February 13, 1945.

Honorable Ganson Purcell,
Chairman,
Securities and Exchange Commission,
18th and Locust Streets,
Philadelphia 3, Pennsylvania.

Dear Ganson:

On reading a recent speech by Randolph Paul on the capital gains tax, it occurred to me that you might be interested in seeing the enclosed excerpts from it because it brings out the fact that the alleged deterrent effects on new enterprise have so often been grossly exaggerated. Of course the situation has changed drastically since 1938 when tax rates on the upper income groups were much lower and there was no such incentive as now exists for either individuals or corporations to enter the real estate field as well as the stock market. While Randolph is not discussing the capital gains tax as an anti-inflation device, nevertheless, his comments seem to me pertinent to our discussion and to the problem of making sure that the tax does not get in the way of desirable venture capital after the emergency.

I was particularly struck by the fact that in 1938 capital gains were so heavily concentrated in the very high income groups. So far as I am aware, none of these groups who are now discussing postwar taxation propose to do away with the tax on capital gains. Thus, the CED advocates the full taxation of capital gains coupled with full deduction of capital losses when corporate and personal income taxes have been substantially reduced. And even the so-called Twin Cities Tax Plan would retain a capital gains tax of 12-1/2 per cent after the war.

With best regards,

Sincerely yours,

Enclosure

ET:b

February 13, 1945.

Honorable Fred M. Vinson,
Director,
Office of Economic Stabilization,
Federal Reserve Building,
Washington 25, D. C.

Dear Fred:

I am enclosing an excerpt from a speech given by Randolph Paul on the capital gains tax, which has just come to my desk. I was impressed on reading it over with his comment on the fact that the allegedly deterrent effects on venture capital have been greatly exaggerated in the past. He is talking about postwar and not discussing the tax as an anti-inflation instrument but, nevertheless, I thought his comment interesting and illuminating.

I was particularly struck by the heavy concentration of capital gains from stock market operations in 1938. At that time, of course, individual and corporate income taxes were much lower than they are now and there was not the great differential that adds to the inducement to both individuals and corporations to go into real estate as well as into the stock market.

So far as I am aware, the outstanding groups which have lately been discussing postwar taxation, such as those represented in the CED, in the Ruml-Sonne plan, as well as in the Twin Cities Tax Plan, do not propose to do away with the capital gains tax. The CED, which is especially concerned with inducing venture capital, advocates, for example, the full taxation of capital gains coupled with full deduction of capital losses when corporate and personal income taxes have been substantially reduced in the postwar.

Sincerely yours,

Enclosure

BT:b

"The theory is frequently voiced that profits realized over a period of time from investment in securities or property should not be taxed in the ordinary way because it would have a deterrent effect on risk capital. So, it is urged, the capital gains rate should be lowered, or the tax eliminated, as an incentive to business. Critics insist that the tax has a 'chilling effect' and 'checks risk taking', that its repeal would free 'venture capital'. Some even go so far as to say that the elimination of the tax would stop depressions.

"They further argue that revenue would be increased by repeal or reduction of the tax, since market activity would be stimulated by removing a barrier to selling. The idea is that the tax inhibits selling, especially in the case of older investors who will be able at death to pass on their gains tax free. Congressional committees have been wooed with extravagant estimates of increased yield. These claims, however, over-simplify the problem. No one will deny that the capital gains tax has a regulatory effect. That is true of any tax. But many factors determine the yield of a tax on capital gains: the level of the market, anticipation of future prices and future taxes, the cost of assets in the hands of the holders, the distribution of assets by income brackets, and the extent to which individuals holding assets with gains also hold assets with losses. The method of taxing capital gains is only one of many factors affecting the amount of gains realized. Variations in capital gains revenue have been determined primarily by changes in stock prices rather than by changes in tax methods. Furthermore, the elimination of the capital gains tax would not stop depressions. We had depressions before we had the tax. England does not have the tax and it has depressions.

"We must also distinguish between long-run and short-run revenue effects, and between the direct yield from the capital gains tax and its indirect effects. The tax is designed not only to raise revenue directly, but also to prevent the avoidance of other taxes. Other income can be converted into capital gains in many ways as, for example, by allowing profits to remain in corporations. Section 102 of the Internal Revenue Code, which is designed to prevent avoidance of individual income taxes by the accumulation of corporate surpluses, is not adequate to prevent this avoidance.

"Finally, we should know who realizes most capital gains. About 80 per cent of capital gains come from stock market operations, and a slightly smaller percentage of losses. In 1938, a fairly typical year, capital gains constituted less than 1 per cent of the net income reported by individuals with incomes under $5,000, less than 3 per cent of the net income of persons with incomes between $5,000 and $25,000, and 96 per cent of the net income of persons with incomes over $25,000.

"The distribution of capital gains is preponderantly to the high incomes. The income class from $100,000 to $1 million, for example, reported in 1938 only 2.5 per cent of aggregate net income, but it reported 33 per cent of capital gains. It is plain to see that a more favorable treatment of capital gains would benefit only a small high income group.

"Arguments for special treatment of capital gains, based on the premise that concessions in this direction would stimulate business activity, fail to face the choices before us. Practically every tax has some effect on the willingness of investors to risk their capital in hazardous enterprises. High surtaxes have that effect. So do corporate taxes. But what are the alternatives? Merely a choice of evils. We cannot renounce all taxes because they reduce business activity. That would be jumping from the frying pan into the fire."

ADVANCE RELEASE

For use after 6:30 p.m., EWT, Tuesday, January 30, 1945.

Text of address by Randolph E. Paul, former General Counsel of the Treasury, at the fifth dinner forum of the New School, 66 West 12th Street, New York City, at 6:30 p.m., EWT, Tuesday, January 30, 1945.

THE TREATMENT OF CAPITAL GAINS AND LOSSES

I hardly need tell you how much at home I feel at the New School. I have participated in many stimulating discussions here and it is good to be back again.

There are two principal drawbacks to being a member of a panel such as this. The first is having too much to say so you must race to the finish. The second, and the more formidable, is the necessity of following other speakers who are sure to say all the things you meant to say -- and better than you.

Sound results in taxation are not always achieved in direct proportion to the number of words that are spoken and written on a particular subject. Sometimes the very opposite may be true -- as, for example, with the treatment of capital gains and losses. Reams have been written about them and for three decades they have been the subject of almost constant debate. Today they still pose an unsolved problem.

Before 1921 capital gains were taxed in the same manner as any other income, and losses were deductible without restriction. Since 1921 our tax system has distinguished between the common garden variety of gains and the kind known as "capital" gains. It has also differentiated between ordinary losses and capital losses. There is, of course, another possible method of treating capital gains and losses, and that is to ignore them altogether. This is what the British are somewhat inaccurately said to do.

Why should capital gains be treated more favorably than any other kind of income? Advocates of special treatment have one good reason for their stand and several other reasons which, I believe, weaken under the light of careful scrutiny.

The good reason applies only to gains which have accrued over a reasonably long period of time -- at least more than a year. Realizing a gain in a single year bunches in that year income that has accrued over a longer period. So the tax is higher than it would have been if the gain had been taxed bit by bit as it grew. A highly progressive rate structure and high rates emphasize this inequity. It is no more than fair that the tax on a gain when realized should approximate a year-by-year tax as the gain accrued.

However, this reasoning is only partially sound. It is based on the premise that gains do accrue ratably over the period of ownership of an asset. But that is not always true. It may be true of an evenly developing real estate gain, or a stock gain arising from the steady accumulation of profits in a corporation. It is not true of a real estate gain that arises from a sudden community boom or that stems fortuitously from some local improvement. It would not be true of many stock gains which reflect expectations of enhanced future profits.

Nevertheless, it is probably true that a large proportion of capital gains do accrue gradually, if not evenly, over the period of ownership, and there is much rough justice in extending to them a tax treatment which avoids the effect of an artificial concentration of taxable income in one year. The 1934 Revenue Act applied this theory. It provided for taxing capital gains according to the length of time the assets had been owned; the longer the period, the lower the tax. No special treatment was available until an asset had been held over a year. Whatever its faults, this provision had much in its favor from the standpoint of equity.

Another argument for special treatment, frequently advanced, is more vulnerable. The contention is that capital gains merely reflect a general rise in the price level, so there is no real increment at all in terms of purchasing power. They may be no more than a manifestation of inflation. Therefore, say the advocates of special treatment, capital gains are illusory.

But the fact remains that price fluctuations affect all kinds of income. Higher wages may not represent any increase in a man's ability to pay taxes, if the cost of living has kept pace with the wage rise. No tax law can do absolute justice all along the line in an economy of shifting dollar purchasing power.

The impossibility of doing absolute justice is not a valid reason for failing to do justice that can be done. A perfectionist is a dangerous man in the tax world, which is full of things that need to be done as well as they can be done. War conditions have accentuated a problem which was with us before the war, but which now recurs too frequently to be neglected any longer. I want to give you a simple case history. In 1913 Mr. Smith came to Washington to work for the Government. He bought a house for $5,000. In 1943, after he had devoted 30 years to Government service, he was ordered to Chicago. He sold his house for $15,000 and moved his family. Plainly he had a capital gain of $10,000. But Mr. Smith was spoiled; he liked to own his home; moreover, in Chicago he could find no apartment at a reasonable rental. So he bought another house. It was no better than the one he had sold in Washington, but it cost him $15,000, exactly the amount he had received for his Washington house.

The amount he had received, yes. But not the amount he had left in his pocket. The Treasury had part of the first $15,000, and Mr. Smith had to dip into his savings to pay for the second house.

Mr. Smith's tax lawyer told him he had no recourse. But if Mr. Smith had been in business and his house had been a ship which was requisitioned by the Government for $15,000, the advice would have been different. Then he would have had an "involuntary conversion", and he could have established a fund with the first $15,000 to replace the ship. Then he would have had no taxable gain, and the $15,000 would have been in his pocket and available to buy the second ship.

In practical fact, Mr. Smith had an involuntary conversion. He had no choice but to go to Chicago. It is hard to see why he should not enjoy the financial position in Chicago that he did in Washington.

There are thousands of Mr. Smiths in Government and in business. Never were business conditions so chaotic as today, and never was so much geographical shifting of personnel required both by business and Government. If Mr. Smith were politically-minded, he could make a strong case for tax relief. He has had no increase in the type of wealth which gives him ability to pay taxes. But he is just an ordinary citizen, not an oil company, or a lumber owner, or a commercial air line, or the owner of a natural gas pipe line. So he takes his medicine. But the income tax is not popular in that house in Chicago. Mr. Smith might pay his other taxes more willingly if he thought he had been fairly treated.

Of all the reasons urged for eliminating or reducing the capital gains tax, the lamest is that we should emulate the British. It is true that the British tax gains from transactions that are part of the taxpayer's regular business at regular rates. But the British situation differs fundamentally from ours. Transactions which are not part of a taxpayer's regular business are relatively less important in Great Britain than they are here. But, even more significant, the British system permits serious tax avoidance, and for that reason it has been condemned by British tax authorities.

The theory is frequently voiced that profits realized over a period of time from investment in securities or property should not be taxed in the ordinary way because it would have a deterrent effect on risk capital. So, it is urged, the capital gains rate should be lowered, or the tax eliminated, as an incentive to business. Critics insist that the tax has a "chilling effect" and "checks risk taking", that its repeal would free "venture capital". Some even go so far as to say that the elimination of the tax would stop depressions.

They further argue that revenue would be increased by repeal or reduction of the tax, since market activity would be stimulated by removing a barrier to selling. The idea is that the tax inhibits selling, especially in the case of older investors who will be able at death to pass on their gains tax free. Congressional committees have been wooed with extravagant estimates of increased yield. These claims, however, over-simplify the problem. No one will deny that the capital gains tax has a regulatory effect. That is true of any tax. But many factors determine the yield of a tax on capital gains: the level of the market, anticipation of future prices and future taxes, the cost of assets in the hands of the holders, the distribution of assets by income brackets, and the extent to which individuals holding assets with gains also hold assets with losses. The method of taxing capital gains is only one of many factors affecting the amount of gains realized. Variations in capital gains revenue have been determined primarily by changes in stock prices rather than by changes in tax methods. Furthermore, the elimination of the capital gains tax would not stop depressions. We had depressions before we had the tax. England does not have the tax and it has depressions.

We must also distinguish between long-run and short-run revenue effects, and between the direct yield from the capital gains tax and its indirect effects. The tax is designed not only to raise revenue directly, but also to prevent the avoidance of other taxes. Other income can be converted into

capital gains in many ways as, for example, by allowing profits to remain in corporations. Section 102 of the Internal Revenue Code, which is designed to prevent avoidance of individual income taxes by the accumulation of corporate surpluses, is not adequate to prevent this avoidance.

Finally, we should know who realizes most capital gains. About 80 percent of capital gains come from stock market operations, and a slightly smaller percentage of losses. In 1938, a fairly typical year, capital gains constituted less than 1 percent of the net income reported by individuals with incomes under $5,000, less than 3 percent of the net income of persons with incomes between $5,000 and $25,000, and 96 percent of the net income of persons with incomes over $25,000.

The distribution of capital gains is preponderantly to the high incomes. The income class from $100,000 to $1 million, for example, reported in 1938 only 2.5 percent of aggregate net income, but it reported 33 percent of capital gains. It is plain to see that a more favorable treatment of capital gains would benefit only a small high income group.

Arguments for special treatment of capital gains, based on the premise that concessions in this direction would stimulate business activity, fail to face the choices before us. Practically every tax has some effect on the willingness of investors to risk their capital in hazardous enterprises. High surtaxes have that effect. So do corporate taxes. But what are the alternatives? Merely a choice of evils. We cannot renounce all taxes because they reduce business activity. That would be jumping from the frying pan into the fire.

And what of capital losses? Existing law limits the right to deduct losses in various ways. Some taxpayers think that the Government is guilty of sharp practice in taxing their gains in full and refusing to give the same full consideration to their losses. If capital gains were taxed in full, there would be no justification for any such limitation. But the favored treatment of capital gains, plus the fact that the timing of both gains and losses is largely an option of the taxpayer, affords considerable justification on grounds of equity.

However, the problem goes beyond strictly equitable considerations. The question of risk-taking is relevant. As things now are, the extent to which investors may use the limited loss provisions of the statute depends primarily upon the availability of other income. Obviously, the positions of taxpayers differ widely in this respect. There are discriminations between large and small investors; large investors

are more likely to have other income against which to offset losses. Inequities of this type increase economic concentration and tend to lower the volume of new investment. It is worth serious consideration whether the gain to the economy to be derived from increased risk-taking would not be worth more than the revenue loss involved in some reasonable averaging devices, the extension of the carry-forward period for losses, and a less discriminatory treatment of capital losses. Such provisions would, however, take away much of the existing justification of special treatment for capital gains. They would leave untouched the justification inherent in the argument that capital gains are "bunched" in a single year, and perhaps the argument (applicable only to stock transactions) that a differential rate is justified by the corporate tax.

The postwar tax plan of the Committee for Economic Development advocates the full taxation of capital gains and the full deduction of capital losses [redacted] when corporate and personal income taxes have been substantially reduced and the averaging of income is permitted. For the present, like the Ruml-Sonne plan, the CED recommends a retention of the present differential treatment. The CED also recommends that capital gains and losses should be recognized at transfer by gift or at death. The Twin Cities Tax Plan, on the other hand, would reduce the tax on capital gains to 12-1/2 percent.

A short time ago I remember hearing over the radio the words: "It's time for a change." I think it is time for a change -- for another kind of change -- a change in emphasis. Capital gains are, after all, only one small sector of our tax front. Instead of tinkering with the treatment of capital gains, let's take a longer and broader view. Our future taxes will have an important bearing upon our postwar economy and our national well-being. A sound overall system will help toward full employment and prosperity. Let's go after a postwar tax system that will produce capital gains instead of capital losses. Let's keep our eyes on that ball. Then taxes will take care of themselves.