent capital gains tax bracket, expecting to move into a 15 percent bracket would profit by selling and reinvesting, unless he expects 59 percent or more appreciation in the currently held asset. The appreciation may accrue over a period of years.

The results of the preceding analysis are reversed if the investor expects his marginal capital gains tax rate to decrease. Obviously, an investor who expects such a decrease may save taxes by holding the asset until the lower rate prevails. This would increase the required differential in returns expected from prospective and currently held assets to offset the tax paid on an exchange.

Beazer interprets the results of his analysis as follows,

> It is clear that under current tax law there is very little incentive for a person to feel locked into his portfolios by capital gains if he expects to eventually pay taxes on them and if he also expects to move into higher tax brackets as income rises over time. In fact, at the lower income and tax levels, there is a very real incentive to realize gains in order to avoid paying a higher tax on them later. The incentive to feel locked-in is considerable, however, if the individual expects to face lower tax rates as income falls, particularly if the expected tax rate difference is large and the change imminent, such as might be the case if the investor were near retirement.[27]

After considering the general upward trend of income in the United States and the large percentage of capital gains realized by persons, not in the maximum capital gains tax bracket or near retirement, Beazer stated,

> . . . it seems fair to conclude that a sizeable proportion of capital gains do accrue to people who have virtually no basis for being locked-in by unrealized gains and, in fact, might even deem it expedient to realize them.
>
> The analysis tends to reinforce the contention that the lock-in effect should be a relatively weak influence on investor decisions, except as the investor approaches retirement and old age.[28]

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[27]*Ibid.*, pp. 314-315.

[28]*Ibid.*, p. 317.

Results of the survey concerning "anti-lock-in" effects

A series of questions was included in the questionnaire to obtain an indication of the respondents' reactions to expected changes in their marginal income tax rates and to evaluate the significance of Beazer's arguments.

Table 13 presents an analysis of the replies.

There were 169 responses to the series of questions relating to respondents' reactions to expected changes in their marginal tax rates. A total of 136 of the respondents either expected no change in income or had not been influenced by the expected change. An insignificant number of persons did not respond to each question, and these are ignored in the percentage calculations.

A brief review of the responses reveals that 111 (66 percent of all the respondents) expected a change in income that would affect their tax rate. A substantial percentage (approximately 80 percent) of persons in the 25 to 34 and the 55 to 64 age groups expected such a change. Generally, the younger persons would be expecting an increase and the older persons, nearing retirement, would be expecting a decrease.

About 28 percent of those expecting a change indicated that it had affected a portfolio decision. The percentage influenced by the expected change rose rather steadily from 22 percent of the 25 to 34 age group to 41 percent of the 55 to 64 age group. Of those who had been

TABLE 13

ANALYSIS OF RESPONSES TO QUESTIONS CONCERNING EFFECTS OF ANTICIPATED CHANGES IN THE RATE OF TAX ON PORTFOLIO DECISIONS

169 Respondents

Do you expect a change in your income which will affect the rate at which your income will be taxed?

No: 57--34% Yes: 111--66%

If a change is anticipated, has this expected change affected any of your portfolio decisions?

No: 79--72% Yes: 31--28%

If the anticipated change has affected your decisions, what kind of change do you expect?

Increase: 12--40% Decrease: 18--60%

This increase has influenced you to: (Number of persons)					This decrease has influenced you to: (Number of persons)				
9	1	1	1	0	16	2	0	0	0
Hold an appreciated asset	Sell an appreciated asset	Hold an asset that has decreased in price	Sell an asset that has decreased in price	Other	Hold an appreciated asset	Sell an appreciated asset	Hold an asset that has decreased in price	Sell an asset that has decreased in price	Other
reaction	reaction	reaction	reaction	reaction	reaction	reaction	reaction	reaction	reaction
I	II	III	IV	V	VI	VII	VIII	IX	X

influenced by the expected change 40 percent were anticipating an increase in their income, and 60 percent were anticipating a decrease.

As indicated in Table 13, there were five possible answers to the final question, and each might have been selected by a person expecting an increase or a decrease in his income. Thus, there were ten possible reactions to an expected change in income.

Beazer's anti-lock-in effect is reaction II, a person expecting an increase in his income being influenced to sell an appreciated asset. As shown in Table 13, only one of the 169 respondents to the series of questions indicated this reaction.

Beazer also noted that expectation of a decrease in income and in the rate of tax would exert additional pressure on a person to hold an appreciated asset, reaction VI. As shown in Table 13, 16 of the 18 persons influenced by an anticipated decrease in income, indicated this reaction. As might be expected, the majority of these responses were given by older persons, nearing or in retirement. Fifteen of the 16 were 45 years of age or over, and 12 were 55 or over.

About 22 percent of all the respondents who were 55 years of age or over indicated they had been influenced to hold an appreciated security by an expected decrease in their tax rate. This compares with slightly over nine percent of all the respondents.

Other logical reactions would appear to be: (1) to hold an asset which had decreased in price, if an increase in the tax rate is expected (reaction III), and (2) to sell an asset which had decreased in price if a decrease in the tax rate is expected (reaction IX). Only one person reported either of these reactions.

However, based on Beazer's line of reasoning, reactions I, IV, VII, and VIII would appear to be illogical. In spite of this, nine of the 30 persons influenced indicated reaction I. Reaction I, to anticipate an increase in the rate of tax and to be influenced to hold an appreciated asset because of this expectation, does not conform to the analysis. Whether these replies were the result of a lack of understanding of the question or of factors not included in the analysis could not be determined.

The results of the survey concerning investor reactions to expected changes in their incomes and tax rates were not entirely conclusive. A relatively small number (31 of 169 respondents) indicated that an anticipated change in their tax rate had influenced their portfolio decisions. Of these, 25 indicated that they had been influenced to hold, rather than sell an appreciated asset. The answers of only one respondent indicated any anti-lock-in effects from an expected increase in income and marginal tax rates. On the other hand, considerable lock-in effects of an expected decrease in the tax rate were noted. A total of 16 of the 18 respondents, affected by an expected decrease in their tax rate, had been influenced to hold an appreciated asset. This effect appeared particularly important to those nearing or in retirement (12 of the 16 were 55 years of age, or over). The conclusions from the results of the survey indicate that the respondents were generally unresponsive to expectations of future changes in marginal tax rates, with the exception of older persons who indicated a significant lock-in influence from an anticipated decrease in their marginal tax rates.

Research on Other Effects of a Tax on Realization

The survey provided additional information concerning the effect of the realization criteria on taxpayers' investment decisions. One question asked the respondents which aspects of taxes had affected their decisions to hold their currently appreciated securities. By far the most frequently mentioned aspect was the desire to postpone the tax that would have to be paid when the security was sold. This answer was given by 62 percent of those indicating their decisions to hold securities had been influenced by taxes. This represented about 52 percent of all respondents owning appreciated securities. These large percentages tend to support the argument that the capital gains tax rate does produce a lock-in effect on many investors.

Authorities have expressed differing opinions concerning lock-in from the capital gains tax rate. Smith views lock-in as a justification for reduction in income tax rates.

> . . . it [the present capital gains tax rate] does discourage the sale of property on which a large gain has developed. . . . The principal reason for a reduction in the tax rate would be to thaw frozen investments . . .[29]

The authors of Effects of Taxation: Investments by Individuals emphasized the avoidable and objectionable nature of a tax levied on the sale of a capital asset as follows:

> . . . there are reinforcing emotional considerations which are likely to deter investors from selling capital assets on which gains have accumulated. By selling, the investor brings on himself an otherwise avoidable tax--a tax which many investors view as a highly objectionable form of capital levy. . . . Given these alternatives, the choice of taking positive action which will precipitate a distasteful tax in return for a dubious future benefit may well be resolved by a decision to do nothing. At any rate, the sale is much less likely to be made under these circumstances than if no tax were levied on the gain.[30]

However, they found the capital gains tax rate less important than the holding period in influencing the timing of investment decisions.

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[29]Smith, Federal Tax Reform, p. 146.

[30]Butters, Thompson, and Bollinger, Effects of Taxation, pp. 334-335.

> Our data indicate that the timing of investment transactions was definitely influenced by the capital gains tax for a sizeable fraction--between a quarter and a half--of the individuals in the active investor sample in all except the lowest income and wealth groups. Generally speaking, transactions appear to have been affected by the six months' holding period to a much greater degree than by the long-term rate of 25%. The tendency to defer the realization of gains has been stronger than that to accelerate the realization of losses.[31]

A study for the New York Stock Exchange by Louis Harris and Associates implied a strong lock-in effect from the capital gains tax rate. According to their conclusions, reductions in the capital gains tax rate would increase realizations enough to substantially increase tax revenues.[32]

The authors of Economic Behavior of the Affluent expressed skepticism of the Harris' findings. They were:

> . . . not convinced by the finding of two Harris polls for the New York Stock Exchange that substantial numbers say they would sell assets if the capital gains tax were lower. The responses to such "iffy" questions are generally not good predictors of behavior.[33]

Seltzer noted that the 12 1/2 percent tax rate, effective in 1928 and 1929, was charged with creating investor lock-in. Referring to this, he stated,

> But for the many investors who lacked strong opinions respecting the probable trend of prices

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[31] Ibid., p. 45.

[32] Effects of a Reduced Capital Gains Tax on Locked-in Capital and Federal Revenue (New York: New York Stock Exchange, Department of Research and Statistics, 1961), pp. 3-5.

[33] Barlow, Brazer, and Morgan, Economic Behavior of the Affluent, p. 120.

> for one or more of their assets, even a moderate tax on capital gains could doubtless deter liquidation. Such an investor had to consider that if he sold, he not only gave up the chance of benefiting from a possible rise in the value of the asset but faced a certain loss of capital resources and earning power through paying the tax. If he contemplated shifting his funds to what seemed a more attractive investment, the tax on his accrued gains would rationally deter him unless the contemplated new commitment seemed sufficiently more attractive than the old to offset the <u>certain</u> (a.i.) loss of capital funds entailed by the transfer.[34]

Walter Heller, who is, in general, dubious of the extent of lock-in from the capital gains tax, said,

> But can we dismiss it as insignificant? In the absence of more adequate and decisive facts, the answer is "no," for three main reasons: (1) After all the screening, there remain rational investors at or near the margin of selling whose decisions are affected by the tax, i.e., whose reservation price is higher than it would be without the tax; (2) in the face of uncertainty, many investors will not trade the likelihood of a more-than-compensating improvement in yield or capital appreciation on a new security (or drop in price of the old) for the certainty of an immediate diminution of capital via the gains tax; and (3) in the light of frequent investor inertia and irrationality, the tax may exert a psychological effect not limited to its actual cost . . .[35]

Summary of the Research on Lock-in Resulting from the Imposition of a Tax on Realization

Many authorities have engaged in mathematical analyses that, subject to artificial constraints, generally show only a relatively small differential in returns is necessary to offset the payment of income tax on an exchange of

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[34]Seltzer, <u>Tax Treatment</u>, p. 166.

[35]Heller, <u>Federal Tax Policy</u>, p. 386.

earning assets. From this, they infer that the lock-in effect from the capital gains rate should not be a major deterrent to an investor contemplating an exchange. Many note, however, that there may be intangible factors, such as uncertainty or investor inertia, that would modify this conclusion. Others argue that the effect of the tax is exaggerated by investors or that the certainty of paying tax on the sale may be a dominant factor when considering uncertain returns. Respondents to the survey had difficulty determining the required return in a relatively simple, hypothetical problem. In addition, the majority of respondents overstated the effect of the tax on the transfer. This evidence tends to support the view that tax considerations are exaggerated in the minds of investors.

Beazer theorized that many investors, expecting to move into higher tax brackets, should be induced by the capital gains tax rates to sell rather than hold appreciated assets. A majority of the respondents to the survey anticipated a change in their tax rates, but less than 30 percent were influenced by the expectation. Only one person indicated an "anti-lock-in" effect from the expected change. On the other hand, a large majority of those affected by an expected change in their tax rate were influenced to hold appreciated securities. This was primarily true of older investors, expecting a decrease in their tax rate because of retirement. It appeared that the situation produced significant lock-in effects for the elderly investors.

A majority of the respondents owning appreciated securities indicated that the desire to postpone payment of the tax had influenced their decisions to hold rather than sell their appreciated securities. This would tend to support arguments that the capital gains tax rate exerts lock-in pressure on a large number of investors.

The overall conclusion from the research was therefore, that the imposition of a tax on realization of capital gains does influence many investors to hold rather than sell their appreciated securities. A significant lock-in effect results from this area of the capital gains tax.

The Combined Lock-in Effect of the Capital Gains Tax

The preceding sections have presented the results of research on each of the three areas of the capital gains tax allegedly creating lock-in. An overall evaluation of the combined lock-in effects of these areas may now be made.

A total of 84 percent of the respondents indicated that the capital gains tax had influenced their investment decisions to some extent, and a substantial number considered the influence to be significant.

In identifying the aspects of the capital gains tax which had influenced their decisions to hold their currently appreciated securities, 62 percent of the persons responding mentioned the desire to postpone the tax; 16 percent mentioned the desire to avoid the tax at death; 12 percent indicated the six months holding period had not elapsed. A small number of respondents indicated such aspects as the loss of capital involved in payment of the tax and the desire to offset gains with losses. About 20 percent did not identify any specific area.

Regarding the degree of influence the capital gains tax exerted on their decisions to hold rather than sell their currently appreciated securities, well over 50 percent indicated that the influence had been significant or dominant. About 34 percent said that tax considerations had exerted little influence on their decisions. Less than 16 percent felt no influence from the capital gains tax.

In answering the question asking for the investor's primary reasons for holding rather than selling his currently appreciated securities, many of the respondents provided more than one answer. Some 36 percent indicated tax considerations as a primary reason for not selling their appreciated securities. It should be noted that, although this answer may not have been applicable to all appreciated securities in each person's investment portfolio, a very substantial percentage of the respondents did feel that taxes were a primary influence on their decisions. It should also be noted that the 36 percent is a minimum estimate, since the question referred only to current holdings.

A majority of persons in the highest income class reported tax considerations as a primary reason for holding their appreciated securities. A total of 53 percent of the persons in the $50,000 and over income class, so reported, compared to slightly over 35 percent for the other income classes. Tax considerations thus seemed to be more important to decisions of investors with higher incomes than those with lower incomes.

The last question in the survey concerned the combined effects of the capital gains tax. It asked, "Do you presently own any security which you would sell if there were no capital gains tax?" A total of 17 percent of the respondents owning appreciated securities answered in the affirmative. This number appears to be significant, in view of the fact that these people felt the capital gains tax was actually preventing them from selling an appreciated security. Also, it represented only a minimum estimate, referring to current holdings.

Summary and Conclusions

The preceding discussion notes several degrees of influence exerted by capital gains tax on investor decisions to hold rather than sell appreciated securities.

Jonathan A. Brown saw the lock-in effect of the capital gains tax as a restricting, rather than a dominating force.

> Although the term "locked in" suggests a specific limit to action established by a physical barrier, the actual effect is more analogous to the hobbling of an animal, or the attractive force of an electro-magnet rather than a locked door. For the effect of a hobble or a magnet will vary widely depending on the relative sizes and weights, the strength and makeup of the materials involved, and about as many other factors as are involved in getting an investor to transfer his capital funds from one asset into another.[36]

The varying degrees of influence noted in responses in the survey would tend to support Brown's view. Eighty-four percent indicated that tax considerations had exerted some influence on their decisions, and 36 percent considered it a primary reason for not selling their appreciated securities. A total of 17 percent indicated they were prevented from selling currently appreciated securities by the capital gains tax. This variation is not surprising in view of the many factors that may affect each investment decision. Tax consequences are important and should be considered by an investor; however, there are other variables involved in investment decisions.

Several conclusions may be summarized from the results of the survey with regard to the lock-in effect of the capital gains tax.

(1) Each of the three primary areas of the capital gains tax considered, created some degree of lock-in for the respondents, and the combined effects were substantial.

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[36]Brown, Federal Tax Policy, p. 368.

(2) The majority of respondents considered the tax aspects of their investment decisions and were influenced by tax considerations.

(3) Tax considerations were generally more influential on respondents with higher incomes than those with lower incomes.

(4) Older investors were subject to particularly strong lock-in effects from the tax on capital gains.

These observations support the central hypothesis of the study that federal income tax implications do influence investors to hold appreciated securities that might otherwise be sold. The conclusion derived from the survey regarding the hypothesis is that, for a substantial number of the respondents, a lock-in effect is created by the capital gains tax, and that the lock-in influence is significant.

CHAPTER VI

ALTERNATIVE PROPOSALS FOR ALLEVIATION OF THE LOCK-IN EFFECTS OF THE TAXATION OF CAPITAL GAINS

A number of recommendations have been proposed to alleviate or eliminate the lock-in effects allegedly created by provisions of federal income taxation relating to capital gains. Some of the more important proposals are examined briefly in this chapter in order to evaluate their effectiveness in reducing investor lock-in.

This investigation of lock-in has been based primarily on the laws of federal income taxation as they existed prior to the 1969 tax reform. The Tax Reform Act of 1969 produced some changes in the treatment of capital gains and losses. An explanation of the modifications contained in the tax reform and an evaluation of their effects on investor lock-in are also presented in this chapter.

The Accrual Proposal

According to the accretion concept of income, changes in the value of capital assets, whether unrealized or realized, represent income to the taxpayer. Based on this concept, proponents of accrual taxation contend that changes in the value of capital assets should be included in income and taxed as they occur.

One proposed method of taxing capital gains and losses on an accrual basis involves an annual valuation of assets and computation of income, a final valuation of assets and computation of income at the time of death of a taxpayer, and full taxation of changes in capital asset values as ordinary income. This method would represent a departure from the present realization criteria; however, one result would be the elimination of the main areas of investor lock-in. There would be no need for a holding period, since ordinary income and capital gains would receive equal treatment, and holding period lock-in would be eliminated. All capital gains and losses, realized and unrealized, would be included in income annually, so there would be no tax advantage or disadvantage to be derived from holding or selling a capital asset. Thus, tax considerations would no longer provide an impediment to transfers of capital assets. A final computation of income would be made at the time of a taxpayer's death, and any appreciation since the last annual reporting of income would be taxed. The elderly investor would not be encouraged, by tax considerations, to hold his appreciated assets, since the tax could not be avoided at death. Consequently, the accrual proposal would eliminate all major lock-in effects of the present capital gains tax and would allow greater mobility of capital.

A major disadvantage of the accrual proposal is that annual valuation of assets would be required. Valuation would produce compliance and enforcement problems, particularly for unlisted securities, real estate, small businesses, and other assets requiring appraisals or estimates of value.

Another disadvantage of accrual taxation would be the problem of liquidity. Some taxpayers, lacking cash to pay taxes on their accrued gains, might be forced to liquidate holdings of assets in order to pay the income taxes.[1]

The Rollover Proposal

Another recommended alternative for reducing the lock-in effects of capital gains taxation is based on the "rollover" concept. The proposal is basically a modification of the realization criteria. Rollover treatment is currently provided for certain transactions involving a taxpayer's personal residence.[2]

Under the rollover proposal, capital gains would be included in taxable income, if proceeds from the sale of a capital asset were not reinvested in other capital assets.

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[1]One formal proposal for taxation of capital gains and losses on an accrual basis was presented by Martin David in Tax Reform 1969.

[2]Internal Revenue Code, Section 1034.

If the proceeds were reinvested, any gain from the sale of a capital asset would not be recognized for tax purposes but would reduce the basis of the asset obtained. In this manner, recognition of a capital gain for tax purposes would be postponed until the sale of an appreciated asset occurred, without reinvestment of the proceeds. The postponement would be similar to an interest-free loan from the federal government in the amount of the deferred tax.

The primary difference between the present tax structure and the rollover proposal is the treatment of exchanges involving capital assets. The rollover concept provides no criteria for taxation at death, although most proposals for rollover include recognition of any unrealized appreciation at the time of death. If such unrealized gains were not taxed at death, the tax could be postponed for an indefinite period of time through succeeding generations of taxpayers, and it is likely that only a small percentage of total capital appreciation would ever be taxed. If constructive realization were adopted with rollover provisions, lock-in from the avoidance at death provisions would be eliminated.

Another aspect of investor lock-in that would be affected by the rollover proposal is the influence of a tax on realization. An investor would be influenced not to realize gains on appreciated assets if he did not expect to reinvest the proceeds. Such gains would be recognized and taxed. Rollover would, however, allow a taxpayer to ignore the income tax on realization of gains in his investment decisions involving the sale of a capital asset and reinvestment of the proceeds. Rollover would, consequently, reduce the lock-in effects of the tax on those persons desiring to switch capital assets and would increase the mobility of capital in this respect.[3]

Modifications of the Holding Period Requirement

Most authorities agree that the present tax structure influences many investors to postpone realization of gain on their appreciated capital assets, until the six months holding period has elapsed. As a result, many people have suggested reduction or elimination of the six months holding period.

Elimination or Reduction in the Length of the Holding Period Requirement

Obviously, if the holding period requirements did not exist, lock-in effects of the holding period would be eliminated. A primary purpose of the six months holding period is to distinguish between investment activity and speculative activity. Regardless of the effectiveness of this rather crude method of distinction, many persons feel it would be unacceptable to eliminate the holding period requirement. Securities that are purchased and sold for

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[3]A detailed rollover proposal may be found in Clark, Tax Revision Compendium, pp. 1243-56.

short-term profits are similar to items of inventory that are specifically excluded from the definition of a capital asset.

Reducing the length of the holding period requirement, to three months for example, would probably exert opposing forces on the significance of holding period lock-in. Long-term capital gain status would be reached sooner, reducing the number of investors affected at any point in time and the length of time that any particular investment would be affected. On the other hand, the strength of lock-in on an investor with a potential short-term capital gain would probably be greater because the waiting period necessary to attain long-term status would be shorter. In addition, some persons who would not be willing to wait six months might be willing to postpone a sale for the shorter period to achieve tax savings.

Thus, it is likely that reducing the length of the holding period requirement would decrease the overall effects of holding period lock-in, but the strength of the inducement to wait until the holding period had elapsed to realize a capital gain probably would be increased.

Multiple Holding Periods

Another alternative proposal, incorporating a system of several holding periods, probably would reduce the severity of holding period lock-in. Under the present law, a taxpayer may exclude 50 percent of a gain realized on a capital asset held for more than six months. Therefore, he may reduce his tax bill on such gains by 50 percent or more, by postponing realization until the six months holding period has elapsed. One purpose of multiple holding periods is to reduce the intra-period differentials in effective tax rates on capital gains. The proposal would be designed so the amount of gain deductible from income would vary with the length of time an asset had been held. The actual percentage deduction would be determined by normal legislative process; however, the percent of gain that could be excluded from tax would increase with time.

For example, a taxpayer might be allowed to deduct 10 percent of a capital gain for each six month period of time the asset had been held, up to a maximum of 50 percent. If a taxpayer has a potential tax bill of $5,000 on a short-term capital gain under the present law, he may reduce this to $2,500 by postponing realization until six months have elapsed. This allows a substantial tax savings and provides a strong incentive to postpone the sale.

With the multiple holding period structure, the taxpayer could save only $500 by holding the asset an additional six months. He would have to hold an asset for two and one-half years to achieve the maximum 50 percent deduction.

The proposal would exert opposing forces on investors. The incentive to postpone realization for an additional period would probably be reduced because of the smaller savings that would result. Nevertheless, even the smaller savings might encourage some people to continue to hold their appreciated assets. In addition, any degree of lock-in that existed would affect a taxpayer for a longer period of time. Presently, a taxpayer may be locked-in for a maximum of six months; however, in the example two and one-half years would be required for the taxpayer to completely escape the holding period lock-in. In summary, the expected result of multiple holding periods would be a reduction in the strength of holding period lock-in on an investor, but an increase in the duration of the influence.[4]

Modifications of Provisions Concerning Transfers at Death

The provisions allowing complete avoidance at death of income tax on capital appreciation are considered by authorities to produce the strongest lock-in effect of any aspect of the capital gains tax. Complete avoidance is possible because unrealized appreciation is not recognized at the time of a taxpayer's death, and a step-up in basis, to the fair market value at the time of death or alternative estate valuation date, is provided for a person acquiring a capital asset from a decedent.

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[4]Federal income tax laws contained multiple holding period provisions from 1934 to 1942; however, differences in the length of periods and the rates make comparison difficult.

Constructive Realization

One proposed solution to the lock-in problem resulting from the avoidance at death provisions is the taxation of any unrealized gains at the time of a taxpayer's death. This is referred to as presumptive or constructive realization. Unlike present provisions, constructive realization would insure that all capital gains on assets held by a taxpayer and not transferred by <u>inter</u> <u>vivos</u> gift would be taxed during, or at the end of his life. Payment of taxes could be deferred but only for a taxpayer's lifetime. Tax deferral would be similar to an interest-free loan in the amount of the tax. Nevertheless, the possibility of complete avoidance and the resulting investor lock-in would be eliminated.

Carryover of Basis

Provision for carryover of basis is an alternative proposal for reducing lock-in from the avoidance of income taxation at death option. This alternative would provide similar treatment of assets transferred by bequest, as is presently afforded transfers by gift. A person acquiring an asset from a decedent would use the decedent's basis to determine the amount of gain or loss from the sale of the asset. The step-up in basis provisions of the current law would be eliminated, although realization and payment of income taxes could be postponed indefinitely. An elderly taxpayer might also experience some additional lock-in from the proposal, if he were in a higher tax bracket than the person expected to receive the asset when the taxpayer died. Some tax advantage could be gained by holding the asset until death and allowing the heir to realize the gain at his lower marginal tax rates.

Reductions in the Effective Capital Gains Tax Rates

The magnitude of the effective rates applicable to capital gains affects the degree of lock-in created by the capital gains tax. Obviously, if a gain from realization of a capital asset were not taxed, there would be no lock-in effect. Most authorities agree that complete exclusion of capital gains from income taxation is unacceptable because of the resulting inequities among taxpayers.

Reductions in income tax rates applicable to capital gains could be achieved by increasing the deduction for long-term capital gains or lowering the rates applicable to such gains. Other proposals for reducing the effective progressivity of the present income tax rates involve averaging or proration devices. Regardless of the method used, reducing the effective income tax rates applicable to capital gains would probably decrease the strength of investor lock-in. As previously noted, the results of the Harris' poll of investors indicated that substantial increases in realizations of capital gains would result from relatively small reductions in the tax rate.[5]

The Tax Reform Act of 1969[6]

The tax reforms enacted in 1969 represented a very broad revision of the federal income tax laws. The reforms were not specifically designed to influence the lock-in effects of capital gains taxation, and, in fact, included very few modifications of the provisions pertaining to capital gains and losses. The reforms are discussed in this chapter for the purpose of reviewing the changes in taxation of capital gains and losses and evaluating the effects of the changes on investor lock-in.

The Alternative Tax Computation

The alternative tax computation was modified for taxable years beginning after 1969. An individual may still deduct one-half of the excess of his net long-term capital gains over his net short-term capital losses in computing adjusted gross income. (The Tax Reform Act refers to the excess as "net section 1201 gains.") The old law, however, limited the tax on the excess of net long-term capital gains over net short-term capital losses to a maximum of 25 percent of the realized gain. The general effect of the new

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[5] Effects of Reduced Capital Gains Tax, pp. 3-5.

[6] The explanations of the 1969 Tax Reform were based on Tax Reform Act of 1969 (Englewood Cliffs: Prentice-Hall, Inc.), 1970.

alternative computation is to limit the tax to 25 percent on $50,000 only ($25,000 for a married taxpayer filing a separate return) of net section 1201 gains. The maximum effective tax rate applicable to net section 1201 gains in excess of $50,000 a year is raised 29.5 percent for taxable years beginning in 1970 and 32.5 percent for taxable years beginning in 1971. Thereafter, net section 1201 gains in excess of $50,000 will be taxed at one-half the taxpayer's marginal tax rate for ordinary income (a maximum of 35 percent).

Several observations may be made about the new alternative tax computation.

(1) The old and new alternative tax computations are generally not relevant to taxpayers in tax brackets of 50 percent or less, so the revision affects primarily high-income taxpayers (over $44,000, if married and filing a joint return).

(2) The maximum tax on $50,000 or less of net section 1201 gains remains at 25 percent of the gain. Thus, the revised alternate tax computation would affect only persons with more than $50,000 of such gains in a taxable year.

(3) The maximum tax on any net section 1201 gains in excess of $50,000 is increased to 29.5 percent in 1970, 32.5 percent in 1971, and

35 percent thereafter. The maximum increase in effective rates is 10 percent.

The revision will affect a relatively small fraction of all taxpayers (those with high incomes) reporting capital gains or losses. The latest year for which detailed information on sales of capital assets is available is 1962. In that year only about 89,000 of the nearly six million individual taxpayers reporting a gain or loss on capital assets found the alternative tax computation (limiting the tax to 25 percent of the gain) advantageous.[7]

The revised alternative tax computation would allow persons in tax brackets greater than 50 percent to minimize their taxes by limiting realization of net section 1201 gains to $50,000 annually. The possible tax savings could range up to a maximum of 10 percent of the gain after 1971.

As an example of the maximum savings, consider a married taxpayer, with $200,000 of taxable income each year. In 1972, he considers the sale of stock that has appreciated $100,000 since acquisition in 1970.

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[7]U.S. Treasury Department, Sales of Capital Assets Reported on Individual Income Tax Returns--1962 (Washington, D.C.: U.S. Government Printing Office, 1962), p. 6.

If the taxpayer realized the entire gain in one year, his income taxes would be:

	1972	1973	Total
	$140,980	$110,980	$251,960

If the taxpayer realizes one-half the gain in each of two years, his income taxes would be:

	1972	1973	
	$123,486	$123,486	246,960
Tax savings from postponing $50,000 of the gain:			$ 5,000

Tax savings for other amounts of income and capital gains would vary with the particular amounts involved; however, the savings would range from zero to 10 percent.

Any comparison of changes in the degree of lock-in from the old and new laws is applicable only to the high-income taxpayer and to his net section 1201 gains in excess of $50,000. This income would be subject to the increased effective tax rates. The increased effective rates would provide a greater incentive for a taxpayer to postpone realization of capital gains. The revision of the alternative tax computation will have no effect on lock-in for a large number of investors with appreciated capital assets. It will also have no direct affect on holding period lock-in or lock-in from avoidance at death provisions.

The Minimum Tax

The 1969 tax reform provided for a new method of taxing, the minimum tax, that is imposed on certain items receiving some form of preferential treatment under the income tax laws. Capital gains, specifically the 50 percent of net section 1201 gains that may be deducted from income, are among the preference items. Others include stock options, accelerated depreciation, and depletion.

The effect of the minimum tax is to impose, subject to certain limitations, an additional 10 percent tax on preference items. The tax is applied to the total of the preference items, less the total of (1) a $30,000 exemption ($15,000 for a married taxpayer filing a separate return) and (2) the amount of income taxes imposed for the year.

The minimum tax, like the new alternative tax computation, will probably be a consideration for only a few investors. A taxpayer, with no other preference items, could realize $60,000 worth of net section 1201 gains annually, plus an amount equal to his income tax for the year without being subject to the provision. For taxpayers subject to the minimum tax, the effect is to increase the effective rate applicable to net section 1201 gains by five percent. The minimum tax, by raising the effective tax rates for certain taxpayers, provides an additional incentive for these investors to postpone realization of capital gains.

Income Averaging

Under the old laws, capital gains were not subject to the income averaging provisions. The reform act modifies the income averaging provisions and allows a taxpayer to include his net section 1201 gains in his averageable income. Income averaging allows a taxpayer with "bunched income" to obtain relief. As previously mentioned, the progressive rates of the income tax may place a heavier tax burden on fluctuating or bunched incomes than steady incomes.

An individual may qualify to use the averaging provisions, if his taxable income for the current year exceeds his "nonaverageable income" (120 percent of his average taxable income for the four preceding years plus $3,000).

For example, the average taxable income of a taxpayer with adjusted taxable incomes of $12,000, $9,000, $11,000, and $8,000 in the four preceding years would be $10,000. His nonaverageable income for the current year would be 120 percent of this ($12,000) plus $3,000, or $15,000.

The excess of taxable income in a year over the nonaverageable income is the taxpayer's "averageable income." The averaging period is five years, and the averageable income is taxed as if it had been received in equal amounts over the five-year period. The amount of income tax liability is the tax on the nonaverageable income plus five times the tax applicable to one-fifth of the averageable income. The result of income averaging is a reduction of the progressivity of effective tax rates and thus a reduction in the amount of taxes that must be paid on bunched income. If income averaging is elected, however, the alternative tax computation is not allowed.

The overall effect on investor lock-in of including net section 1201 gains in the averaging computations is difficult to predict. Certainly the provision will allow some taxpayers to realize rather substantial capital gains and pay less tax than they would have paid under the old provisions. This would tend to lessen lock-in effects due to the capital gains tax rate. Nevertheless, each individual situation must be evaluated, and the advantages of averaging are especially clear for medium-sized gains of low and middle income taxpayers. Perhaps many taxpayers, with only small amounts of gain to be realized, would not have enough bunched income to qualify for income averaging. Also, the implications of the revised alternative tax computations and the minimum tax must be considered by taxpayers contemplating very large realizations.

In the final analysis, the revised income averaging provisions will probably reduce the income taxes that must be paid on realization of some capital gains and reduce the lock-in effects of the capital gains tax for some taxpayers. Generalizations are difficult, however, because of the importance of the specific circumstances of each individual taxpayer.

Capital Loss Offsets

The provisions for capital losses, discussed in Chapter II, were modified by the 1969 tax reform. The change of primary interest provides more parallel treatment for capital gains and losses than the old provisions. Under the old laws any excess of capital losses over capital gains for a year was used to reduce other taxable income, up to a maximum of $1,000, for individuals. Under the new law, long-term capital losses may still be offset in full against capital gains, but only half of any excess may be deducted from ordinary income. The maximum amount of reduction in ordinary income by capital loss deductions remains $1,000; however, $2,000 of long-term capital losses would be required to achieve this reduction.

In effect, long-term capital losses will be more valuable to a taxpayer, if offset against capital gains, than if used to reduce ordinary income. A taxpayer will probably consider this when he is contemplating realization of a long-term capital loss. If he does not expect to have any capital gains in the taxable year, he may benefit by postponing realization of a long-term capital loss until a later year when capital gains are expected. The reform will probably increase the lock-in of taxpayers who were considering the sale of a capital asset at a loss and who expect to have no capital gains in a given tax year.

If the taxpayer did not desire to, or could not postpone the realization of the long-term capital loss, then he might be influenced to realize a capital gain to obtain the full value of the loss offset. Therefore, the modification of the treatment of long-term capital losses might result in some minor "anti-lock-in" effects.

Summary of the Effects of the Tax Reform

The sections of the Tax Reform Act of 1969 that concern capital gains are likely to produce little change in investor lock-in from the capital gains tax. Since the holding period requirement and the treatment of transfers at death are not changed, the tax reform will not directly affect investor lock-in from these areas. The effects of the reform on lock-in from the capital gains tax rate are uncertain. The minimum tax and the alternative tax computation, by increasing the effective rate on long-term capital gains of certain high-income taxpayers, should increase lock-in from the capital gains tax rate on these persons.

The reforms complicate the calculation of tax consequences from a sale of an appreciated capital asset, particularly for high-income individuals. The changes in the procedure for capital loss offsets will probably increase lock-in for taxpayers with unrealized capital losses, who do not expect to have capital gains in a taxable year. The modification of the averaging provisions should, by reducing the effective progressivity of tax rates for some taxpayers, reduce the lock-in effects of the capital gains tax rate on these persons.

The evaluation of the effects of the tax reform on investor lock-in must be regarded as speculation about how a "rational" investor may react to the revisions. The provisions of the tax reform will probably result in only moderate changes in effective rates of a few taxpayers. It is not certain that investors react to moderate changes in tax rates.

Summary

Included in this chapter are brief evaluations of the effectiveness of various tax reform proposals in alleviating or eliminating the lock-in effects of the capital gains tax. An explanation of the major changes in the treatment of capital gains and losses caused by the Tax Reform Act of 1969 and its probable effects of investor lock-in is also presented.

CHAPTER VII

PROPOSED RECOMMENDATIONS FOR TAX REFORM

This chapter contains recommendations for reform of the federal income tax laws concerning capital gains and losses. As discussed in previous sections, there is disagreement among authorities concerning the principles of taxation, the nature of capital gains and losses, and the significance of the lock-in effects of capital gains taxation. Because of this disagreement, it is unlikely that any proposal for revision of the capital gains tax will receive complete acceptance or agreement. Each proposal probably reflects the opinions and biases of its advocate, and the proposal contained in this chapter may be subject to the same criticism.

Assumptions

The basis of our present system of federal income taxation is retained in the structure of the proposed reform. Among the tenets of the present system of income taxation included in the proposal are that:

(1) ability-to-pay is an acceptable basis for taxation,

(2) income of a taxpayer is a proper measure of his ability-to-pay,

(3) present, progressive income tax rates are in conformity with society's concept of vertical equity,

(4) realization of income creates taxpaying ability; therefore, income should be recognized, for tax purposes, at the point of realization, and

(5) realized capital gains do create taxpaying ability.

It is possible that these concepts cannot be combined to create an optimal tax system for capital gains and losses or that other concepts may produce a more satisfactory system. The assumptions have, however, provided the foundation for our system of federal income taxation for many years, and on this basis they may be said to be acceptable to our society.

The following proposal is structured to conform to the principles of taxation, to be practicable, and to allow for politically and socially acceptable modifications. The basic proposal includes one major deviation from our current system. In the proposal, capital gains and losses are considered income to the taxpayer and are taxed in the same manner as ordinary income. Full taxation of capital gains and losses is not an essential element of the recommended reform, and a provision for possible modification of the treatment is presented in the section containing a modified proposal.

Basic Proposal

The recommended method for taxation of income, including full taxation of capital gains and losses, is based on a cumulative averaging technique developed by William Vickrey over thirty years ago. A detailed description of the technique may be found in Vickrey's book, Agenda for Progressive Taxation, and in an article by him in the June, 1939, Journal of Political Economy. Much of the following discussion of the cumulative averaging technique is taken from these sources.

Vickrey felt that preferential treatment for capital gains was provided to relieve the bunching of income problem and to compromise with those who argue that capital gains are not income. Nevertheless, in his opinion,

> . . . the relief thus granted is capricious in its incidence, probably excessive in most cases, and opens considerable loopholes for tax avoidance.[1]

Vickrey noted the many opportunities for manipulation of income and avoidance of income taxes created by the arbitrary realization criteria. Various provisions of the laws designed to prevent this manipulation and avoidance add considerable complexity to the tax laws and, in his opinion, are largely ineffective.

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[1]William Vickrey, "Averaging of Income," p. 380.

The realization criteria may conflict with the equity principle of ability-to-pay, and as expressed by Vickrey,

> It is an obvious extension of the principle of taxation according to ability to pay that no taxpayer should bear a heavier or lighter burden merely because certain items of his income happen to be earned or realized in one year or another, regardless of whether this be by chance or by design of the taxpayer and regardless of any fluctuations in the needs of the government for revenue or the rates of tax in effect at various times.[2]

According to Vickrey, a system of income taxation should conform to this principle and, in order to be practicable and equitable, should meet the following criteria:

> 1. The discounted value of the series of tax payments made by any taxpayer should be independent of the way in which his income is allocated to the various income years.
> 2. The revenue for any given year should be capable of being raised or lowered by suitable modifications of the rates without too long notice.
> 3. If the taxpayer leaves the jurisdiction at any time, there should be no accumulations of untaxed income left behind and no tax due except possibly the regular tax for the last year. . . .
> 4. Any given tax payment should not be too large in relation to the income of the period immediately preceding.
> 5. Transition to and from other methods of assessing income tax should be simple.
> 6. The method of computing the tax should not be beyond the ordinary taxpayer's capacity.
> 7. The administrative burden should not be excessive.[3]

Vickrey discussed an advantage of postponing tax payments and proposed an imputation of interest to eliminate

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[2]*Ibid.*, p. 381.

[3]*Ibid.*, p. 382.

the value of tax deferral. He assumes two taxpayers, A and B, in the same tax status, with equal capital and rates of return, and identical earnings for a taxable period. Their expenditures are identical, except that A pays taxes on his income during the period, and B postpones payment of taxes until the end of the period. Vickrey explained,

> B's total income for the period will then exceed A's total income by the compound interest on the amounts which A paid as installments on his income tax but which B avoided paying and so was able to invest. If, then, to A's total income is added the compound interest on the taxes which A has paid from the time they were paid to the end of the period, an amount which will be called the "adjusted total income" is obtained which is the income A would have had if he had paid no taxes during the period. It may readily be seen that this adjusted total income will remain the same for any given taxpayer, regardless of any changes that may occur in the allocation of the realization of his income to the various years within the averaging period.[4]

The adjusted total income may be accumulated for a taxpayer's income-producing lifetime (perhaps from age 21 to death), and this would be the basis for computing the tax liability. Algebraically, the adjusted total income would be:

$$Y_n = Y_{n-1} + r\ T_{n-1}(Y_{n-1}) + Y_n$$

where:

Y_n = annual income for year n

$T_n(Y_n)$ = the tax function for the cumulative income in year n

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[4] *Ibid.*, pp. 382-383.

r = the rate of return available to a taxpayer and the imputed interest rate.[5]

The tax liability on this cumulative, adjusted total income should be determined so that the present value of tax payments is the same regardless of the pattern of realization of income. The tax liability is computed as if the accumulated adjusted total income had been received in equal amounts annually, thereby averaging the income. The taxpayer is credited with the amount of taxes previously paid and the imputed interest that could have been earned on the amount if it had not been paid. Algebraically, the "adjusted tax payments" (T^*) would be:

$$T^* = (1 + r)\ T_{n-1}\ (Y_{n-1})$$

The "taxes due" are equal to the amount of the income tax liability computed for adjusted total income less the adjusted tax payments. Algebraically, the taxes due (t_n) are:

$$t_n = T_n\ (Y_n) - T^*$$

Computational Simplicity of the Proposal

Although the cumulative averaging technique is rather complicated to explain, one of its advantages is simplicity of computation and administration. The present averaging technique requires information from tax returns

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[5]The formulas describing the cumulative averaging technique are found in Martin David, Alternative Approaches to Capital Gains Taxation (Washington, D.C.: The Brookings Institution, 1968), p. 186.

of the four preceding years, knowledge of a number of specific rules for determination of qualification for averaging, and the completion of a separate, rather complicated form. In the words of Martin David, "The present averaging form is incomprehensible to most taxpayers."[6]

On the other hand, calculation of tax liability using a cumulative averaging technique is relatively simple. Many of the computations may be built into tax tables similar to those presently used. One possible form, suggested by Vickrey, would require only seven lines for computation of the tax liability. A taxpayer would need to refer only to his previous year's tax return for two items of information. As stated by Vickrey,

> At first sight this method of determining the annual payments to be made by the taxpayer may seem hopelessly complex; it is possible, however, by constructing special tables and carrying figures forward from previous returns, so to arrange the computation that the actual work required of the taxpayer will be considerably less than that at present required of taxpayers having capital gains and losses.[7]

A different tax table would be required for each additional year of a taxpayer's productive life. The Treasury Department could easily provide the appropriate table with a taxpayer's Form 1040 each year. An example of the computation of a tax table was included in Vickrey's article.

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[6] *Ibid*., p. 165.

[7] Vickrey, "Averaging of Income," p. 384.

The following is a sample of such a table for taxpayers averaging over two years. The rates taken are the surtax rates of the revenue act of 1936 for both years, with interest at 5 percent.

Adjusted Total Income (Dollars)	Total Present Value of Tax (Dollars)	Rate of Tax on Excess within Next Bracket (Per Cent)
0	0	0.0000
8,000	0	4.0959
12,004	164	5.1186
16,009	369	6.1408
20,015	615	7.1625
24,022	902	8.1836
28,030	1,230	9.2043
32,039	1,599	11.2441
36,050	2,050	13.2818
40,063	2,583	15.3176
......	.....	....

The figures given in the table are computed as follows: A taxpayer with a steady annual income (after exemptions) of $12,000 pays a surtax each year, under the present law, of $440. Interest on the first year's tax at 5 per cent is $22. This $22, added to the total income for the two-year period of $24,000, gives the adjusted total income of $24,022 given in the first column. The total present value of the tax is $440 + $440 + $22 = $902. The next higher level of income in the present tables is $14,000, giving similarly an adjusted total income of $28,030 and a total present value of tax of $1,230; thus, the size of the total adjusted income bracket is $4,008, and the tax on this bracket is $1,230 - $902, or $328. The rate of tax on this bracket is therefore $328 ÷ $4,008, or 8.1836 per cent.[8]

[8]*Ibid.*, pp. 384-385.

Using such a table furnished by the Treasury Department, the computation of taxes might be accomplished as follows:

> The required computations might be set as follows on the income-tax return.
>
> 1. Net income this year (after exemptions)..$18,500.00
> 2. Adjusted total income as of previous year (copied from item 5 of previous year's return)........................... 9,200.00
> 3. Total value of income taxes paid as of previous year (copied from item 6 of previous year's return).................. 252.00
> 4. Interest for past year on taxes paid (5 per cent of item 3)................... 12.60
>   (The rate of interest may be varied from year to year by the Treasury in accordance with current economic conditions. The rate of interest must, of course, be the same as that used in the computation of the surtax tables.)
> 5. Adjusted total income (sum of items 1, 2, and 4)............................... 27,712.60
> 6. Present value of tax on item 5 (computed from surtax table)............ 1,204.02
> 7. Present value of past income taxes paid (sum of items 3 and 4)............. 264.60
> 8. Tax due (item 6 minus item 7)........... 939.42
>
> The figures given are for the 1938 return of a taxpayer who is averaging over the two years 1937-38, having a net income, after exemptions, of $9,200 in 1937 and $18,500 in 1938. For the first year, items 2, 3, and 4 are zero, so that item 5 for the first year is simply the income of that year, and so appears unaltered in item 2 above.
>
> Item 6 is calculated as follows: The largest amount in the first column of the surtax table not greater than item 5 is $24,022.00, the excess being $3,690.60. The tax on the first $24,022.00 is given in the second column, $902.00; the tax on the excess at the rate given in the third column, 8.1836 per cent, is $302.02, a total of $1,204.02. Except for the unrounded figures, this computation is precisely the same as that now required in computing surtax.[9]

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[9] *Ibid.*, pp. 385-386.

Reduction of Timing Advantages and Disadvantages

This method of tax imposition and computation contains other distinct advantages over the present system. The adjusted total income and the amount of taxes paid by taxpayers with equal earning assets will be the same, regardless of the timing of recognition of income. The technique allows retention of the realization criteria but negates tax advantages or disadvantages that may result from differences in the timing of receipt of income or recognition of gains or losses. As stated by Shoup,

> The greatest advantage of this cumulative averaging system is that it would make it a matter of indifference to the taxpayer whether he reported any particular item of income in an earlier year or a later year. He would gain nothing by delaying the realization of income, and would lose nothing by reporting it earlier . . .[10]

In effect, the cumulative averaging system charges interest on money retained by a taxpayer through deferral of tax payments. Martin David suggested that the rate of interest imputation should be the market rate for prime commercial paper or broker's loans.[11] The value of tax deferral is eliminated, if the imputed rate of interest is equal to the earnings rate of a taxpayer's investments. If the earnings rate of a taxpayer's investments is greater than the interest rate, the effect is similar to a loan in

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[10] Tax Reform, 1969, pp. 4266-67.

[11] David, Alternative Approaches, p. 187.

the amount of the deferred taxes. Interest is imputed at the lower interest rate, and the investment earns at the higher earnings rate. Consequently, a taxpayer may still profit by deferring tax payments, if the earnings rate of his investments is greater than the interest rate; however, the advantage is greatly reduced compared to present tax deferral advantages. On the other hand, a taxpayer with investments earning at a rate lower than the interest rate would pay more for the use of deferred tax money than he would earn on it. If a purpose of our capital market system is to direct funds to enterprises with higher earnings rates and away from enterprises with lower earnings rates, these results would be desirable.

Constructive Realization at Death

Averaging periods may be any length, but it might be logical to extend the averaging period from age 21 until the taxpayer's death. Constructive realization at death of capital gains and losses would be appropriate to provide a final accounting of all income and to prevent the shifting of income outside the averaging period. Constructive realization would create no great valuation problems for many estates, since valuation of assets is now required for estate taxation. Under constructive realization, valuation of assets would also be required of some smaller estates, not presently subject to estate taxes.

There is no present provision for taxation of unrealized capital gains at death, and the constitutionality of such a deviation from the realization criteria has been questioned. A number of authorities have concluded, however, that taxation of unrealized capital gains at death would be constitutional.[12] Under constructive realization, any unrealized gain would be included in a decedent's final income tax return and taxed at the death of the taxpayer. The basis for gain or loss to a person acquiring an asset from a decedent would be the fair market value used in the final tax return of the deceased.

It has also been argued that constructive realization of capital gains would produce liquidity problems for many estates. The liquidity problems could be alleviated by allowing payment of taxes on unrealized capital gains any time within a given time period, for example five years, and charging interest on tax payments that are postponed.

Constructive Realization at Time of Transfer by Gift

It would probably be desirable to eliminate a major area of possible tax avoidance that would remain in the cumulative averaging proposal. As is presently the case, a taxpayer would be able to shift income and unrealized capital gains to another taxpayer by *inter vivos* gift of

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[12] *Tax Reform, 1969*, pp. 4307-4309.

the asset. A number of authorities contend that this avenue for avoidance should be eliminated by integration of the gift and estate taxes. Specifically, in this proposal, unrealized capital gains and losses on assets transferred by gift would be subject to the income tax. A detailed discussion of the problems of estate and gift taxation is beyond the scope of this study;[13] however, taxation of unrealized capital gains transferred by gift would be a desirable feature of the cumulative averaging proposal.

Definition of a Taxable Entity

Definition of the appropriate taxable entity and changing taxpayer status are related problems that require solution before the proposal could be adopted.

It would be possible to tax each individual separately on his personal income, thereby eliminating problems created by marriage, divorce, or other change in taxpayer status. Separate return status of all taxpayers would, however, involve many opportunities for income manipulations (through inter-family transfers) that would need to be eliminated.

Vickrey considered the taxation of an entire family as a taxable unit, to be a radical but satisfactory method. The income of a family would be apportioned to family members "according to proportions fixed by statute," and each member

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[13]A detailed discussion of estate and gift taxes may be found in Carl Shoup, Federal Estate and Gift Taxes.

would be taxed separately. This method would reduce inter-family transfer problems and would modify the tax burden of a family unit according to its size.[14]

David suggests valuation of assets and constructive realization of gains and losses at the time of marriage, separation, or divorce. Some adjustments in the tax tables would be required to alleviate inequities; however, he concedes, ". . . it would not be possible to make the interruption [change in status] a matter of indifference in all cases."[15]

The present averaging provisions contain adjustments for changes in taxpayer status during the averaging period. The rules are rather arbitrary; however, it might be relatively easy to convert them for use in a cumulative averaging system.

Full Taxation of Capital Gains

As previously discussed, many authorities contend that capital gains should not be taxed in the same manner as ordinary income. The following is a brief outline of the rationale which, if accepted, calls for equal treatment of capital gains and losses and ordinary income.

(1) According to the accretion concept of income, accepted by many authorities, capital gains are income; and

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[14]Vickrey, "Averaging of Income," p. 392.

[15]David, <u>Alternative Approaches</u>, p. 189.

with the addition of the realization criteria, capital gains are income, recognized by the accounting profession and the present tax system.

(2) Real capital gains improve the real economic position of the taxpayer and, when realized, represent tax-paying ability.

(3) Illusory capital gains (resulting from changes in the price level, market interest rate, or capitalization rate) improve the relative economic position of the taxpayer. The present federal laws of income taxation are concerned with relative economic positions of taxpayers, as measured by money rather than real income. In addition, there are no special provisions for other problems created by price level, interest, or capitalization rate changes.

(4) Capital gains are uncertain in nature; however, many elements of ordinary income are also uncertain in varying degrees. At any rate, once a capital gain has been realized, the uncertainty is eliminated and may then be taxed.

(5) The disposition of an item should not be a criterion for purposes of classifying income elements. An item of income should be taxed as income, regardless of whether it is consumed or reinvested.

(6) The realization criteria and full taxation of capital gains and losses would create a number of problems

in income taxation; however, the proposal is designed to eliminate or alleviate many of these problems.

(7) Various aspects of existing provisions of federal income tax laws create a lock-in effect on investors. Full taxation of capital gains and losses would probably increase investor lock-in in the present system; however, the proposal is designed to minimize the lock-in effects of the capital gains tax.

(8) The full taxation of capital gains and losses would allow tremendous simplification of the federal income tax laws. In addition, it would eliminate much of the time and effort spent by taxpayers in avoiding income taxes through the capital gains loophole and by the government in administrating and enforcing the income tax laws. This consideration has not been discussed in the preceding sections and requires additional expansion.

Simplification of the Federal Income Tax Laws

The federal laws of income taxation are extremely technical and complicated and provisions pertaining to capital gains and losses create much of the complexity. As stated by Stanley S. Surrey,

> The income tax provisions of the 1954 Internal Revenue Code (most of which are still in effect) represent probably the most complex revenue law ever enacted in the fiscal history of any country. The subject singly responsible for the largest

amount of complexity is the treatment of capital gains and losses.[16]

The proposal presented in this chapter recommends equal treatment of income from capital assets and ordinary income. The numerous provisions necessary to define capital assets, to specify treatment of income from capital assets, to enumerate exceptions and provide special treatment for similar items of favored income may be eliminated. Carl S. Shoup has estimated that 60 to 70 percent of the pages in the Internal Revenue Code could be eliminated if a proposal similar to the one recommended in this chapter were adopted.[17]

Martin David has estimated that "compliance costs" (efforts of accountants, lawyers, taxpayers, and government enforcement agencies) regarding the capital gains loophole may be as high as one billion dollars a year.[18] The income tax laws would be greatly simplified; and the costs of compliance with, and administration of, these laws should be greatly reduced with elimination of special treatment for capital gains and losses.

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[16] Stanley S. Surrey, "Definitional Problems in Capital Gains Taxation," Tax Revision Compendium, Compendium of Papers on Broadening the Tax Base Submitted to the Committee on Ways and Means (Washington, D.C.: U.S. Government Printing Office, 1959), p. 1203.

[17] Shoup, Tax Reform, 1969, pp. 4266-67.

[18] Martin David, "Economic Effects of the Capital Gains Tax," American Economic Review Proceedings, Vol. LIV (May, 1964), 288-299.

Modified Proposal

The preceding recommendation provides for full taxation of capital gains and losses, although our present income tax system has afforded special treatment to such gains and losses for many years. Our society has accepted preferential treatment for capital gains in the income tax laws; however, it has not been proven that this preferentialism provides any greater benefits to the economy than full taxation of capital gains. Nevertheless, if preferential treatment of these gains is desired, the cumulative averaging proposal could be implemented with little modification. Any desired deduction for long-term capital gains could be included in arriving at taxable income, as in the present system.

Compared to the present income tax system, the modified cumulative averaging system would greatly reduce the value of altering the timing of the recognition of gains and losses because of tax considerations. Also, the lock-in effects from the avoidance at death provisions would be eliminated if constructive realization were retained in the modified proposal. The major remaining area of investor lock-in would be created by the holding period requirement. The holding period could remain at six months; and although the resulting lock-in is probably substantial, it is at least only temporary for each appreciated security. If a multiple holding period requirement, such as that discussed in Chapter VI, were adopted, some reduction in strength of investor lock-in from the holding period might be achieved. It appears that a multiple holding period requirement would meet the objectives and would provide several advantages over the present six months requirement. Therefore, if the length of time an asset has been held is to be used in distinguishing those capital gains deserving preferential treatment, a multiple holding period requirement is recommended.

Evaluation of the Proposal's Conformity to the Principles of Taxation

Adequacy of Revenue

The proposed reform should produce greater revenue than the present system of income taxation. The increase would result from taxation of the portion of long-term capital gains that are now deducted from income, the taxation of capital gains that are transferred untaxed at death in estates, and from an increase in the amount of gains realized by reducing the lock-in effects of the tax. In fact, it would be likely that the increase in revenue would be substantial enough to allow considerable reduction in the present tax rates, if desired.

Equity

Many authorities argue that the present preferential treatment of capital gains violates the horizontal equity principle. Horizontal equity requires that taxpayers in similar economic circumstances be taxed equally. If capital gains are income, and if income is the measure of taxpaying capacity, then capital gains should be taxed in the same manner as income from other sources. The proposal's treatment of capital gains and losses would seem to meet the criteria of horizontal equity.

Neutrality

A common interpretation of the neutrality principle is that a tax structure should exert a minimal influence on the choices and decisions of taxpayers. The proposal would be expected to reduce the lock-in effects of the system of taxation and eliminate a major "preference" form of income. To this extent, the proposal would conform to the principle of neutrality better than the present system.

Simplicity

The principle of simplicity connotes that a tax system should be designed to minimize the costs of collection, administration, and enforcement of income taxation. As previously noted, the proposal would substantially reduce the voluminosity and complexity of present tax laws, would simplify the computation of income taxes for the taxpayer, and would reduce administrative effort. The proposal would seem to meet the criteria of simplicity better than the present system.

Summary

This chapter contains a proposal for revision of the federal laws of income taxation concerning the taxation of capital gains and losses. The structure of the proposal was explained, its advantages and disadvantages were discussed, and the characteristics of the system were evaluated on the basis of conformity to the principles of taxation.

CHAPTER VIII

SUMMARY AND RECOMMENDATIONS FOR FURTHER RESEARCH

The provisions of federal income tax laws pertaining to capital gains and losses have been the subject of considerable controversy and criticism over the years. One area of debate and disagreement concerns the existence and degree of influence exerted by lock-in effects of capital gains taxation on investors. A primary purpose of this study was to obtain, from a survey of selected investors, empirical evidence of the extent and significance of investor lock-in from capital gains taxation.

The term lock-in was defined in Chapter I as a situation that exists if a taxpayer is reluctant to dispose of a capital asset because of the federal income tax consequences of the disposition. The hypothesis of the study was that federal income tax implications do influence investors to hold appreciated securities that might otherwise be sold, and therefore that lock-in exists.

The scope of the study was limited to individual taxpayers and their investments in stocks and bonds.

Particular attention was directed toward persons employed in business or professional occupations with above average incomes, because of the economic significance of this group as investors.

A review of the relevant provisions of federal laws of income taxation was presented in Chapter II. The study was concerned with the lock-in effects of the laws as they existed prior to the tax reforms enacted in late 1969. Three aspects of the laws allegedly create major lock-in effects on investors: the holding period, the imposition of a tax on realization of a capital gain, and the provisions for complete avoidance of income tax by transfer of an appreciated asset through an estate.

Some economic aspects of federal taxation of capital gains were discussed in Chapter III. The principles of taxation were briefly explained, and it was noted that preferential treatment of capital gains conflicts with several of these principles. Some of the arguments that have been given as justification for preferential treatment of capital gains were presented. The arguments are based on considerations that make capital gains doubtful elements of income, on technical difficulties of taxing capital gains at the point of realization, or on adverse economic consequences of taxing capital gains in the present tax structure. The undesirable economic consequences resulting from the lock-in effects of capital gains tax were accentuation of stock market fluctuations and distortion of the functioning of the capital market.

Chapter IV contained a description of the methodology utilized in the survey to obtain information from investors concerning the lock-in effects of capital gains taxation.

An evaluation of the extent and significance of investor lock-in created by each of the areas of the capital gains tax was made in Chapter V. The evaluation was based on analyses and conclusions of previous researchers and the results of the survey. An evaluation of the overall lock-in effects of the capital gains tax was then presented. Results of the investigation supported the hypothesis that investor lock-in does exist, and indicated that this lock-in may exert a substantial influence on the decisions of many investors.

Chapter VI contained a review of recommendations for tax reform that have been proposed to reduce or eliminate the lock-in effects of capital gains taxation. Modifications in the treatment of capital gains and losses resulting from the tax reform in 1969 were presented, and their probable influence on lock-in effects of the income tax was discussed. The following chapter contained a proposal for tax reform that appears to provide a more satisfactory treatment of capital gains and losses than the present provisions or the alternatives discussed in Chapter VI.

Recommendations for Further Research

There is a need for additional research and empirical evidence concerning a number of areas involved in the investigation of this project. Among these areas are:

(1) the principles and concepts of taxation,

(2) the definition and measurement of income,

(3) the economic effects of investor lock-in,

(4) the economic effects of preferential treatment of capital gains,

(5) the extent and significance of investor lock-in,

(6) the construction of models of investor decision-making and behavior,

(7) the effects of uncertainty on investment decision-making, and

(8) the various alternative systems of taxation.

Need for additional research and empirical evidence is not the result of a lack of interest in the subjects but is probably due to the intractable nature of these areas. Perhaps as the tools of the quantitative and behavioral fields of the business and economics disciplines become more complete, the problems of measurement and analysis in these areas will be reduced.

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APPENDIX A

APPENDIX A

LIMITATIONS OF THE SCOPE OF THE STUDY

As stated in Chapter I, the scope of this investigation was limited to:

(1) individual taxpayers,

(2) investments in stocks and bonds, and

(3) the group surveyed included business and professional people and a disproportionately large number of high-income persons.

The purpose of this appendix is to explain the reasons for these constraints on the scope of the study.

Individual Taxpayers

Any taxpayer may sustain a capital gain or loss on the sale or exchange of a capital asset. The term "taxpayer" includes many different types of taxable entities. According to the Internal Revenue Code of 1954, "The term 'taxpayer' means any person subject to any internal revenue tax."[1] As defined in the Income Tax Regulations, which provide an official interpretation of the Code,

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[1]Internal Revenue Code, Section 7701 (a) (14).

> The term "person" includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group. Such term also includes a guardian, committee, trustee, executor, administrator, trustee in bankruptcy, receiver, assignee for the benefit of creditors, conservator or any person acting in a fiduciary capacity.[2]

A comprehensive study of such a heterogeneous group of taxable entities was not considered to be feasible or desirable. The following considerations suggest that individual taxpayers are logical and appropriate taxable entities for investigation.

(1) From the U.S. Treasury Department's Statistics of Income, published annually, it is apparent that individuals represent the largest number of taxpayers, and this group reports the largest number and amount of capital gains.

(2) Research on national wealth, discussed in succeeding sections, indicates that individuals hold a substantial percentage of all capital assets owned domestically.

(3) The majority of the literature related to lock-in effects of capital gains taxation is related to individual investors.

(4) Most individual taxpayers are subject to the same basic provisions of federal income tax laws.

(5) Individuals formulate decisions of other taxable entities.

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[2]Regulations 301.7701-1 (a).

(6) The collective judgments of individuals determine the amount and direction of the flow of savings, influencing the allocation of resources.

The investigation concentrates on lock-in effects of capital gains taxation on individual taxpayers. Nevertheless, it is likely that many of the comments and conclusions regarding individuals are applicable to other types of taxpayers faced with decisions concerning capital assets.

Investments in Stocks and Bonds

The term "capital asset" is not positively defined; nor is an exhaustive list of such assets included in the Internal Revenue Code of 1954. The types of capital assets, about which data is provided in the Treasury Department's *Statistics of Income--Sales of Capital Assets Reported on Individual Income Tax Returns*, are corporate stocks, U.S. Government obligations, other bonds, notes and debentures, insurance and annuities, options to buy or sell, commodities, capital gains dividends, share of capital gains or loss from partnerships and fiduciaries, capital gains distributions from small business corporations, liquidation distributions, retirement plan distributions, livestock, timber and coal, oil and mineral interests, partnership interests, assets used in trade or business, property held for personal use, residences, non-business real estate subdivided, farmland with unharvested crops, other farmland, prior years' installment sales, and other type assets.[3]

Because of the large number and diversity of items that may be taxed as capital gains or losses, it seemed advisable to again limit the scope of the study.

Securities (specifically stocks and bonds) were chosen as appropriate capital assets for investigation for the following reasons.

(1) Ownership of securities involves frequent investment decisions because of the relatively liquid nature and ease of transfer of the assets.

(2) Research on individual wealth indicates that stocks and bonds constitute the largest holding of capital assets in the personal sector and the largest dollar amount in annual sales of capital assets by individuals.

(3) The bulk of the literature on lock-in effects of capital gains taxation is concerned with stocks and bonds.

(4) Securities are instrumental in financing business and government and in allocation of resources. Consequently, stocks and bonds were the capital assets selected for investigation in the study. It is likely that a number of comments and conclusions regarding securities are applicable to other types of capital assets.

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[3] . . . 1962 Sales of Capital Assets, pp. 12-15.

The Significance of High-Income Business and Professional People

The New York Stock Exchange Research Department estimates that 26.4 million persons owned shares in publicly held corporations as of January 1, 1969. This represents approximately one of every six persons in the adult population,[4] but the illusion of broad stock ownership that may result from considering numbers of shareholders is deceptive. In fact, there is considerable evidence that a very small number of investors owns a substantial amount of the securities held by individuals.

High-Income Persons

Studies of the distribution of income and wealth in the United States provide convincing evidence that high-income persons, representing only a small percentage of the total population, hold a large percentage of the wealth and securities owned by individuals.

In his comprehensive investigation of wealth, Robert J. Lampman found that:

> Over 30 per cent of the assets and equities of the personal sector of the economy in 1953 are assignable to the top wealth-holders who were 1.6 per cent of the total adult population that year. The top group owned at least 80 per cent of the corporate stock . . . in the personal sector in that year.[5]

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[4] 1969 Fact Book (New York: New York Stock Exchange, 1969), p. 43.

[5] Robert J. Lampman, The Share of Top Wealth-Holders in National Wealth, 1922-56, (Princeton: Princeton University Press, 1962), pp. 23-24.

Edwin Burk Cox reached similar conclusions about the concentration of stockholdings by high-income investors in his book, Trends in the Distribution of Stock Ownership.

> The distribution of shares held beneficially by individuals or families according to the income of these individuals or families has been roughly approximated for recent years as follows: ranked according to income, the 2 per cent of stockholders with the highest incomes hold 25 per cent of the shares; 5 per cent hold 35 per cent; 10 percent hold 45 per cent; 20 per cent hold 55 per cent; and 50 per cent hold 75 per cent. . . . these figures express a minimum estimate of the degree of concentration of stock ownership by income levels of stockholders.[6]

Dorothy S. Projector and Gertrude Weiss, in Survey of Financial Characteristics of Consumers, reported the following observations.

> Investment assets differ from other major forms of wealth in that holdings are not widely diffused throughout the population. The lower half of the income distribution held 16 per cent of the investment assets compared with 29 per cent of liquid assets and of home equities. Investment assets were similar to businesses as to concentration of holdings in the upper income groups. The top tenth of the income distribution owned 56 per cent of the business equity and the same share of the investment assets. . . .
>
> Holdings of marketable securities other than stock were most concentrated in the upper income brackets. The top tenth of the income distribution of consumer units held more than 80 per cent of the total investment in such securities, compared with 45 per cent of total wealth. . . .
>
> Although publicly traded stocks were more generally owned than were other marketable securities, they ranked next after other marketable securities with respect to concentration of holdings. The top income

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[6]Edwin Burk Cox, Trends in the Distribution of Stock Ownership (Philadelphia: University of Pennsylvania Press, 1963), p. 199.

tenth of consumer units owned 62 per cent of the equity in publicly traded stocks.[7]

Table 14 was constructed from data presented in Survey of Financial Characteristics of Consumers. As shown in the table, consumer units in the study with incomes of $7,500 or more (approximately 30 percent of the consumer units) held some 83 percent of the publicly traded stock and some 89 percent of the marketable securities other than stock. Consumer units with incomes of $15,000 or more (approximately four percent of the consumer units) held some 59 percent of the publicly traded stocks and 79 percent of the marketable securities other than stock.

According to the calculations of Jean Crockett and Irwin Friend, in 1960 individuals owned $354 billion of the approximately $500 billion total market value of foreign and domestic stocks held by residents of the United States. They estimated that:

(1) individuals with an adjusted gross income of $100,000 or more, representing about one-tenth percent of all families filing income tax returns, owned approximately one-fifth of the stock owned by individuals, and

(2) families with an adjusted gross income of $25,000 or more, (one percent of all individual taxpayers) held approximately one-half of the stock owned by

[7]Dorothy S. Projector and Gertrude S. Weiss, Survey of Financial Characteristics of Consumers (Washington, D.C.: Board of Governors of the Federal Reserve System, 1966), pp. 14-15.

TABLE 14

INCOME AND DISTRIBUTION OF INVESTMENT ASSETS
(By Consumer Units)

1962 Income (Dollars)	Percent of all Units	Publicly Traded Stock	Marketable Securities Other Than Stock
$ Negative	*	3	*
$ 0-2,999	28	3	8
3,000-4,999	20	4	1
5,000-7,499	22	8	1
7,500-9,999	15	11	6
10,000-14,999	11	13	4
15,000-24,999	3	10	8
25,000-49,999	1	18	14
50,000-99,999	*	12	39
100,000 and Over	*	19	18
TOTALS**	100	100	100

* Insignificant Amounts--Less than 1/2 of one percent.

**Details may not add to totals because of rounding.

Source: Projector and Weiss, <u>Survey</u>, pp. 136, 151.

individuals. In a discussion of the accuracy of these estimates, they stated:

> . . . the distribution of direct ownership of stock among different income classes is probably somewhat

> more concentrated than these estimates would suggest. . . .[8]

The Projector-Weiss study, one of the most recent and comprehensive investigations of individual wealth, provides additional support for the conclusion that high-income individuals hold more wealth and investments (including stocks and bonds) than other persons.

Table 15 reported in the Federal Reserve Bulletin, presents the average amount of investment assets held by the families surveyed. The information in the table indicates a wide variation in the average amount of investment assets held by families in different income classes. Families with higher incomes held significantly more investment assets (including stocks and bonds) than those with lower incomes.

Table 16 displays information concerning the holdings of publicly traded stock by income class. The data suggest a strong relationship between income of the consumer unit and the amount of equity in publicly traded stock held by the unit. Eighty-four percent of all consumer units had no equity in publicly traded stocks, and only one percent had an equity of $50,000 or over. Consumer units with larger incomes tend to have larger amounts of equity. Eighty-eight percent of the consumer units with incomes of $100,000 and

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[8] Jean Crockett and Irwin Friend, "Characteristics of Stock Ownership," Proceedings of the Business and Economic Statistics Section of The American Statistical Association (Washington, D.C., 1963), p. 167.

TABLE 15

SELECTED COMPONENTS OF NET WORTH
Mean amount of specified assets held by all families
In dollars

Group Characteristic	Business, profession (farm and nonfarm)	Liquid and investment assets					
				Investment assets			
		All	Liquid assets	All	Stocks	Marketable bonds	Other
All families.......	3,913	9,642	2,579	7,063	4,072	456	2,535
1962 income:							
0-$2,999...........	1,418	3,458	1,330	2,128	1,480	201	448
$3,000-4,999.......	1,902	4,663	1,738	2,925	818	19	2,088
$5,000-7,499.......	2,050	5,426	1,716	3,710	2,365	18	1,326
$7,500-9,999.......	2,577	7,500	2,722	4,779	1,476	44	3,258
$10,000-14,999.....	5,174	11,202	4,233	6,969	3,761	316	2,893
$15,000-24,999.....	9,088	39,880	9,241	30,638	18,733	1,445	10,460
$25,000-49,999.....	66,144	111,761	19,098	92,663	58,111	4,742	29,810
$50,000-99,999.....	251,977	387,573	41,845	345,728	204,665	71,971	69,092
$100,000 and over..	288,915	1,058,672	54,426	1,004,246	758,253	121,985	124,008

Source: "Survey of Financial Characteristics of Consumers," Federal Reserve Bulletin, Board of Governors, The Federal Reserve System (Washington, D.C.: March, 1964), p. 293.

TABLE 16

INCOME AND SIZE OF EQUITY IN PUBLICLY TRADED STOCK
(Percentage distribution of consumer units)

Group Characteristic	All units	Negative	Zero	$1-199	$200-499	$500-999	$1,000-1,999	$2,000-4,999	$5,000-9,999	$10,000-14,999	$15,000-24,999	$25,000-49,999	$50,000 and over
All units............	100	*	84	2	1	2	2	3	2	1	1	1	1
1962 income:													
0-$2,999...........	100	*	93	1	*	1	1	1	1	*	1	*	*
$3,000-4,999.......	100	*	92	1	1	1	*	2	1	1	1	1	*
$5,000-7,499.......	100	*	85	3	2	2	3	1	1	*	2	1	1
$7,500-9,999.......	100	*	81	2	4	2	2	4	1	1	*	*	1
$10,000-14,999.....	100	*	68	4	2	3	5	6	6	3	1	2	2
$15,000-24,999.....	100	1	48	3	*	5	8	9	7	4	6	6	4
$25,000-49,999.....	100	*	17	*	3	5	7	11	4	5	10	12	25
$50,000-99,999.....	100	*	12	*	1	*	1	22	2	5	4	17	36
$100,000 and over..	100	*	3	*	*	1	*	1	1	*	*	7	88

*Less than 1/2 of one percent.

Source: Projector and Weiss, Survey, p. 104.

over had an equity of $50,000 or more, and 95 percent of these units had an equity of $25,000 or more in publicly traded stocks.

Table 17 provides an estimate of the distribution of income among consumer units in 1962. Approximately 15 percent of the consumer units had an income of $10,000 or more, and approximately four percent had an income of $15,000 or more.

TABLE 17

INCOME OF CONSUMER UNITS

1962 Income	Percent of all Units
Negative	*
$ 0-2,999	28%
$ 3,000-4,999	20
$ 5,000-7,499	22
$ 7,500-9,999	15
$ 10,000-14,999	11
$ 15,000-24,999	3
$ 25,000-49,999	1
$ 50,000-99,999	*
$ 100,000 and over	*
	100%

*Insignificant Amounts--Less than 1/2 of one percent.

Source: Projector and Weiss, Survey, p. 181.

Table 18 presents a comparison of the distribution of investment assets by income class and in conjunction with Table 17 indicates the degree of concentration of securities in portfolios of high-income persons. Consumer units with incomes of $7,500 or more (about one-third of the total

TABLE 18

INCOME AND DISTRIBUTION OF INVESTMENT ASSETS
(Percentage of total dollars of equity in specified assets held by consumer units)

Group Characteristic	Business, profession (farm and nonfarm)	Portfolio of liquid and investment assets: All	Liquid assets	Investment assets: All	Publicly traded stock	Marketable securities other than stock	Mortgage assets	Real estate	Business not managed by unit
All units	100	100	100	100	100	100	100	100	100
1962 income:									
Negative	1	1	*	2	3	*	*	2	*
0-$2,999	10	8	15	5	3	8	9	5	10
$3,000-4,999	6	10	13	9	4	1	15	12	29
$5,000-7,499	12	10	15	8	8	1	6	12	8
$7,500-9,999	9	14	16	13	11	6	27	18	9
$10,000-14,999	12	14	18	12	13	4	12	13	10
$15,000-24,999	9	12	12	12	10	8	16	14	12
$25,000-49,999	15	13	7	16	18	14	4	18	12
$50,000-99,999	20	9	4	11	12	39	10	3	7
$100,000 and over	5	9	2	12	19	18	2	2	3

*Less than 1/2 of one percent.

Source: Projector and Weiss, Survey, p. 136.

number of consumer units) held some 83 percent of the publicly traded stock and 89 percent of the marketable securities other than stock. Consumer units with an income of $15,000 or more (about four percent of the total number) held some 51 percent of the publicly traded stock and 79 percent of the marketable securities other than stock.

Business and Professional People

The research also indicates that persons in business or professional occupations tend to have above average amounts of income and security holdings. Table 19, from the 1967 Survey of Consumer Finances, indicates that persons employed in business and professional occupations have average incomes substantially above other occupations.

Table 20, from Share Ownership in the United States, displays a connection between share ownership and occupation. Almost 45 percent of the administrative executives, about 19 percent of the operating supervisory officials, and about 13 percent of the professionals owned stock. It would appear that business and professional people are, therefore, more likely to own stock than other occupational groups.

Most research on asset ownership also indicates that the business and professional group owns a very large proportion of the securities held by individuals. Table 21 was extracted from A Study of Savings in the United States.

TABLE 19

MEAN AND MEDIAN FAMILY INCOME--BY OCCUPATION
Percentage distribution of families

Occupation	Mean income in 1966	Total	Less than \$3,000	\$3,000-4,999	\$5,000-7,499	\$7,500-9,999	\$10,000-14,999	\$15,000 or more	Median
Professional, technical	\$12,310	100	3	5	17	20	32	23	\$10,690
Managers, officials	12,940	100	1	3	15	21	37	23	11,390
Self-employed businessmen, artisans	14,260	100	9	10	18	16	22	25	9,530
Clerical, sales	8,580	100	5	15	26	23	21	10	7,930
Craftsmen, foremen	9,310	100	3	10	21	26	31	9	9,060
Operatives	7,540	100	8	17	28	25	20	2	7,290
Laborers, service workers	5,310	100	27	24	25	15	8	1	4,900
Farmers	7,060	100	21	19	27	14	13	6	5,760
Miscellaneous groups	8,130	100	31	18	23	12	8	8	5,160
Retired	3,630	100	57	21	10	6	4	2	2,620

Source: George Katona, James N. Morgan, Jay Schmiedeskamp, John A. Sunquist, _1967 Survey of Consumer Finances_, Survey Research Center, Institute of Social Research (Ann Arbor: University of Michigan, 1968), p. 70.

TABLE 20

INDIVIDUAL SHARE OWNERS OF PUBLICLY OWNED STOCKS DISTRIBUTED BY OCCUPATIONAL GROUPS

Occupation	Number in Population	Individual Share Owners (As a percent of total)
Administrative executives	670,000	44.8
Operating supervisory officials	3,190,000	19.4
Professional persons--personal service[a]	2,980,000	12.4
Professional persons--technical fields[b]	2,270,000	13.2
Sales personnel[c]	1,780,000	11.2
Merchants[d]	2,360,000	10.6
Clerical and kindred workers	7,790,000	7.6
Farmers	4,700,000	6.8
Skilled workers--foremen	9,310,000	4.4
Public service workers	1,180,000	3.4
Semiskilled workers	15,090,000	1.4
Unskilled workers	5,640,000	0.2
Members of armed forces[e]	1,820,000	1.1
Employed--occupation unidentified	390,000	[f]
Non-employed adults	2,250,000	1.3
Non-employed--retired, dependent	6,180,000	9.1
Housewives--non-employed	35,600,000	6.0
Students and preschool age	52,320,000	0.2
Total	155,520,000	4.2

[a]Includes professional persons who render direct personal service such as doctors, lawyers, dentists, educators, clergymen, and the like.

[b]Includes persons engaged in technical professions such as architects, engineers, chemists, and auditors.

[c]Representatives of wholesalers and manufacturers.

[d]Includes wholesale.

[e]Includes only those members of the armed forces who are members of family groups.

[f]Less than 10,000 share owners in the group.

Source: Lewis H. Kimmel, Share Ownership in the United States (Washington, D.C.: The Brookings Institution, 1952), p. 98.

TABLE 21

DISTRIBUTION OF STOCK HOLDINGS BY OCCUPATIONAL GROUP

Occupational Group	Stock Holdings* (Percent of Total)
Professional and Semi-Professional .	18
Managerial	5
Self-employed.	35
Clerical and Sales	4
Skilled and Semi-Skilled	2
Unskilled and Service.	1
Farm Operator	2
Retired.	24
All Other.	9
All Cases.	100

*Includes closely held corporations.

Source: Raymond W. Goldsmith and Dorothy S. Brady and Horst Menderhausen, A Study of Savings in the United States (Princeton: Princeton University Press, 1956), Vol. III, p. 127.

According to the estimates presented in Table 21, people in managerial and professional occupations, and self-employed persons held about 58 percent of the stock owned by individuals. This percentage would probably be increased by inclusion of retired persons who had been members of these occupational groups prior to retirement.

Jean Crockett and Irwin Friend concluded that business and professional people own a majority of stock held by individuals. Table 22 summarizes some of their findings. The occupations of 25 percent of the individuals included in Table 22 were not determinable. However, as shown by the table, business and professional people owned 54 percent of

TABLE 22

DISTRIBUTION OF MARKET VALUE OF INDIVIDUALS' STOCKHOLDINGS BY OCCUPATION

Occupation	Total (Percent)	Total of Known Occupations*** (Percent)
Managers, officials and proprietors*	25.9	34.6
Professionals*	14.1	18.9
Clerical	3.0	4.1
Sales	4.9	6.6
Farmers	2.4	3.2
Other employees (including armed forces)	4.9	6.5
Retired	13.6	18.1
Others not gainfully employed	6.2	8.3
Not known	25.2	--
Totals**	100.0	100.0

*Both salaried and self-employed.

**Columns may not add to totals because of rounding.

***Calculated from preceding column.

Source: Crockett and Friend, "Characteristics of Stock Ownership," p. 157.

the stock held by persons whose occupations were known. This percentage would probably be considerably higher if the retired persons who had been in business or professional occupations prior to retirement were included.

In their conclusions, Crockett and Friend noted that,

> The two occupational groups which show an outstanding propensity to hold stocks are the managerial group and those in the professions.[9]

Thomas Atkinson reported similar findings in The Pattern of Financial Asset Ownership. In his words,

> There are significant differences among occupational groups in the types of financial assets held, both as to frequency of ownership and as to shares of the total dollar value of each type of asset. Most striking is the large proportion of corporate stock held by managerial and self-employed persons.[10]

In summary, the preceding discussions indicate that high-income business and professional people are a highly significant group of investors, and because of this, the survey included individuals in business or professional occupations and a disproportionately large number of high-income persons.

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[9] Crockett and Friend, "Characteristics of Stock Ownership," p. 167.

[10] Thomas R. Atkinson, The Pattern of Financial Asset Ownership--Wisconsin Individuals, 1949, A Study by the National Bureau of Economic Research, New York (Princeton: Princeton University Press, 1956), p. 106.

APPENDIX B

COLLEGE OF BUSINESS ADMINISTRATION
DEPARTMENT OF ACCOUNTING

THE UNIVERSITY OF OKLAHOMA
NORMAN, OKLAHOMA, 73069

Dear Sir:

As a part of the requirements for a Ph.D. degree, I am writing a doctoral dissertation concerned with investor attitudes toward the capital gains tax. My research design is such that I must obtain from a select group of high-income individuals, such as yourself, the information necessary to establish my hypothesis.

Your response is essential to the successful completion of the research, and it will be kept strictly confidential. It is not necessary and, in fact, not possible for me to identify any particular respondent. You will note that the questionnaire has been designed so that only about twenty minutes of your time will be required to complete and return it.

Since my research must be completed by January 1, 1970, would you please take a few minutes and complete the questionnaire now?

Thank you very much for your generous and invaluable assistance to my educational endeavor.

Sincerely,

Donald R. Nichols

Donald R. Nichols

DRN/pas

CONFIDENTIAL QUESTIONNAIRE

1. Are you married? ☐ yes ☐ no. How many children do you have?_____

2. What is your present age in years?_____ What is your sex? ☐ male ☐ female

3. What is the approximate current market value of your and your immediate family's investments in stocks and bonds? . . . . $________________

4. What percent of the dollar amount of stocks and bonds in the answer to question 3 do you manage personally? (make buy, sell, hold, etc., decisions). . . . . ________________%

5. Are any of these securities worth considerably more now than when you got them? ☐ yes ☐ no

If yes

What are your primary reasons for holding, rather than selling these appreciated securities? (May require more than one answer for several securities held or several reasons for holding.)

- ☐ Have never considered selling them
- ☐ Rarely, or never sell appreciated securities
- ☐ No better investment available
- ☐ Expectation of further appreciation
- ☐ Tax considerations
- ☐ Difficult to sell, or not marketable
- ☐ Other reasons_________________________

The influence of Federal taxes on your decisions to hold, rather than sell any of these appreciated securities has been:

- ☐ A dominant influence
- ☐ A significant, but not dominant influence
- ☐ Of little influence
- ☐ Of no influence

If you have been influenced at all by federal taxes, which aspects (may be more than one) of taxation have affected your decisions to hold, rather than sell these appreciated securities?

- ☐ Had not held the security for six months
- ☐ Desire to postpone the tax that will have to be paid when the security is sold
- ☐ Desire to completely avoid the tax on the appreciation by including the security in my estate at death
- ☐ Other____

6. A taxpayer may completely avoid federal income taxes on capital gains from securities which are included in his estate at death. Were you aware of this fact? ☐ yes ☐ no

If yes

Has this fact influenced any of your decisions to hold, rather than sell any appreciated securities? ☐ yes ☐ no ☐ no appreciated securities

The influence which this fact has had on your decisions to hold, rather than sell these appreciated securities has been:

- ☐ A dominant influence
- ☐ A significant, but not dominant influence
- ☐ Of little influence
- ☐ Of no influence

7. If you had received one more dollar of <u>ordinary income</u> in 1968, what percentage of that dollar would you have had to pay in federal income taxes? <u>ESTIMATE ONLY</u> ____________________%

8. If you had received one more dollar of <u>long-term capital gains income</u> in 1968, what percentage of that dollar would you have had to pay in federal income taxes? <u>ESTIMATE ONLY</u> ____________%

9. Do you generally try to hold your securities at least six months? ☐ yes ☐ no

If yes

The influence of the capital gains tax on your desire to hold securities at least six months has been:

- ☐ A dominant influence
- ☐ A significant, but not dominant influence
- ☐ Of little influence
- ☐ Of no influence

10. Do you expect a change in your future income which will affect the rate at which your income is taxed? (Ignore tax rate variations due to the surcharge or possible modifications of the present income tax structure.) ☐ yes ☐ no

If yes | Has this expected change in your tax rate had an influence on any of your decisions concerning your security portfolio? ☐ yes ☐ no

If yes, what change do you expect in the rate at which your income is taxed?

☐ A substantial increase in tax rate
☐ A moderate increase in tax rate
☐ No change in tax rate
☐ A moderate decrease in tax rate
☐ A substantial decrease in tax rate
☐ Other______________________

Has this expected change in your tax rate influenced you to:

☐ Hold a security which has increased in price since you got it
☐ Sell a security which has increased in price since you got it
☐ Hold a security which has decreased in price since you got it
☐ Sell a security which has decreased in price since you got it
☐ Other______________________

The answers to the following four questions should be obtained from your 1968 federal income tax return.

11. What was the amount of your 1968 "adjusted gross income" (gross income less business deductions --found on page 1, line 9 of Form 1040)? . . . . $__________

12. What was the amount of your 1968 "taxable income" (income after all exemptions and deductions are subtracted--found on page 1, line 11d of Form 1040)? . . . . $__________

13. As defined by your 1968 federal income tax return ("Your Filing Status") were you:

☐ Single
☐ Married filing joint return
☐ Married filing separately
☐ Unmarried Head of Household
☐ Surviving Widow(er) with dependent child

14. The answer to the four questions above were ☐ obtained from your 1968 return, or ☐ estimated?

15. Have you ever made a gift of an appreciated asset (other than a charitable contribution) to minimize or reduce your income or estate taxes? ☐ yes ☐ no. Do you plan to make such a gift in the future? ☐ yes ☐ no

16. Do you presently own any security which you would sell if there were no capital gains tax? ☐ yes ☐ no. If yes, this statement is true of approximately what percent of the total market value of your security portfolio? ________%

The following question is concerned with a hypothetical investment decision. You are to assume that the only difference between stocks in the question is the difference in expected price increases. The returns (dividends and appreciation) are exact and certain to occur. There is no risk in either.

17. You own Stock "A" which has a current market value of $100 and is certain to pay no dividends, but is certain to increase in price at the rate of 10 per cent annually for the next ten years. You are considering the sale of Stock "A" and the reinvestment of all the after-tax proceeds ($82.50) in Stock "B," which is certain to pay no dividends in the next ten years. You must assume that the performance of both stocks will be equal after 10 years.
QUESTION: Indicate the minimum annual percentage increase in the price of Stock "B" which would make the sale of Stock "A" and the purchase of Stock "B" profitable.
☐ 10% ☐ 11% ☐ 12% ☐ 13% ☐ 14% ☐ 15% ☐ 16% ☐ 17% ☐ 18% ☐ 19% ☐ 20% or over
☐ I am unable to compute ☐ Other______________________

18. Please indicate any additional comments, suggestions or ideas which might be helpful to me in this study.______________________

THANK YOU VERY MUCH.