
U.S. CAPITAL GAINS TAXES: ARBITRARY HOLDING PERIODS, DEBATABLE TAX RATES

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INTRODUCTION

Since its inception as part of the Revenue Act of 1913¹ and the Income Tax Act of 1916,² the U.S. individual capital gains tax has fostered intensive, incisive, and acrimonious debate among members of Congress, academicians, and interest groups.³ Since the late 1960s, the United States

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1. Revenue Act of 1913, Pub. L. No. 16, ch. 16, § Iib, 38 Stat. 166 (1915).

2. Revenue Act of 1916, Pub. L. No. 64-271, ch. 463, § Iia, 39 Stat. 756, 757 (1918). In fact, during the Civil War, the U.S. Congress also implemented what might be labeled the first U.S. capital gains tax, as the Civil War Income Tax Act of 1867 (Act of Mar. 2, 1867, §13, 14 Stat. 477-78) sought to tax all “gains, profits, and income”—however, the Supreme Court held in the 1872 case, *Gray v. Darlington*, 82 U.S. 63 (1872), that increases of capital value should be excluded from the statutes’ definition of taxable income. *See id.* at 65.

3. When portraying capital gains tax relief on the House floor, Congress members utilize animated language, passionately attacking or supporting each proposal. *See, e.g.*, 143 CONG. REC. H6623-04, H6627 (daily ed. July 31, 1997) (statement of Rep. Goss). Rep. Goss described capital gains tax relief of TRA ‘97 as follows: “For senior citizens about to embark on their retirement, and many of those come to Florida and my district, we have cut the capital gains tax so they can sell some assets without Washington *confiscating*, “*confiscating*” is the word I choose, nearly one third of the gain.” *Id.* (emphasis added). In reply minutes later, Rep. McDermott described his position in regard to capital gains tax cuts:

has shifted and reformed, with increasing frequency, its individual capital gains tax rates as well as the accompanying holding periods necessary for individuals to benefit from the preferential treatment granted to longer-term capital gains.⁴ “Holding periods” may be defined as legislatively drawn timeframes that enable taxpayers to qualify for specified income tax rates upon their sale of securities or other capital assets. Historically, however, holding periods also applied to the Tax Code’s schedule of “exclusion ratios”⁵ for capital gains. Congress recently enacted additional alterations in the individual capital gains tax rates⁶ and holding periods in the Taxpayer Relief Act of 1997⁷ (“TRA ‘97”) as well as the Internal Revenue Service Restructuring and Reform Act of 1998⁸ (“Restructuring and Reform Act”). TRA ‘97 represented Congress’ effort, in part, to re-establish a national commitment toward preserving and enhancing the preferential tax treatment of capital gains income⁹ by implementing a complex, multitiered system of holding periods, tax rates, and income categories. The Restructuring and Reform Act, however, contained provisions simplifying the classification system of TRA ‘97 in response to

The lowering of the capital gains rate benefits the wealthy in this country, and it is clear that what will happen when we get the rate down to 18 percent, which is almost the lowest tax rate on regular income, *that this will have thrown gasoline on the whole class warfare issue.* If I am making \$500,000 or \$600,000 or \$800,000 and I can get my pay given to me in stock options, I will pay 18 percent. That is exactly what people making \$30,000 in this country are paying. We have brought the tax rate for the richest in this country all the way down to 18 percent. *I do not see how anybody can call that fair.*

Id. at H6628 (emphasis added).

4. Interest in tax reform “peaked” during the 1980s and has continued strongly into the 1990s. Indeed, the United States was not alone in pursuing major tax initiatives. *See* Anthony Knoester, *Introduction*, to *TAXATION IN THE UNITED STATES AND EUROPE* 1, 5 (Anthony Knoester ed., 1993) (indicating that many OECD nations undertook tax reform efforts in the 1980s, designed both to neutralize taxation as well as to reduce the overall burden of high tax rates).

5. “Exclusion Ratios” can be defined as the percentage of net capital gain realized within the applicable holding period that may be excluded from gross ordinary income on an individual’s tax return.

6. *See* 26 U.S.C. §1(h) (1998).

7. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §§ 304, 311, 312, 111 Stat. 788 (1997). President Clinton signed the TRA ‘97 on August 5, 1997, stating that, “I continue to have concerns that the across-the-board capital gains relief in H.R. 2014 is too complex and will disproportionately benefit the wealthy over lower- and middle-income wage earners.” Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 1997 U.S.C.C.A.N. 1620-1, *available in* 1997 WL 806822 (statement by President of the United States).

8. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 5001, 112 Stat. 685, 788 (1998).

9. The capital gains tax preference had been eliminated following the Tax Reform Act of 1986, until it was reinstated in 1991 and set at a maximum rate of 28%. *See* J. Andrew Hoerner, *Why Can’t America Get the Capital Gains Tax Right?*, 54 TAX NOTES 893, 896 (1992).

widespread protest and furor over the increasing complexity of the Internal Revenue Code.¹⁰

TRA '97 had established holding periods classified as "short-term capital gains" for capital assets held one year or less and taxed at ordinary income tax rates, versus two categories of "long-term capital gains" for assets held either between 12 and 18 months or longer than 18 months.¹¹ However, within each of these holding period classes, different tax rates applied according to the taxpayer's respective income tax bracket. Moreover, the holding periods did not apply to gains on sales of other assets besides § 1221 capital assets,¹² such as collectibles, unrecaptured § 1250 gains,¹³ § 1202 gains,¹⁴ or § 1031 gains.¹⁵ Under § 1201,

10. See, e.g., Kathy M. Kristof, *Solving the IRS Puzzle: A Windfall Might Await You—If You Can Piece Together the Right Forms*, L.A. TIMES, Mar. 7, 1999, at C1. For an example of the legislative determination to simplify and reduce capital gains taxes, consider Chairman Bill Archer's comment:

I believe we can make changes to our current income tax to remove disincentives to save and invest. While we ought not tax capital gains at all, the least we can do is simplify the current capital gains rules by eliminating the 18-month holding period. For 16 million Americans, capital gains has become a capital headache. Eliminating the 18-month holding period would be a major simplification.

Proposals to Reduce Taxes 1998: Hearing on Reducing the Tax Burden Before the Comm. on Ways and Means of the House of Representatives, 105th Cong. (1998) (statement by Chairman Bill Archer), available in 1998 WL 65366. For a critical view of the Restructuring and Reform Act, see the dissenting views of Pete Stark, Robert T. Matsui, Jim McDermott, and John Lewis: "Ironically, the Republicans could not even pass their prize accomplishment in simple form-capital gains tax relief. The IRS estimates that claiming capital gains tax relief now will take over four hours to calculate. . . ." H.R. REP. NO. 105-599 at § IX (1998).

11. H.R. REP. NO. 105-220, at § 311(a) (1997). See also Brian R. Greenstein, *The Taxpayer Relief Act of 1997—Provisions Affecting Individuals*, 87 J. TAX'N 261 (1997).

12. The Internal Revenue Code defines capital assets as: property held by the taxpayer (whether or not connected with his trade or business), but does not include—stock in trade of the taxpayer . . . if such property would properly be included in inventory of the taxpayer . . . a copyright . . . or artistic composition held by a taxpayer whose personal efforts created such property accounts . . . receivable in the ordinary course of trade or business.

I.R.C. § 1221 (1995).

13. Section 1250 refers to gains from disposition of certain depreciable realty. See I.R.C. § 1250 (1995).

14. Section 1202 gains apply to investments in qualifying small businesses under the Tax Act of 1993 for which a 50% exclusion applies when the investment is held for a period of five years or more. See I.R.C. § 1202 (1995).

15. Section 1031 refers to gains from "like-kind exchanges," for which taxpayers defer paying tax on sale of capital assets when they are able, within a specified time period, to exchange proceeds from sale of one property for another real property. See I.R.C. § 1031 (1995). For a complete discussion of the tax-planning ramifications of TRA '97, see EPHRAIM P. SMITH & CHRISTOPHER J. FENN, *CAPITAL GAINS AFTER TAXPAYER RELIEF ACT OF 1997: QUESTIONS AND ANSWERS FOR PRACTITIONERS* (1998). See also JOSEPH BANKMAN, THOMAS D. GRIFFITH & KATHERINE PRATT, *FEDERAL INCOME TAX* 451-58 (2d ed. 1998). In addition, TRA '97 enacted I.R.C. § 121's permanent exclusion of \$250,000 for individuals and \$500,000 for married couples on gains from the sale of personal residences. See I.R.C. § 121 (1995).

corporations also do not share in the preferential treatment provided to long-term capital gains.¹⁶ In spite of the Restructuring and Reform Act's simplification measures,¹⁷ however, members of Congress and their general constituents appear determined to press further their competing reform efforts in pursuit of a magnificently wide span of fiscal, macroeconomic, and equitable social objectives.¹⁸

Traditional scholarship surrounding capital gains taxation has most often concentrated upon various revenue effects and taxpayers' response elasticities to variations in tax rates and holding periods.¹⁹ However, capital gains tax legislation has also produced unmistakable practical consequences both financially and politically. First, reinstatement of the capital gains preference in 1991 followed by TRA '97 and the Restructuring and Reform Act have generated innovative responses among members of the investment community. The structure of investment management funds as well as corporate mergers and acquisitions have increasingly become tax-guided. For example, "tax-efficient" mutual funds²⁰ for individual investors have been established in order to minimize

16. Section 1201 subjects corporations to an ordinary income tax rate of 35% for qualifying net capital gains. *See* I.R.C. § 1201 (1995).

17. The Restructuring and Reform Act of 1998 eliminated the 18 month holding period, reducing the number of holding period categories to the current 12 months or less period for "short-term capital gains" designation and periods in excess of 12 months for "long-term capital gains." *See* 26 U.S.C. § 1222 (1994). For assets purchased after the year 2000 and held for more than five years, TRA '97 builds in a further preferential reduction in the long-term capital gains rate, from 20% to 18% (the requirement of purchase after the year 2000 does not apply to taxpayers in the 15% income tax bracket, for whom the long-term rate will decline from the current 10% to 8%). *See* Taxpayer Relief Act of 1997, § 311(a)(2)(A), Pub. L. No. 105-34, 111 Stat. 831, 831-32 (1997).

18. A recent bipartisan proposal by Democratic Senator Robert Torricelli demands a \$5,000 exemption in capital gains from taxes (similar to the exemption provided in the United Kingdom). *See* Tom Herman, *A Special Summary and Forecast of Federal and State Tax Developments*, WALL ST. J., Feb. 3, 1999, at A1. *See also* *Gingrich Says Congress Could Cut Capital Gains, Estate Tax*, CONG. DLY., July 16, 1998 (reporting other congressional proposals for capital gains tax cuts), available in 1998 WL 13130799. For a contrary view that tax cuts are unlikely any time soon, see Jacob M. Schlesinger, *Where's the Beef? Even in the Heartland of Revolt, Tax Cuts Don't Top the Agenda*, WALL ST. J., Mar. 5, 1999, at A1.

19. *See generally* Jane G. Gravelle, *The Revenue Cost of Capital Gains Tax Cuts*, CRS REP. FOR CONGRESS 97-559E, available in 1997 WL 424008; J. Eric Fredland, John A. Gray, & Emil M. Sunley, *The Six Month Holding Period for Capital Gains: An Empirical Analysis of Its Effect on the Timing of Gains*, 21 NAT'L TAX J. 467-78 (1968); Joseph J. Minarik, *Capital Gains*, in HOW TAXES AFFECT ECONOMIC BEHAVIOR, 241 (Henry J. Aaron & Joseph A. Pechman eds., 1981); George R. Zodrow, *Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity*, 48 TAX L. REV. 419 (1993); Alan J. Auerbach, *Commentary*, 48 TAX L. REV. 529 (1993).

20. Newly established funds such as T. Rowe Price Tax-Efficient Balanced Fund, Vanguard Tax-Managed International Fund, and American Century Tax-Managed Value Fund are illustrative of this emerging trend. *See generally* Donald J. Peters & Mary J. Miller, *Taxable Investors Need Different Strategies*, 7 J. INVESTING 1 (1998) (arguing that it is critical for investors and portfolio managers to

investors' tax liability by focusing upon strategic combinations of § 103 tax-exempt securities,²¹ low portfolio turnover, and equity securities from which the primary return derives from long-term capital gains (as opposed to § 61 dividend income or short-term capital gains).²² These funds, moreover, recognize capital gains only when simultaneously recognizing comparable capital losses so as to minimize tax liability. Second, in the political arena, on either side of the compromise line that legislators drew in 1997-98, the same exaggerated differences continue between Republican Party proponents of expanded capital gains tax preferences²³ and their opponents in the Democratic Party.²⁴

take into account after-tax consequences of different portfolio choices); Charles A. Jaffe, *Investors Are Paying the Price for Gains on Some Mutual Funds*, SAN DIEGO UNION-TRIB., Mar. 14, 1999 at I-4 (pointing toward pitfalls small, individual investors face when high-turnover mutual funds that lose money nonetheless generate surprisingly large, taxable capital gains distributions). For a contrary investment perspective, viewing dividends as preferential to capital gains on the basis that annual dividend income avoids the classic "bunching problem" associated with large capital gains recognitions in a single year, see JOSEPH TIGUE & JOSEPH LISANTI, *THE DIVIDEND-RICH INVESTOR: BUILDING WEALTH WITH HIGH-QUALITY, DIVIDEND-PAYING STOCKS* 20-23 (1999). The existence of tax-managed mutual funds, as described above, however, reflects the investment community's rational response to asset pricing distortions built into the U.S. capital gains tax system detailed in Part IV. These funds publish comparisons of their tax-managed returns with comparably balanced, un-managed index funds serving as benchmarks. If Congress eliminated holding period distinctions and other arbitrary tax classifications, less need would exist for the establishment of entire funds designed to circumvent income taxation and shift fund management toward substantive economic investment themes.

21. According to § 103 of the I.R.C., gross income for tax purposes "does not include interest on any State or local bond." I.R.C. § 103 (1995).

22. Section 61 defines gross income as all income from whatever source derived, including dividends. See I.R.C. § 61a (1995). "Long-term capital gains" refer to those gains derived from profitable sale of a capital asset held for one year or more. See *supra* note 17 and accompanying text.

23. See generally Aldona Robbins and Gary Robbins, *Tapping the Treasury, The Taxing Question: How Best to Use the Federal Surplus?*, SAN DIEGO UNION-TRIB., Aug. 1, 1999, at G1 (authors from the Institute for Policy Innovation arguing that further reduction in the capital gains tax rate represents one of the largest potential sources of economic growth in the recently proposed Republican tax reform package).

24. President Clinton, however, had supported a 30% exclusion for capital gains during negotiations surrounding TRA '97, in contrast to an across-the-board tax cut. The President's proposal would permit low to middle income taxpayers to exclude from Schedule D income the first 30% of recognized capital gains. However, Democratic Party opponents of capital gains reductions include Rep. Stark who declared in regard to TRA '97 that:

[t]here is no magic in projecting who benefits from this bill. . . . When we cut capital gains from a maximum of 28 to 20 percent or even 18 percent, we help the most affluent Americans.

We should not be reluctant to question whether it is fair to give massive tax breaks to the wealthiest Americans while those at the bottom pay an increase in excise taxes.

143 CONG. REC. H6623-04, H6637 (daily ed. July 31, 1997) (statement of Rep. Stark).

For an opponent of further cuts in capital gains rates in the academic community, see generally John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1 (1995) (concluding that lowering the capital gains rate violates vertical and horizontal equity and probably

This Note focuses principally upon holding periods assigned to differential capital gains tax rates, yet does not undertake an effort to resolve conclusively the classical debates between those who claim that capital gains preferences are critical to capital formation, and those who contend that such preferences chiefly serve financial interests of the wealthy. The existence of differential holding periods among different asset classes suggests a political compromise designed to mitigate tension between supporters and antagonists of capital gains tax preferences. Alterations in the holding period reflect, in part, a social bias against speculative, high-risk activity, in combination with a pragmatic judgment that multiple holding periods constitute a “middle ground” between complete preferential treatment of all capital gains and parallel treatment between ordinary and capital gains income. As such, this article addresses the economic and tax-planning consequences of holding periods as established in TRA ‘97²⁵ and the Restructuring and Reform Act.

In addition, the Note argues that the existence of arbitrary holding periods on individual capital gains taxes²⁶ perpetuates economic distortions that result in sub-optimal asset allocation in financial markets, producing economic effects analogous to an uncertain, exogenously induced “default risk” for corporate bonds. As such, dependent upon economic and social judgments pertaining to whether a capital gains preference should exist at all, capital gains taxes should either be subjected to a lower, preferential, inflation-indexed rate exclusive of any holding period or should be neutrally taxed, parallel with ordinary income. Part II presents an historical and comparative examination of holding periods throughout the twentieth century in the United States and international community. Part III undertakes an evaluation and critique of the rationale behind multiple holding periods for capital gains. Part IV proposes the elimination of holding period distinctions in the U.S. capital gains tax system, incorporating adaptations of two theoretical models for “asset pricing” and “expected default loss” to illustrate detrimental effects that holding periods

results in revenue loss); Roger C. Altman, *The Big Risk of Tinkering With Success*, L.A. TIMES, Aug. 15, 1999, at M1 (arguing that capital gains tax relief may foster inflationary pressures in a potentially overheated U.S. economy).

25. For a discussion of computing “break-even” points when holding assets following TRA ‘97 (in the sense that one could actually achieve an after-tax gain by holding an asset that is declining in value in order to enter the next preferentially taxed holding period), see Rolf Auster, *Choosing to Recognize Short-Term, Mid-Term or Long-Term Gain After TRA ‘97*, 76 TAXES, Feb. 1998, at 19. See also Rolf Auster, *Holding on to Capital Gains: The Long and Short of It*, 7 J. FIN. PLAN. 168 (1994).

26. Even worse, aside from being arbitrarily assigned over time, capital gains holding periods in the United States appear subject to frequent changes that result from periodic political finagling. See *infra* Part II.

exert upon capital markets. The Note concludes by articulating a coherent set of policy guidelines that the U.S. Congress may consider when debating the nature and extent of holding periods and rates for capital gains taxes in future years.

If the U.S. individual capital gains tax system forever fails to conform to and accept the Haig-Simons definition of income,²⁷ as has historically been true,²⁸ then the next best alternative is for Congress to determine categorically whether alleged capital formation and economic growth benefits of the capital gains preference outweigh efficiency benefits that would be obtained from “neutral taxation” of capital gains versus other ordinary income.²⁹ Either way, arbitrarily prescribed holding periods should be abolished.

27. For a synopsis of the Haig-Simons definition, see BANKMAN ET AL., *supra* note 15, at 31-32. These authors describe the Haig-Simons approach as follows:

Under that definition known as the *Haig-Simons* definition of income, income equals the sum of (i) the taxpayer's personal expenditures plus (or minus) (ii) the increase (or decrease) in the taxpayer's wealth. Not everyone agrees that the Haig-Simons definition of income is correct and even supporters admit that full implementation of the definition is impossible. Nonetheless, the Haig-Simons definition provides a widely accepted theoretical benchmark against which we can compare the current tax treatment of specific items.

Id. at 32.

28. See RICHARD GOODE, *THE INDIVIDUAL INCOME TAX* 98, 179 (1976). In order for the capital gains tax to more closely approximate the Haig-Simons approach, the U.S. could opt instead for a “mark-to-market” method of determining capital gains. See generally Mark L. Louie, Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857 (1982). The author of this 1982 article proposed various recommendations for solving the valuation and liquidity problems associated with a “mark-to-market” method by restricting its application to marketable securities of publicly held corporations as well as other prudent limitations. However, the “mark-to-market” approach, utilizing yearly accretions to taxpayer wealth as a taxable guideline, presents inefficiency and equity problems comparable to the current holding period system. In particular, if one considers a hypothetical investor who invests \$1,000 at the start of year 1 in a marketable security, but then realizes a \$500 capital gain by the end of that year, then a tax corresponding to the applicable capital gains rate would be assessed. However, suppose that by the time the individual files her taxes, the value of the security declines to \$100, then the taxpayer is forced to pay a significant tax at a time when her portfolio value has deteriorated and the capital loss carryback would not provide relief until the following tax year. See *id.*

29. For a discussion of “neutral taxation” with reference to capital gains, see generally Gregg A. Esenwein, *The Neutral Taxation of Capital Gains Income Under the Individual Income Tax*, CRS REP. FOR CONGRESS 94-395E, available in 1994 WL 802580. Esenwein states that “[s]tandard economic theory holds that except in very special circumstances, taxes best promote economic efficiency if they are neutral towards different activities, investments, and types of income. The basic reason is that economic resources are limited.” *Id.* at 1.

II. HISTORICAL EVOLUTION OF HOLDING PERIODS

A. ORIGINS OF HOLDING PERIODS FOR CAPITAL GAINS TAXES

Although infrequently recognized, the U.S. capital gains tax originated as a subset of an excise tax placed upon corporations as part of the Corporation Excise Tax Act of August 5, 1909.³⁰ This Act, as described in *Hays v. Gauley Mountain Coal Co.*³¹ imposed “annually a special excise tax with respect to the carrying on or doing business by the corporation ‘equivalent to one per centum upon *the entire net income* over and above five thousand dollars received by it from all sources during such year.’”³² In response to a mining firm’s challenge that capital gains merely represented converted capital rather than a portion of net annual income as described in the Act, the *Hays* court employed a form of rudimentary holding period analysis by stating that “[t]he expression ‘income received during such year,’ employed in the act of 1909, looks to the time of realization rather than to the period of accrument, except as the taking effect of the act on a specified date . . . , excludes income that accrued before that date.”³³ The corporate capital gains tax in the 1909 Act, however, represented a mere one percent tax with a high threshold exclusion that did not possess any applicable holding period beyond the requirement that the only gain taxed would be that which accrued after December 31, 1908.

The first individual capital gains tax incorporated into the Revenue Act of 1913³⁴ also did not possess any particular holding period requirements. This tax incorporated capital gains by defining taxable income as “gains, profits, and income derived from salaries, . . . trade, commerce, or sales, or dealings in property, whether real or personal . . . or gains or profits and income derived from any source whatever. . . .”³⁵ In 1914 and 1919, the U.S. Treasury Department issued private statements and regulations, respectively, declaring officially that taxable income

30. Corporation Excise Tax Act, ch. 6, § 38, 36 Stat. 11, 12 (1909).

31. 247 U.S. 189 (1918). In *Hays*, a mining firm purchased shares of another coal company in 1902 and later sold them in 1911 for a profit of \$210,000.

32. *Id.* at 192 (emphasis added).

33. *Id.* In deciding that capital gains represented taxable income, the court utilized “opportunity cost” analysis by determining that “[t]he gain represented by the increase of selling price over cost price must be regarded as a substitute for whatever return some other form of investment might have yielded.” *Id.* at 193. See also *United States v. Cleveland, Cincinnati, Chicago & Saint Louis Ry. Co.*, 247 U.S. 195 (1918); *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918).

34. Revenue Act of 1913, ch. 16, 38 Stat. 166 (1915).

35. *Id.* at 167.

included “gains derived from the sale or other disposition of capital assets.”³⁶ In 1921, the Supreme Court decided the case of *Merchants’ Loan & Trust Co. v. Smietanka*,³⁷ holding that a capital gain represented “income” within the meaning of the Sixteenth Amendment to the U.S. Constitution, in part because the definition of “income” in the Revenue Act was deemed compatible with the definition provided in the 1909 Corporate Excise Tax Act.³⁸ Moreover, the Court in *Eisner v. Macomber* had already adopted a definition of “income” that read as follows: “[i]ncome may be defined as a gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through sale or conversion of capital assets. . . .”³⁹ As such, the *Merchants’ Loan* Court granted Congress sweeping powers to tax income derived from the sale or exchange of capital assets, including the eventual establishment of variable holding periods.

By recognizing capital gains as taxable income, the United States distinguished its national taxation system from that of most other nations for the better part of the twentieth century, until perhaps the late 1980s and 1990s. In the United Kingdom, capital gains were not taxed whatsoever until 1965, as was the case for Canada until 1972, Japan until 1988,⁴⁰ and

36. Treas. Reg. § 45, art. 21, T.D. 2831, 21 Treas. Dec. 176 (1919), cited in Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What’s Law Got To Do With It?*, 39 Sw. L.J. 869, 875 (1985). Kornhauser’s article contains an extensive discussion of the early “capital gains cases” as described herein. She concludes that the Supreme Court’s decision to regard capital gains as taxable income within the language of the Revenue Acts represented a restoration of “the precarious balance of power and reestablished a pattern of behavior that still holds today: a deference of the Court to Congress and negligible constitutional restraint on the taxing power.” *Id.* at 871. In view of the fact that prior case history of the Supreme Court conflicted, she views the contemporary economic and political context as a controlling factor in the Court’s ultimate conclusion. *See id.* at 926.

37. 255 U.S. 509 (1921).

38. In *Merchants’ Loan*, a trustee challenged the taxability of an approximately \$700,000 profit on sale of stock within a trust account on behalf of a widow and her four children in 1917. *Id.* at 515. The testamentary trust had directed that the trustee be “the final judge [of] ‘net income’ of the estate,” directing in particular that “‘stock dividends and accretions of selling values shall be considered principal and not income.’” *Id.* at 514-15 (emphasis added). The Court relied upon the definitions established in the *Hays* case above as well as in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920). *See id.* at 515.

39. 252 U.S. at 207 (quoting *Doyle v. Mitchel Bros. Co.*, 247 U.S. 179, 185 (1918)).

40. For an excellent comparative treatment of the capital gains tax systems in the Japan versus the United States as of 1990, see Brian Van Vleck, Note, *A Comparison of Japanese and American Taxation of Capital Gains*, 14 HASTINGS INT’L & COMP. L. REV. 719 (1991). Van Vleck concludes that both countries should move toward non-recognition of capital gains transactions as opposed to across-the-board tax cuts in order to maximize the facilitation of capital from less efficient to optimal investment choices. *See id.* at 747.

France until 1976.⁴¹ As illustrated in Appendix A, even by the late 1970s, the United States represented one of the few developed nations that possessed a separate tax structure for capital gains income. Indeed, numerous countries, such as Switzerland, the Netherlands, Greece, New Zealand, Belgium, and Singapore continue to treat capital gains as virtually or completely tax-exempt.⁴² However, arbitrary holding periods have also crept into many of the tax codes in countries that have experimented with capital taxation in recent decades.

Nevertheless, the United States' treatment of capital gains as a matter of fiscal policy provides fertile ground for examining the effects of different holding period structures and rates. Although the United States has almost always treated capital gains preferentially,⁴³ Congress has enacted over twenty significant changes to the rates and/or holding periods since the Revenue Act of 1913.⁴⁴ Since the U.S. Congress and Treasury Department diverged from European and contemporary economists' views that capital gains are separate from "income" in the classical sense,⁴⁵ the

41. See NORMAN B. TURE & B. KENNETH SANDEN, *THE EFFECTS OF TAX POLICY ON CAPITAL FORMATION* 172 (1977). See also LUIGI BERNARDI & JEFFREY OWENS, *TAX SYSTEMS IN NORTH AFRICA AND EUROPEAN COUNTRIES; COMPARATIVE TAX SYSTEMS: EUROPE, CANADA, AND JAPAN* (Joseph A. Pechman ed., 1987); INT'L FISCAL ASS'N, *VISIONS OF THE TAX SYSTEMS OF THE XXIST CENTURY* (1997).

42. Hong Kong also remains a legendary jurisdiction for tax-free capital gains. See 1997 INTERNATIONAL TAX SUMMARIES: A GUIDE FOR PLANNING AND DECISIONS (George J. Yost, III ed., 1997). See also DAVID G. DAVIES, *UNITED STATES TAXES AND TAX POLICY* 93 (1986). Note, however, that a common characteristic of these remaining countries who exempt capital gains is that they represent smaller, open economies that possess special needs to attract large volumes of capital. Davies notes that, with certain exceptions, many of these countries have enjoyed high economic growth rates. See *id.* at 93-94.

43. An important exception, as mentioned previously, was the Tax Reform Act of 1986's temporary elimination of the capital gains preference, a feature of the code that endured until 1991. See generally Hoerner, *supra* note 9.

44. See Minarik, *supra* note 19, at 270-73. See also Jane G. Gravelle, *Capital Gains Taxes: An Overview*, CRS REPORT FOR CONGRESS, 2-3, 96-759E, available in 1997 WL 851131.

45. The notion that realized capital gains should not be a component of annual income for either corporations or individuals has been thoroughly rejected in the United States, even by the most ardent capital-gains tax cut proponents. See Noel B. Cunningham & Deborah H. Schenck, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 325-26 (1993). In *Merchants' Loan*, the Supreme Court noted its opinion regarding the definition of income as follows:

In determining the definition of the word "income" thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.

255 U.S. at 519.

The Court continued its justification for treating capital gains as taxable income by disposing of the British legal precedent as meaningless: "The British income tax decisions are interpretations of

U.S. system has contained numerous “compromise” treatments of the capital gains tax, offering a partial yet incomplete preference rate or, as in the early days from 1913 until 1921, treating capital gains as ordinary income. From 1913 until the early 1920s, the U.S. Congress’ principal objective in taxing capital gains was revenue-raising, in part to pay for wartime expenses associated with World War I.⁴⁶ Over time, however, with the exception of smaller, open economies as noted above, the U.S. and European views toward capital gains taxes and holding periods have somewhat converged.⁴⁷

B. THE U.S. EXPERIMENT WITH MULTIPLE HOLDING PERIODS

The practice of differentiating between capital assets held for variable time periods originated in the United States with the Revenue Act of 1921.⁴⁸ This Act defined capital assets as, “property held for profit or investment in excess of two years (excluding inventory or property held for personal use).”⁴⁹ For qualifying capital assets meeting the two-year threshold, therefore, the Act prescribed an alternative, preferential tax rate of 12.5%⁵⁰ as well as full deductibility of capital losses against all ordinary income.⁵¹ Judicial recognition of preferential treatment toward the sale of

statutes so wholly different in their wording from the acts of Congress which we are considering that they are quite without value in arriving at the construction of the laws here involved.” *Id.* at 521-22.

46. See Kornhauser, *supra* note 36, at 871-72.

47. This convergence may be in part attributed to concerns for equity and fairness, as well as to governments’ views toward achieving optimal fiscal policy from an economic standpoint. When the United Kingdom introduced its capital gains tax in the 1960s, James Callaghan, a chief advocate of the bill, declared “Yield is not my main purpose . . . the failure to tax capital gains is . . . the greatest blot on our system of direct taxation. This new tax will provide a background of equity and fair play. . . .” Chris Whitehouse, *Capital Gains: New Rates and Rebasing*, 138 NEW L.J. 849 (1988). See generally Knoester, *supra* note 4.

48. See generally Income Tax Act of 1921, ch. 136, 42 Stat. 227 (1923).

49. *Taxation of Capital Gains and Losses: Hearings Before the Comm. on Ways and Means, Prepared By the Staff of the Joint Comm. on Taxation*, 97th Cong. 4 (1983) [hereinafter *Taxation of Capital Gains and Losses*].

50. Commentators have observed that due to the relatively low ordinary income tax rates for most citizens at the time, this preferential rate mainly provided benefits to the wealthy. See *id.* at 4. Note that during the World War I era, income taxes upon the wealthy reached exorbitantly high rates of 73%. See Van Mayhall, *Capital Gains Taxation—The First One Hundred Years*, 41 LA. L. REV. 81, 87 & n.41 (1983).

51. Although the deductibility of capital losses represents a critical feature of any capital gains tax system, the subject of capital losses goes beyond the scope of this note. At present, § 1211(b) provides for deductibility of capital losses as follows:

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 (if such losses exceed such gains) the lower of \$3,000 (\$1,500 in the case of a married individual filing a separate return), or the excess of such losses over such gains.

I.R.C. § 1211(b) (1999).

capital assets based upon holding periods first arose in *Alexander v. King*,⁵² in which the Court quoted the House Ways and Means Committee's rationale as follows:

Prior to 1921, gain realized from the sale of capital assets was treated as all other income, and subject to the same tax rates. The tax rates were high in the upper surtax brackets, and the gain from such sales often reached into such brackets. Because of such high rates, sales were not made and business was stagnating. Accordingly, the Ways and Means Committee reported out section 206 . . . to relieve this situation, and in explanation thereof stated:

The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum. . . in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law.⁵³

The desire to provide tax relief in the 1920s also represented, in part, a response to the post-War inflation that began in 1921.⁵⁴ As such, Congress maintained the capital gains preference based on a two-year holding period through the Revenue Acts of 1924⁵⁵ and 1926⁵⁶ and continuing through 1934 when a completely novel schedule of holding periods was announced.

52. 46 F.2d 235 (10th Cir. 1931) (holding that proceeds of royalty income from oil well are taxable as ordinary income as opposed to the more favorable capital gains under the Revenue Acts of 1924 and 1926).

53. *Id.* at 236. *See also* *Burnet v. Harmel*, 287 U.S. 103 (1932). In *Burnet*, the Supreme Court also took judicial notice of the Revenue Act of 1921's provisions to relieve the excessively high tax rates on capital gains by means of establishing a two year holding period to qualify for lower rates. *Id.* at 105-06. *Burnet* involved an owner of oil properties in Texas who leased the lands in return for "bonus payments" totaling \$57,000 in cash plus royalties, but reported the funds as income from the sale of capital assets in order to qualify for lower tax rates on the basis that he held the land for three years prior to sale. The Supreme Court ruled against the landowner, holding that "[w]e cannot say that such payments by the lessee to the lessor, to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by the actual production." *Id.* at 112.

54. *See* DAVIES, *supra* note 42, at 92.

55. Revenue Act of 1924, § 208(a)(1,8), I.R.C. § 939 (1925). This Act also utilized holding periods to differentiate between the deductibility of capital losses on capital assets held for less than two years and those held in excess of two years—net capital losses could only be deducted from gross income "to the extent that such deduction[s] did not reduce the tax by more than 12 1/2% of the net loss." David Carris, *Capital Gains Taxation: A Full Circle?*, 14 T. MARSHALL L. REV. 43, 48 (1989). In addition, deductions for short-term losses (under the two year holding period) were only allowable against short-term capital gains. *See id.* at 48.

56. Revenue Act of 1926, § 208(a) (1927).

The Great-Depression-era system of holding periods for capital gains represented a graduated layout of exclusion rates.⁵⁷ The holding period structure during this time period reflected governmental activism stemming from a desire to ameliorate harsh economic conditions perceivably derived from unregulated, chaotic financial markets in the late 1920s and early 1930s. From 1934 until reform legislation was passed in 1938, the tax inclusion rates for long-term capital gains were divided into five categories according to length of holding period:

TABLE 1: UNITED STATES HOLDING PERIOD EXCLUSION SCHEDULE, 1934-1937

Holding Period	Exclusion Ratio
One Year or Less	0%
Over 1 Year to 2 Years	20%
Over 2 Years to 5 Years	40%
Over 5 Years to 10 Years	60%
Over 10 Years	70%

Congressional enactment of this extensive holding period system represented the outcome of “attacks on the preference given to capital gains and losses” under the prior Revenue Acts in the 1920s.⁵⁸ Undoubtedly, these attacks may have been intensified by the contemporary Depression-era economic suffering that motivated legislators to regulate investors’ asset allocation decisions through the tax code.

Following Congressional reform efforts in 1938, the holding period system was revised once again to provide for significantly reduced total duration of the longest holding periods as well as a reduction in total number of holding periods.⁵⁹ In particular, a 0% exclusion ratio was applied to holding periods on capital assets of eighteen months or less; a one third exclusion ratio was applied to assets held for between eighteen months and two years; and a 50% exclusion applied to capital gains income realized after two or more years.⁶⁰

57. The U.S. holding periods of the 1930s closely resembled the Swedish system of the 1970s. See *infra* Appendix A.

58. See Carris, *supra* note 55, at 48.

59. See Minarik, *supra* note 19, at 270-71. See also, Income Tax Act of 1938, ch. 289, 52 Stat. 452.

60. See Minarik, *supra* note 19, at 270-71.

The modern design of holding periods, incorporating the official statutory designations of “short-term” and “long-term” capital gains, commenced upon passage of the Revenue Act of 1942,⁶¹ which provided a 50% exclusion of long-term capital gains (defined as capital assets held for greater than six months then sold for profit) and a 0% exclusion of short-term gains held less than six months.⁶² The alternative maximum tax placed on long-term capital gains was 25%. This reform measure endured with minimal adaptations⁶³ until the late-1970s, at which point the U.S. Congress reinstated its briefly abandoned tradition of reworking the capital gains holding period and rate system with seemingly little regard for the reliance interests of taxpayers. Appendix A provides an encapsulated summary of holding period revisions that Congress enacted in the late 1970s and 1980s, culminating with recent passage of TRA ‘97 and the Restructuring and Reform Act. The current Tax Code no longer relies principally upon exclusion ratios, instead it establishes capital gains tax rates that vary based upon an individual’s income level, the type of asset being held, and the holding period of each asset sold.

The United States’ “experiment” with variable holding periods for preferential capital gains treatment has demonstrated the following: (1) a convergence in the latter part of this century toward holding periods of shorter duration, typically fewer than two years;⁶⁴ (2) a degree of inconsistency that likely reflects utilization of holding periods as more of a political “bargaining chip” as opposed to an instrument for genuine fiscal reform; (3) rhetoric surrounding political debates in connection with holding periods (as opposed to the capital gains tax generally) has focused increasingly upon efficiency and equity rather than revenue effects,⁶⁵ and

61. Revenue Act of 1942, ch. 619, 56 Stat. 798 (1943). See also Gravelle, *supra* note 44, at 4.

62. See Minarik, *supra* note 19, at 272.

63. See *id.* at 272-73.

64. Even the 18 month maximum holding period incorporated into TRA ‘97 (as a means of reducing the apparent “windfall” to the wealthy associated with the lower 20% and 18% rates) generated considerable protest. See, e.g., *Proposals to Reduce Taxes, 1998: Testimony of William Stevenson, Chairman, Federal Taxation Comm., National Society of Accountants, On Reducing the Tax Burden Modification to Capital Gains Laws Before the Comm. on Ways and Means, 105th Cong.* (1998), available in 1998 WL 65351. Stevenson states the opinion of the National Society of Accountants as follows:

The National Society strongly supports the proposition that a low capital gains rate is critical to spurring capital formation and prosperity for the American work force. However, the mind-boggling complexity in the new capital gains rates and reporting should be eliminated. In particular, NSA endorses elimination of the 18 month holding period. . . .

Id. An important exception to the notion that shorter holding periods are viewed more favorably would be TRA ‘97’s new five year holding period for capital assets purchased after December 31, 2000.

65. The revenue effects associated with eliminating the distinction between short-term and long-term capital gains suggest that capital gains revenue would increase. See S. KAPLAN, THE HOLDING

(4) taxpayers' *actual* holding periods for capital gain realizations exhibit a high degree of sensitivity to the highest marginal capital gains tax rate.⁶⁶ However, targeted reform efforts in the 1990s threaten to resurrect the arbitrary, multi-classificatory holding period schemes of earlier decades and merit serious attention from those concerned with streamlining and improving the U.S. Tax Code.⁶⁷

III. AN ANALYSIS OF HOLDING PERIOD JUSTIFICATIONS

A. DESIRE TO MITIGATE "LOCK-IN" EFFECTS

Even critics of capital gains tax preferences acknowledge that one of the most powerful arguments in support of the preference continues to be that high capital gains taxes induce significant "lock-in" incentives for investors.⁶⁸ In fact, the "lock-in" effect represents an argument not only in favor of a general capital gains preference irrespective of holding periods, but also supports the notion of establishing different preferential rates proportionate to different holding periods. According to a report that the

PERIOD DISTINCTION OF THE CAPITAL GAINS TAX (National Bureau of Economic Research Working Paper No. 762, 1981) *cited in* Lawrence B. Lindsey, *Rates, Realizations, and Revenues of Capital Gains*, in *TAXES AND CAPITAL FORMATION* 17 (Martin Feldstein ed., 1987).

66. See Eric W. Cook & John F. O'Hare, *Capital Gains Redux: Why Holding Periods Matter*, 45 NAT'L TAX J. 53, 61-62 (1992). These authors conduct an empirical study demonstrating that "higher tax rates on capital gains are associated with longer holding periods for these assets." *Id.* at 61. This result conforms to intuitive microeconomic economic theory which would suggest that lowering the price of realizing a capital gain as time passes would most likely produce a "substitution effect" toward longer holding periods. This substitution effect should outweigh any counterbalancing "income effect" that could lead some investors to realize gains partially for consumption purposes in relation to their feeling "wealthier" following a tax cut for longer holding periods. See generally Fredland, et al., *supra* note 19.

67. See Appendix B for a detailed depiction of current U.S. marginal capital gains tax rates and holding periods. The current rate and holding period structure suggests several significant implications: (1) a much stronger incentive exists for individual taxpayers to wait for expiration of the short-term gain period of one year than to wait the full period of time necessary for TRA '97's special five year rate beginning in 2001; (2) little motivation exists from a capital gains perspective for investors to incorporate other than through "pass-through" entities such as S Corporations or Limited Liability Companies; (3) collectibles markets are severely disadvantaged relative to securities and other capital markets; and (4) the Qualified Small Business Stock exclusion ratio effectively preserves a 14.0% rate after accounting for the 50.0% exclusion ratio.

68. See generally Cunningham & Schenk, *supra* note 45. In spite of their concluding view that the capital gains preference represents very poor policy, even as a "second-best" solution to problems with the U.S. income tax system, these authors state that "[t]he most serious argument in favor of a capital gains preference is premised upon the so-called lock-in effect." *Id.* at 344. For a contrasting viewpoint, that the lock-in argument is at best only minimally persuasive, consider Daniel Halperin, Comment, *A Capital Gains Preference Is Not EVEN a Second-Best Solution*, 48 TAX L. REV. 381 (1993).

staff of the Joint Committee on Taxation prepared in the early 1980s, “[a]nalysis of whether it is appropriate to differentiate the tax treatment of capital gains and losses based on the length of time the asset is held generally begins with an analysis of why capital gains and losses should be treated differently than other kinds of income.”⁶⁹ Hence, the “lock-in” argument represents one of the principal motivating forces behind the United States’ near-persistent preferences for capital gains in the form of holding periods.

The “lock-in” effect stems from the realization requirement for capital gains taxation—in view of the fact that the capital gains tax theoretically is an entirely “discretionary” tax⁷⁰ based on the realization requirement as well as the stepped-up basis of capital assets upon the taxpayer’s death.⁷¹ A significant incentive exists for taxpayers never to sell capital assets for a gain. In general, the “lock-in” effect can be said to exist in two forms: (a) “the requirement that assets be held for a minimum length of time before preferential treatment is granted inhibits the sale of assets held for less than that period”⁷² and (b) upon selling a capital asset profitably, the tax due upon the gross receipts would partially consume the profit derived from selling that asset in favor of an alternative generating a higher pre-tax yield. Empirical studies of the 1934 to 1937 time period in the United States reveal that “the five graduated holding periods in the law . . . significantly reduced the turnover of capital assets.”⁷³ In addition, in terms of capital allocation across the full range of potential investment securities, the “lock-in” effect may keep investment funds tied up in the securities of more established firms, thereby denying sources of investment capital to “newer entrepreneurial ventures.”⁷⁴ The “lock-in” effect has also been blamed for

69. *Taxation of Capital Gains and Losses*, *supra* note 49, at 5.

70. *See* Lindsey, *supra* note 65, at 17.

71. *See* I.R.C. § 1014 (1995).

72. Minarik, *supra* note 19, at 244.

73. *Id.*

74. JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE GREAT DEBATE OVER TAX REFORM* 116 (1996). For a more extensive discussion pertaining to the effect of capital gains taxes upon the supply of available venture capital, see DAVIES, *supra* note 42, at 111-15. Davies explains this phenomenon as follows:

A direct connection exists between the net rate of return and the supply of venture capital. . . . Capital gains taxation decreases risk taking by investors for two reasons. . . . First, . . . a tax increase on assets that gain in value causes a shift in investment away from risky new ventures to older enterprises that pay a larger share of earnings in the form of dividends. New firms are usually small companies that pay no dividends in their early development.

A second factor that inhibits risk taking is the loss-offset provisions in the tax law. *Id.* at 111-12.

exacerbating volatility in securities markets in view of the incentive for investors not to sell during periods of rising prices and to sell for offsetting capital losses during periods of market decline, effectively intensifying both upward and downward market movements.⁷⁵

More specific to holding periods in particular, the “lock-in” effect can be summarized mathematically as the “tax effect on the comparison of investments” as illustrated succinctly by Martin David in 1968:

1. The decrease in present value of the portfolio occasioned by the tax on gains realized now rather than at a later date.
2. The difference in present value of the investment alternatives that can be attributed to differences in the tax treatment of investments held for different optimum holding periods.
3. Changes in the expected holding period induced by interaction of investor’s sensitivity to after-tax return and price anticipations.⁷⁶

As such, numerous scholars, including David, in the 1960s and 1970s proposed a graduated holding period as a means of reducing the “lock-in” effect.⁷⁷ In theory, at least, it was thought that in conjunction with a general increase in the capital gains tax *rate*, the “tax barriers to transactions in long-held, appreciated assets” would be reduced by a “downward graduation of the proportion of capital gains included in

Critics of this perspective counter that entrepreneurial capital responds more to market forces and economic opportunity than to changes in tax policy. See Lee, *supra* note 24, at 13-18. In addition, it should be noted that § 1202(a) of the I.R.C. offers a 50% capital gains exclusion for qualified small business stock. See Richard L. Delap & Michael G. Brandt, *RRA '93 Cut in Capital Gains Tax Encourages Investment in Small Businesses*, 80 J. TAX'N 266 (1994).

75. See GOODE, *supra* note 28, at 197-98.

76. MARTIN DAVID, *ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION* 131 (1968).

The model that David employs in his analysis consists of the following:

$$A_x = (P_{ix} - P_{0x})(1 - T[Y_1, H_1]) + P_{0x}$$

Where: P_{0x} = the purchase price of the asset x held in the current portfolio today,

P_{ix} = the price of asset x today, and

$T[Y_1, H_1]$ = the effective tax rate on the gain from sale, given current year income Y_1 and holding period H_1 , for asset x.

Id. at 129-32.

77. David, while acknowledging that the current system of holding periods as of 1968 was clearly suboptimal in terms of exacerbating the “lock-in” effect, stated that “the lock-in effect of any increase in capital gains tax rates could be greatly reduced by an appropriate gradation of the preferential rates with the length of the holding period.” *Id.* at 136-37. However, it is important to be aware that David’s analysis was written prior to the rational expectations revolution in economics (in the late 1970s), at a time when regulatory intervention in financial markets met with greater favor among economists than in the present period.

taxable income with the number of years the capital assets had been held by the taxpayer before realization of the gain.”⁷⁸

However, the existence of any graduated system of rates and holding periods merely adds structurally to the lock-in effect itself. Although it is true that the lock-in effect would be higher under a system in which capital gains were always taxed as ordinary income, a counterbalancing factor would be the potential desire by rational investors to realize their capital gains more frequently in order to spread the payment of taxes derived from gains over time. In a sense, therefore, the delineation of variable time periods accompanied by shrinking tax rates represents an offset to the above incentive to “pay-out” one’s taxes owed on a more consistent basis. On the other hand, under a neutral or income-discriminating tax system with holding period requirements, the possibility of deferring payment of any capital gains taxes whatsoever would easily overwhelm the above effect because of the possibility that future capital losses might be utilized to offset the existing capital gain.⁷⁹ Empirical studies have demonstrated a “higher ratio of short-term to long-term gains in the lower-income brackets.”⁸⁰ Therefore, the “lock-in” effect appears inescapable under both taxation of capital gains as ordinary income as well as most variations of holding period systems. In addition, the imprecision of a taxpayer’s expectations when deciding to purchase capital assets is exacerbated when the holding period schedule itself becomes subjected to unanticipated future changes. These factors contribute to the current capital gains system’s inadequacies as witnessed through individuals’ proclivities to

78. TURE & SANDEN, *supra* note 41, at 126. Interestingly, scholars during this time period (1960s and 1970s) appeared reluctant to propose the more obvious means of removing tax-related obstacles to shifting investments toward higher net present value projects, which would be the creation of a single, preferential capital gains tax rate irrespective of capital asset holding periods.

79. Indeed, economists have demonstrated with theoretical certainty that “under fairly general assumptions it is optimal to only realize capital losses and to *never* realize a capital gain.” Cook & O’Hare, *supra* note 66, at 54 (citation omitted). A modified version of this rule might be that it is optimal also only to recognize a capital gain when simultaneously recognizing a capital loss of equal magnitude. From an attorney’s planning perspective, however, it is important to keep in mind that prospective tax liability represents only a single variable in an infinitely complex equation when providing investment advice to clients. See SMITH & FENN, *supra* note 15, at 115. These authors prudently caution that, “stock selection should not be governed by tax considerations alone; rather, it should be driven by non-tax factors such as long-term potential, time horizon, diversification, and risk.” *Id.* at 115.

80. JANE G. GRAVELLE, THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME 144 (1994) (citing Harley H. Hinrichs, *An Empirical Measure of Investors’ Responsiveness To Differentials in Capital Gains Tax Rates Among Income Groups*, 16 NAT’L TAX J. 224, 224-29 (1963)). However, the author points out some limitations to these studies including insufficient control variables, suggesting the possibility of omitted variable bias.

hold “less preferred set[s] of investments.”⁸¹ The elimination of holding periods would, on balance, reduce the “lock-in” effect since variable capital gains rates would no longer affect taxpayers’ decisions to hold capital assets over time, even though the “lock-in” effect would continue to manifest through the realization requirement and the desire to distribute payment of capital gains taxes over time.

B. HOLDING PERIODS AS MEANS OF DISCOURAGING SPECULATORS

In both the United States and Europe, legislators have adopted various policies to discourage or inhibit private speculation on grounds that speculation creates harmful effects on society. In response to popular culture views that speculators represent “gamblers” who constantly seek arbitrage situations or other information from which to reap quick, extraordinary profits, legislators on both continents have been motivated to reduce any advantages that speculators possess relative to ordinary taxpayers as well as to regulate speculative activity directly. The desire to curb speculative profits—in contrast to the perceived advantages of encouraging long-term investments—represented one of the motivating forces behind TRA ‘97’s four-tiered holding period structure. Representative Stenholm addressed the floor of the House, stating that, “[i]n the area of the capital gains tax cut, one thing that . . . will prove to be hopefully a goal for the future is to recognize longer held investments should be entitled to capital gains reductions, not necessarily the short term that provides for speculation and quarterly report syndrome.”⁸² As such, in the United States, it appears that higher capital gains taxes paid upon the sale of capital assets held for less than one year signify a response among Congress members to (a) discourage speculative trading activity by requiring a very high threshold for an alternative, positive present value project to surpass in order for a trader to switch investments, and (b) provide subsidies⁸³ to long-term investors in the form of prospectively lower taxes for assets to which they are willing to make significant time commitments. Indeed, the ability of holding periods to discourage speculation may serve a critical, counterbalancing function from the point

81. *Id.* at 125.

82. H.R. 2014, 105th Cong., 143 CONG. REC. H6623-04 (1997) (enacted) (statement of Rep. Stenholm).

83. *See generally* David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549 (1998) (arguing that realization represents an effective subsidy for private savings and investment by means of enabling individuals and corporations to select the tax rate they will pay on capital gains). In fact, Schizer comments that the realization requirement actually increases the after-tax yield for growth-oriented investments relative to income-generating investments. *See id.* at 1552-53.

of view of legislators because the realization requirement already serves as a means of encouraging investment in higher-risk assets that may appreciate more rapidly over time.⁸⁴

In Europe, parliaments have generated more direct attacks upon speculative activities by labeling certain short-term trading practices as “inherently” speculative in nature. For example, in Italy, historically, the existence of a “speculative motive” represented the principal requirement for an investor to be subjected to a capital gains tax.⁸⁵ In addition, the German tax system currently exempts individual capital gains from taxation with the exception of “speculative gains” defined as the sale of corporate shares held for six months or less.⁸⁶

However, it is important to recognize that culturally biased attitudes toward individual speculators may be based upon a fundamental misunderstanding of the key role that speculators play in securities markets and should not, therefore, govern fiscal policy. Commentators have noted the omnipresent existence of anti-speculator bias in Anglo-American culture:

As long as securities have been traded, Anglo-American popular culture has contained a few strands of thought suspicious of trading and hostile to speculators. The securities market has been widely thought to involve more deceit than markets in other items, because securities have been consistently perceived to be more susceptible to price manipulation than anything previously known. The political power of speculators – their incentive and perceived ability to nudge public policy in the direction that will push securities prices up or down – has been a constant source of public concern. The belief that securities trading is a nonproductive sphere of the economy, one that drains resources from more fruitful activities, has been ever present. These strands of thought were pervasive in England in the 1690s, and they are still pervasive in the United States today.⁸⁷

In contrast to the popular perception that speculators engage in economically sub-optimal activities, the role of speculators as balancing

84. Schizer notes that the realization requirement builds a bias toward risky assets into the tax code. *See id.* at 1612.

85. *See* Laura Castellucci, *Italy*, in *COMPARATIVE TAX SYSTEMS: EUROPE, CANADA, AND JAPAN*, *supra* note 41, at 217.

86. *See* 1997 INTERNATIONAL TAX SUMMARIES, *supra* note 42, at G-5. *See also Comparative Tax Systems: Hearing Before the Comm. on Fin.*, 102d Cong. 10 (1992).

87. Stuart Banner, *What Causes New Securities Regulation? 300 Years of Experience*, 73 WASH. U. L.Q. 849, 850-51 (1997). Banner notes the coincident correlation between incidents of securities regulation and prior market declines over the past three hundred years in the United States and England. *See id.*

forces in the economy may, at times, be vital. Economists have frequently observed that “[s]peculation . . . plays a preponderant role, since it facilitates [market] equilibrium by allowing for a better circulation of information among participants. . . .”⁸⁸ During periods of extreme securities market gyrations, speculators assist in reducing volatility (and therefore uncertainty) by supporting depressed assets when the general market’s prices experience steep declines. In this sense, although holding periods for capital gains taxes may serve to increase volatility,⁸⁹ the activity of speculators—that which holding periods are designed to curb—serves a steadying function in the economy that stabilizes markets and restores assets to their efficient price levels.⁹⁰ This role of speculators has not been unrecognized among tax scholars⁹¹ but appears unlikely to persuade members of the general public until a more significant number of individuals perhaps join the ranks of speculators themselves.

88. Hubert De Vauplane & Odile Simart, *The Concept of Securities Manipulation and Its Foundation in France and the USA*, 23 BROOK. J. INT’L L. 203, 213-14 (1997). Vauplane and Simart recognize the welfare benefits that normal, market speculation can produce, but scorn effects of illicit stock price manipulation.

89. See DAVID, *supra* note 76. David notes that non-judiciously created holding period gradations may cause suboptimal asset allocation that leads to asset sales which otherwise would not be desirable. See *id.*

90. Of course, one could counter that speculators may often be the initial “over-reactors” who set in motion volatile cycles in the market. For a critical discussion of purely speculative stock trading as opposed to information arbitrage, see Lynn A. Stout, *Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?*, 75 WASH. U. L.Q. 791 (1997). Stout distinguishes potential positive welfare benefits that information arbitrage activity may produce from wealth-shrinking effects of ignorant speculation:

At best, speculation that takes the form of information arbitrage can provide an indirect social benefit of lesser or greater magnitude in the form of improved allocative efficiency from more accurate pricing. Purely speculative trading that springs from the natural dispersion of investors’ subjective opinions under conditions of uncertainty, however, drains investor wealth without providing any compensating public or private gain. And by reducing the transactions costs associated with speculative trading and possibly increasing the dispersion of investors’ opinions, the new information technology may encourage just such speculation.

Id. at 813. However, it seems logical to conclude that as internet technology lowers the costs of information acquisition, that the balance of speculative activity will gradually swing in favor of information arbitrage and transaction costs of error will decrease.

91. See, e.g., Sanford M. Guerin, *Capital Gain and Loss Tax Policy—Economic Substance or Legalistic Form?*, 1985 ARIZ. ST. L.J. 905 (1985). Guerin depicts the inequitable treatment of speculators as follows:

The apparent congressional rationale for requiring a specific arbitrary holding period is to prevent speculators’ gains from being preferentially taxed. This distinction is somewhat dubious. Why should speculators, who, like long-term investors, obtain profit from the appreciation in value of an asset, be fully taxed on such gain while investors are not? If the purpose of the capital gains tax preference is to encourage investment and reinvestment, it seems logical that even speculators or short-term investors should be encouraged to invest and reinvest.

Id. at 926.

In addition, one further justification for holding periods may be that to the extent that short-term “traders” in capital assets pursue such activity as their primary source of earned income, then short-term trading should be taxed at ordinary income tax rates. Indeed, in other countries throughout this century, should an individual’s number of trades exceed a governmentally defined limit, that individual was then classified as a trader and taxed at ordinary income tax rates even where capital gains had normally been tax-exempt.⁹² Clearly, then, an alternative exists to taxing automatically all short-term investment profits, in the form of specially designated “traders,” although the desirability of such an arrangement remains open to questions concerning the number and value of requisite trades that must be accomplished. The removal of holding period requirements to achieve capital gain preferences would, in effect, compensate speculators for the added risk that they absorb in securities markets. Moreover, abolition of holding periods and other arbitrary capital gains classifications would preserve a free market atmosphere in which asset prices more accurately reflect business-related information which speculators, institutional investors, and other market participants utilize. Holding periods represent serious impediments to efficiency and equity in securities markets.

IV. PROPOSAL TO ELIMINATE HOLDING PERIODS IN THE U.S. CAPITAL GAINS TAX SYSTEM

A. EQUITY CONSIDERATIONS—HOLDING PERIODS CREATE INEQUITABLE OUTCOMES

1. *Horizontal Equity*

Horizontal equity represents an attempt to evaluate the relative fairness of particular tax or other fiscal proposals by assessing whether those in equal positions to pay (i.e. with equal incomes and/or assets) are taxed as equally as possible. In regard to taxation of capital gains, even absent any preference, the realization requirement, from the outset, provides “favored treatment” to those who realize a large percentage of their income from capital compared to the general populace.⁹³ As such,

92. See DAVIES, *supra* note 42, at 94.

93. See Cunningham & Schenck, *supra* note 45, at 365. However, these authors maintain that a violation of basic horizontal equity should not constitute a pre-determined basis for rejecting a tax proposal because equity must be balanced with efficiency, which can ultimately affect equity once again. *See id.*

when evaluating horizontal equity in the context of holding periods for capital gains, an imperfect background exists that must be viewed independently from one's ultimate assumptions about particular policy proposals. In addition, recall that in *Alexander v. King*, the Tenth Circuit recognized that one of the original purposes of the two-year holding period for obtaining a capital gains preference was to relieve the inequity associated with capital gains tax "bunching," a factor that contributed to horizontal inequity in the taxation system at the time.⁹⁴

Nevertheless, the current system installs additional, arbitrary restrictions in the form of multiple holding periods that perpetuate horizontal inequities that should be considered grounds for their rejection. According to Professor Sanford M. Guerin, "[i]n addition to its complexity and inefficiency, the current system fails to attain a reasonable measure of horizontal equity because it distinguishes between similarly situated taxpayers arbitrarily, based on a formal rather than substantive analysis of an asset holding period."⁹⁵ Consider the following example: investor X, who earns \$55,000 per year and owns \$50,000 in assets, purchases shares of ABC Corporation for \$25,000 and holds the investment for 370 days, generating a profit of \$20,000; versus investor Y, who earns \$55,000 per year and owns \$50,000 in assets who purchases the same number of shares of ABC for \$25,000 but holds them for an equal profit after just 360 days. In the preceding example, under the current capital gains tax system, investor X would be taxed at a preferential rate of 20%, whereas investor Y's profit—derived from the same investment held just ten fewer days—would be taxed at the ordinary income tax rate of 31% (a tax of \$6,200 versus \$4,000, a 55% higher tax for individuals in identical positions to pay). Clearly, this example and numerous possible others illustrate the extent to which holding periods violate basic principles of horizontal equity.⁹⁶ The more discomfiting aspect of this inequitable outcome is that no substantive justification exists for the distinctive tax brackets that two similarly situated taxpayers may face. Moreover, depending upon whether one believes that capital gains should be taxed preferentially at all or should always be classified as ordinary income, the choice to eliminate

94. 46 F.2d 235, 236 (10th Cir. 1931).

95. Guerin, *supra* note 91, at 926.

96. Horizontal inequity also exists with regard to asset categories. Higher long-term rates for collectibles versus securities discriminate unfairly against the art market and those who prefer more tangible forms of storing or potentially gaining wealth.

arbitrary holding periods on capital gains would preclude these forms of horizontal inequity from arising.⁹⁷

2. *Vertical Equity*

In addition, potential vertical equity arguments can be raised to justify elimination of the holding period requirements. Vertical equity relates to a fair distribution of the tax burden among people who possess different abilities to pay. When Congress reinstated the capital gains tax preference in the early 1990s, it was argued that both vertical and horizontal equity were violated: vertical equity because those who possessed greater ability to pay received tax relief relative to the less wealthy, and horizontal equity because a distinction was created between earnings from different sources.⁹⁸ Applying vertical equity concepts to holding periods, the present system of complex holding periods among different types of capital assets (securities, collectibles, personal residences, etc.) creates a costly need for strategic tax planning advice among investors—under such circumstances, the wealthy will be better able to take advantage of the holding periods in such a way as to gain an advantage relative to other taxpayers. Of course, this argument could be raised with respect to income taxes in general. Hence, the horizontal equity argument stands out as the more persuasive equity concern. Nevertheless, it seems reasonable to assume that greater simplification helps to ensure a more progressive degree of vertical equity in the tax system.

B. HOLDING PERIODS, ASSET PRICES, AND “DEFAULT RISK” THEORY

1. *Basic Asset-Pricing Model for Fixed-Income Security*

The purpose of presenting an asset pricing model that incorporates capital gains taxes subject to variable holding periods is to demonstrate mechanistically and theoretically from a money market perspective the means by which holding periods generate asset price distortions. To the extent that public policy concerns surrounding the capital gains debate balance efficiency and equity, a detailed portrayal of holding periods' inefficiencies is instructive and necessary. This section utilizes two financial models associated with (a) the differential rate of taxes on interest

97. For example, if both investors were taxed at a single preferential rate of 20%, then horizontal equity principles would not be violated. The same applies if both were investors to be taxed at the non-preferential ordinary income tax rate.

98. See, e.g., RONALD PASQUARIELLO, TAX JUSTICE: SOCIAL AND MORAL ASPECTS OF AMERICAN TAX POLICY 86-87 (1989).

versus capital gains for corporate bonds and (b) the expectation function for corporate bond “default risk” in order to draw an analogy between shifting capital gains tax rates with varying holding periods and unexpected or altered probabilities of corporate bond default.

The basic model reveals the fundamental complexity that a holding period system introduces into the asset pricing model. This complexity for pricing a fixed-income security is heightened even further when applied to equity securities whose investment return may be subject to a broader range of uncertainty. Moreover, the analogy above demonstrates theoretically an additional source of asset pricing “shocks” that legislative changes in holding period statutes generate. To the extent that rational investors attempt to incorporate probabilities of different tax rates for different holding periods into their asset pricing forecasts, legislative alterations in the holding period generate significant changes in bond prices and yields with economically inefficient results.

The standard model depicting the initial price for a coupon bond held to maturity in a world with different tax rates on capital gains and interest income can be shown as follows:

Where P_m = present market price;
 I_t = interest payment at the end of year t ;
 P_s = market price upon date of sale;
 n = number of years to sale;
 r = after-tax yield of the fixed-income security;
 T and $G[H_t]$ = marginal tax rates on interest income and capital gains (given Holding Period H_t), respectively.⁹⁹

This formula can be read literally to mean that the current market price of a fixed-income security (e.g., a corporate bond) is composed of the summation over time ($t = 1$ through n) of the discounted value of future

99. For the basic structure of the model for a bond held until maturity, see JAMES C. VAN HORNE, FINANCIAL MARKET RATES AND FLOWS 231 (1984). The model above modifies the standard asset pricing model for bonds held until maturity in two ways: first, by incorporating a system of holding periods into the capital gains tax variable, and second, by assuming that the investor sells the bond instead of holding until its maturity date. It is also important to recognize that this model is discrete rather than continuous, consistent with the structure of holding periods and individual sale dates (i.e. the capital gains tax does not shrink continuously with the running of time).

interest payments, reduced by tax rate T , plus capital gains ($P_s[H_t] - P_m$), reduced by the capital gains tax G for holding period H_t . In effect, the market price of a fixed-income security must take into account the effects of ordinary income tax rates as well as the probabilistically determined capital gains taxes and tax rates. The asset pricing model demonstrates that holding periods represent a variable that inputs a substantial source of uncertainty into securities prices. Moreover, the model suggests that much simpler asset pricing would occur under two potential reforms, either of which would reduce or effectively eliminate the middle term of the above summation equation. First, if holding periods were abolished and capital gains taxed neutrally with ordinary income, then T and $G[H_t]$ could be equated. Second, if capital gains were tax-free irrespective of holding periods, the asset pricing model would reflect only the ordinary tax on interest income.

This model reflects the fact that if the ordinary income tax rate, T , is greater than the capital gains rate, G , then a dollar of capital gain is worth more than a dollar of interest income.¹⁰⁰ However, the magnitude of the difference is dependent upon the different capital gains rate structure based upon holding periods one through n . Under a system of fixed capital gains rate holding periods, the pricing of this bond varies only with the presumably “fixed” values of each variable. However, historically, holding periods for capital gains preferences have been subjected legislatively to frequent change. As such, pricing structures of the typical bond become infinitely more complicated. When purchasing securities in liquid capital markets, investors face price structures that reflect fully the marketplace’s judgment concerning a combination of factors built into this model as well as other factors beyond the model’s scope. Through strategic trading, the asset price eventually reflects (either instantly or gradually depending upon the relative efficiency of the market) the capital markets’ aggregate, balanced perception of the reliability of future interest payments in addition to judgments regarding optimal periods to hold the investment in relation to its maturity date and likely future tax rates. The potential for a change in the tax rate for different holding periods of capital gains, therefore, may be considered analogous to the sudden appearance of an unexpected “default risk.”

100. See *id.* at 231.

2. "Default-risk" Model

In financial theory, the "expected default loss"¹⁰¹ for a security is equal to the difference between its "promised" and "expected yields," where the "expected yield" (EY) is represented by the following equation:

$$EY = \sum_{x=1}^n Y_x P_x$$

where Y_x = x th possible yield;
 P_x = probability of occurrence of that yield; and
 n = total number of possibilities.¹⁰²

The expected yield of a security, according to this formula, can be stated as the summation of possible yields multiplied by the individual probabilities of occurrence of those yields once the security has been purchased. The default-risk model, therefore, illustrates formulaically that the market's "expected default loss" can be measured by the promised rate of return minus the expected yield. By combining these elements of the default-risk model with the asset pricing model illustrated above, the complete ramifications of holding periods for capital gains can be illustrated in terms of their asset misallocation effects. In essence, first, the existence of a holding period structure for capital gains introduces a measure of complexity into capital markets at the asset pricing level, as illustrated by different prices, and therefore yields, that would result for an asset to be held for longer or shorter durations. Second, in the event that holding periods are subjected to change, as has historically been true in the United States,¹⁰³ such changes can be measured and illustrated by the suddenly greater or lesser "expected default losses" that result. Should the capital gains tax rate be modified based on holding periods, then the difference between the expected yield as reflected in the current market price and the expected yield following the change introduces an exogenous "shock" into the capital market that instantly alters investors' preferences for holding particular securities. In the above model, the expected "loss" resulting from a change in the capital gains rate for a particular holding period would be represented non-dynamically by the following: $(P_s[H_t] - P_m) \cdot [E\{G[H_t]\} - G[H_t]]$, where $E\{G[H_t]\}$ equals the expected capital gains rate given holding period H_t subject to a probability distribution.

101. *Id.* at 167.

102. *Id.*

103. See Schizer, *supra* note 83, at 1581. Schizer states that "[h]istory thus suggests that, whatever the rate structure is today, it is likely to be different in a year or two." *Id.*

From the combination of these models, one can observe that the pricing of the corporate bond, P_m , would be extensively complicated and altered given the need for market participants to formulate discrete probability distributions for each potential tax rate on capital gains in each holding period H_i . Even absent differential holding periods, it has been determined theoretically that “an unexpected increase (decrease) in the effective capital gains tax rate relative to that for interest income would be expected to be associated with an increase (decrease) in yield” on bonds purchased at a discount versus bonds purchased at par.¹⁰⁴ It becomes clear, therefore, that the capital market’s ability to generate efficient asset prices may vary not only with the accuracy of traditional economic forecasts but also with the tax structure applied to capital gains as reflected in holding periods. Holding periods introduce a measure of arbitrariness into asset markets that divert prices away from underlying economic fundamentals, forcing investors to balance tax-related risk factors with more meaningful economic data.

3. *Asset Misallocation Implications*

The foregoing analysis illustrates the degree to which “shifting” holding periods for capital gains result in shocks analogous to increases or decreases in “default risk” for corporate bonds. A similar analogy could be made for other securities or capital assets beside corporate bonds. Even to the extent that holding periods eventually approach a stationary average (in relative terms), the difference in holding period requirements for capital gains preferences generates significant economic distortions, both static and dynamic. According to economists, “[w]hen a substantial proportion of the capital stock is being subsidized at different rates, as it was in 1985, there may be considerable misallocations of resources and biased economic growth. This misallocation could imply substantial welfare losses.”¹⁰⁵ To the extent, therefore, that multi-tiered holding periods for individual and corporate capital gains taxes contribute to welfare-reducing distortions in the U.S. and global capital markets, serious attention should be devoted to abolition of holding periods altogether.

Under the current system as of 1999, in spite of political rhetoric favoring simplification of Title 26 of the U.S. Code, holding periods continue to present sub-optimal, distortive asset pricing structures. Current proposals passed by Congress, but that will likely be vetoed by President

104. VAN HORNE, *supra* note 99, at 236.

105. Don Fullerton & Mario Karayannis, *United States*, in *TAX REFORM AND THE COST OF CAPITAL: AN INTERNATIONAL COMPARISON* 363 (Dale W. Jorgenson & Ralph Landau eds., 1993).

Clinton, merely lower the top capital gains tax rate from 20.0% to 18.0% and do not address holding periods.¹⁰⁶ As reflected in Appendix B, capital pricing markets must incorporate holding periods that distinguish between short-term and long-term capital gains (defined as assets held less than one year or more than one year, respectively), as well as additional, lower rates beginning in the year 2000 for assets held more than five years, on top of a five year holding period requirement imposed upon § 1202(a) small-business exclusions.¹⁰⁷ Although it is true that the overall “federal capital gains tax is responsible for less than 10% of the overall federal capital income tax burden,”¹⁰⁸ scholars have demonstrated empirically that investors are highly sensitive even to extremely modest changes in holding periods.¹⁰⁹

It is precisely this sensitivity among members of the investment community to capital gains tax rates and holding periods which suggests widespread asset misallocation and price distortions concurrent with the present holding period structure. The investment fund industry itself has established entire categories of mutual funds and investment management vehicles dedicated principally to maximizing shareholders’ after-tax returns by circumventing the Tax Code’s holding period structure.¹¹⁰ Each investment decision predicated upon avoidance of higher rates attributable to particular holding periods is ultimately indicative of a more substantial asset misallocation problem facing the national economy.

Although the Republican-led Congress appears resolved to pursue renewed cuts in capital gains taxes,¹¹¹ a solid, less-controversial first step in

106. See Curt Anderson, *GOP Wins Passage of Big Tax Cut, President Clinton Stands By His Vow to Veto \$792 Billion Measure*, SAN DIEGO UNION-TRIB., Aug. 6, 1999, at A1. See also Knight Ridder News Service and The Boston Globe, *Clinton Axes Republicans’ \$792 Billion Tax Cut Plan: GOP Says Veto Robs Families, Puts Hopes in 2000 Election*, SAN DIEGO UNION-TRIB., Sept. 24, 1999, at A-1.

107. See Delap & Brandt, *supra* note 74, at 266. See also Appendix B.

108. GRAVELLE, *supra* note 80, at 141.

109. See *id.* at 144.

110. See *supra* note 20 and accompanying text. The point of singling out the new “tax-efficient” mutual funds is not to criticize the funds themselves, as they may very well provide significant tax advantages to individual investors, but to recognize that these funds illustrate the investment industry’s innovative responses to changes in the U.S. Tax Code. The incentive to establish these funds would be reduced if the U.S. system of taxing capital gains were simplified and/or neutralized.

111. See H.R. 2014, 105th Cong., 143 Cong. Rec. H6623-04 (1997) (statement of Rep. Solomon). This Republican Congressman ambitiously outlines the conservative capital gains agenda, as well as its rationale, as follows:

And you have not seen nothing yet. Wait until next year and the year after, because we are going to come back to eliminate capital gains taxes. . . . A sharp cut in the capital gains tax cut will, without question, stimulate job growth, and investment, and the real incomes of all working American families. According to the Congressional Budget Office, and this is so

capital gains tax reform would be to eliminate arbitrarily imposed holding periods historically placed upon capital gains income. To the extent Congress determines that a capital gains preference is desirable, the Tax Code would promote fewer asset misallocations by taxing all capital gains derived from any capital asset and recognized by either individuals or corporations¹¹² at a single, preferential (or even non-existent) inflation-indexed tax rate, irrespective of asset holding periods. However, if Congress believes that capital gains tax preferences are not meritorious, then capital gains derived from sales of applicable capital assets should be taxed consistently with ordinary income tax rates (i.e., similar to the current treatment of short-term gains for individuals).¹¹³

CONCLUSION

Whether a capital gains tax preference should be maintained, eliminated, or strengthened represents a purely political decision for which legal and economic analysis can only provide suggestions helpful in the evaluation process.¹¹⁴ The extreme political nature of capital gains tax reform serves as an explanation for the extent to which the present system represents such a “compromise” solution between stark extremes.¹¹⁵

terribly important because it goes back to this business of class warfare. . . . [T]hree-quarters of America's families own assets such as stocks, bonds, homes, real estate and businesses. NASDAQ reports that 47 percent of all investors are women. . . . [T]he Treasury Department reports that nearly two-thirds of all tax returns reporting capital gains income are filed by people whose incomes are under \$50,000.

Id.

112. If legislators truly defend the Internal Revenue Code's preferential treatment of capital gains as an incentive for generating capital formation, then the capital gains preference should extend to corporate capital gains, as a means of refining the efficient allocation of capital in securities markets. Corporations possess incentives similar to individuals to invest risk capital in positive net present value projects. By achieving parity between individual and corporate capital gains tax rates, the current form of entity discrimination under the Internal Revenue Code would be reduced. *See, e.g., Proposals To Reduce Taxes, 1998: Hearing Before the Comm. on Ways and Means of the U.S. House of Representatives*, 105th Cong. (Feb. 12, 1998) (statement of Mark Bloomfield, President, Am. Council for Cap. Formation).

113. *See* I.R.C. § 1(h) (1998).

114. *See, e.g.,* Joseph Stiglitz, *Tax Reform: Theory and Practice*, in *THE ECONOMICS OF TAX REFORM* 22 (Bassam Harik ed., 1987). Stiglitz writes that “[o]ur tax system is an important forum within which our national values become stated. In other words, what is at issue is more than just economics.” *Id.*

115. If one contrasts the investment community's views toward capital gains tax preferences with the views of many legal scholars, the differences are remarkable. Consider the following statements by investor Mark Mobius: “Capital gains taxes are the enemy of all equity investors. . . . Probably one of the biggest depressants on the rate of capital formation is the risk of confiscation by governments via taxation.” MARK MOBIUS, *MOBIUS ON EMERGING MARKETS* 11, 58 (1996).

Nevertheless, the idea of eliminating holding period requirements for capital gains preferences altogether has been given attention. In the late 1960s, a conference of economists and policy analysts examined various proposals, including elimination of the holding period distinction altogether, adopting a “rollover” policy for capital gains, and other solutions.¹¹⁶ More recently, Representative Lindsey Graham stated that, “[t]he very idea of the Federal Government dictating time constraints on the holding of investments runs counter to the fundamental concept of our market-driven economy. With present holding periods, how can we conclude that an 18-month investment is better than a 17.9-month investment?”¹¹⁷

In conclusion, therefore, the following recommendations and guidelines should be considered in order to eliminate inequities and price-distorting inefficiencies from the U.S. system of capital gains taxation:

- Removal of the holding period requirements for capital gains tax preferences and either opting for a single, preferential capital gains tax or a capital gains tax consistent with ordinary income to neutralize income taxes;¹¹⁸
- Corporate and individual capital gains taxes should be equilibrated¹¹⁹ and inflation-indexed;¹²⁰ and

In contrast, many scholars strongly disagree. *See supra* note 24 and accompanying text. The current holding period structure, therefore, suggests elements of concession between such diametrically opposed interest groups.

116. *See* DAVID, *supra* note 76, at 224-25.

117. H.R. E2175, 105th Cong., 143 CONG. REC. E2174-04 (daily ed. Nov. 4, 1997) (statement of Rep. Lindsey Graham).

118. *See generally* David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967). Professor Slawson proposed both equating capital gains tax rates with ordinary income tax rates as well as adopting the “mark-to-market” method of taxing capital gains appreciation annually based upon an IRS-determined price of securities during a given month per year. The 1967 article represented a cogent effort to address perceived biases in Title 26 toward the wealthy, who derived increasing amounts of wealth from tax-deferred capital gains. The proposal also included detailed specifications for addressing valuation concerns in regard to corporate control. *See id.* However, *see supra* note 28 for a critique of the “mark-to-market” method. Note also that holding periods should be removed in every instance that they currently exist, including the five-year requirement for small-business exclusions under § 1202(a).

119. *See* GRAVELLE, *supra* note 80, at 142.

120. Indexation of capital gains, while not yet implemented, has been acknowledged by a majority of scholars as an important reform measure on both equitable and economic grounds. A more general discussion of the issue is beyond the scope of this note. *See generally* WILLIAM A. KLEIN & JOSEPH BANKMAN, FEDERAL INCOME TAXATION 836 (1997); Mark I. Schwartz, *Why Capital Gains Should Be Indexed*, 67 TAX NOTES 421-23 (1995); Martin Feldstein, *Inflation and the Excess Taxation of Capital Gains on Corporate Stock*, 31 NAT'L TAX J. 107 (1978). President Clinton, argues that indexation might add needless complication to capital gains taxes. *See supra* note 7 and accompanying text.

- Distortions among types of assets, such as between collectibles and securities, should be minimized or eliminated.¹²¹

Adherence to these proposals, while politically difficult to effectuate, would inevitably achieve a higher standard of efficiency and welfare in the U.S. economy, while also maximizing horizontal equity under the U.S. Tax Code. Capital market investors would no longer face potentially disruptive fluctuations in the tax rates that force frequent re-calculations of expected return upon them, while individual investors who possess sincere needs for access to their savings would no longer have to wait an arbitrary, additional period of time to obtain preferential capital gains treatment.

However, the inflation adjustment would be a mere one-step calculation on Schedule D. So long as indexation applies neutrally to all entities, asset categories, and time periods, it would bring the U.S. Tax Code more closely proportionate to the Haig-Simons income definition, while generating possible efficiency gains. For a discussion of the Treasury Department's authority to administer indexation, see generally Charles J. Cooper, Michael A. Carvin, & Vincent J. Colatiano, *The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains*, 12 VA. TAX REV. 631 (1993).

121. See Esenwein, *supra* note 29.

APPENDIX A

COMPARATIVE CAPITAL GAINS TAX STRUCTURES IN LATE
1970S

Country	Description of Capital Gains Tax on Investment Securities	Top Marginal Capital Gains Tax Rate for Long-Term Gains	Presence of Holding Period Requirements
Australia	No capital gains tax. However, if one were classified as a "trader" by making numerous transactions per year, then capital gains could be treated as ordinary income.	0%	No.
Belgium	No capital gains tax. However, gains from "speculative transactions" are taxed at rate of 30%.	0%	No.
Canada	Introduced taxation of capital gains in 1972. Capital gains taxed at ½ the rate of ordinary income	22%	No.
France	Capital gains income completely exempt until 1976. However, French Parliament introduced limited tax (16%) on sale of securities with a \$6,000 exclusion and 10-year holding period exclusion.	16%, 0%	Yes.
West Germany	Long-term gain (securities held in excess of six months) tax-exempt. Short-term gain taxed as ordinary income.	0%	Yes.
Italy	Capital gains historically exempt. In 1990, however, Italy introduced a 25 percent capital gains tax.	0%	No.

Japan	<p>Capital gains historically not taxed provided that fewer than 50 trades and 200,000 shares were traded per year.</p> <p>Beyond the above limit, however, 100% of short-term gains and 50% of long-term gains (held for 5 years or more) were taxed.</p>	0%	No.
Netherlands	<p>Capital gains have been exempt from taxation unless the transaction involved a substantial interest in the corporation being traded (defined as in excess of 1/3rd ownership).</p>	No.	No.
Sweden	<p>Elaborate system of holding periods and tax rates:</p> <p>Shares held < 2 years: 100%</p> <p>Shares held < 3 years: 75%</p> <p>Shares held < 4 years: 50%</p> <p>Shares held < 5 years: 25%</p>	25%	Yes.
United Kingdom	<p>Capital gains exempt until 1965.</p> <p>Afterward, net annual capital gains were taxed at lesser of (1) 30% or (2) half of the first 5000 Ls. Surcharge of 15% on investment income (including capital gains) over 2000 Ls.</p>	30%	No.
United States	<p>Capital gains rates changed every year from 1976 until 1980. In 1978, the short-term gain holding period was changed from 9 months to 12 months. For long-term gains, 50% of the gain was taxed as ordinary income (40% by the end of 1978), resulting in a top rate that declined from 35% to 28%.</p>	28%	Yes.

APPENDIX B

CURRENT STRUCTURE OF MAXIMUM MARGINAL CAPITAL
GAINS

TAX RATES AND HOLDING PERIODS

Taxpayer Type	Short-term Gain (1 year or less)	Long-term Gain (1 year or more)	TRA '97 Five Year Special Rate (assets held more than 5 years and acquired after Dec. 31, 2000)	§1202 Qualified Small Business Stock (held more than 5 years and acquired after 1993)	28% Rate Gain or Loss
Low-Income, Unmarried Individuals [Defined as those whose tax rate is 15.0%].	15.0%	10.0%	8.0%	50.0% Exclusion Ratio applies. 28.0% tax rate thereafter (effectively 14.0% rate).	15.0%
Middle to High-Income, Unmarried Individuals	Ordinary Income Tax Rates apply: 28% over \$22.1K 31% over	20.0%	18.0%	50.0% Exclusion Ratio applies. 28.0% tax rate thereafter (effectively 14.0% rate).	28.0%

	\$53.5K 36% over \$115K 39.6% over \$250K				
Subchapter C Corporations	34.0% if taxable income exceeds \$75K, plus adjustments if over \$100K. 35.0% if taxable income exceeds \$10 million, plus adjustments if over \$15 million.	35.0%	Does not apply.	Does not apply.	Does not apply.