May 16, 1946

Chairman Eccles

Senator Fullbright's Amendment

Richard A. Musgrave

I am attaching the proposed amendment, with a brief explanatory statement for transmittal to the Senator.

As you will note I have proposed that the new provision should apply to the sale of assets purchased after the date of introduction. This is much simpler than the alternative provision of applying it to the sale of any asset after the introduction of the amendment, whenever purchased. The latter provision might have some equity advantage. However, it would not be better with regard to curtailing future buying, and it might in the short-run have some tendency to curtail selling.

Alternatively, the provision might have been made effective for any sale after July 1. This might have the advantage of inducing a selling spree in the interim, but would have the disadvantage of being somewhat unpredictable in its effects.

The solution proposed in the amendment seems simplest and, on the whole, best.

Attachments

RAM:lmb

AMENDMENT TO THE BILL (S--) FOR THE EXTENSION OF THE EMERGENCY PRICE CONTROL ACT OF 1942

(1) The dividing line between long-term and short-term capital gains and losses as defined in Section 117 of the Internal Revenue Code is changed from 6 months to 18 months by striking out the words "6 months" wherever they appear in said section, as well as in Sections 115, 182, 711, and 720, and substituting therefor the words "18 months".

(2) This amendment shall be effective for gains or losses incurred in the sale or exchange of capital assets purchased on or after the date of introduction of this amendment.

EXPLANATORY STATEMENT TO PROPOSED AMENDMENT

The Amendment

Under the proposed amendment, the dividing line between short-term and long-term capital gains is raised from 6 to 18 months. Gains or losses from the sale of assets held for a period of 6 to 18 months, now given favorable treatment as long-term capital gains, would thus be redefined as short-term gains. As short-term gains, they will have to be counted fully in computing taxable income, while under present law only 50 per cent of such gains is counted. Gains from the sale of assets held for less than 6 months or for longer than 18 months are not affected. The amendment would restore the definition of short-term gains applicable prior to the amendments of the capital gains provisions under the Revenue Act of 1942. No change is made in the percentage of long-term gains to be taken into account when computing net income.

Effective Date

It is proposed that the amendment be effective for gains derived from the sale or exchange of capital assets purchased on or after the date of its introduction. This is easy to understand, eliminates questions of legality under a retroactive provision and avoids the danger of precipitating accelerated purchases during the interim period which would result if a later effective date was set.

Objectives

The taxation of capital gains as amended under the Revenue Act of 1942 gives preferential treatment to income derived from speculation in capital assets. Gains derived from the purchase and sale of capital assets are taxed at a maximum rate of 25 per cent, except where the holding period has been less than 6 months. Under present conditions this is a most unsound policy. Speculation propels inflation and in no area has price rise been more rampant than in the field of capital assets.

Stock prices recently reached the highest levels in 16 years. Only during 1929 and part of the years 1928 and 1930 have they been so high. The current level is 60 per cent above the average for 1939 and 120 per cent above the average for 1942. During the past 12 months the rise has been rapid with prices increasing 30 per cent.

Farm values now stand 69 per cent above the 1940 level and in many states have surpassed the boom-time peak of the 1920's. The increase during the last 12 months was 13 per cent or higher than in the preceding year. During the last four months alone prices have risen by 7 per cent and there is no indication of any slackening in the upward trend. On the contrary, the most critical period is still ahead. Yet even the present level of prices in many areas is entirely out of line with any reasonable expectation for future farm income.

The prices of low-cost houses are now estimated to be 65 per cent above the level of 1940, while higher cost houses have risen somewhat less. In many areas, such as the Pacific Coast, the increase has been close to 100 per cent. The rate of increase has been fastest since V-J Day, and all indications are that the rise will continue.

While there has already occurred a substantial inflation of capital values in most areas, further increases threaten. Backed by a huge volume of liquid funds at the public's disposal, the inflation trend is far from ended. If values are permitted to rise further, additional inequities will develop. They will continue to bear most heavily upon the veterans, who already failed to partake in the economic gains of the war period. Higher capital values, moreover, will mean increased incomes, thus speeding up the general process of inflation.

We must do all we can to prevent further damage in this area, which is not protected by the checks of direct price control. Above all, we must take speculative pressure out of the market. To do so, we must amend the tax treatment of capital gains which has been an important factor in inviting speculation. We must reduce the tax advantage to be derived from the purchase of capital assets and their early resale at higher prices. Such speculative activity, now widespread in the markets for residential houses, farms, and stocks, serves no useful economic purpose. It only kindles the fires of inflation.

The proposed lengthening of the required holding period on long-term capital gains will not be sufficient to do the job. However, it will curtail the tax inducement now given to the speculator. It will be an important step in the right direction.