

Report of the Interdepartmental Tax Committee on the
Proposed Penalty Tax on Speculative Capital Gains

In accordance with the request of the Economic Stabilization Board, the Interdepartmental Tax Committee has studied the proposal of the Chairman of the Federal Reserve Board 1/ for a special penalty tax on wartime speculative capital gains and submits the following report.

The proposal is for a "substantial wartime penalty rate on speculative capital gains obtained from the resale of assets purchased during the period of the inflationary emergency and dating back to January 1, 1945." Although designed as a penalty the levy would be imposed in the form of a tax. This tax would be in lieu of current taxes on all profits defined as capital gains under present tax law, whether received by individuals or corporations, but only with respect to assets purchased after January 1, 1945. Steep rates are proposed; the rate schedule suggested is 90 percent if the property has been held for less than two years, declining by 10 percentage points for each additional year, until the existing effective rate on capital gains is reached. It is further proposed that capital losses incurred on transactions subject to the proposed tax on capital gains should be deductible against such gains.

The principal argument presented by Chairman Eccles for his proposed tax on wartime speculative capital gains is that there is an "ever present danger" of a serious "further inflation of capital values"; that if left uncontrolled "the vast and rising tide of war-created liquid funds" could be used to produce a "disastrous inflation of capital values"; that the result would be "calamitous for Government financing," "would wreck the stabilization program," "would make a mirage of the G. I. Bill of Rights," would give large amounts of war profits to speculators subject to low tax rates, and by leading to postwar deflation "would undermine postwar stability"; that a high penalty tax on capital gains "is the most effective and simple over-all instrument to take the speculative fever out of the market for real estate, stocks, commodities, and other capital assets"; that "this weapon would reach both cash and credit transactions entered into for capital gains, and would do so without interfering with normal nonspeculative transactions"; and finally, that "the case for prompt action on this line is so strong that it is difficult to see how Congress could refuse to act."

1/ Confidential memorandum, "Stabilization of Capital Values,"
February 8, 1945.

In the analysis of the resale capital gains penalty tax as thus proposed, four principal questions stand out for consideration:

1. Are the dangers of increases in the prices of capital assets acute enough to warrant drastic action?
2. Would the proposed tax prove effective in securing the desired results without important offsetting disadvantages?
3. Would Administration sponsorship of a resale capital gains penalty tax be politically wise?
4. What other measures can be proposed in lieu of, or supplementary to, the proposed tax?

I. Danger of serious inflation of capital values

It is our understanding that Chairman Eccles in general favors a high level of capital values in the postwar period but is concerned with preventing a speculative rise to a level which may prove to be out of all proportion to postwar earnings after allowing for a low level of interest rates. This concern with the speculative aspects of the problem is evident in the references to "disastrous inflation of capital values," and "inflationary fires." Among others the "little people who are ruined as we are drawn into the vortex of upward spiraling prices" are of concern to him. It appears that he believes it is particularly important to prevent prices from rising beyond their stable postwar levels and to avoid widespread public participation in the speculative market.

Wide movement in the prices of capital assets -- far wider than in prices of consumers' goods and services generally -- are common in peacetime as well as in war. A capital asset represents a bundle of possible future incomes. Even moderate changes in the public expectations with respect to the amount, stability, and certainty of the future income, in the appraisal of the risk of capital loss involved, and in the rate of interest, may create very pronounced changes in the values of capital assets. The recent rise in the value of securities, urban real estate, and farms has to a considerable extent been of this character since commodity prices and income have risen, interest rates have fallen, and prospects for postwar business activity and national income are substantially above the prewar period.

It is a question whether farm and urban real estate values are already at or beyond reasonable long-run values on the basis of present expectations. Undoubtedly the situation is spotty. Farmland values have risen by about 30 percent of the 1935-39 average during the past two years; they are now about 50 percent higher on the average than during that base period. While the increase during the past year has

been at a lesser rate than in the previous year, a substantial inflationary development appears to be occurring in this area. (See chart 1.) However, national averages obscure variations between States; by November 1944, 8 States had increases in average farm real estate of over 60 percent while the increase in 6 other States was less than 20 percent. (See chart 2.) It is interesting to note also that the number of voluntary transfers per 1,000 farms has increased rapidly since 1939, reaching a high of 53 in 1943. (See chart 3.)

Measures of advances in urban real estate values are more difficult to obtain, and the advances themselves have varied greatly in different regions, but HOLC and FHA press releases indicate widespread advances of 25-50 percent despite rent control of residential real estate. (See appended press release of National Housing Agency, March 2, 1945.)

Standard and Poor's Price Index of Common Stocks has risen about 80 percent since the spring of 1942. (See chart 4.) Prices of low grade bonds and stocks, however, have increased by a much larger percent.

It should be observed that the recent rise in the value of capital assets, particularly securities, has been from a relatively depressed base. Standard and Poor's Price Index of Common Stocks, for example, was lower in the spring of 1942 than it had been since 1933. In the light of excellent current earnings and expectations of active post-war business, a pronounced upward movement in stock prices, as in many other capital assets, was natural. The advances to date have probably not been out of proportion to actual and anticipated improvement in corporate profits, and farm income, and to fuller occupancy of urban commercial buildings on the assumption that a high level of income will be maintained after the war.

Purchases of urban residential real estate appear to be primarily by persons urgently in need of housing facilities rather than by speculators, and while there has been some evidence of speculation in this area it is less serious than in the case of farm real estate. Prices of houses, however, have gone up sharply in many urban areas because of the scarcity of new buildings, the influx of war workers and demands for additional or improved housing arising out of higher money incomes. In terms of the current outlook for postwar replacement costs of urban residential real estate the present prices appear to be high.

Observers in the farm real estate field have reported considerable speculative activity there and anticipate more when the manpower shortage eases.

There are a number of evidences of increased speculative activity in the stock market. The volume of trading on the New York Stock Exchange is now more than double the average 1942 level, and despite the unprecedented volume of available cash the extent of margin trading is surprisingly high and has been increasing. Credit extended to customers has increased substantially since 1942 but is still much below the levels attained in the first part of 1937. (See chart 5.) Sales of put and call option contracts are now running over 150,000 shares a month, more than double the 1942 level. The short interest, which usually rises in major and minor movements, now stands at 1,580,000 shares as compared with 349,000 at the 1941 low.

There is a reasonable prospect that the recent rate of advance in the prices of capital assets will continue for at least the duration of the German war, and there is more than a small possibility that it may become greatly accelerated either before the end of the German war or thereafter. If this is the case, a level of values will be reached which probably cannot be sustained later. However, we are not inclined to view the outlook with as much alarm as does Chairman Eccles, especially if the use of credit can be further restricted, and if commodity price control can be maintained during the reconversion period. Without control during this period an inflationary movement worse than that of 1919-20 is entirely possible.

We are in agreement with Chairman Eccles that a speculative boom in capital assets would have very undesirable repercussions. A spectacle of rapidly mounting values during wartime is bad for public morale and for the whole stabilization program. Rapid and conspicuous increases in the wealth and power of speculators and even of ordinary owners of capital assets are incongruous with the serious sacrifices being daily asked of millions. The force of arguments against wage increases and other price advances would be lessened.

Moreover, capital gains, whether realized or unrealized, stimulate additional consumption expenditures. The gains are in many cases treated as income by the recipient and in other cases are regarded as at least justifying a fuller expenditure of ordinary income.

Although these repercussions on the wartime economic stabilization program would occur to some extent if capital values rose in response to changes in economic outlook, we are in agreement with what we believe to be the position of Chairman Eccles, that the repercussions would be much greater from a speculative market with widespread public participation.

After the war it would be grossly unfair to the returning veteran if he were to find the prices of homes and farms far beyond his reach; or if the price he had to pay and the debt he had to incur rested upon such inflated values that a substantial subsequent loss would be inevitable.

Moreover, the subsequent downward adjustment of capital values after a pronounced speculative boom would doubtless interfere for some time with the achievement and maintenance of the high level of employment and production. After a collapse in values, stability in agriculture and in industry would take some time to achieve.

A final point which Chairman Eccles has emphasized is that in the event of an extreme speculative general inflation of the prices of capital assets even Government financing may suffer. Individuals may be tempted to cash their "E" bonds or reduce their further purchases of new issues in order to devote their funds to speculation in rising capital values. We are not inclined to believe that prospective increases in prices of capital assets are likely to interfere in any serious degree with Government financing, although we recognize the possibility of this danger should there be a general and marked inflation of commodity prices.

There are a number of restraining forces which will operate with increasing force as war spending declines and civilian production rises from present emergency levels. Production capacity in most fields has been greatly expanded, and when released for civilian output would curb inflationary pressures on commodity prices.

While the prices of most agricultural products are guaranteed by price floor provisions for two years after the war, many of these price floors are substantially below present prices. Further, the large volume of output of the war years may not find so ready a market after the war, and no real or implied promise exists on the part of the Government that quotas for agricultural production will not be established in the two years following the war if surpluses develop. The great losses suffered after the last war as the aftermath of the inflation in agricultural land values should exercise some restraining influence.

II. Effects of the proposed tax

The effectiveness of the proposed tax in securing the desired results without offsetting disadvantages is considered here under four headings; (1) effectiveness in checking rises in capital values; (2) extent of restrictive effects in the transition period; (3) equity; and (4) administrative problems.

1. Effectiveness in checking rises in capital values

The proposed resale capital gains tax would, we believe, largely prevent or eliminate widespread public participation in the speculative capital markets. It would discourage the short-term speculative demand for capital assets by eliminating the bulk of any possible profit.

To a lesser extent, it would also reduce the demand of longer term investors because they, too, often insist upon retaining the freedom to sell at any time that changed personal circumstances or altered economic adjustments might dictate. Accordingly, it should be effective in preventing a runaway speculative market. Without speculative participation, it does not seem probable that capital values will rise extremely far above levels that can be sustained in the postwar period.

The tax would not necessarily prevent a rise in capital values, however, especially if the anticipation of higher values in the postwar period were generally shared. Those who had purchased their assets before 1945 would be reluctant to sell because they would become locked up in any new investment they made with the proceeds, whereas they could realize profits on their existing holdings without penalty at any time. This would give their present holdings a distinct advantage even over very promising alternatives. In the meantime, if inflationary forces prevailed, the underlying values of the frozen securities would continue to rise, and the market values would reflect this development in large part, at least, by reason of the bidding of those who were prepared to lock themselves in. Insofar as the tax would apply, it would be paid almost solely by the necessitous seller.

2. Restrictive effects in the transition period

An important consideration is whether the proposed tax would interfere with normal nonspeculative transactions. We think that there is substantial likelihood of such interference because of the previously mentioned tendency of the tax to lock capital assets in the hands of present owners. Equally or more important is the fact that normal business investment is a speculative operation, at least in the broad sense of the word. The process of capital investment, especially risk-taking investment, is often one of putting money in a project with the idea of making it a success, selling it to others and getting out with a profit. A great deal of such speculative investment will be needed in the transition period if high levels of business activity and employment are to be maintained, and plans for such operations should already be in the process of making.

A very large number of capital transactions are commonly entered into by businessmen who contemplated a period no longer than 2 to 5 or 6 years for the fruition of the investment. Frequently the transactions actually require longer periods than those originally contemplated, but even in these cases the possibility of getting out in a medium term period of, say, 2 to 6 years is generally necessary to secure the original commitment. It is believed that if business is to be rapidly reconverted and expanded in the transition period, many capital transactions of this type will be necessary. A tax as drastic as the proposed penalty tax would seriously discourage numerous medium-term capital transactions now being planned for the reconversion period.

In considering the financing of new businesses and expanding businesses in the transition period, Chairman Eccles recognizes the importance of encouraging new investment and indicates that provision should be made to prevent the tax from being a deterrent to investment in new desirable private enterprise. New issues of securities could be made exempt. Similarly, it would be possible to provide for the exemption of new investment in proprietorships and partnerships. Such exemption might stimulate the flow of capital into new and expanding enterprise by diverting the funds from speculative uses. There would, however, be substantial difficulty in drawing the line between the exempt and taxable commitments of capital. (See technical appendix 1.) More important, it may be questioned whether the climate of the market would under the proposed tax be conducive to the flotation of new securities and the commitment of capital in new enterprise. A stock market which is seriously narrowed does not furnish a good medium for floating new equity issues and expanding business investment. The restrictive effects of the proposed penalty tax may well create such a market.

Moreover, the proposed tax might be interpreted by business as an indication of the Government's hostility and lack of sympathy with its problems. This could adversely affect the level of private investment and might even result in a serious retardation of the reconversion process and business expansion after the war.

3. Equity of the proposed penalty tax

A number of equity considerations are involved in the proposed penalty tax. If successful in preventing an otherwise threatened speculative boom in capital values and the subsequent deflation, the inequities avoided would be truly imposing. There are, however, some other equity considerations which should at least be passed in review.

The average person is not in the speculative market and would not secure any of the speculative profits. The proposed tax by reducing the speculative profits would reduce the inequity between those profiting from the sale of capital assets in the speculative markets and those not in the markets. As Chairman Eccles points out, the present capital gains tax rates give a tremendous tax advantage to persons reaping war profits in the form of capital gains. The proposed tax, if successful, would prevent those gains from being exaggerated by the addition of speculative price rises on top of price rises likely to occur in any event.

On the other hand, the tax treats differently persons who bought their capital assets prior to January 1, 1945, and those who were unable to do so until after that date. Nor would the proposal touch war-made increases in the value of securities and other property unless the assets were sold before the expiration of the tax. There would be

hardships and discriminations apparent in numerous cases in which people would be affected differently by the tax. Thus, for example, some have urged that capital gains reflecting a corresponding decline in the purchasing power of the dollar may not be real economic gains.

It is our belief, however, that if the tax were successful it would not on balance be inequitable as a war measure, since the resulting increases in equity would outweigh the decreases.

4. Technical and administrative problems

A very high rate of tax would undoubtedly give rise to substantial administrative and policing problems of enforcement. Sales for currency, failure to record deeds, failure to state the correct consideration in the deed -- a common practice today -- would present difficult problems of enforcement. It is believed that these are not insuperable but that a substantial amount of attention to policing would be necessary. There are other substantial administrative and technical problems and issues, for example, the treatment of dealers, the classification of assets according to date of acquisition and sale, loss offsets and the question of exemptions. These are also discussed in technical appendix 1.

It is suggested by Chairman Eccles that the definition of capital gains under the present law be used for the proposed tax. However, as indicated in the appendix the objectives of the proposed tax cannot be attained by simply accepting this definition; it is too broad in certain respects and too narrow in others.

III. Political aspects

The business and financial community would undoubtedly interpret the tax as a direct attack on it and would fight back. The efforts of the Administration to reassure the public of its desire to promote a high level of business activity based upon private investment would probably be offset to a considerable extent.

Powerful members of Congress have already indicated their belief that the measure attacks economic symptoms and not fundamentals and would accordingly be ineffective. Since the economic operations and effects of the proposal are not easy to grasp, the views of these members might prevail. Moreover, it would be relatively easy to foresee and overemphasize examples of hardships and inequities which might flow from the legislation.

The penalty tax is an extraordinary measure and would scarcely receive a hearing in the Congress without the support of overwhelming evidence that the stabilization program is currently in danger and unless such evidence were submitted with the full support

of the President, the Director of Economic Stabilization, and the heads of the several departments and agencies responsible for the stabilization program. Some people have argued that such testimony might speed a speculative boom in stock exchange and other capital assets, especially if the proposal were expected to fail. On the other hand, if the public had faith in the Government's ability and willingness to stop inflation of capital values the announcement effects of the proposal would be to curb speculative activity even before enactment of the legislation.

Another point should be mentioned. As Chairman Eccles has rightly pointed out, the proposal is more properly viewed as a penalty and not as a tax at all. Nevertheless, it would have to be imposed as a tax under the taxing power and would be considered by the congressional committees dealing with taxation. These committees in general have a strong aversion to the use of the tax mechanism for purposes other than the raising of revenue.

IV. Alternative and supplementary measures

The proposed tax is a radical step, and we believe it desirable accordingly to examine several less extreme measures which may be viewed as alternatives.

1. Strengthening and extension of credit controls

Although, as previously indicated, the volume of cash in the hands of speculatively inclined persons may contribute substantially to an inflationary boom in capital values, the strengthening and extension of credit controls would help to restrain the boom and would also minimize the hangover of excessive debts to be liquidated later.

It is true that there is now an unprecedented amount of actual cash in bank deposits and circulation. But without the leverage which credit would give to this cash, it is difficult to believe that a pronounced speculative inflation of capital values could develop or be long sustained. The rewards of successful speculation and hence the inducement to speculation are substantially less when the financing of speculation is confined to cash than when it is financed in part by credit, and the amount of cash in the hands of speculatively inclined persons sets limits to the volume of speculation.

Although, for example, the present total of debit balances on securities, about \$1 billion, seems small when compared with the aggregate market value of listed securities, it is far more potent than this comparison suggests. The bulk of outstanding securities remains unchanged in ownership from month to month.

Only a small fraction of the total actually enters the market and changes hands in the course of an entire year. The debit balances are incurred almost wholly in connection with that segment of the total holding which is actively changing hands. For this reason, aggregate debit balances of about \$1 billion may exert a direct influence on the bid prices for securities far out of proportion to the aggregate value of securities outstanding.

The same considerations apply to increases in the amount of credit used to purchase farms and homes. These increases in credit enormously facilitate advances in prices, regardless of the disproportion between the aggregate amount of credit and the aggregate value of farms and homes because these increases in credit augment the bidding power which is directed in the first instances at the relatively small fraction of assets entering into the market.

An advantage of restricting credit in the field of urban real estate is that the controls would extend to all types of buyers, those that purchase for use as well as those that purchase for speculative resale. In the urban real estate situation a large part of the problem of rent control stems from competitive bidding for housing among the purchasers for use.

Under existing laws, margins on both new and existing brokerage accounts could be substantially increased. Since half of all customer trade in the stock market is now carried on through margin accounts, an increase in margins would undoubtedly impose some limitation on the volume of speculative trading. In addition, the S.E.C. can take further steps to limit stock trading. Thus, for example, its Trading and Exchange Division recently recommended the adoption of a rule which would prohibit floor trading in stocks on New York exchanges. It might also be desirable to regulate trading in puts, calls, straddles and other options used by professional speculators.

New legislation or executive orders under the War Powers Act would probably be necessary to control credit in the form of urban and farm mortgages. The restriction might take the form of a limitation of the loan to a percentage of 1942 (or some other) level of values, or it might take other form deemed advisable by the Government agencies in these other fields.

2. Taxation

As Chairman Eccles points out, the current tax law provides a large differential in tax rate between capital gains on assets held over 6 months and other income. Capital gains on assets held 6 months or less are treated as ordinary income. The 6-months holding period was introduced in 1942 largely at the instance of

stock exchange interests and because a very low level of floor trading as well as prices prevailed in the market at that time. Prior to that time, the holding period for long-term gains was 18 months and the minimum tax rate was not reached until assets were held for more than 2 years. Prior to 1938, the holding period for long-term gains was 2 years.

The 6-months holding period combined with the 25-percent maximum effective rate on long-term gains places a premium on wartime profits realized in the form of capital gains. Whatever might be the merits of the present capital gains provisions in a postwar tax structure these provisions are inadequate and discriminatory in a wartime situation.

Lengthening the holding period for preferential capital gains treatment from 6 months to 2 or 3 years would operate in many ways similar to the proposed resale capital gains tax although it would be milder. It would undoubtedly have a substantial effect on the volume of trading and speculative operations. It would reach gains on securities purchased prior to January 1, 1945. On the other hand, for most taxpayers the rate would not be as high as the proposed penalty tax rate and the effects on longer term speculation would be much less pronounced. The proposal could be defended on the grounds of equity and to rectify an overdose of leniency put into the 1942 law as an experiment. On the other hand, though proposed as a temporary emergency provision, it might be viewed as a permanent measure and this would have some disadvantages from the point of view of securing its enactment in comparison with a clearly temporary war emergency measure.

On balance we believe that such a lengthening of the holding period would achieve a substantial portion of the preventive effects on speculation anticipated from the proposed resale capital gains tax, while avoiding some of the objections both economic and political.

The existing capital gains tax could also be strengthened by increasing the maximum rate on long-term gains and the percentage of capital gains subject to tax. These changes would probably meet with more legislative resistance.

The effects of such changes on the rates of tax applying at different levels of income are discussed in technical appendix 2.

3. Other measures

While credit controls and capital gains adjustments appear to be most practicable at this time other alternatives might be mentioned as for instance:

(a) Tax on transfers. The suggestion has been made that a tax on transfers would be more effective than the resale capital gains penalty tax since it would be directed at buyers rather than sellers and thus could not be avoided by the buyer by holding the asset beyond the effective period of the tax. The tax has the disadvantage of falling on transactions which result in loss as well as transactions that result in profit and thus would have inequitable results. Moreover, the effectiveness of the tax would depend on the rapidity of price rise and would be more effective for preventing rapid turnover with small price changes than less rapid turnover with large price changes, although the latter might be as dangerous from the viewpoint of speculation as the former.

(b) Restrictions on transfers of capital assets. We understand that in Australia direct control over the transfer of capital assets is exercised through a provision requiring securities to be held for a minimum period of time. In the case of real estate transfers purchasers must be licensed and the price must be approved by the control authorities. Assuming the constitutionality of such measures, which may be open to serious doubt, we question their feasibility under American conditions. The political objections to the penalty tax would undoubtedly be present in even greater degree with reference to prohibition or licensing of sales or purchases.

(c) Price control. The suggestion has been made that the prices of capital assets, such as real estate and securities, might be controlled in the same manner as are the prices of consumers' goods and services. Such control if enforceable would of course stop the rise in capital values including the possibility of a speculative boom. The freezing of capital assets in the hands of existing owners, previously mentioned as one of the expected effects of the proposed penalty tax, would be even more pronounced if prices were fixed and might completely destroy the market. Moreover, the enforcement of prices on capital assets would be much more difficult than on current goods and services because a single transaction involves a long series of future speculative incomes which would justify much greater efforts to evade the controls. This problem has already been mentioned in connection with the penalty tax and would probably be much greater under controlled prices.

V. Conclusion

While we recognize the danger of a speculative boom in security and real estate values, we are of the opinion that the situation as it is now foreseen does not justify the general imposition of so drastic a measure as the proposed resale capital gains penalty tax, especially in view of the possible adverse effects of that tax on the reconversion and expansion of business in the transition period, and of the probable negative congressional reaction to the tax. In

coming to this conclusion, however, we recognize that a special situation may exist in respect of farm real estate and that if politically feasible the penalty tax would on balance be desirable in this field.

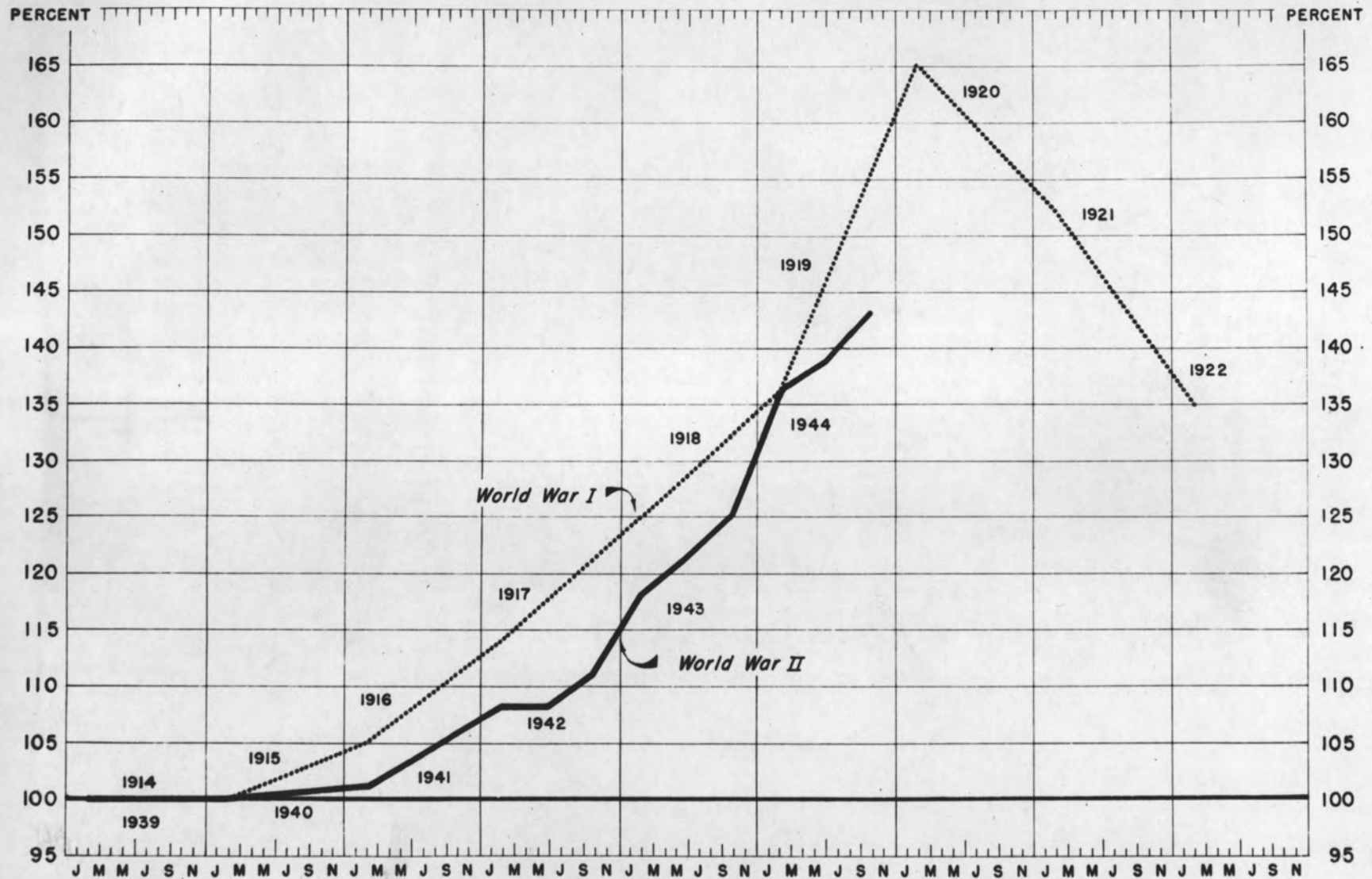
We believe that the situation calls for action. Further credit restrictions appear to us to be desirable. We believe that the minimum holding period of long-term capital gains should be lengthened. Such a tax measure, which is milder than Chairman Eccles' proposal and merely reestablishes the law in force for many years prior to 1942, would have a greater chance of acceptance, particularly if presented as a temporary measure. We suggest that the problem be discussed informally with the appropriate committees of Congress with a view to securing their support for this change.

March 6, 1945

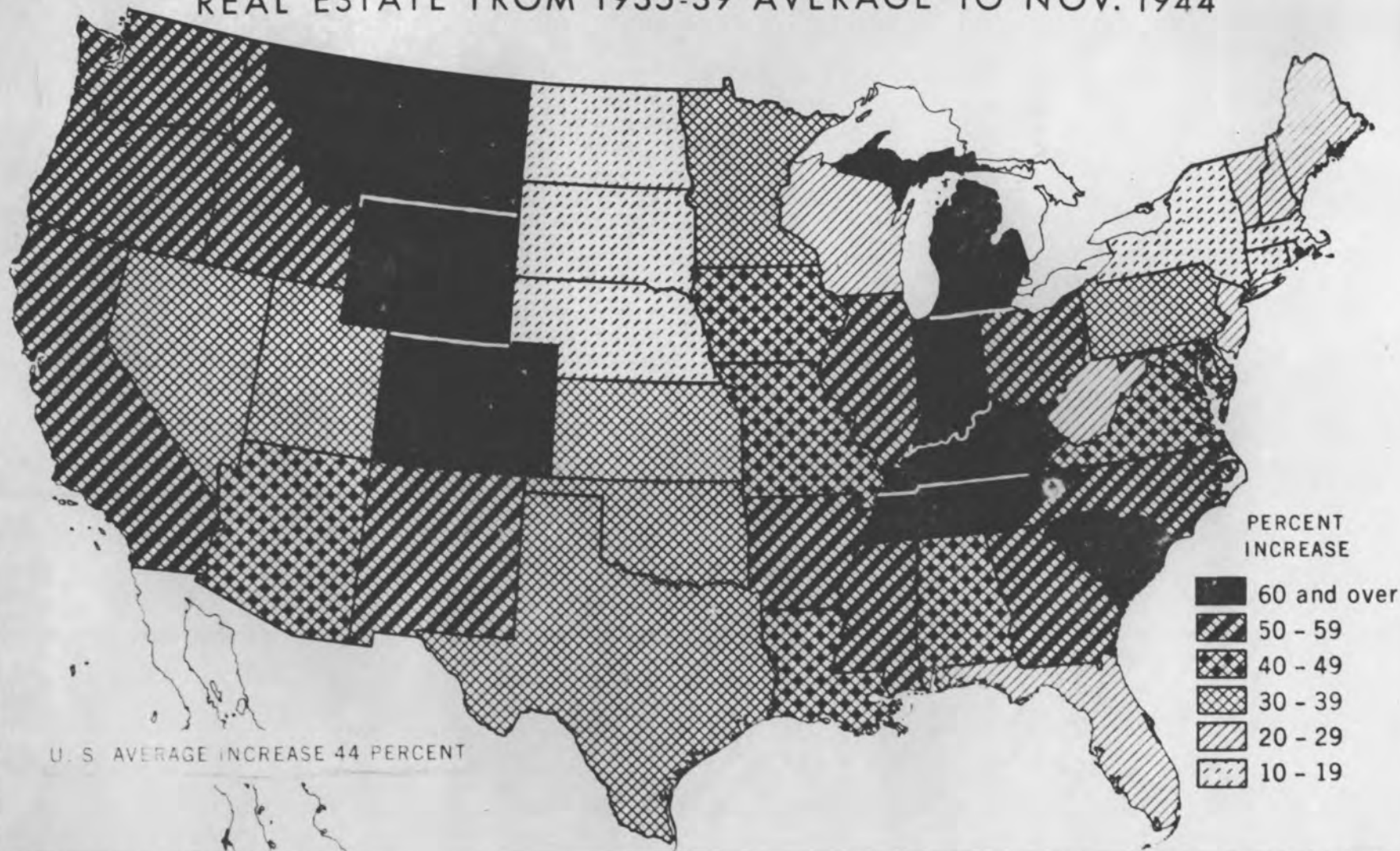
Chart 1

FARM REAL ESTATE VALUES IN TWO WORLD WARS

World War I, 1914=100; World War II, 1939=100

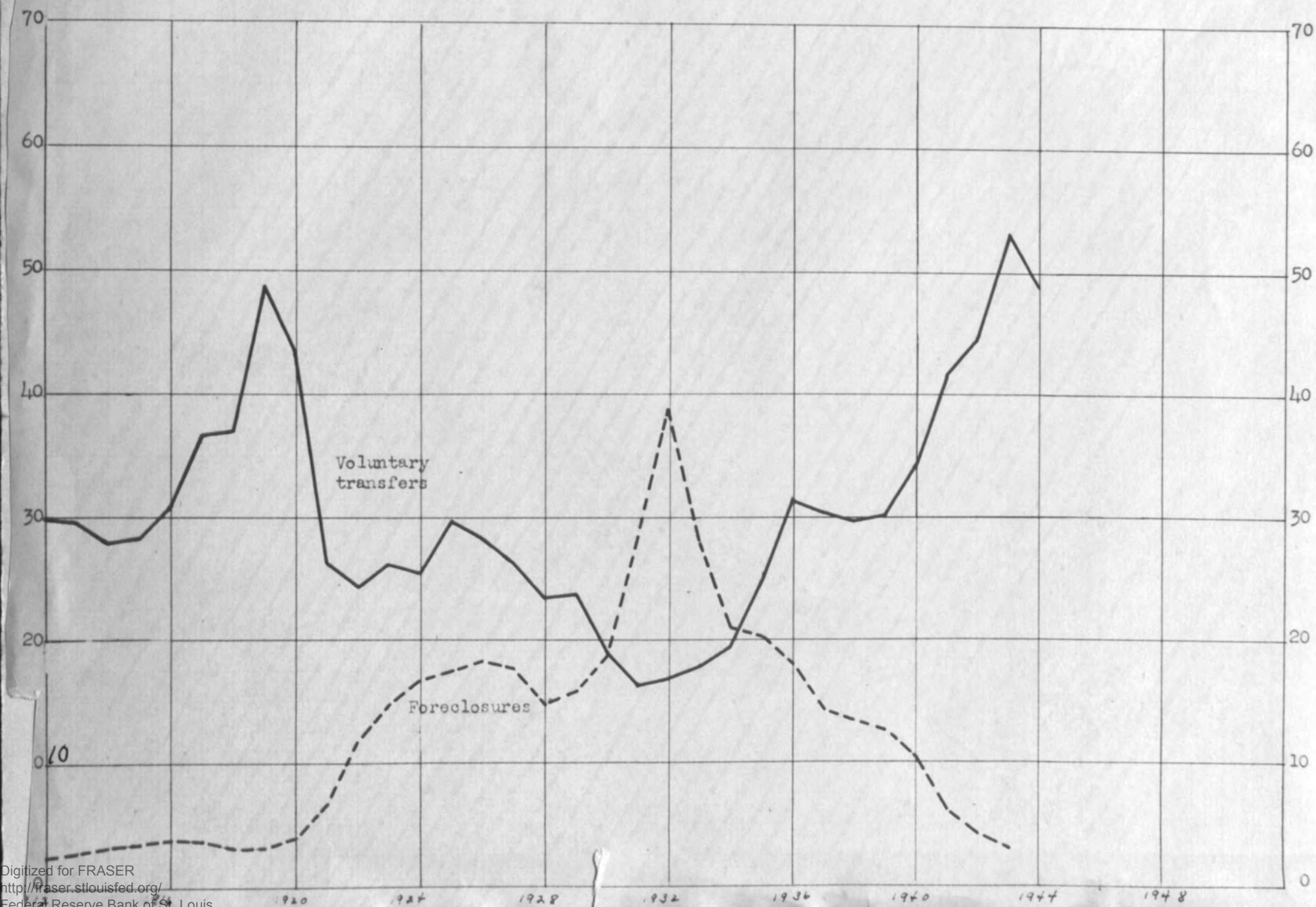


PERCENTAGE CHANGE IN AVERAGE VALUE PER ACRE OF FARM
REAL ESTATE FROM 1935-39 AVERAGE TO NOV. 1944



VOLUME OF FORECLOSURES AND ASSIGNMENTS AND VOLUNTARY TRANSFERS,
UNITED STATES, 1912-44

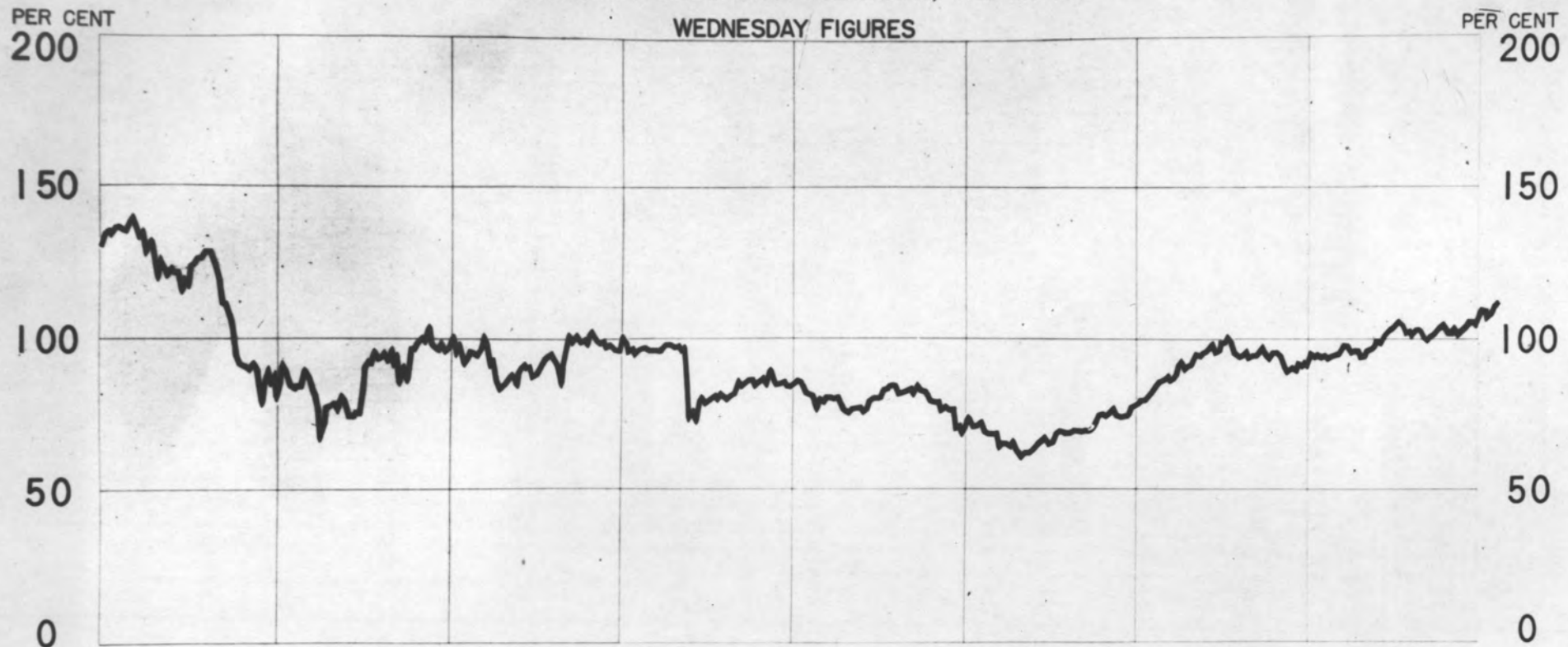
transfers per 1,000 farms



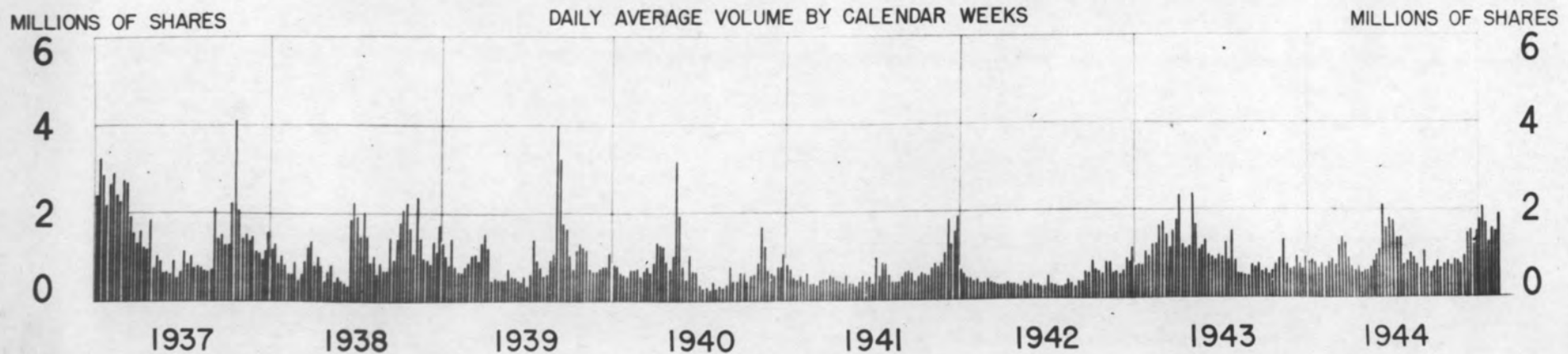
PRICES OF COMMON STOCKS

STANDARD AND POORS' CORP. 402 STOCKS, 1935-39=100

WEDNESDAY FIGURES



VOLUME OF TRADING ON NEW YORK STOCK EXCHANGE



MEMBER FIRMS OF N.Y.S.E. CARRYING MARGIN ACCOUNTS

BROKERS AND BROKER-DEALERS

END OF MONTH FIGURES

MILLIONS OF DOLLARS

MILLIONS OF DOLLARS

