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FLAWED FOUNDATIONS: A RE-EXAMINATION OF THE REASON AND PURPOSE BEHIND THE CAPITAL GAINS TAX PREFERENCE

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The favorable taxation of capital gains has seen extensive ex-post celebration and condemnation, but the ex-ante reason for its enactment has largely been forgotten. This Note, written one hundred years after the capital gains tax preference was first enacted in 1921, responds to this gap by re-examining legal history to ask two simple questions: why does the capital gains preference exist as a matter of law and what can be learned from why it was enacted? I find that Congress was presented with two options to address the problem of high tax rates on capital gains yielding surprisingly little revenue in the early 20th century. The first option was to adopt broader, foundational changes to the taxation of capital gains to make the tax harder to avoid, while the second was to simply enact a low, preferential tax rate that taxpayers would willingly pay. They chose the second option, and I present data from the IRS Statistics of Income to provide some empirical evidence that the lower rates did yield greater revenue. The story behind the capital gains tax preference is important for current policy discussions since tax law is still grappling with the legacy of Congress's decision to tax capital gains at reduced rates rather than fix the underlying problem that a realization-based income tax is easily gamed by taxpayers. If policymakers wish to impose higher tax rates on capital, they must reverse the decision taken in 1921 by both raising rates and changing how the law conceptualizes capital gains altogether. By only raising rates, Congress may find itself faced with

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the same string of issues that led to it enacting the capital gains tax preference in the first place.

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Introduction

In 1921 the United States Congress enacted a special lower tax rate on the sale of capital property, known as capital gains, which quickly became one of tax law's most controversial provisions.[1] One hundred years later the Internal Revenue

1. Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227. Hereinafter, the only legislation called the "1921 Revenue Act" is the final statute that passed into law. For a discussion of the controversy see Noel B. Cunningham &

Code (the "Code") still taxes capital gains at preferential rates compared to other income like wages or interest, something referred to as the capital gains tax preference.[2] Politicians across the political spectrum decry this preference as unsatisfactory, in need of dire change, and one of the cardinal sins of

Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993); Daniel I. Halperin, *A Capital Gains Preference is not EVEN a Second-Best Solution*, 48 TAX L. REV. 381, 381 (1993); and George R. Zodrow, *Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity*, 48 TAX L. REV. 419, 419 (1993).

2. Currently, the top capital gains tax is 20% for individuals earning above $425,800; 15% for individuals earning between $38,601 and $425,800; and 0% otherwise under I.R.C. § 1(h), as modified by I.R.C. §§ 1(j)(5). Subchapter P of Chapter 1 of the Internal Revenue Code deals with capital gains and losses. *See* I.R.C. §§ 1202–98. Under current law, the capital gains tax exists in a complex network of rules for taxing savings and capital, which loosely includes capital gains and losses, interest, dividends, and derivatives. Present law taxes interest and non-qualified dividends as ordinary income, but the sale of capital assets and qualified dividends at preferential capital gains rates, effectively halving the tax on gains, losses and dividends for assets held longer than one year. Qualified dividends are taxed at preferential rates under I.R.C. § 1(h)(3)(B) and defined under I.R.C. § 1(h)(11). The general regime regarding the taxation of capital gains and losses may be found in Subchapter P of the I.R.C. Interest is deductible under I.R.C. § 163 while it is includible in general income under I.R.C. § 61(a). If a capital asset held for less than the one-year period is sold, it generates short-term gains or losses. I.R.C. § 1222. Since debt and equity can be used interchangeably to recreate the same income stream, the different tax treatment of debt and equity is a fundamental flaw of the Internal Revenue Code. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958) (foundational work regarding the debt-equity irrelevance principle under certain assumptions, notably no tax distortions); Alvin C. Warren, *US Income Taxation of New Financial Products*, 88 J. PUB. ECON. 899 (2004) (discussing how different instruments can be used to recreate the same cash flows but with different tax consequences). There are some important differences between debt and equity and the possible effects they may have on firm value, such as the "pecking order" theory by Myers and Majluf and the agency problems discussed by Jensen and Meckling. *See*, respectively, Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors do not Have*, 13 J. FIN. ECON. 187 (1984) and Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For the problems caused by put-call parity for the current Code see Warren, *supra*, at 903. For an overview of the current taxation of capital, see HENRY J. AARON, LEONARD BURMAN & C. EUGENE STEUERLE, TAXING CAPITAL INCOME (2007). For another discussion *see* Alvin Warren, *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585 (1974).

U.S. taxation.[3] How, then, has it persisted for so long? Although there has been extensive work on the early history of notable tax provisions, such as the corporate tax,[4] the taxation of interest,[5] dividends,[6] and even capital losses,[7] work on capital gains is far more limited.[8] I respond to this gap by closely studying the legislative history of the enactment of the capital gains tax preference to answer why a special, preferential tax rate exists in the first place, and what lessons it holds for modern tax policy.

The hundred-year anniversary of the capital gains tax is an opportune time to investigate the issue since similar tensions to those that concerned legislators in 1921 are prompting discussion of how to treat capital gains today. Prior to the COVID-19 pandemic, rising inequality and concerns that the wealthiest taxpayers were not paying their fair share induced calls to reform the taxation of capital gains, which are mostly reported by high wealth individuals.[9] The ongoing health cri-

3. Edward Kleinbard, *Designing an Income Tax on Capital*, *in* TAXING CAPITAL INCOME 165, 170 (Henry J. Aaron, Leonard Burman, & Eugene Steuerle eds., 2007) (calling the differential taxation of debt and equity an "original sin" of U.S. taxation).

4. Steven Bank has written prolifically on this topic. *See* STEVEN A. BANK, FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT, at ix (2010); Steven A. Bank & Ajay K. Mehrotra, *Corporate Taxation and the Regulation of Early Twentieth-Century American Business*, *in* CORPORATIONS AND AMERICAN DEMOCRACY 177 (William J. Novak & Naomi R. Lamoreaux eds., 2017). *See also* Joseph J. Thorndike, *Taxing Corporations is Always Popular – Until It Isn't*, 100 TAX NOTES ST. 297, 298 (2021).

5. Camden Hutchison, *The Historical Origins of the Debt-Equity Distinction*, 18 FLA. TAX REV. 95, 103 (2015).

6. *Id. See also* BANK, *supra* note 4 (much of Bank's analysis deals with taxes on dividends as stand-ins for direct taxes on corporations, or vice-versa).

7. LAWRENCE ZELENAK, FIGURING OUT THE TAX: CONGRESS, TREASURY, AND THE DESIGN OF THE EARLY MODERN INCOME TAX 135 (2018) (covering withholding, charitable contributions, step-up at death, and capital losses).

8. For the current literature, see Ajay K. Mehrotra & Julia C. Ott, *The Curious Beginnings of the Capital Gains Tax Preference*, 84 FORDHAM L. REV. 2517 (2016); Joseph J. Thorndike, *FDR Tried to Stop a Capital Gains Tax Cut — and Failed*, 99 TAX NOTES ST. 919 (2021); Joseph J. Thorndike, *The New Deal and Capital Gains: A Cautionary Tale for Biden?,* 99 TAX NOTES ST. 727 (2021); Joseph J. Thorndike, *Tax History: Biden Wants to Reform the Capital Gains Preference — It Will Be Hard*, 99 TAX NOTES ST. 473, (2021).

9. *See* Leonard E. Burman & Peter D. Ricoy, *Capital Gains and the People who Realize Them*, 50(3) NAT'L TAX J. 427 (1997). *See also* Jeff Larrimore et al.,

sis and related financial difficulties suffered by millions of Americans despite record stock index highs has only made the situation worse.[10] Moreover, in 2020 the federal deficit broke all previous peace-time records, with the Congressional Budget Office reporting the deficit at $3 trillion, or 16% of GDP.[11]

Similarly, the postwar 1918–1921 period saw tensions between labor and capital erupt into widespread conflict culminating in record strike activity, bombings, the first Red Scare, deportations of suspected socialists, and restrictions on free speech.[12] The federal government had likewise just issued massive amounts of debt to finance World War I.[13] In order to

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Recent Trends in U.S. Top Income Shares in Tax Record Data Using More Comprehensive Measures of Income Including Accrued Capital Gains, 129 J. POL. ECON 1319 (2021).

10. By December 31, 2020, the Dow Jones hit a record high of 30,409.56. *See* Zacks Equity Research, *Stock Market News for Dec 31, 2020*, NASDAQ (Dec. 31, 2020), https://www.nasdaq.com/articles/stock-market-news-for-dec-31-2020-2020-12-3. For the impact of Covid on consumer spending and savings, see Olivier Coibion et al., *The Cost of the Covid-19 Crisis: Lockdowns, Macroeconomic Expectations, and Consumer Spending* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27141, 2020).

11. CONG. BUDGET OFFICE, *An Update to the Budget Outlook: 2020 to 2030* (2020) https://www.cbo.gov/system/files/2020-09/56517-Budget-Outlook.pdf. As a percentage of GDP, such levels have not been seen since World War II. The large deficits were caused by COVID-19 related impacts and stimulus. For discussions, see Anthony J. Makin & Allan Layton, *The Global Fiscal Response to COVID-19: Risks and Repercussions*, ECON. ANALYSIS & POL'Y, Mar. 2021, at 340; Mariateresa Maggiolino, Robin Morgan & Maria Lucia Passador, *The State-of-the-Art of NPLs in the Post COVID World: An Ongoing Concern for the Future*, 10 LAW & ECON. YEARLY REV. 108 (2021) (discussion in the European banking sector context).

12. *See* ROBERT K. MURRAY, RED SCARE: A STUDY IN NATIONAL HYSTERIA, 1919–1920 (Univ. of Minn. Press 1955); WILLIAM E. FORBATH, LAW AND THE SHAPING OF THE AMERICAN LABOR MOVEMENT (Harv. Univ. Press 2009). Disillusioned with the divergence between the promises of liberalism and reality, the 1920s saw the rapid development of nascent social sciences critiquing many aspects of classic liberalism's socio-political framework. Legal scholarship in the 1920s saw the growth of legal realism which sought to address the role of the law in distributing wealth between social classes. *See, e.g.*, Duncan Kennedy, *The Stakes of Law, or Hale and Foucault!*, 15 LEGAL STUD. F. 327, 327 (1991); Richard A. Posner, *Legal Formalism, Legal Realism, and the Interpretation of Statutes and the Constitution*, 37 CASE W. RSRV. L. REV. 179, 181 (1987).

13. For the amount of debt outstanding see U.S. TREASURY, Historical Debt Outstanding, https://fiscaldata.treasury.gov/datasets/historical-debt-outstanding/historical-debt-outstanding (last visited Feb. 10, 2022) [herein-

fund the war effort and service that debt, in 1918 Congress dramatically increased tax burdens with top marginal tax rates on income reaching upwards of 70%.[14] Wartime tax collection could not last forever, and between 1920 and 1921 Congress took up the task of tax reform. A small but crucial part of the tax reform problem related to capital gains, which is the focus here. After extensive analysis and debate, Congress decided to substantially reduce tax rates on capital gains—and only capital gains—to 12.5%, thereby creating the capital gains tax preference.

This Note has two main goals. First, to understand Congress's reasons for enacting the preference, both in terms of rates and special treatment relative to other types of income. Sources include the record of legislative hearings, draft bills, and congressional debates. This review finds that the preference was adopted more as a recognition that the system was broken but too complicated to fix rather than as an attempt to benefit the private sector. Congress ignored and in fact rejected explicit pro-capital or pro-business rationales, though such a bias may have been implicitly embedded in Congress's worldview at the time. Arguments and evidence that wealthy taxpayers had easily avoided the capital gains tax and hence prevented the Treasury from collecting substantial revenue from the 73% top marginal rate led to sweeping support for reform. Presented with several options, Congress preferred the introduction of a special low tax rate on capital gains that would be easier to administer than more wholistic reform options. Other structural reform proposals like apportionment of gains across periods or calculating gains according to an inflation-adjusted basis were also raised, but these were dismissed as being too complex. This story likewise reveals some important concepts in tax scholarship that are thought to have been developed much later. For example, in 1921 Senator Jones proposed a consumption tax many decades before Bill Andrews revolutionized tax law by seemingly writing about such taxes for the first time in 1974.[15]

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after Treasury Debt Data]. Between 1915 and 1920 outstanding debt increased by around $25 billion.

14. *See infra* Part I.

15. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1973). For the ensuing discussion, see Alvin C. Warren Jr., *Fairness and a Consumption-Type or Cash Flows Personal Income Tax*,

The second goal is to investigate the validity of Congress's revenue-raising hypothesis. Were legislators right in thinking that the 12.5% rate would increase tax receipts compared to the prior 73% rate? To address this question, the note presents data on wealthy taxpayers' capital gains from the IRS Statistics of Income between 1915 and 1925. In view of the general shortcomings of empirical analysis regarding capital gains elasticities and the questionable relevance of century-old tax data, the note presents summary statistics rather than econometric analysis.[16] I find that the IRS data is consistent with Congress's hypothesis: tax receipts from capital gains for top-bracket taxpayers were indeed greater following the 1921 reform compared to before. Given the above limitations this finding should not be taken to imply causation, nor do I argue that a 12.5% tax rate for capital gains was optimal in the 1920s or today. Instead, I echo and develop the arguments of Tim Dowd, Zach Richards, Joel Slemrod, and Wojciech Kopczuk that elasticities depend in part on the general structure of the Code and the relative taxation of savings more broadly, not only tax rates.[17]

This re-examination provides lessons for modern debates on taxing capital gains, especially those of high wealth taxpayers. Widely recognized as being inadequate, both sides of the political spectrum have advanced considerable reform propos-

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88 HARV. L. REV 931 (1975) and William D. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1974). For a history see Reuven S. Avi-Yonah, *The Rise and Fall of the Consumption Tax: A Historical Perspective* (Univ. of Mich. L. and Econ. Rsch. Paper Series., Working Paper No. 14-0245, 2015) (includes tariffs and taxes on the sale and consumption of goods as consumption taxes proper, which I do not do here).

16. *See* Tim Dowd & Zach Richards, Contextualizing Elasticities for Policymaking: Capital Gains and Revenue-Maximizing Tax Rates (Mar. 10, 2021) (unpublished manuscript) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3767121).

17. *Id.* at 15, 23. This point is also made by Emmanuel Saez & Gabriel Zucman, *Progressive Wealth Taxation*, 2019 BROOKINGS PAPERS ON ECON. ACTIVITY 437, 458 (2019) (arguing that tax avoidance under a wealth tax is a policy choice). The point is made more forcefully by Natasha Sarin et al., *Rethinking How We Score Capital Gains Tax Reform* (Nat'l Bureau of Econ. Rsch., Working Paper No. 28362, 2021); Joel Slemrod & Wojciech Kopczuk, *The Optimal Elasticity of Taxable Income*, 84 J. PUB. ECON. 91 (2002) (modelling scenarios where policymakers control other instruments which can influence elasticity).

als.[18] Assuming that tax burdens should be greater than they currently are, the focus here will therefore be on proposals which aim to increase taxes on capital. Perhaps the most famous proposal, Thomas Piketty has argued for top marginal tax rates of roughly 80% on income over half a million in addition to wealth taxes.[19] Similarly, proposals made by Senators Warren and Sanders during the 2019–2020 Democratic Primaries included wealth taxes and raising capital gains tax rates, while President Biden aims to raise tax rates on capital gains without imposing a wealth tax.[20]

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18. Republican proposals have typically been centered around the consumption tax. For a practical discussion of actual proposals see David A. Weisbach, *A Guide to the GOP Tax Plan – The Way to a Better Way*, 8 COLUM. J. TAX L. 171 (2017). For a theoretical discussion, see Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006). For Democrat proposals see *infra*, note 20. For a more theoretical discussion of such proposals especially wealth tax ones, and the inherent problems with the current system, see Saez & Zucman, *supra* note 17.

19. THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY 513–14 (Harv. Univ. Press 2014) is Piketty's piece concerning income inequality and taxation. Theoretically, Piketty's point can be made distinct from eliminating the favorable taxation of capital gains, but he recommends ending it. There have been extensive responses to his work which will not be discussed here. Other public economics research supporting higher tax rates than those normally proposed in the optimal income tax literature include Thomas Piketty, Emmanuel Saez & Stefanie Stantcheva, *Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities*, 6 AMERICAN ECON. J.: ECON. POL'Y 230–71 (2014).

20. Senator Warren proposed a mark-to-market system for capital, and set gains tax rates equal to ordinary income rates, making the baseline rate roughly 40%. Team Warren, *Ending the Stranglehold of Health Care Costs on American Families* (Nov. 1, 2019), https://medium.com/@teamwarren/ending-the-stranglehold-of-health-care-costs-on-american-families-bf8286b13086. For Senator Sanders's proposal, see Friends of Bernie Sanders, *Tax on Extreme Wealth*, https://berniesanders.com/issues/tax-extreme-wealth/ (last visited Apr. 4, 2020). The exact schedule is as follows: 1% on net worth between 32-50 million; 2% from 50 to 250 million; 3% from 250 to 500 million; 4% from 500 million to 1 billion; 6% from 2.5 to 5 billion; 7% from 5 to 10 billion; and 8% exceeding 10 billion. All for married couples. For the wealth tax bill referred to the House Committee on Ways and Means and co-sponsored by Warren and Sanders, see the Ultra-Millionaire Tax Act of 2021, H.R. 1459, 117th Cong. (2021) [hereinafter Ultra-Millionaire Tax Act]. For President Biden's plan, see Greg Iacurci, *Biden's Top Tax Rate on Capital Gains, Dividends Would Be Among Highest in Developed World*, CNBC (June 21, 2021, 7:57 AM), https://www.cnbc.com/2021/06/21/biden-tax-plan-raises-top-capital-gains-dividend-tax-rate-to-among-highest-in-world.html.

The 1921 capital gains tax rate reduction cautions against simply raising capital gains tax rates while ignoring structural reforms to the underlying taxation of capital, especially the realization requirement. I argue that some, if not most, of the failure of the high tax 1917–1921 years comes from structural inadequacies of the Code, not because high tax rates are inherently wrong. How much revenue a given tax can collect depends on the overall legal architecture in which it exists, with the implication for current policy being that larger tax levies on capital must be supported by reforms targeting accumulated savings and entity level taxation more broadly.[21] Recent wealth tax proposals are interesting since their strength may lie precisely in their ability to reduce taxpayers' ability to avoid, evade, or defer taxes on capital, though there may be other practical difficulties regarding enforcement and administration.[22]

This Note proceeds as follows. Part I surveys the early taxation of capital to situate the 1921 reform within the broader legal and socio-economic framework. I define "capital" and "savings" as including interest, dividends, and capital gains, which can be used interchangeably by corporations or taxpayers to recreate the same income stream with different tax consequences.[23] Part II looks at the legislative and political history of the enactment of the preference, first introduced in the 1921 Revenue Act.[24] Part III presents IRS Statistics of Income from the 1915–1925 period to determine whether, as Congress anticipated, the capital gains preference resulted in an in-

21. In the public economics scholarship Slemrod and Kopczuk analyze the sensitivity of avoidance of one type of tax (e.g., a capital gains tax) relative to other related policy instruments (e.g., the corporate tax), which is argued later in the piece. *See supra* note 17 and accompanying text.

22. *See* Saez & Zucman, *supra* note 17 (arguing that the value of a wealth tax comes from its ability to broaden the base); *see also* Florian Scheuer & Joel Slemrod, *Taxing Our Wealth*, J. ECON. PERSPS., Fall 2021, at 207. *But see* Lawrence H. Summers, *Would a Wealth Tax Help Combat Inequality?*, *in* COMBATING INEQUALITY: RETHINKING GOVERNMENT'S ROLE 141, 141 (Olivier Blanchard & Dani Rodrik eds., 2021).

23. Especially important is that income from capital includes capital gains which is but one possible way of structuring returns to capital, such that capital and capital gains are two distinct concepts.

24. Revenue Act of 1921, Pub. L. No. 67-98, 42 Stat. 227. From now on (and since the beginning of this piece), the only legislation that shall be called the "1921 Revenue Act" is the final statute that passed into law.

crease in tax receipts from top-bracket taxpayers. I then discuss how the Code's legal structure could have led to this result. The Note concludes and discusses the takeaways for current tax policy.

I.
THE TAXATION OF SAVINGS AND CAPITAL BETWEEN 1861 AND 1919

Understanding the purpose and effect of the capital gains preference requires the study of two related topics: the early taxation of capital and the impact of World War I on United States fiscal policy. One scholar who has extensively studied the early income tax, Lawrence Zelenak, describes scholarship on the United States' early tax history as offering "a selective—very far from comprehensive—description of the early technical development of the federal income tax."[25] He is too modest in this assessment, since while historical tax work does indeed select and study specific elements of the tax system, the analysis proves detailed, in-depth, and singularly insightful in contextualizing the divergence in approaches taken to taxing returns on investments.

A. *The First Income Taxes: 1861–1909*

The United States enacted its first income tax in 1861 to fund the Union's wartime expenses during the Civil War, taxing every person's annual income at a 3% rate.[26] However, it was only in 1862 that the federal government introduced a withholding tax on interest and dividends paid by corporations.[27] To avoid double taxation, these payments were fully deductible by taxpayers.[28] What constituted deductible interest changed significantly from year to year, with Congress failing to settle on a coherent approach.[29] Regarding dividends,

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25. ZELENAK, *supra* note 7, at 3.

26. For the statute itself, see An Act to Provide Increased Revenue from Imports, to Pay Interest on the Public Debt, and for Other Purposes, § 49, 12 Stat. 292, 309 (1861). *See* Hutchison, *supra* note 5, at 103–14.

27. Hutchison, *supra* note 5, at 105; An Act to Provide Internal Revenue to Support the Government and to Pay Interest on the Public Debt, § 90, 12 Stat. 432, 469–70 (1862).

28. Hutchison, *supra* note 5, at 105–06.

29. *Id.* at 109–13. Mortgage interest became deductible in 1864. An Act to Provide Internal Revenue to Support the Government, Pay Interest on the

Steven Bank, a prolific writer of tax history especially as it relates to corporate taxation, notes that the scheme was both over- and under-inclusive,[30] and did not cover all industries.[31] It was under-inclusive because dividends were withheld at a 5% rate and were fully deductible by individuals even though the top individual tax rate was 10%, and was over-inclusive because even those who owed no taxes still saw their dividends subjected to 5% withholding.[32] These conceptual difficulties did not last long, as this income tax was repealed in 1871.[33]

After extensive Congressional debate, the short-lived 1894 Act,[34] allowed for the deductibility of all interest, whether "bonded or other indebtedness," by corporations.[35] Although interest was includable as income, there was no direct dividend tax: corporate income was taxed instead at the entity level.[36] Bank explains that this policy was a streamlined version of a dividend tax, not an attempt to tax corporate income.[37] While the Act was important for the future development of the income tax, it was quickly struck down by the Supreme Court in *Pollock v. Farmers' Loan & Trust Co.*[38] Responding to the inability to enact a federal income tax, in 1909 Congress enacted

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Public Debt, and for Other Purposes, §§ 120–22, 13 Stat. 223, 281–82, 283–85 (1864). Only business-related interest was deductible following 1867. An Act to Amend Existing Laws Relating to Internal Revenue, and for Other Purposes, § 13, 14 Stat. 471, 478 (1867). All interest became deductible in 1870. An Act to Reduce Internal Taxes, And For Other Purposes, § 6, 16 Stat. 256, 258 (1870).

30. BANK, *supra* note 4, at 20–21.

31. *Id.*

32. *Id.*

33. An Act to Reduce Internal Taxes, and for Other Purposes, § 6, 16 Stat. 256, 257 (1870) [hereinafter 1870 Act] provided that the income tax would expire in 1871, as Hutchison, *supra* note 5, at n.24.

34. The 1894 Act, An Act to Reduce Taxation, to Provide Revenue for the Government, and for Other Purposes, §§ 27–33, 28 Stat. 509, 553–57 (1894), was struck down by the Supreme Court in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895).

35. *Id. See* Hutchison, *supra* note 5, at 114–24 for the historic discussion. For the quote, see Hutchison, *supra* note 5, at 119 n.111.

36. BANK, *supra* note 4 at 51.

37. *Id.* at 50–51.

38. *Pollock*, 157 U.S. 429 (where the Supreme Court found that certain portions of the 1894 Act, namely the tax on income derived from real estate and personal property, were direct taxes and hence must be apportioned under U.S. CONST. art. I, § 2. Since apportionment was not satisfied, the entire Act was struck down).

an excise tax on corporations which allowed for the deduction of interest from bonds.[39] The excise tax limited the amount of the deduction to paid-up-capital stock based on the fear that corporations would exchange equity for debt, making unlimited interest deductions politically undesirable.[40]

B. *The Sixteenth Amendment and the 1913 Income Tax*

In 1913 Congress bypassed the ruling in *Pollock* by enacting the Sixteenth Amendment, giving it the power to collect taxes from income from any source and without apportionment, and subsequently passed the 1913 Revenue Act.[41] This new and now constitutional income tax maintained interest deductibility, but the limit was changed to half of paid-up-capital plus half of outstanding debt.[42] As before, interest income was fully includible for individuals. The Act likewise included a direct corporate tax which was again seen as an indirect way of taxing shareholder wealth, with the corresponding exclusion of dividends from the individual income tax.[43] A major development in the 1913 Act was the introduction of a surtax that rose progressively with income and included dividends in addition to the "normal" flat tax.[44]

The 1913 Act created great confusion regarding the taxation of capital gains.[45] Much of this confusion arose from the explicit inclusion of all "gains, profits, and income derived from . . . dealings in property, whether real or personal," even though Zelenak writes that the primary author of the 1913 Act, Cordell Hull, emphatically stated that capital gains were excluded.[46] This legal uncertainty was only settled in 1921 thanks to four Supreme Court rulings that capital gains constituted

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39. Hutchison, *supra* note 5, at 124–25. This was not the first corporate excise tax. *See* Bank & Mehrotra, *supra* note 4.

40. Hutchison, *supra* note 5, at 126.

41. *See id.* at 122; U.S. CONST. amend. XVI; Pub. L. No. 63-16, § II.A–G, 38 Stat. 114, 166–71 (1913) (An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes) [hereinafter 1913 Act].

42. 1913 Act, *supra* note 41, § II(G), at 176. *See also* Hutchison, *supra* note 5, at 130 (accompanying n.174).

43. 1913 Act, *supra* note 41, § II(G), at 170.

44. 1913 Act, *supra* note 41, § II(A)–(B), at 166–67.

45. ZELENAK, *supra* note 7, at 136.

46. *Id.* at 135.

income.[47] The 1913 Act was silent regarding capital losses,[48] with Zelenak describing Congress's view on capital losses as "wandering in the tax policy wilderness" until they finally arrived at the current approach in 1942.[49] Regardless, soon after the enactment of the 1913 Act, the Treasury denied the deductibility of capital losses, despite Cordell Hull's position to the contrary.[50]

Students of tax law will quickly note the tax asymmetries and their distortion of investment decisions. The 1913 Act saw interest fully includible and deductible (with limits) at the corporate level, dividends includible in the surtax but not deductible by corporations, capital gains fully includible, and capital losses not includible at all.[51] In stark contrast with the capital gains preference under current law, investors were disincentivized from adopting investment strategies based on realizing appreciated capital assets.[52] Since the combined top marginal rate was 6% (and only on income exceeding $500,000), any distortions were likely smaller relative to later tax schedules.[53]

C. *World War I and the Revenue Acts of 1916, 1917, and 1918*

World War I was a turning point for the United States. According to Jeremy Atack and Peter Passell the change in global economic conditions caused by the outbreak of war in Europe benefited the United States with the demand for foodstuffs, consumer goods, and resources at all-time highs.[54] Gold also flowed into American banks, increasing the money supply

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47. Marjorie Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got to Do with It?*, 39 SOUTHWESTERN L.J. 869, 876–80 (1985) (The four Supreme Court cases discussed are Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921); Eldorado Coal Co. v. Mager, 255 U.S. 522 (1921); Goodrich v. Edwards, 255 U.S. 527 (1921); and Walsh v. Brewster, 255 U.S. 536 (1921)).

48. ZELENAK, *supra* note 7, at 139.

49. *Id.* at 137.

50. *Id.* at 139.

51. *See supra* notes 45–50 and accompanying text.

52. Contra the situation described in the prior paragraphs with that in Halperin, *supra* note 1. Under current law capital gains are taxed at favorable rates, while under the 1913 Act capital gains were taxed less favorably since there was no offsetting provision for losses. *Id.*

53. 1913 Act, *supra* note 41, § II (A), at 166.

54. JEREMY ATACK & PETER PASSELL, A NEW ECONOMIC VIEW OF AMERICAN HISTORY: FROM COLONIAL TIMES TO 1940, 557 (2d ed. 1994).

and prices.[55] About halfway through the war the United States Congress enacted the 1916 Revenue Act, which raised tax rates on both the flat tax and the surtax.[56] Although the 1916 Act was less impactful in terms of capital tax policy, Congress reversed course and allowed the deduction of investment losses to the extent they offset investment gains.[57] This change reduced the drawback from strategies aiming to generate income streams from selling appreciated assets, especially since taxpayers could choose when to trigger (realize) those gains.

The United States formally declared war on the Central Powers on April 6, 1917, and quickly found itself in a problematic situation. A decentralized political apparatus and a free-market economic system hindered the mobilization of goods and manpower.[58] To remedy this situation the federal government attempted to integrate the private sector directly into the war effort.[59] Two noteworthy examples were the Council for National Defense, which was charged with coordinating industry and resources for the war, and the War Industries Board, responsible for procuring war supplies.[60] Both were created to serve the needs of a war-time command economy and were staffed by prominent members of the corporate world.[61] This fusion of private and public sector interests was seen as necessary to keep the American war machine running smoothly.[62]

Upon joining the war, the federal government's expenditures rose from below $760 million a year to more than $760

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55. *Id.* at 555.

56. Pub. L. No. 64-271, §1, 39 Stat. 756 (1916) (An Act to Increase the Revenue, and for Other Purposes) [hereinafter 1916 Act].

57. *Id.* § 5(a) at 756. *See also* ZELENAK, *supra* note 7, at 140–42.

58. ATACK & PASSELL, *supra* note 54, at 555.

59. *Id.* at 555–56.

60. *See* GROSVENOR B. CLARKSON, INDUSTRIAL AMERICA IN THE WORLD WAR: THE STRATEGY BEHIND THE LINE, 1917-1918, (1923); ROBERT D. CUFF, THE WAR INDUSTRIES BOARD: BUSINESS-GOVERNMENT RELATIONS DURING WORLD WAR I (1973).

61. ATACK & PASSELL, *supra* note 54, at 556, 560 (the Council for National Defense was created in 1916 prior to the U.S. entering the war to prepare for the eventual possibility of US involvement in World War I). *See* 50 U.S.C. § 1. *See* ERNA RISCH, QUARTERMASTER SUPPORT OF THE ARMY: A HISTORY OF THE CORPS, 1775–1939 604 (1989) (historic overview of the War Industries Board).

62. *See* Ajay K. Mehrotra, *Lawyers, Guns, and Public Moneys: The U.S. Treasury, World War I, and the Administration of the Modern Fiscal State*, 28 LAW & HIST. REV. 173, 179–81 (2010).

million a month,[63] with federal spending soaring from 0.2% of GDP in 1914 to 3.2% in 1919.[64] Most of the revenue required for this spending came from income taxes, corporate taxes, debt, and tariffs.[65] While the 1916 Revenue Act had a top marginal tax rate of 15% (a combination of the 2% flat rate, plus the 13% surtax on all income above 2 million),[66] the 1917 War Revenue Act set a top combined marginal tax rate of 67% on individuals and imposed excess profits taxes for companies (so-called "war profits" taxes) between 20–60% of excess profits relative to peace-time margins.[67] These "excess profits" were measured inverse proportionally to invested capital, which included equity and undistributed profits but not most debt financing.[68] Despite the surge in applicable tax rates on both individual taxpayers and corporate entities, the taxation of interest, dividends, capital gains and losses vis-à-vis each other remained largely unchanged.

Of course, there was ample opposition to high tax rates. Camden Hutchison writes that "with American soldiers fighting overseas, business leaders were reluctant to directly criticize higher taxes. Rather than lobbying for the reduction of nominal tax rates, businesses instead focused on the tax laws' more technical provisions," like the interest deduction limit.[69] The 1918 Revenue Act accordingly allowed for some debt to be included as invested capital, but only debt whose interest was not deducted from income.[70] Since this was only a partial remedy, extensive lobbying resulted in payments becoming fully deductible in 1919.[71]

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63. ATACK & PASSELL, *supra* note 54, at 556–57.

64. Mehrotra, *supra* note 62, at 179.

65. *Id.* at 179–80.

66. An Act to Increase the Revenue, and for Other Purposes, Pub. L. No. 64-271, § 1, 39 Stat. 756 (1916).

67. An Act to Provide Revenue to Defray War Expenses, and for Other Purposes, Pub. L. No. 65-50, § 1, 40 Stat. 300 (1917).

68. Hutchison, *supra* note 5, at 133–34.

69. *Id.* at 132.

70. *Id.* at 135. For the 1918 Revenue Act, see An Act to Provide Revenue, and for Other Purposes, Pub. L. No. 65-254, § 301(a), 40 Stat. 1057, 1088 (1919) (note, that despite the Act appearing in 1919, it is referred to as the 1918 Revenue Act and covered the calendar year ending in 1918) [hereinafter "1918 Revenue Act" or "1918 Act"].

71. Hutchison, *supra* note 5, at 133–36 (strongly recommended reading regarding the deductibility of interest and dividends).

The 1918 Revenue Act saw further increases in taxes.[72] The highest combined marginal rate rose to 77% for 1918, 73% for subsequent years, and tax rates on excess profits were increased as well.[73] The Act likewise removed limitations on capital losses, making them fully deductible.[74] Besides taxes, the United States issued upwards of 25 billion in debt to fund the war.[75] Despite the signing of the armistice on November 11, 1918, spending would not return to pre-war levels.[76] Instead, expenditures in the 1920s were more than three times their pre-war levels.[77] Particularly important was the rise in interest payments on government debt, which by 1927 corresponded to 22% of the federal budget compared to 2.5% in 1913.[78] The additional revenue required to sustain the increase in expenses primarily came from income and corporate taxes.[79] High levels of debt and other revenue requirements had fundamentally changed conceptions of the modern fiscal state, making effective taxation a priority.[80]

Using corporations to defer shareholder-level taxation was an important feature of U.S. taxation between 1916–1921. Such deferral was valuable because of lower corporate tax rates and the introduction of the individual surtax.[81] Congress responded by targeting retained earnings through an undivided profits tax in the 1913 Act, but its application was too weak to matter.[82] As income tax rates rose between 1916 and 1918 so too did the incentive to retain earnings. However, Congress replaced the undistributed profits tax in 1917 with the wartime excess profits tax thereby lessening the cost of deferring

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72. 1918 Act, *supra* note 70, Title II, Part II.

73. *Id.* For a contemporary article discussing the legislation, see Roy G. Blakey & Gladys C. Blakey, *The Revenue Act of 1918*, 9 AM. ECON. REV. 214 (1919).

74. ZELENAK, *supra* note 7, at 140–42.

75. Treasury Debt Data, *supra* note 13.

76. ATACK & PASSELL, *supra* note 54, at 557.

77. *Id.*

78. *Id.*

79. *Id.*

80. *See generally* Mehrotra, *supra* note 62; AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877-1929 (2013).

81. Bank & Mehrotra, *supra* note 4, at 187–88.

82. *Id.*

shareholder taxation.[83] Indeed, Bank and Mehrotra report that large corporations were able to manipulate capital structure to reduce their liability under the excess profits tax, which made them appealing tax avoidance vehicles for wealthy shareholders subject to high marginal rates.[84] Corporate-level deferral of shareholder taxes likely impacted the performance of taxes on between 1917 and 1921, as discussed in Part III.

II. THE 1921 CAPITAL GAINS PREFERENCE

A. *Introduction to the 1921 Reform*

In the early 1920s the reality of expanded government, increased expenditures, and war debt coming due required the federal government to raise substantial revenue.[85] However, existing taxes were seen as easily avoided by the wealthy and the tax burden was seen as having become excessive because of wartime revenue needs, a feeling which was exacerbated once the country entered into a recession between 1920–1921.[86] The need to reduce tax burdens while still maximizing revenue featured heavily in the minds of the architects of the 1921 Revenue Act.[87]

The 1921 Act introduced several staples of modern tax law, with a first example being the full inclusion of debt at the shareholder level and full deductibility at the corporate level, which resulted from Congress repealing the excess profits tax without changing the taxation of interest.[88] A second is the expansion of the tax-free reorganization rules, which had originally been adopted in a weaker form in 1918.[89] Yet another feature, the focus here, is a lower tax rate on capital gains compared to other income.[90]

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83. *Id.* at 191–92.

84. *Id.* at 191–93.

85. *See* discussion *infra* Section II.B (especially Adams's testimony).

86. *Id.* at 196.

87. *See* Anne L. Alstott & Ben Novick, *War, Taxes, and Income Redistribution in the Twenties: The 1924 Veterans' Bonus and the Defeat of the Mellon Plan*, 59 TAX L. REV. 373, 374–75 (2006).

88. Hutchison, *supra* note 5, at 136.

89. *See* Bank & Mehrotra, *supra* note 4, at 196–97.

90. The special rate is found in section 206 of the 1921 Revenue Act. *See* Revenue Act of 1921, Pub. L. No. 67-98, §§ 206(b), 210–11, 42 Stat. 227, 233–37 (1921). Taxpayers could elect to have this special lower rate (12.5%)

The formal political reform process went relatively quickly, beginning in December of 1920 and ending with the signing into law of the Revenue Act on November 23, 1921. During this period, both the House Ways and Means Committee and the Senate Finance Committee held hearings with testimony from academics, members of the Treasury, representatives of industrial interests, and members of the public.[91] While the entire process will be canvassed shortly, the preliminary hearings before the House and Senate committees are particularly revealing as to the concerns and options available to Congress.

B. *House Ways and Means Hearings, December 1920 to January 1921*

In December 1920, the House Ways and Means Committee was given the mandate to prepare a draft for a new, postwar tax regime.[92] The Committee heard from Treasury officials, organizations, associations, experts, and other interested parties to help them with their task. Among the experts who testified was Thomas Sewall Adams, a Professor of tax and economics at Yale who served as economic advisor to the U.S. Treasury between 1917 and 1933.[93] In addressing the Commit-

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apply to all capital gains. Only those taxpayers with income above $12,000 benefited from such an election, since rates on brackets below $12,000 were less than the special 12.5% rate.

91. Some examples include Professor T. S. Adams, representing the Treasury, *Revenue Revision: Hearings Before the H. Comm. on Ways & Means*, 66th Cong. 3–42 (1921) [hereinafter *1920–21 W&M Hearings*] (statement of Thomas S. Adams, Tax Advisor, the Treasury Department), Thomas W. Hardwick and Ellis C. Johnson, representing the National Association of Bottlers of Carbonated Beverages, *id.* at 141–51 (statement of Hon. Thomas W. Hardwick, Representative, the National Association of Bottlers of Carbonated Beverages), 151–52 (statement of Ellis C. Johnson, Representative, the National Association of Bottlers of Carbonated Beverages) (in hindsight his testimony is especially interesting since they argued that soda should receive a tax subsidy because of their health benefits), and E.F. McGrady, representing the American Federation of Labor, *Internal-Revenue Hearings: Hearing on the Proposed Revenue Act of 1921 Before the S. Comm. On Fin.*, 67th Cong. 404–08 (1921) [hereinafter *Senate Finance Committee Hearings*] (statement of Edward F. McGrady, Representative, American Federation of Labor).

92. *See 1920–21 W&M Hearings*, *supra* note 91, *passim.*

93. *Id.* at 3. T.S. Adams was an early tax scholar in the United States. In this piece he features prominently, with many of the contours of the early capital gains preference being either created with him or deeply shaped by

tee he represented himself in his capacity as a tax specialist and also acted as the representative of the Treasury Department and then-Secretary of the Treasury David Houston.[94]

Adams began his testimony by relaying Secretary Houston's primary recommendations for tax reform. The Secretary was primarily concerned with raising revenue:

> [U]nder the existing circumstances in which we found ourselves, *particularly by reason of the very large amount of floating debt which we are carrying and the business uncertainties*, . . . it is necessary that the tax revenues be kept on a level of approximately [$4 billion] a year until the close of the year 1923. That is a question about which, in particular, you gentlemen will want to make up your own minds. . . . The Secretary . . . has concluded it is the part of wisdom to keep our tax revenues at a point sufficient to enable us to pay off by the close of the fiscal year 1922 and the first half of the calendar year 1923 our floating debt of [$2.3 billion], approximately. . . . *The Secretary's conclusion is that it [the debt] ought to be extinguished, and that premise having been accepted, it follows that if we repeal or reduce certain taxes we must, as a consequence, try to replace them with other tax revenues of equivalent yield.*[95]

Revenue requirements were a paramount concern, brought on by the need to repay war debt and make floating interest payments. Critically, Adams noted that the nation's wealthiest were being "forced" into investing in tax-exempt se-

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his input. In this piece, he appears as a tax adviser to the Treasury, but he was also a professor, first at the University of Wisconsin–Madison and then at Yale, President of the National Tax Association between 1922–1923, and President of the American Economic Association in 1927. *See* A. E. Holcomb, *Thomas Sewall Adams*, 18 BULL. NAT'L TAX SOC'Y 194 (1933); *Adams, Thomas Sewall*, Wisconsin Historical Society, https://www.wisconsinhistory.org/Records/Article/CS4700 (last visited Feb. 10, 2022).

94. *See 1920–21 W&M Hearings*, *supra* note 91, at 4. David F. Houston was the 5th Secretary of Agriculture in office from March of 1913 to February of 1920, after which he was the 48th Secretary of the Treasury between February of 1920 to March of 1921. *See* LEWIS L. GOULD, *Houston, David Franklin*, *in* AMERICAN NATIONAL BIOGRAPHY (2000), American National Biography Online. While the hearings for the 1921 tax reform began while he was Treasurer, he would cease to be the Treasurer before they were finally enacted. *Id.*

95. *1920–21 W&M Hearings*, *supra* note 91, at 6 (emphasis added).

curities instead of ordinary industrial securities subject to taxation.[96] The need to raise short-term revenue would be a generating force behind the capital gains preference.

In addition to the revenue requirement, the Treasury was concerned with the burden caused by war-time taxation. Throughout the hearings, the Committee and various members of the Treasury, including Adams, repeatedly stressed that tax rates were too high.[97] While testifying on his own behalf Adams stated that "we simply can not successfully collect in the long run income tax which ranges as high as 70 per cent."[98] He further stressed that his reasoning was not based on notions of a "tender heart," but was instead an economic approach involving a "calculation . . . as to how we can get the most revenue."[99] Adams's point was that lower rates, independently of whether they were moral or just, would yield greater tax receipts.

His arguments were based on the high tax 1917–1921 period. He stated that the high marginal capital gains tax rates had failed to bring in substantial revenue with high-income taxpayers having found various ways to avoid large tax bills,[100] and that those very high rates were not driven by sound policy considerations but rather special war-time circumstances: "the truth of the matter is that under the pressure of war we have overdriven the income tax."[101] In light of this overdriving, Adams, a self-described "friend of the income tax," explained that it is "because I want to save the income tax [that] I want to see its burdens reduced to the point where it is bearable."[102] He thus argued that by lowering tax rates until they were bearable, Congress would collect greater tax receipts.

The Committee likewise heard "from many sources that very wealthy men [were] rapidly and have been rapidly chang-

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96. *See id.* at 10.

97. *Id.* at 10, 12.

98. *Id.* at 13.

99. *Id.*

100. *Id.* ("There is a possibility of getting a good round income from rates which the wealthier tax payers will pay rather than purchase municipal bonds. With a 28 or 30 per cent maximum rate, the ordinary tax payer can invest in industrial, railroad and similar securities and still have as much left after he has paid his tax as he would have if he bought municipal or other tax-free securities.").

101. *Id.* at 12.

102. *Id.*

ing their investments to municipal bonds and other tax-exempt sources."[103] The implication being that the "unbearable" rates were leading to rampant tax avoidance. Adams specifically addressed this issue in his testimony, stating that he thought Congress could generate "a good round income from rates which the individual taxpayer will pay rather than choose municipal bonds . . . or other tax-free securities."[104] While Adams's main recommendation was to reduce rates, he offered several alternatives which would minimize the impact of avoidance behavior, including that tax rates be set based on total [gross] income rather than net income, resulting in more tax receipts even if tax-free income were not itself taxed.[105] Likewise, the Committee considered a sales tax to combat avoidance, though dismissed these proposals as being too complex.[106]

A complicating factor was the prominent view that the excess profits tax should be repealed, and indeed Title III of the 1921 Revenue Act limited the top marginal excess profit tax rate to 40% for 1921 and ended it effective 1922.[107] Adams testified that a substitute capable of generating $450 million in revenue was needed if the excess profits tax was abolished.[108] While reducing surtaxes and eliminating the excess profits tax would be an important part of tax reform, the need to pay war debts necessitated some level of tax neutrality.[109] David Friday, Professor of Political Economy at the University of Michigan, observed that the American public blamed the excess profits tax for rising prices, with businesses simply shifting the tax onto consumers.[110] President Harding,[111] Andrew Mellon (the new Secretary of the Treasury and a famous proponent of low

103. *Id.* at 14.

104. *Id.* at 13.

105. *Id.* at 15.

106. *See id.* at 21–43.

107. *Id.* at 215. Revenue Act of 1921, Pub. L. No. 67-98, § 301(a), 42 Stat. 227, 272.

108. *1920–21 W&M Hearings*, *supra* note 91, at 9–10 (statement of T.S. Adams).

109. *Id.* at 6–7, 9–10, 17, 215.

110. *Id.* at 258–63.

111. *See Senate Finance Committee Hearings*, *supra* note 91, at 505 (statement of Frank E. Seidman, Certified Public Accountant); *see also* Benjamin G. Rader, *Federal Taxation in the 1920s: A Re-examination*, 33 HIST. 415, 417 (1971).

tax rates),[112] and many Congressmen and Senators likewise favored the repeal of the excess profits tax.[113]

Among the speakers who followed Adams was Frederick R. Kellogg, a New York lawyer and an important figure in the enactment of the capital gains tax preference.[114] His role is discussed by Ajay Mehrotra and Julia Ott's review of the capital gains tax between the First and Second World Wars, which notes that Kellogg played a critical role in the development of the preference and suggest that the idea for it may have originated with him.[115] Although many were thinking of a capital gains preference at the time—not just Kellogg—Mehrotra and Ott are right to highlight the key role he played in the legislative process.

Kellogg began his testimony to the Ways and Means Committee by declaring that he was "not purporting to give [the Committee] any more than [his] own personal experience, corroborated by a number of comparisons and notes with other men in New York City."[116] The problem, he explained, was that many transactions fell through due to prohibitively high surtaxes:

> It has so happened that within the last three years in matters that have come to my desk involving sales, transfers, reorganizations, and various activities, both of a corporate and an individual nature, there have been a great many millions of dollars of proposed transactions which I have had to kill absolutely, simply because of the fact that the people who were going to make those transactions would have had to pay anywhere from 40 to 70 odd per cent to the Govern-

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112. *See Senate Finance Committee Hearings*, *supra* note 91, at 505 (statement of Frank E. Seidman); *see also* Rader, *supra* note 111, at 421. Note that the Secretary of Treasury at the time of the Ways and Means hearings was David Houston. He resigned in March of 1921 and was succeeded by Andrew Mellon. *Compare 1920–21 W&M Hearings*, *supra* note 91, at 4 *with Senate Finance Committee Hearings*, *supra* note 91, at 76. For a contemporary biography of Secretary Mellon see HARVEY O'CONNOR, MELLON'S MILLIONS: THE BIOGRAPHY OF A FORTUNE; THE LIFE AND TIMES OF ANDREW W. MELLON (1933).

113. *See Senate Finance Committee Hearings*, *supra* note 91; *see also* Rader, *supra* note 111, at 422.

114. *See 1920–21 W&M Hearings*, *supra* note 91, at 127.

115. Mehrotra & Ott, *supra* note 8, at 2525–26.

116. See *1920–21 W&M Hearings*, *supra* note 91, at 128.

> ment in taxes, and they simply would not; the business could not stand it.[117]

His arguments hinged on both private and corporate transactions not going through, including workers who gave up on selling their homes to move to a different city for job purposes,[118] and holders of stock who gave up reinvesting in more profitable securities.[119] A complementary point was brought up by Congressman Treadway, who asked whether this argument was similar to the idea that a lower tax rate on capital would respond to top-bracket taxpayers investing in tax-exempt sources.[120] Kellogg replied in the affirmative.[121]

Kellogg stated his main points in favor of a special, lower rate on capital, beginning with the government being able to secure "a great many hundreds of thousands [in dollars of revenue] . . . which have not been paid and never will be paid because the transaction did not go through. . . ."[122] The next argument he made was against "frozen capital," the well-known lock-in problem caused by high tax rates, which is a pure tax distortion causing taxpayers to refrain from investing in new, higher-return securities with the government, in turn, losing out from the revenue from such sales and reinvestment.[123] While certain committee members seemed to sympathize with this problem, their core concern was revenue. They asked Kellogg to produce an estimate of how much revenue would be generated by lower tax rates on capital gains.[124] Congressman Longsworth conceded that "it would be conceivable . . . that a tax as low as 10 or 15 per cent would raise more revenue on these transactions than we are getting now, simply from your statement, which is corroborated in many quarters."[125]

117. *Id.*
118. *Id.* at 128–29.
119. *Id.* at 129.
120. *Id.* at 131.
121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.* at 132.
125. *Id.* at 133. For a broader discussion of this point, and whether it is true in the abstract or simply because of systemic factors which existed at the time, *see infra* Section III.B.

Others who thought that capital gains taxes should be reformed included Edgar Rogers, a tax lawyer from Indianapolis. Rather than a lower tax rate on gains, he suggested a broader change to tax "profit by considering it to have accrued pro rata in each of the years from the date of acquisition . . . to the date of sale. Each year's accrual to be taxed at the rate for that year."[126] To illustrate his point, suppose that a taxpayer had held an asset for five years and then disposed of it at a $100 gain, with the tax rate being 50% in the first year and 10% thereafter. Under a realization-based tax the $100 would be taxed once on disposition at the 10% rate, resulting in a $10 tax bill. Under Rogers's proposal and assuming linear growth, the taxpayer would foot a $10 bill just for that first year on the year's $20 gain. The taxpayer would likewise owe for the last four years, giving a total tax on disposition of $18. This idea was particularly interesting since Congress had recently considered a similar solution.

Debated and drafted in early 1920, Section 3 of H.R. 14198, "An Act to Amend and Simplify the Revenue Act of 1918," would have allowed taxpayers who disposed of capital assets held for longer than three years to allocate that gain over the years that the asset was held.[127] The tax benefit came from being able to spread the gain across several years which may have reduced surtax rates.[128] H.R. 14198 was passed by the House and deliberated by the Senate Finance Committee, though it was never passed into law, possibly because broader reforms to the 1918 Revenue Act had already begun with the process leading up to the 1921 Act.[129] Critically, the proposal shows that several members of the House had already ac-

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126. *Id.* at 265 (statement of Edgar Rogers of Doney Rogers & Co. Inc., Federal Tax Specialists).

127. An Act to Amend and Simplify the Revenue Act of 1918, H.R. 14198, 66th Cong. § 3 (1920). For the hearings, see *Amending the Revenue Act of 1918: Hearing on H.R. 14197 and H.R. 14198 Before the S. Comm. on Fin.*, 66th Cong. (1920).

128. As an example, a taxpayer held an instrument for two years and sold it for a profit of $200. Graduated rates impose a 10% tax on income between 0–$100, and 30% thereafter. Without apportionment, the taxpayer would owe 10%*100+30%*100=$40. With apportionment, along the lines of H.R. 14198, the taxpayer would only owe $20.

129. *Senate Finance Committee Hearings*, *supra* note 91, at 535 (while it does not seem that Kellogg was the originator of the bill, he did submit a brief to T.S. Adams on the matter).

cepted, and indeed tried to pass into law, structural capital gains tax reform which went beyond tax rates.[130] The apportionment rules in H.R. 14198 tried to get around the problem of taxing gains that had accrued over several years at once, which resulted in gains being taxed more harshly than if they were spread out across the holding period. This issue was likewise important to the Ways and Means deliberations in 1920, and was one of the reasons why Kellogg proposed a low flat tax which the Committee seemed to agree with.[131] Yet, it seems to have been dismissed as being too complex relative to a special, lower rate.[132]

Not all who testified favored the creation of a special, preferential regime for capital gains. Some, like the Taxation Committee of the National Retail Dry Goods Association, argued that "profits from the sales of capital assets, should be taxed at a higher rate than income from business and in still greater degree than income from manual or mental effort."[133] The Association's proposal arose from a notion of fairness and equity, that income that is "worked" for (being a product of physical or mental labor) should be taxed less than passive income like interest, dividends, or capital gains.[134]

Others, such as famed banker Otto H. Kahn, preferred flat reductions to tax rates without special regimes or exceptions for capital gains,[135] although Kahn agreed that a capital gains preference was better than the status quo.[136] He argued that special preferential tax rates would create long-term problems and thought it best "wherever possible, to do away with them altogether."[137] When asked specifically about the possibility of segregating profits from sales of capital assets at a separate and lower rate, Kahn responded:

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130. *See id.*

131. *See 1920–21 W&M Hearings*, *supra* note 91, at 128–31 (statement of Frederick R. Kellogg).

132. *Hearings on Internal-Revenue Revision: Hearing Before the H. Comm. On Ways & Means Together with Certain Portions of the Proceedings of the Committee in Executive Session*, 67th Cong. 405–06 (1921) [hereinafter *1921 W&M Executive Hearings*].

133. *See 1920–21 W&M Hearings*, *supra* note 91, at 248 (report of the Taxation Committee of the National Dry Goods Association).

134. *See id.* at 249.

135. *See id.* at 167 (statement of Otto H. Kahn).

136. *Id.*

137. *Id.*

> I think a great deal can be said for that, and I know it is recommended by a good many people whose opinion I respect. I think in theory and in principle it is a wise exemption. I do not believe it is a necessary exemption, provided our extreme surtaxes are duly reduced.[138]

He maintained that reasonable, generally applicable income tax rates were preferable to segregating profits from the sale of capital to a different category.[139] Kahn also stressed that high wealth individuals had been heavily investing in tax-exempt securities, which grounded his recommendation to enact lower rates that everyone would willingly pay.[140] He suggested a top tax rate of around 40% as being appropriate, and otherwise seems to have predicted many problems caused by a capital gains tax preference.[141]

C. *Hearings Before the Senate Committee on Finance: May 9–27, 1921*

The Senate Committee on Finance conducted its own hearings on tax reform between May 9th and 27th.[142] The transcripts begin with a letter from Secretary Mellon which, like Adams's testimony to the House Committee on Ways and Means, emphasized two points.[143] First, Mellon discussed the war debt, highlighting revenue requirements.[144] Second, he wrote that "the higher rates of income surtaxes put constant pressure on taxpayers to reduce their taxable income, interfere with the transaction of business and the free flow of capital into productive enterprise, and are rapidly becoming unproductive."[145] His main suggestions were:

> [To] [r]epeal the excess-profits tax and make good the loss of revenue by means of a modified tax on corporate profits or a flat additional income tax upon

138. *Id.*
139. *Id.*
140. *See id.* at 166–68.
141. *See id.* at 168–71.
142. *Senate Finance Committee Hearings*, *supra* note 91.
143. Note the new Secretary of Treasury since the Ways and Means hearings. *See supra* note 112 and accompanying text.
144. *See Senate Finance Committee Hearings*, *supra* note 91, at 7–9 (Letter of the Secretary of the Treasury Relative to Internal-Revenue Laws).
145. *Id.* at 10.

> corporations, and the repeal of the existing $2,000 exemption . . . . [And to] [r]eadjust the income-tax rates to a maximum combined normal tax and surtax of 40 per cent for the taxable year 1921, and of about 33 per cent thereafter, with a view to producing aggregate revenues substantially equivalent to the estimated receipts from the income tax under existing law.[146]

The Committee was thus sensitized to much of what had been discussed in the House Committee on Ways and Means, particularly the revenue requirements brought on by government spending and the perception of an excess burden caused by high tax rates.

There was less discussion of capital gains in the Senate Finance Committee's hearings than in the House discussion. However, Kellogg returned with a more structured testimony, seemingly benefiting from his previous appearance. He began by making it explicit that high taxes on the sale of capital assets had robbed the treasury of significant income by killing transactions that would otherwise have taken place.[147] His first point was clear: the Treasury was losing revenue. His second point was the "frozen capital" or locked-in gains problem discussed previously, while his final point was that the system in place was an "injustice" to the taxpayer.[148] He delivered his main pitch early in his testimony:

> I believe that I am sound in saying so, gentleman, that when a tax law ceases to produce revenue, when it operates as a full stop to business and not as a revenue producer, there must be things in it that have no business in any tax law that the United States of America should pass; and I know from my personal experience in the cases I have already mentioned to you, and many others, that this law has operated to kill many transactions which, in themselves, are perfectly laudable and perfectly worthy . . . and would have produced revenue for the United States Govern-

146. *Id.* at 10–11 (note that the $2,000 exemption referenced is of the first $2,000 of corporate income from taxation).

147. *Id.* at 534 (statement of Frederick R. Kellogg). This is the same Kellogg who testified before the House Ways and Means Committee.

148. *Id.*

> ment which has been entirely lost in those cases and which never will be produced in any similar set of cases.[149]

He repeatedly emphasized that lower tax rates would yield greater tax revenue, perhaps due to how this argument was received during his prior testimony.[150] Senator Jones responded that "we are all practically agreed on the evil that you have pointed out. It is a question of the remedy" after Kellogg again mentioned that the United States had "lost millions of dollars of revenue . . . because of the transactions that never went through."[151]

The Senate hearings appear to be the first time someone brought up inflation in the context of capital gains, at least in the hearings leading up to the 1921 reform. Senator McCumber asked Kellogg:

> Suppose property was purchased in 1914 and held until 1921 and it has increased in value 100 per cent. A dollar has decreased 50 per cent. The property has increased mainly because of the inflation and the cheaper dollar rather than from any more income that you could get out of it. Is it not unjust to say that a person, because he sells it for the same number of dollars that he purchased it for in the general market, has got to pay the Government some money?[152]

Kellogg answered: "I think you have touched the most vital point in the whole matter. . . . I believe that is one of the strongest reasons. I am very sorry that I did not think of it myself. But it is absolutely sound, as it appeals to me now."[153] Despite the importance of inflation then and now, little attention seems to have been paid to McCumber's point.

Little else was said during the Senate hearings concerning the taxation of capital gains, perhaps due to consensus that a lower tax rate on capital gains was the easiest way of generating more revenue, rendering further discussions unnecessary. However, towards the end of the hearings, Senator Jones began to suggest reform that went beyond tax rates: "[h]ave you

149. *Id.* at 537–38.
150. *See id.* at 540–42.
151. *Id.* at 542.
152. *Id.* at 545.
153. *Id.*

considered . . . . allowing an exemption equal to a reasonable return on the investment for the period that the property has been held[?]"[154] Senator McLean responded negatively, answering "[t]hat is not the thing that really determines the matter. . . . There are undoubtedly hundreds of thousands of transactions which, if they had been permitted to be made on a small flat tax, would have resulted in returning to the Treasury much more money than has been collected under existing law."[155] Timing was of the essence. Congress needed revenue immediately but was still confronted with the issue of avoidance through investment in tax-exempt securities. Senator Garner authoritatively argued that Constitutional reform to eliminate such tax-exempt instruments would be unwise, with the Committee needing to focus on "a bill here which will raise revenue for this year, and not five or ten years from now."[156]

D. *House Committee on Ways and Means Hearings in Executive Session: August 1, 1921*

On August 1, 1921, two weeks before the first draft of the revenue bill was finalized by the House, the Committee on Ways and Means held hearings in executive session with Secretary Mellon and other members of the Treasury.[157] Mellon reiterated that Treasury's priorities were to secure revenue necessary to run the government and pay off the debt coming due, reduce prohibitively high surtaxes, and eliminate the excess profits tax.[158] The Committee, or at least the Chairman, seemed to agree with these priorities. When Congressman Frear asked whether it would be a sound idea to reduce rates further than what was suggested, looked at shortly, Committee Chairman Fordney replied that "it would, except that you need the money [now]."[159]

154. *Id.* at 546.
155. *Id.* at 547.
156. *1921 W&M Executive Hearings*, *supra* note 132, at 160 (statement of Rep. John N. Garner).
157. *Id.* at 384.
158. *See id.* at 394–97 (statement of Andrew W. Mellon, Secretary of the Treasury, accompanied by S. P. Gilbert Jr., Assistant Secretary in Charge of Fiscal Affairs, T. S. Adams, and Joseph S. McCoy, Government Actuary).
159. *Id.* at 398.

The view among Treasury staff was that lower tax rates on capital gains would raise revenue appears to reflect those in both chambers of Congress. When asked whether creating a capital gains tax preference would increase tax receipts, Mellon stated that "in the long run it will produce at least as much at a lower rate, the reason being that the higher surtax prevents the consummation of transactions that would be consummated, and from which the Government would receive revenue."[160] Echoing the point already made in various committee sessions, Mellon thought that a capital gains preference would be a revenue raiser.[161]

Congressman Hawley then turned the Committee's attention to sections 210 and 211 of Treasury's suggested revisions to the 1918 Revenue Act, presented at the session, which stated that:

> A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 15 per cent of the capital net gain, or minus 15 per cent of the capital net loss, as the case may be.[162]

When explaining the reasons behind the provision, Adams stated that there was "a legitimate demand" to reduce tax rates on profits from the sale of capital assets.[163] He further noted that the previous proposal to apportion gain over an asset's holding period once had the approval of the Treasury, but that it would create too great of an administrative burden, so they now preferred a simple, flat, low rate.[164]

Adams made another point related to the proposed capital gains preference, this time about capital losses. He explained:

> There is one other important feature of that amendment. Most of the amendments suggested in the past have not applied to losses, and in this amendment the section is made correlative . . . . [I]n my opinion there are going to be very many more such losses in

160. *Id.* at 399.
161. *See id.* at 399–400.
162. *Id.* at 405.
163. *Id.*
164. *Id.*

> the near future than gains. I feel that this provision would not only relieve this class of transactions from a prohibitive tax, but *it would reduce the deductions for losses in such a way that the net revenue to the Government would be increased.*[165]

Today, the deduction for capital losses is seen as an issue of tax neutrality, or even of fairness.[166] However, Adams's testimony suggests that the reason behind extending the lower rates to capital losses was to prevent significant capital loss deductions from eroding revenue during an economic downturn.[167] Such a provision did not exist under previous proposals but, again, was included as a means of raising net tax receipts. Adams himself would later reject this reasoning, and losses were made fully deductible against regular income under the 1921 Revenue Act.[168]

E. *The Revenue Act of 1921: H.R. 8245*

The first draft of what would become the Revenue Act of 1921, H.R. 8245, was introduced on August 15, 1921 by Congressman Fordney.[169] This was the first bill to contain a flat preferential tax rate on capital gains and losses. Section 207(b) of the Bill read:

> In the case of any taxpayer (other than a corporation) whose ordinary net income and capital net gain together exceed $40,000, there shall be levied, collected, and paid, in lieu of the taxes imposed by [the standard income tax], a tax determined as follows: [a] partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the

165. *Id.* at 405–06.

166. *See, e.g.*, Alvin C. Warren, Jr., *The Deductibility by Individuals of Capital Losses Under the Federal Income Tax*, 40 U. CHI. L. REV. 291 (1973) (a particularly good, and classic, article on the matter).

167. For a more general discussion of the related 1920–1921 recession, see Patrick Newman, *The Depression of 1920–1921: A Credit Induced Boom and a Market Based Recovery?*, 29 REV. AUSTRIAN ECON. 387 (2016).

168. ZELENAK, *supra* note 7, at 144–45, 147. For a fuller discussion of the reasoning, see *infra* Section II.E.

169. A Bill to Reduce and Equalize Taxation, to Amend and Simplify the Revenue Act of 1918, and for Other Purposes, H.R. 8245, 67th Cong. (as introduced by Rep. Joseph Fordney, August 15, 1921).

> total tax shall be this amount plus 15 per centum of the capital net gain, or minus 15 per centum of the capital net loss, as the case may be.[170]

There were three particularly important features: the $40,000 floor for the applicability of the special capital gains regime (quickly reduced to $29,000); the 15% rate for capital gains or losses; and the symmetric treatment of capital gains and losses. Capital assets were defined in § 207(a), and there was no mention of any holding period.[171]

The report accompanying the draft explained why § 207 limited the taxation of gains and losses to 15%.[172] The main reason was the "belie[f] that the passage of this provision would materially increase revenue" since the sales of capital assets including farms, financial instruments, and natural resources were being harshly taxed as lump sums in one tax year rather than spread out over the holding period.[173] The symmetric deduction reasoning given by Adams during the Committee on Ways and Means executive session laid the foundation for subjecting losses to the 15% rate rather than making them fully deductible: "the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."[174]

The bill was passed on August 16,[175] then sent to the Senate on August 22.[176] The Senate made several changes, including some restructuring through which the capital gains section became § 206.[177] Moreover, the provision's scope was broadened to include corporations by removing the applicability to all persons "other than a corporation."[178] The Senate also modified the capital gains tax rate. Instead of it being a fixed,

170. *Id.* at § 206.

171. *Id.* The final version of the Revenue Act of 1921 included a holding period before the preferential rate could be accessed. Revenue Act of 1921, Pub. L. No. 67-98, § 206(a)(6), 42 Stat. 227, 233 (1921).

172. H.R. REP. NO. 67-350, at 10–11 (1921).

173. *Id.*

174. *Id.* at 11.

175. H.R. 8245 (as passed by House, August 16, 1921). The rate was amended from 15% to 12.5%, however, everything else remained the same. H.R. 8245 § 206 (as referred to S. Comm. on Fin., August 22, 1921).

176. H.R. 8245 (as referred to S. Comm. on Fin., August 22, 1921).

177. H.R. 8245 § 206 (as reported by Sen. Penrose, September 26, 1921 and passed by Senate, November 7, 1921).

178. *Id.* at § 206(b).

flat rate, it was changed such that 40% of capital net gains would be included in income and subject to the surtax.[179] Finally, any mention of capital losses was eliminated, making capital losses fully deductible.[180]

The report submitted on September 26 by Senator Penrose from the Senate Committee on Finance explains the changes. It began by acknowledging, as did the House report, that transactions involving the sale of capital assets had been mostly halted due to prohibitively high tax burdens.[181] It likewise reported that the committee had removed the restriction on corporations, while also removing the $29,000 floor and creating a formulaic approach to broaden the provision's applicability.[182] This broadening was suggested by Adams. During the September Senate Committee on Finance discussions, attended by the Committee, Adams, and various members of Treasury, several Senators, notably Senator Walsh, questioned why the flat rate existed if it "discriminate[d] in favor of those who have incomes of over $29,000."[183] Others had sent in letters complaining of this point as well.[184]

In response, Adams devised a method "which seem[ed] to [him] altogether simple and escape[d] the objections which ha[d] been entered against this paragraph."[185] His alternative allowed taxpayers to only include 40% of capital gains as taxable income, which he noted would apply to everyone and escape the problem of discrimination in favor of higher earners.[186] The Senators did not forget the primary goal of raising revenue: Senator McClean asked what the result would be on returns, and after hearing that it would increase revenue he asked the same question phrased differently to make sure.[187]

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179. *Id.*

180. *Id.*

181. S. REP. NO. 67-275, at 12 (1921).

182. *Id.* at 13. In the September 26 report Senator Penrose provides a summary which paints a slightly different picture than what really happened regarding the 60% exclusion rate. *See* discussion *infra* and accompanying notes.

183. *Internal Revenue: Hearings on H.R. 8245 Before the S. Comm. On Fin.*, 67th Cong. 39 (statement of Sen. David I. Walsh, Member, S. Comm. On Fin.).

184. *Id.* at 38–41.

185. *Id.* at 305.

186. *Id.*

187. *See id.* at 307.

Adams proposed to remove the limitation on capital losses for the reasons explored in Part II, though his change of heart from first denying losses, to favoring symmetrical loss treatment, and finally advocating for full deductibility is curious.[188] The Senate Finance Committee Report gave more opaque reasons for the change, explaining that the decision to exclude capital losses took "an intermediate position between the extreme views embodied, respectively, in the present American and British laws."[189]

The Senate proposed further amendments. Its final draft, completed on November 4, is notable for two reasons in addition to those just discussed. First, the definition of "capital asset" under § 206(a) was changed to include a holding period of more than two years, whereas previously there had been no holding period requirement.[190] This amendment was introduced by Senator Walsh to exclude speculative transactions from the preference's ambit.[191] While his suggested holding period was originally three years, after an exchange with Senator McCumber it was reduced to two years as a compromise since McCumber thought three years was too long.[192] Second, "stock or shares in a corporation" was removed from the definition of capital asset.[193] During Senate debate, Senator Lenroot argued that if stock sales were taxed at preferential rates, then corporations would cease to issue cash dividends and instead issue stock dividends, which could be sold and taxed at preferential rates.[194] He and Senator Walsh, therefore, agreed

188. *See id.* at 305–06. *See also* ZELENAK, *supra* note 7, at 144–45.

189. S. REP. NO. 67-275, at 13 (1921) (capital losses could only be deducted against capital gains in the United States, while capital gains but not losses were excluded altogether under British law). *See* Harry Wallop, *Capital Gains Tax: A Brief History,* TELEGRAPH (May 27 2010, 7:00 PM), https://www.telegraph.co.uk/finance/personalfinance/capital-gains-tax/7771799/Capital-Gains-Tax-a-brief-history.html.

190. A Bill to Reduce and Equalize Taxation, to Amend and Simplify the Revenue Act of 1918, and for Other Purposes, H.R. 8245, 67th Cong. § 206 (as passed by Senate, November 7, 1921).

191. *See* 61 CONG. REC. 6575 (1921) (statement of Sen. David I. Walsh).

192. *See id.* (statements of Sen. David I. Walsh and Sen. Porter McCumber).

193. H.R. 8245 § 206(a)(6) (as passed by Senate, November 7, 1921).

194. 61 CONG. REC. 7477–78 (statement of Sen. Irvine Lenroot).

that the preferential tax on the sale of stock should be removed to prevent this development.[195]

The November 19 Conference Report summarized the negotiations between the Senate and House, outlining which amendments were accepted or rejected.[196] One of the rejected amendments was the provision's inapplicability to corporate stock.[197] Next, the report discussed the rejection of amendment 115 concerning the change from a flat tax of 12.5% to 40% includability, the elimination of the $29,000 floor, the application of the provision to corporations, and the full deductibility of capital losses.[198] During Senate deliberations the clerk read a letter written by Senator Penrose, explaining that 40% includability for capital gains was inadvisable, since this would set a top rate of 23% which "is high enough to freeze up or prevent capital transactions of the kind which, for the sake of the revenue, it is desired to encourage."[199] Penrose further noted that 40% includability coupled with the Senate amendment to allow the capital gains preference to apply to corporations resulted in a 5% capital gains tax for corporations.[200] He wrote that this "discrimination or difference between the individual and corporation taxes on capital gains impressed the conferees as extreme and accordingly . . . it is recommended that the privilege of paying a reduced rate on capital gains be confined, as in the House bill, to individuals" and that individuals be able to include capital gains derived from the sale of stock.[201]

Senate debate following the conference and preceding the ultimate adoption of the law reveal pushback, especially concerning the rejection of 40% includability. Senator Jones decried the 12.5% flat rate, arguing that the 40% rate applied to everyone while only those earning above $31,000 or more (approximately $450,000 in 2021 dollars) would benefit from

195. *Id.* at 7478 (statements of Sen. Irvine Lenroot and Sen. David I. Walsh).
196. H.R. REP. NO. 67-486, at 1–2 (1921).
197. *Id.* at 20.
198. *Id.* at 3, 20.
199. 61 CONG. REC. 8109 (statement of Sen. Boies Penrose).
200. *Id.* Note that 40% of 12.5% = 5%.
201. *Id.*

the 12.5% rate.[202] Other senators joined in, with Senator King calling the 12.5% flat rate a "monstrous inequality" and expressing his disbelief that the conference committee would willingly adopt such a rule.[203] Regardless, the Senate would reject their complaints, ultimately agreeing that a 12.5% rate was the right course of action to raise revenue.[204] The Senate further noted several inconsistencies with a 40% includability rule, including that the rate on ordinary corporate income was 12.5% meaning its application to corporations resulted in a 5% tax rate, which was too low, and that the 40% includability rule resulted in a top marginal capital tax rate of 23%, which was too high.[205]

The Revenue Act was signed into law on November 23, 1921. Section 206 of the Act defined capital gains as "taxable gain from the sale or exchange of capital asset" in § 206(a)(1), with capital losses being deductible losses "resulting from the sale or exchange of capital assets."[206] Under § 206(a)(6), capital assets were "property acquired and held by the taxpayer for profits or investments for more than two years (whether or not connected with his trade or business)" with some exceptions for property held for personal use, consumption, or inventory.[207] Finally, § 206(b) outlined the taxation of capital gains. It stated that instead of having their net capital gains included as ordinary income, taxpayers could elect to have them taxed at a preferential rate of 12.5%.[208] Additionally, the provision stipulated that "if the taxpayer elects to be taxed under this section the total tax shall be in no such case less than [12.5%] of the total net income."[209]

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202. *Id.* at 8172 (statement of Sen. Andrieus Jones). Inflation adjustment using *CPI Inflation Calculator*, U.S. BUREAU OF LAB. STAT., https://www.bls.gov/data/inflation_calculator.htm (last visited Jan. 23, 2022) (calculated based on December 2021 buying power of $31,000 in January 1921).

203. *Id.* (statement of Sen. William H. King).

204. This can be seen from the final bill. *See* Revenue Act of 1921, Pub. L. No. 67-98, § 206(b), 42 Stat. 227, 233. Note that the 12.5% rate for capital sales was equal to the corporate income tax rate, which was one of the reasons why the special rate did not apply to corporations.

205. *See* 61 CONG. REC. 8109.

206. Revenue Act of 1921 § 206(a)(1)–(2).

207. *Id.* § 206(a)(6).

208. *Id.* § 206(b).

209. *Id.*

F. *Discussion of the Enactment of the Capital Gains Tax Preference*

The reason for the preference under § 206 of the 1921 Revenue Act is there in the title: revenue. Time and again, the winning pitch for the capital gains preference was not that capital gains should be taxed less on the grounds of fairness or efficiency, but rather that reducing the tax rate on sales or dispositions of capital assets was the simplest way to raise revenue.[210] This argument was based on perceptions of lackluster receipts from high-income taxpayers during the 1917–1921 period when capital had been taxed at high rates (over 70%).[211] In effect, the preference was a recognition that the high-rate capital gains tax regime under the 1917 Act had not worked as intended with taxpayers easily able to avoid such taxes. Congress could have responded by either fixing the leaks or reducing the rates to the point where the leaks did not matter. It chose the latter, which would profoundly impact tax policy for at least a century to come.

Although the focus was on revenue, efficiency and equity were still relevant but only insofar as they were assessed from a framework of cost-effective revenue-raising. For example, Adams's complaint about unreasonable burdens on capital gains was not a normative or philosophical appeal to persuade Congress to cut rates. Instead, it appears he meant that the high tax rates made little sense precisely because they yielded less revenue than was anticipated, with reasonable tax burdens being those which maximized revenue. Additionally, Congress understood that a flat 12.5% preferential rate would only benefit high-income earners with marginal tax rates above 12.5%, but thought that the additional revenue they would receive from such a preference outweighed the social inequity.[212] Their belief that a 23% rate was still too high grounded their rejection of the 40% inclusion rule proposed by the Senate, which would have extended the benefits of the preference to

210. *See* discussion *supra* Sections II.B–E. Only Kellogg seems to have mentioned fairness. *See Senate Finance Committee Hearings*, *supra* note 91, at 534–36 (statement of Frederick Kellogg).

211. *See* discussion *supra* Sections III.B–E,.

212. *See, e.g.*, *1920–21 W&M Hearings*, *supra* note 91, at 13 (statement of T.S. Adams). *See also* 61 Cong. Rec. 8108–09 (1921).

all taxpayers, not just the wealthy.[213] However, Congress also rejected the 40% inclusion rule since it would have disproportionately benefited corporations by leaving them subject to a trivial 5% tax rate on capital gains, leaving some space for notions of tax fairness.

Congress showed little interest in eliminating tax distortions when it conflicted with raising revenue. Senator McCumber correctly identified the need to tax real appreciation rather than nominal appreciation; a realization that would lead to some of the most important tax policy proposals and debates of the late 20th and early 21st centuries.[214] Senator McClean even suggested exempting the reasonable rate of return which, while mechanically different from immediate expensing of investment followed by full inclusion, is effectively the same type of consumption tax proposed by Bill Andrews in 1974.[215] Kellogg spoke at length about the various ills inflicted by realization coupled with large capital gains tax rates, but Congress seemed to exclusively care about the argument that a lower tax rate on capital gains would increase tax receipts. Any points raised about frozen capital or suboptimal allocation of resources only seemed relevant insofar as this prevented transactions that would have raised revenue, while Congress viewed more holistic tax reform proposals as too complicated to be worthwhile.

Much of Congress's reasoning regarding the impact of high tax rates on revenue hinged on the behavior of high-income taxpayers.[216] The idea that the wealthy had invested in tax-exempt bonds, deferred realization of capital gains, or found other ways to avoid the tax featured prominently during the hearings.[217] Having seen that high tax rates induced behavior that robbed Treasury of revenue, Congress hypothe-

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213. *See* 61 CONG. REC. 8108–09.

214. *Senate Finance Committee Hearings*, *supra* note 91, at 545. This refers to consumption taxes. For a discussion of various proposals that almost became law and an overview of a consumption tax as a system, see Weisbach, *supra* note 18, at 181–95.

215. *See generally* Andrews, *supra* note 15.

216. *See supra* notes 91–124, 147–53, 199–201 and accompanying text.

217. *See supra* notes 97, 101, 104, 140 and accompanying text.

sized that lower rates would reduce avoidance and other behavioral responses and hence increase tax receipts.[218]

Their theory had merit and closely tracks a branch of public economics developed during the 1980s and 1990s, which aims to determine optimal capital gains tax rates by studying the extent to which taxpayers respond to different rates.[219] This branch is known as the study of the elasticity of taxable income, which quantifies how much distortion is caused by changes in tax rates.[220] For example, taxpayers can respond to increases in capital gains tax rates by investing in tax-free sources like municipal bonds,[221] engaging in tax planning, evading taxes, or simply deferring realization of gains and accelerating losses.[222] A large subset of the scholarship focuses

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218. *See supra* notes 105, 118–24, 147, 149–51, 160–61, 173, 181 and accompanying text.

219. The tax responsiveness literature is voluminous. For an overview, see Dowd & Richards, *supra* note 16. *See also* Emmanuel Saez et al., *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LITERATURE 3 (2012); LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 82–87 (2008); Seth H. Giertz, *The Taxable Income Elasticity over the 1980s and 1990s,* 97 PROC. ANN. CONF. ON TAX'N & MINUTES ANN. MEETING NAT'L TAX ASS'N 236 (2004). For the direct works, see Lawrence B. Lindsey, *Individual Taxpayer Response to Tax Cuts: 1982–1984: With Implications for the Revenue Maximizing Tax Rate*, 33 J. PUB. ECON. 173 (1987); Martin Feldstein, *The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act*, 103 J. POL. ECON. 551 (1995); Leonard E. Burman & William C. Randolph, *Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data*, 84 AM. ECON. REV. 794 (1994); Alan J. Auerbach & James Poterba, *Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric*, 1988 BROOKINGS PAPERS ON ECON. ACTIVITY 595 (1988); Austan Goolsbee, *What Happens When You Tax the Rich? Evidence from Executive Compensation*, 108 J. POL. ECON. 352 (2000); Alan J. Auerbach & Jonathan M. Siegel, *Capital-Gains Realizations of the Rich and Sophisticated*, 90 AM. ECON. REV. 276 (2000).

220. For an overview of public economics and behavioral responses, not just to capital gains taxes but more broadly, see KAPLOW, *supra* note 219.

221. High wealth taxpayers found municipal and state bonds particularly attractive since the interest was tax-exempt. In 1921 it was settled that the federal government could not tax State or municipal bonds as a matter of constitutional law. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 586 (1894). The Supreme Court reversed this position in 1988 in *South Carolina v. Baker*, 485 U.S. 505, 524 (1988).

222. For example, if the capital gains tax were set to increase one year from now, taxpayers would trigger gains now. If taxes were to fall one year from now, taxpayers would defer all gains.

on reported capital gains for high wealth (top-bracket) taxpayers.[223]

Congress's largely unscientific, heuristic, anecdote-riddled reasoning nonetheless reflects the elasticity literature's main takeaways, despite predating that scholarship by more than 50 years. Congress understood and applied the somewhat counterintuitive point that higher tax rates may not necessarily lead to greater tax receipts and that capital was far more sensitive to tax rates than other income,[224] at least in the short-term.[225] However, their steadfast belief that a 12.5% rate was revenue-maximizing was almost certainly incorrect. A recent piece by Natasha Sarin et al., mentions how the prevailing wisdom among the tax legislation community is that present estimates of the revenue-maximizing capital gains tax rate is around 30%,[226] though this rate is contested as being on the low end.[227] Tim Dowd and Zach Richards survey the literature on reported capital gains elasticities, highlighting the vastly different ranges in estimates for behavioral responses resulting from small changes in econometric specifications, even within the same study.[228] Thus, Congress had no real reason behind their seeming fixation on 12.5% as the revenue-maximizing rate. Given that the current revenue-maximizing rate is generally regarded to be about 30%, it seems reasonable to think

223. *See, e.g.*, Goolsbee, *supra* note 219; Auerbach & Siegel, *supra* note 219; Jon Gruber & Emmanuel Saez, *The Elasticity of Taxable Income: Evidence and Implications*, 84 J. PUB. ECON. 1 (2002).

224. Discussed at length in JAMES BANKS & PETER DIAMOND, *The Base for Direct Taxation*, *in* DIMENSIONS OF TAX DESIGN 548 (Stuart Adam et al. eds., 2010).

225. Burman & Randolph, *supra* note 219, at 795, stress the difference between long-term and short-term effects. They find that short-term elasticities to changes in the capital gains tax rate are far larger than long-term elasticities. *Id.* at 806–07. This point is similarly made by Auerbach & Siegel, *supra* note 219, at 276, who additionally estimate that only rich taxpayers who engage in avoidance and have access to tax planning advice significantly change their long-term behavior.

226. Sarin et al., *supra* note 17, at 2. There is a discussion about how relevant discussions relating to the optimal rate in 1921 is to current tax policy in Section III.A. *infra*.

227. *See* Sarin et al., *supra* note 17, at 3–4.

228. Dowd & Richards, *supra* note 16.

that rates as high as 15%, 25%, 35%, or perhaps even higher would have outperformed 12.5%.[229]

III.
The Effectiveness of the Capital Gains Preference Between 1915 and 1925

The important follow-up question is whether the capital gains preference successfully raised revenue as was predicted, which is what this Part seeks to answer. Regarding the taxation of capital and savings, the architects of the 1921 reform envisioned two mechanisms through which the capital gains preference would be a revenue raiser. The first was that tax avoidance and investment in tax-free sources would fall.[230] The second was that taxpayers would be more willing to sell locked-in gains: appreciated assets which they were holding on to in order to avoid paying high taxes on their disposition.[231]

The finding that the capital gains preference was a revenue raiser would be significant due to the dramatic reduction in the applicable tax rate from 73% to 12.5%. Moreover, if the rate reduction successfully raised tax receipts, then both taxpayers subject to those top rates and the ultimate recipients of those tax receipts would be better off, making the 12.5% rate Pareto superior to the 73% rate.[232] Since the primary targets

229. Sarin et al., *supra* note 17, at 3–4, 12–13, 16. There are, of course, many differences between now and the 1920s, but two large ones appear to be the proliferation and sophistication of tax planning today and the relative infancy of the revenue collection agency (the IRS) back then. The first effect would tend to mean that the optimal rate would be higher in the 20s, while the second would suggest the opposite.

230. *See, e.g.*, *1920–21 W&M Hearings*, *supra* note 91, at 13–15 (statement of T. S. Adams).

231. *Id.* at 128–29 (statement of Frederick R. Kellogg). *See also Senate Finance Committee Hearings*, *supra* note 91, at 534–36, 539 (statement of Frederick R. Kellogg).

232. To explain, imagine the government reduces tax rates on top-bracket taxpayers, which results in increased labor effort and lower noncompliance. Should these behavioral responses increase taxable income to the point where tax receipts under the lower rate exceed tax receipts under the larger rate, then top-bracket individuals and the government are better off since both have more money. Presumably, there would also be greater economic efficiency. The government can now achieve greater transfers or fund more public goods and services for lower-income individuals, increasing their welfare, while rational top-bracket individuals would not choose to work more unless it were utility increasing. This explanation follows the distribution-

of the capital gains preference in 1921 and modern proposals to tax savings are high wealth individuals, this Part focuses on the performance of the top marginal rate and hence the impact of the capital gains preference on "top-bracket taxpayers," defined as persons with over $1,000,000 in annual income,[233] equivalent to about 14.5 million in 2021 dollars.[234] A graphical representation of top marginal rates is presented in Figure 1, but note that between 1915 to 1925, top marginal rates did not always start at exactly $1,000,000.[235]

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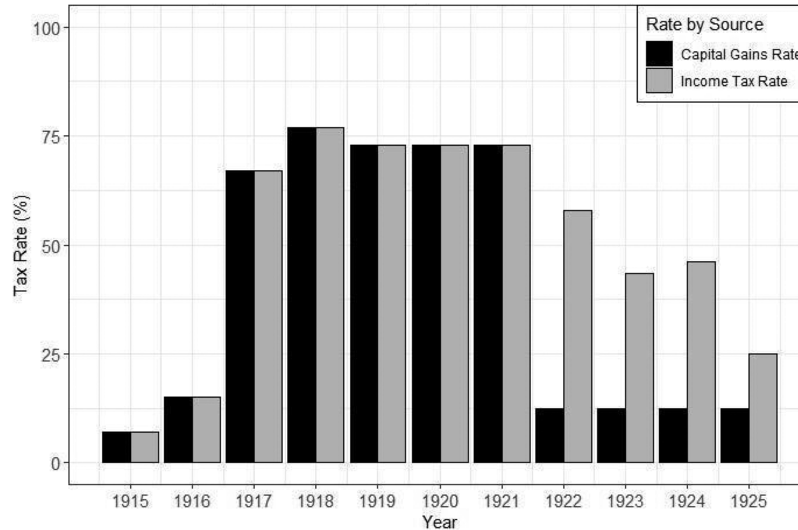
neutral income tax adjustment analysis described in KAPLOW, *supra* note 219, at 25–29. Thus, everyone is better off and the tax reform was a Pareto improvement compared to the initial rate.

233. As discussed shortly in the text, the period looked at is 1915–1925. In 1915, the top rate was 7% and applied to all income above $500,000. *See* 1913 Revenue Act, *supra* note 41, § 2(A), at 166. In 1916, the top rate was 15% on income above $2,000,000, and 13% on income above $1,000,000. *See* Act of Sept. 8, 1916, Pub. L. No. 64-271, § 1(b), 39 Stat. 756, 756–57. In 1917, the top rate was 67% on income above $1,000,000. *See* Act of Oct. 3, 1917, Pub. L. No. 65-50, § 1, 40 Stat. 300, 300–01. In 1918, a top rate of 77% applied to income applied to income above $1,000,000, and between 1919 and 1921, the rate was 73%. *See* 1918 Revenue Act, *supra* note 70, § 2, at 1062, 1064. In 1922, the top rate was 58% on income above $200,000, s*ee* Act of Nov. 23, 1921, Pub. L. No. 67-98, §§ 210–11, 42 Stat. 227, 233–37, while in 1923, the top rate was 43.5% on income above $200,000 after the 25% credit, *see* Act of June 2, 1924, Pub. L. No. 68-176, §§ 209(b), 210–11, 43 Stat. 253, 264–66. The top rate in 1924 was 46% on income above $500,000, which likewise established the 25% credit for 1923. *See* Act of June 2, 1924, *supra*, § 211, 43 Stat. at 267. The top rate in 1925 was 25% for income above $100,000. *See* Act of Feb. 26, 1926, Pub. L. No. 69-20, §§ 210–11, 44. Stat. 9, 21–23. Of potential importance would be taxpayers manipulating their income to fall just below the $1,000,000 mark, which would be particularly easy to do with capital gains. The benefit of doing so would depend on the steepness of the surtax. In practice, the benefit would be very small (with only a few percentage points' difference in marginal tax rates between brackets). Thus, this effect is ignored. For a graphical representation of the top marginal rates as they compare to the top rate preferential rate on capital, see Figure 1.

234. *CPI Inflation Calculator*, U.S. BUREAU OF LAB. STAT., https://www.bls.gov/data/inflation_calculator.htm (last visited Jan. 23, 2022) (calculated based on December 2021 buying power of $1,000,000 in January 1921).

235. *See supra* note 233 and accompanying text.

FIGURE 1: INCOME AND CAPITAL GAINS TAX RATE BY YEAR



Since the IRS Statistics deemed the top income class in this period to be those earning above $1,000,000, that group is the subject of the analysis here. For consistency, I call those individuals top-bracket taxpayers, despite the slight misnomer. The analysis focuses on the 1915 to 1925 period to try and develop insight into the longer-term effects of the reform on top-bracket dispositions of property, since only looking at 1921 and 1922 would emphasize transitory responses. "Dispositions of property" means income from the sale of capital assets that would classify as capital gain regardless of whether the holding period is satisfied, including what would today be long-term and short-term gain.[236] This broad definition is necessary since capital gains only existed following 1921, and the question then becomes whether top-bracket tax rates on capital were more productive before or after 1921.

Numerically, yearly tax receipts from dispositions of property by the group of taxpayers subject to the top marginal rate averaged 7.01 million between 1917 and 1921 and 14.39 million between 1922 and 1925. However, concluding that tax receipts rose because of the capital gains preference is poten-

236. 26 U.S.C. § 1222(1)–(2).

tially misleading, as many factors could have substantially impacted income and tax receipts from dispositions of property. Some confounders include the use of corporate solution for shareholder-level deferral, the rapid development of U.S. capital markets in the early 1900s, changing corporate payout policy, the development of the tax-free reorganization rules, and the general impact of the war.[237]

Congress's reasoning and the relevant economics literature both predict that the dramatic reductions in rates for the disposition of property in the 1921 Act should have led to significant capital gains being triggered following 1921, with a larger transitory response in 1921 and 1922 and a smaller though still significant permanent response from 1922 to 1925. While expectations are clear for income, the same cannot be said for tax receipts. Since tax receipts depend on the magnitude of behavioral responses, elasticities—of taxable income, of labor, of capital gains, and so on—are critical in estimating expectations of the effectiveness of tax reforms.[238] Unfortunately, there are no elasticity estimates and little data for the 1915–1925 period, though the testimony given in support of the capital gains preference speaks to a commonly held belief that the capital gains preference would increase tax receipts. As will now be seen, the data is consistent with this hypothesis.

A. *IRS Statistics of Income Data*

I used data on tax receipts and reported taxable income for the 1915–1925 period obtained from publicly available IRS Statistics of Income.[239] The hand-crafted data set is manually compiled and transcribed from publicly available IRS Statistics of Income for the 1915–1925 period, such that all graphs and figures presented here are original. Macroeconomic information, like GNP, is taken from Department of Commerce statis-

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237. *See* discussion *supra* Section I.C.

238. *See generally* KAPLOW, *supra* note 219.

239. *See SOI Tax Stats Archive - 1916 to 1933 Statistics of Income Reports,* INTERNAL REVENUE SERV., https://www.irs.gov/statistics/soi-tax-stats-archive-1916-to-1933-statistics-of-income-reports (last visited Jan. 25, 2022). Complete data from 1915 is unavailable, but some data points exist in data for subsequent years.

tics.[240] 1915 is chosen as the start date because that is when the IRS began collecting data, though most relevant income and tax data is only available from 1917 onwards. I take 1925 as the end date in an attempt to escape the influence of exceptional stock market performance and speculation of the mid-to-late 1920s, though other work on tax receipts in the 1920s takes the entire 1920–1929 period into account.[241] Another benefit of choosing the 1915–1925 period is that the 1921 reform occurred at roughly the midpoint.[242] As mentioned, only looking at 1921 and 1922 would produce disproportionate effects and potentially conflate transitory and permanent tax reform ef-

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240. *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COM., LONG TERM ECONOMIC GROWTH, 1860–1965 (1966), https://fraser.stlouisfed.org/files/docs/meltzer/cenlon66.pdf (last visited Jan. 23, 2022). Inflation data is taken from the Bureau of Labor Statistics CPI Databases. *See Consumer Price Index (CPI) Databases*, U.S. BUREAU OF LAB. STAT., https://www.bls.gov/cpi/data.htm (last visited Jan. 25, 2022).

241. *See, e.g.*, Gene Smiley & Richard H. Keehn, *Federal Personal Income Tax Policy in the 1920s*, 55 J. ECON. HIST. 285 (1995). By including the 1925–1929 period, the outcome may be biased in favor of the success of the reform: in other words, in favor of higher returns from lower taxes and predicting higher behavioral responses since the various effects of the "roaring twenties" may be more easily conflated with tax effects. Conversely, estimates obtained by excluding those years will be more conservative and potentially biased against the success of the reform, as an added precaution.

242. Note that there were several Mellon tax cuts in the early and mid-1920s. All rate changes between 1915 and 1925 are accounted for, though the focus of the analysis is on the 1921 reform since that saw the enactment of the capital gains preference. See Figure 1 above for a graph of the applicable top-bracket tax rates between 1915 and 1925, and see the 1921 Congressional Record, *supra* note 191, at 6592, for the rates.

fects. Other metrics such as bond yields,[243] trading volumes,[244] and stock indexes are examined in Section III.B.[245] Where necessary, all figures are inflation-adjusted.[246] The two important categories of data are top-bracket income and tax receipts from dispositions of property.

1. *Top-Bracket Gross Income for the 1915 to 1925 Period*

Table 1 presents results for top-bracket gross income, which fell by about a third between 1916 and 1917. This effect may have been exacerbated by the anticipation of high rates in 1917. Moreover, between 1916 and 1921, reported income was strictly falling. This finding includes 1919, which is an interesting data point for reasons discussed shortly. The downward trend is expected, but the economic contraction of 1920–1921

243. Bond spreads (high grade corporate yields less high grade municipal bonds yields) are taken from the NBER Macrohistory database. *See NBER Macrohistory: XIII. Interest Rates*, NAT'L BUREAU OF ECON. RSCH., https://www.nber.org/research/data/nber-macrohistory-xiii-interest-rates (last visited Jan. 25, 2022). The data is cross-referenced with the data from Global Financial Data ("GF") and the Federal Reserve Economic Database ("FRED") for historic economic and financial time-series data. While the municipal bond yield exists for the 1915–1925 period, corporate bond yields only exist starting in 1919. This makes bond-related data even less helpful in addition to the yield spread being a very noisy indicator. However, the corporate-municipal spread generally rises between 1919 and 1921, and it generally begins to fall around late 1921. Speculatively, this could very loosely be interpreted as showing that demand for tax-exempt municipal bonds was falling, though the data is quite inconsistent and inconclusive in this respect.

244. These trading volumes include the New York, Boston, Chicago, Los Angeles, and San Francisco stock exchanges. Trading volume for the 1915–1925 period was (in millions) 192.5 for 1925; 267.5 for 1916; 205 for 1917; 157.5 for 1918; 353 for 1919; 260 for 1920; 193 for 1921; 315 for 1922; 288 for 1923; 338 for 1924; and 520 for 1925. *See* TWENTIETH CENTURY FUND, THE SECURITY MARKETS: FINDINGS AND RECOMMENDATIONS OF A SPECIAL STAFF OF THE TWENTIETH CENTURY FUND 750–51 (1935). For an overview of the development and trading volume of the 1880s–1930s, see Mary O'Sullivan, *The Expansion of the U.S. Stock Market, 1885-1930: Historical Facts and Theoretical Fashions*, 8 ENTER. & SOC'Y 489 (2007).

245. Dow Jones Industrial Index data is taken from the GFB Finaeon database. *See GFB Finaeon Database*, GLOB. FIN. DATA, http://www.globalfinancialdata.com (data on file with author) (presented *infra* Figure 3) (last visited Jul. 20, 2021).

246. Where appropriate, the data is normalized to 1929 values. 1929 values are chosen since that is what GNP is normalized to in the Department of Commerce data used. *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COM., *supra* note 240.

likely had a large impact. The data clearly shows that profits from dispositions in the 1917–1921 period were far lower than those between 1922 and 1925.

TABLE 1: TOP-BRACKET INCOME AND PROFITS FROM DISPOSITION, IN MILLIONS, PLUS ASSOCIATED RATIOS

YEAR	GNP	GROSS INC	GI/GNP (‰)[a]	PD[b]	CAP GAINS	PD/GI (%)	PD/GNP (*pcm*)[c]
1915	60,424						
1916	68,870	851.64	12.37				
1917	67,264	486.43	7.23	13.60		2.80	20.22
1918	73,361	215.64	2.94	2.88		1.33	3.92
1919	74,158	194.74	2.63	39.41		20.24	53.15
1920	73,313	93.40	1.27	4.06		4.34	5.53
1921	71,583	55.98	0.78	0.32		0.57	0.45
1922	75,788	169.69	2.24	59.61	55.34	35.13	78.65
1923	85,819	182.53	2.12	74.29	73.94	40.70	86.57
1924	88,361	188.43	2.13	53.08	50.15	28.17	60.07
1925	90,529	460.35	5.09	261.35	234.20	56.77	288.69

NOTE – GNP = Gross National Product, Gross Inc or GI = gross income, PD = profits from dispositions, Cap Gains = capital gains.

[a] Per mille is used to facilitate comparison across years.

[b] Profits from dispositions includes taxes on capital gains beginning in 1922.

[c] Per cent mille is used to facilitate comparison across years.

The lowest reported income for top-bracket taxpayers occurred in 1921 and was significantly lower than in other years, which could have resulted at least partially from large timing (transitory) responses or the recession.[247] Gross income throughout the 1922–1925 period strictly increased. The ratio of top-bracket gross income to GNP fell between 1916 and 1921, then trended upwards between 1922 and 1925, although it was slightly higher in 1922 than in 1923 and 1924. The most dramatic results from Table 1 regard profits from dispositions. Except for 1919, the 1917–1921 period shows relatively little profits from dispositions, as amounts, percentage of top-

247. The importance and magnitude of large timing responses is well known in the elasticity literature. For a discussion, see Saez et al., *supra* note 219; Slemrod & Kopczuk, *supra* note 17; Giertz, *supra* note 219; Burman & Randolph, *supra* note 219; and Auerbach & Siegel, *supra* note 219.

bracket total gross income, or as a faction of GNP. 1919 is striking, with profits from dispositions being almost 4 times the 9.3 average of the 1916–1921 period, more than 7 times the 5.2 average if 1919 is excluded, and roughly 14 times greater than 1918 and 10 times greater than 1920. These results are mostly the same in terms of the profit from disposition to gross income ratio. The substantial profit from dispositions in 1919 is curious since taxpayers would presumably have expected tax rates to fall following the 1918 armistice.[248]

Each year between 1922 and 1925 saw profit from dispositions in the tens or hundreds of millions. In millions, the average reported income from sales of capital assets across the 1922–1925 period was 112.08, the average for the 1917–1921 period was 12.05, and the average for the 1917–1920 period was 14.98.[249] 1923 saw greater profits from dispositions than 1922. Between 1922 and 1925, net capital gains made up the majority (at least 89% each year) of yearly top-bracket income from dispositions, meaning individuals had been holding assets for at least 2 years to access capital gains treatment. Finally, comparisons between total top-bracket dispositions as a share of gross income and GNP are dramatic. The average ratio of dispositions of property to GNP were almost 8 times higher between 1922 and 1925 (128.50 *pcm*) than between 1917 and 1921 (16.65 *pcm*), and the ratio of income from dispositions to gross income rose from an average of 5.86% between 1917 and 1921 (7.18% between 1917 and 1920), to 40.19% between 1922 and 1925.

Table 2 presents gross income by source, presented graphically in Figure 2. In millions, the average yearly top-bracket wage income between 1922 and 1925 was 5.31 and barely exceeded the 5.30 average between 1917 and 1921, though it was lower than the 6.98 average between 1916 and 1921, with yearly wage income falling between 1922 and 1924. Wage income was consistently a relatively small share of top-bracket taxpayer gross income. Top-bracket taxable interest income and dividend income were strictly falling between 1917

248. Roy G. & Gladys C. Blakey, *The Revenue Act of 1918*, 9 AM. ECON. REV. 214, 214 (1919).

249. Standard deviation for the 1922–1925 period was 99.9. Standard deviation for the 1917–1921 period was 16.01, while standard deviation for the 1917–1920 period was 16.97.

and 1921, then strictly increasing between 1922 and 1925.[250] Dividends were a major source of top-bracket income, averaging 54.16% of gross income between 1916 and 1925, with dividend income between 1922 and 1925 falling below that average. In 1925, profits from dispositions were higher than dividend income (almost twice) for the first time since the IRS began collecting taxpayer statistics, whether by percentage of gross income or numerical amounts.

TABLE 2: TOP-BRACKET TAXPAYER GROSS, WAGE, DIVIDEND, INTEREST, INCOME AND PROFITS DISPOSITIONS (MILLIONS)

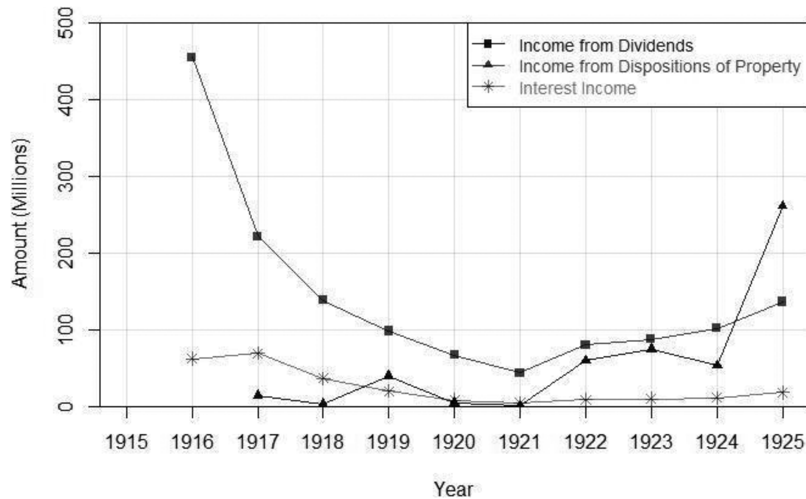
YEAR	WAGE INC	WI/GI (%)	PD[a]	PD/GI (%)	DIV INC	DIV/GI (%)	INT INC	INT/GI (%)
1915								
1916	15.39	1.81			455.43	53.48	62.05	7.29
1917	12.34	2.54	13.60	2.80	221.75	45.59	69.05	14.20
1918	5.08	2.35	2.88	1.33	138.48	64.22	36.20	16.79
1919	3.36	1.73	39.41	20.24	97.89	50.27	19.48	10.00
1920	3.25	3.48	4.06	4.34	66.44	71.13	7.94	8.50
1921	2.46	4.40	0.32	0.57	43.61	77.91	4.11	7.35
1922	5.02	2.96	59.61	35.13	79.78	47.01	8.11	4.78
1923	4.51	2.47	74.29	40.70	87.09	47.71	9.59	5.25
1924	3.99	2.12	53.08	28.17	101.71	53.98	11.06	5.87
1925	7.73	1.68	261.35	56.77	136.23	29.59	17.64	3.83

NOTE – Wage Inc or WI = wage income, GI = gross income (reported in Table 1), PD = profits from dispositions, Div Inc or Div = dividend income, Int Inc = interest income.

[a] Profits from dispositions includes taxes on capital gains beginning in 1922.

250. Dividends appear to be somewhat sticky, which is one of the key findings of the extensive research in finance about dividends. For dividend income data, see Figure 2 and Table 2. The standout year of 1916 may be attributable to a few corporate owners paying out accumulated earnings in anticipation of the 1917 tax increase. *See generally* Franklin Allen & Roni Michaely, *Payout Policy*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 337 (George M. Constantinides, Milton Harris, & René M. Stulz eds., 2003). *See also* John Lintner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 AM. ECON. REV. 97 (1956) (foundational piece which has proven to be quite an accurate representation of how management sees dividends); Christian Andres & Ulrich Hofbaur, *Do What You Did Four Quarters Ago: Trends and Implications of Quarterly Dividends*, 43 J. CORP. FIN. 139 (2017) (more recent confirmation of this insight into dividends).

FIGURE 2: TOP BRACKET PROFIT FROM DISPOSITIONS, INTEREST INCOME, AND DIVIDENDS



2. *Top-Bracket Tax Receipts for the 1915 to 1925 Period*

Tax receipts between 1915 and 1925 are reported in Table 3. Regarding total top-bracket tax receipts, the 1917–1919 years were the largest between 1915 and 1925. Despite 1920 and 1921 being recession years, 1920 compares favorably to 1924 and exceeds 1923. Thus, except for taxes from dispositions of property, the higher tax rate years produced greater revenue. Between 1917 and 1921, top-bracket tax receipts and the ratio of top-bracket taxes to total taxes were strictly decreasing, even in 1919. However, each year between 1922 and 1925 saw greater tax receipts from dispositions than 1917–1921, except for 1919. Again, 1919 is an outlier within the 1917–1921 period and saw greater tax receipts from dispositions of property than any other year except 1925. Average yearly tax receipts from top-bracket taxpayer dispositions of property were 7.01 million for the 1917–1921 period, and 14.34 for 1922–1925.[251] This finding coincides with the enactment of the capital gains preference in 1921, with income

251. Standard deviation is 10.5 and 13.6, respectively. If 1919 and 1925 are excluded from the sample variance and standard, deviation falls significantly, as does the mean.

from dispositions, which includes capital gains, increasing significantly following its enactment (except for 1919).

TABLE 3: AGGREGATE AND TOP-BRACKET TAX RECEIPTS, IN MILLIONS, PLUS ASSOCIATED RATIOS

YEAR	TAX REV	TB TAX	TBT/TR (%)	TAX ON DISP[a]	CAP TAX	TD/TBT (%)	TD/GNP (*pcm*)[b]
1915	114.82						
1916	284.35	84.44	29.70				
1917	985.86	159.76	16.21	4.85		3.04	7.21
1918	1,375.27	108.44	7.88	1.86		1.72	2.54
1919	1,320.42	102.99	7.80	25.57		24.83	34.48
1920	956.80	43.77	4.58	2.59		5.91	3.53
1921	647.45	28.28	4.37	0.20		0.72	0.29
1922	869.67	50.01	5.75	8.48	6.92	16.96	11.19
1923	676.92	36.50	5.39	7.06	6.84	19.35	8.23
1924	697.22	46.74	6.70	7.13	6.07	15.26	8.07
1925	727.21	66.20	9.10	34.72	28.56	52.45	38.35

NOTE – GNP = Gross National Product, Tax Rev or TR = aggregate revenue from income taxes for the tax year, TB = top-bracket taxpayers, TBT = aggregate tax receipts from top bracket taxpayers, Tax on Disp or TD = tax on income from profits on dispositions, and Cap Tax = tax on capital gains.

[a] Profits from dispositions includes taxes on capital gains beginning in 1922.

[b] Per cent mille is used to facilitate comparison across years.

B. *Systemic Factors, Causal Effect, and the Capital Gains Preference*

Before jumping into continued discussion about the capital gains preference, it is worth summarizing the conclusions of the empirical analysis. First, there is a clear trend in terms of both income and tax receipts from dispositions of property, with the post-reform years (1922 and after) generally performing much better than the high tax 1917–1921 years.[252] Superficially, this suggests that the capital gains preference was successful and that taxpayers responded quite dramatically to rates and changes in rates. We can draw two possible conclusions regarding realization-based capital income taxes. The first, and more brazen conclusion, is that tax rates on capital

252. As discussed above, 1919 is a bit of an exceptional year. *See supra* Section III.A.2.

should be low since wealthy taxpayers are simply more sensitive to them. Under this conclusion, the capital gains preference works regardless of the tax system in which it is embedded. The second, more nuanced conclusion, is that tax rates on capital should be low when avoidance opportunities are plentiful and when people think that rates are not permanent. Hence, given the general structure of tax law and the political and economic climate, the capital gains preference was and may continue to be necessary for revenue-maximization. The corollary of this more narrow conclusion is that the structure of the tax code matters deeply in whether a given tax rate is optimal. This seems to be the correct way of interpreting the results, for reasons that will now be explored.

The summary statistics presented above should not be taken as showing that the capital gains preference caused an increase in tax receipts between 1922 and 1925 relative to the period between 1917 and 1921. There was a great deal happening in terms of tax policy, socio-economic changes, financial markets, the war, and interactions between capital and entity level tax regimes, all of which likely had a large impact on dispositions of property. Thus, it would be premature to conclusively declare Congress lowering rates on capital gains taxes in 1921 as an outright victory. The idea that behavioral elasticities depend in part on the structure of the Code has been discussed before, with Joel Slemrod and Wojciech Kopczuk modeling how deductions and policy tools can influence taxpayer elasticities.[253]

As seen in Part I, between 1913 and 1916 taxpayers were disincentivized from adopting sales-based investment strategies. Interest was taxed at the same rate as gains but deductible (with limits) at the corporate level, and dividends were excluded from the normal tax.[254] A large drawback was that capital losses only became deductible following 1916.[255] Thus, at that time, there were serious tax disincentives to adopting sales-based investment strategies, meaning that they may have been underdeveloped.

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253. *See* Slemrod & Kopczuk, *supra* note 17; *see also* Wojciech Kopczuk, *Tax Bases, Tax Rates and the Elasticity of Reported Income*, 89 J. PUB. ECON. 2093 (2005).

254. *See supra* Part I.

255. *See* 1916 Act, *supra* note 56, at §5(a).

This situation changed in 1916. Rising tax rates made dividend and interest income less appealing, whereas dispositions from capital losses could be deducted at high rates. More importantly, the realization requirement meant that the possibility of deferring gains made sales-based strategies more tax-favorable than interest or dividends. The 1900s, 1910s, and 1920s also saw dividend payout and retained earnings policy change dramatically, with corporations reducing dividends and increasing the amount of retained earnings for business purposes.[256] The introduction of high rates in 1917 saw retaining earnings through corporate solution become a valuable source of deferral for high wealth investors and a "shield" against the surtax, although this was tempered by the excess profits tax.[257] The tax benefits of retained earnings, the effects of the excess profits tax, and the reduction of yearly dividend payouts all affected deferrals and hence all had some effect on tax receipts from dispositions of property. Similarly, the development of tax-free reorganization rules in 1918 and their expansion in 1921 probably had some impact on dispositions of property.[258]

Taxpayers probably also thought that the dramatic increases in tax rates caused by World War I would be temporary.[259] This would have greatly increased the incentive to defer realization until tax rates fell, which taxpayers could have assumed would happen soon after the war ended. Such an effect would have increased (probably greatly) the propensity of top-bracket taxpayers to engage in deferral strategies. The war, the short-lived post-war boom, and the 1920–1921 recession likewise impacted tax receipts in complex ways which are otherwise difficult to disentangle from the effects of tax policy.

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256. BANK, *supra* note 4, at 91–92; WILLIAM H. LOUGH, BUSINESS FINANCE: A PRACTICAL STUDY OF FINANCIAL MANAGEMENT IN PRIVATE BUSINESS CONCERNS 477 (1917); *see also* Jack W. Wilson & Charles P. Jones, *An Analysis of the S&P 500 Index and Cowles' Extensions: Price Indexes and Stock Returns, 1870–1999*, 75 J. BUS. 505 (2002).

257. BANK, *supra* note 4, at 84, 101.

258. *Id.* at 120–38.

259. It is possible that taxpayers could have looked to the experience of the first income taxes in the 1860s, seen in Section I.A *supra*. There, the tax was repealed outright a few years after the war ended. *See* 1870 Act, *supra* note 33; Hutchison, *supra* note 5; *supra* note 24 and accompanying text.

World War I also saw a dramatic expansion of public involvement in capital markets. According to some estimates, the number of Americans owning publicly traded NYSE stock grew from only one hundred thousand before the war to more than two million by 1920.[260] Furthermore, Bank notes that both the number of companies going public and trading volumes on public exchanges increased significantly between 1915 and 1920.[261] He also writes that the eleven million people who purchased Liberty Bonds had now been introduced to the world of investing, and brokers who previously marketed Liberty Bonds now promoted the purchasing of publicly traded securities.[262] This increased demand could have contributed to a favorable climate for top-bracket taxpayers to generate capital gains.

FIGURE 3: DOW JONES INDUSTRIAL AVERAGE (1915–1925)

260. BANK, *supra* note, 4 at 116–17. The following materials are also relevant and are likewise quoted by Bank: ROBERT SOBEL, INSIDE WALL STREET: CONTINUITY AND CHANGE IN THE FINANCIAL DISTRICT (1977); JONATHAN BARRON BASKIN & J.R. MIRANTI, A HISTORY OF CORPORATE FINANCE (1997).

261. For an overview of the development and trading volume of the 1880s–1930, see O'Sullivan, *supra* note 244.

262. BANK, *supra* note 4, at 116–17.

Stock market performance and income and tax receipts from dispositions of property appear relatively correlated, as would be expected. Figure 3 presents the Dow Jones Industrial Average between 1915 and 1925, with both 1919 and 1925 being very good years for the index. This may be a partial explanation as to why 1919 was such an exceptional year in terms of income and tax receipts from dispositions of property, as wealthy taxpayers chose to trigger a highly taxed gain rather than risk a highly deductible investment loss.

The Statistics of Income are consistent with large behavioral responses to tax rates on dispositions of property, though again, this is inconclusive as to causation. Income from dispositions in 1921 is the lowest of the period by far at roughly $320,000, despite stock markets beginning to recover in late 1921, suggesting large transient responses. Similarly, tax receipts from top-bracket taxpayers generally fell between 1917 and 1921 (except from dispositions of property in 1919) and then rose between 1922 and 1925, with seemingly larger effects in 1921 and 1922. This is consistent with deferral of realization-based gains, top-bracket taxpayers shifting investment portfolios in response to tax rates, and accounts of top-bracket individuals' vast holdings of tax-exempt bonds between 1917 and 1921.[263] Stock trading volume was also higher each year between 1922 and 1925 compared to the period between 1917 and 1921 (except 1919).[264] Interestingly, Table 2 provides some indicia that the increase in profit from dispositions did not significantly erode other tax bases. Wage, dividend, and interest income appear to be stickier than income from sales, as expected, although wage income fell between 1922 and 1924. Such a drop could have been caused by rate arbitrage as taxpayers shifted compensation from salaries to capital gains, which could have equally happened between 1917 and 1921 to defer earnings.[265]

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263. *See supra* Part II.

264. See O'Sullivan, *supra* note 244, and associated numerical values outlined in the note for trade volume data.

265. The most famous example of rate arbitrage is exactly the case of the entrepreneur. *See* James M. Poterba, *Venture Capital and Capital Gains Taxation*, 3 TAX POL'Y & ECON. 47 (1989); Christian Keuschnigg & Soren Bo Nielsen, *Start-ups, Venture Capitalists, and the Capital Gains Tax*, 88 J. PUB. ECON. 1011 (2004).

There are some limited but nonetheless important takeaways that we can draw from the 1921 experience. First, tax policy is hard, and there are many moving parts which makes coming to clear-cut conclusions difficult. This is especially true when data is over a hundred years old, but as Dowd and Richards write, it equally applies today.[266] Even though the 12.5% capital gains preference does indeed seem to be associated with higher tax receipts from the highest income taxpayers, the story is a bit more complicated than just directly looking at the numbers from the IRS Statistics of Income would suggest.

Second, there is a clear takeaway from the story behind the creation of the capital gains preference—given the situation faced by the United States in the late 1910s and early 1920s, the capital gains preference seems to have been a policy success.[267] At a higher level, the policymaker's question is how to maximize societal welfare through the tax system—how to ensure that everyone in society is best off.[268] One component of this is taxing capital. To craft policy, the policymaker can both look to theory, which is plentiful but not necessarily an accurate representation of the physical world,[269] and to the past, which, while an accurate representation of reality, may not be applicable today.[270] The analysis presented here falls into the latter category. Hence, understanding the context behind the capital gains preference is a critical part of the story.

While there are notable differences between the 1910s–1920s and today, there are likewise some striking similarities, which renders the experience insightful for modern tax policy. One of the nuances explored above is that "structural" issues embedded in the wording of tax law itself leading

266. Dowd & Richards, *supra* note 16.

267. *See supra* Section III.A.

268. For a framework, see KAPLOW, *supra* note 219.

269. Dowd & Richards, *supra* note 16 (for a discussion in the context of the elasticity of capital gains).

270. This is well known in statistics. *See generally* JAMES H. STOCK & MARK W. WATSON, INTRODUCTION TO ECONOMETRICS (4th ed. 2019). The idea is that certain sets of factors (confounders) may have existed in the past which no longer exist and, if they are not controlled for, can generate spurious association. This is the risk here with capital gains taxes, requiring careful examination of the context behind the 1917–1925 period.

to capital gains taxes being easy to game.[271] This is equally true today.[272] Additionally, we see that deferral is especially useful when tax rates are expected to fall, which was likely the case during World War I.[273] Today's climate of political uncertainty and volatility similarly means that tax policy is far from constant, lowering the chance that a spike in capital gains tax rates will become a permanent feature of the tax code.[274] In that case, much like taxpayers could have done after 1917, taxpayers can realistically avoid selling and simply wait until Congress passes lower rates. Worse still, taxpayers could harvest losses during the high tax years and capture gains during low tax years.

To summarize: the enaction of the capital gains preference is consistent with the idea that capital gains in a realization-based system should be taxed at somewhat low rates, given several important factors.[275] The 70% rate appears to have failed relative to a 12.5% rate precisely because taxpayers could easily defer triggering gains until rates fell again, had ample access to tax planning opportunities, and probably thought that high rates would be temporary. In the abstract, if tax planning was heavily limited and rates were stable (such that a 70% rate would be seen as a permanent tax rate), then a 70% rate would have performed much better than it did during the 1917–1921 period. This does not mean that a 70% rate is the theoretically best rate. But it does mean that context matters when evaluating tax policy reform, which is a critical

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271. The main issue is the realization principle and deferral at the corporate level. *See* Bank & Mehrotra, *supra* note 4, at 187–88; *supra* Sections II.B–C.

272. *See, e.g.*, Daniel I. Halperin & Alvin C. Warren, Jr., *Understanding Income Tax Deferral*, 67 TAX L. REV. 317 (2014).

273. See the explanation given *supra* note 259.

274. COVID-19 seems to have particularly exacerbated this trend. *See* Julie Jiang et al., *Political Polarization Drives Online Conversations About COVID-19 in the United States*, 2 HUM. BEHAV. & EMERGING TECHS. 200 (2020). In the tax context, see David Kamin & Jason Oh, *The Effects of Capital Gains Rate Uncertainty on Realization* (UCLA Sch. of L., Law-Econ Research Paper No. 19-06, 2019), https://papers.ssrn.com/abstract=3365305.

275. The main factors, all of which are discussed in this section, are the ability to defer capital gains taxes because of the realization requirement, other legal structural concerns in tax law like the ability to use corporate solution as a further deferral mechanism, the belief that rates would change (hence taxpayers are more willing to defer to get hit by a lower applicable rate) and developing financial markets.

point often forgotten in both political and academic discussions.[276] A capital gains preference may make sense in one context, given one set of laws and political realities, while being welfare reducing tax policy in other contexts.

Conclusion and Insight for Current Tax Policy

The enactment of the capital gains preference repeats a well-known story. The golden rule of taxation, which was true in the 1920s, is true in the 2020s, and will remain true forevermore, is that taxpayers will always try to minimize their taxes.[277] The legislative history and associated IRS Statistics presented here are nothing more than a manifestation of the idea that capital-rich taxpayers are especially sensitive to high tax rates, partly because the foundational norms of the current taxation of capital allows taxpayers to easily escape the present taxation of accrued capital value. Right now, it seems like small rate increases on capital gains could bring in more revenue.[278] However, if Congress wants to tax capital substantially more heavily then it must go beyond simply raising rates and change the very structure of capital taxation, which currently rests on the same foundational norms that existed in 1921.

The circumstances surrounding the enactment of the capital gains preference show the importance of the architecture of the Code and interaction between provisions when forecasting responses to changes in rates or evaluating reform proposals. This Note cautions against estimating changes in tax receipts from capital gains without controlling for the impact of other sections of the Code, which is similar to the point made by Dowd and Richards, and Slemrod and Kopczuk, regarding the elasticity literature.[279] For example, in an environment of high personal income tax rates but comparatively lower corporate tax rates, wealthy taxpayers may use corporate solutions as a deferral mechanism, as appears to have been the case in the

276. This point is closely related to those raised by Dowd & Richards, *supra* note 16.

277. For the leading treatise on tax administration and enforcement, see JOEL SLEMROD & CHRISTIAN GILLITZER, TAX SYSTEMS (2014), which includes a discussion of avoidance historically and across different cultures.

278. The optimal rate seems to be about 30%. *See* Sarin et al., *supra* note 17.

279. Dowd & Richards, *supra* note 16, at 23; Slemrod & Kopczuk, *supra* note 17, at 6.

1910s. This means that high tax rates will not necessarily raise more revenue than lower rates, just as they did not during the 1915–1925 period (regardless of whether that was caused by the rates themselves). Deep discussions about how taxpayers respond to different tax systems and associated rates should be front and center in policy debates on reforming capital taxation, including for wealth taxes.[280]

To note that the wealthiest are not paying their stated tax burdens is an important first step in tax reform, but the critical questions are why and how that happens. The strength and weakness of a tax regime will be felt most strongly when rates are high. Thus, for high tax rates to be effective policymakers need to minimize avoidance opportunities. In 1921 Congress settled on the easier path of simply lowering tax rates to reduce the marginal benefit of avoidance, but that solution seems untenable today given surging deficits, rising inequality, and a Code that does not adequately tax capital. Further lowering rates would almost certainly not be revenue increasing.[281] However, if Congress decides to seriously increase the tax burden on capital, these increases must be coupled with significant reform targeting how and when the Internal Revenue Code captures return to investment. Otherwise, capital-rich taxpayers will find ways around the high rates like they did between 1917 and 1921.

The current taxation of capital is unsatisfactory for a multitude of well-known reasons, whether from the perspective of revenue-raising, welfare maximization, or regarding questions of inequality.[282] If Congress wishes to fix this problem—and it does—then there are three broad paths of increasing complexity that it can go down. The first is to leave the general structure of the tax code unchanged while modifying tax rates.

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280. *See* Ole Agersnap & Owen M. Zidar, *The Tax Elasticity of Capital Gains and Revenue-Maximizing Rates* (Nat'l Bureau of Econ. Rsch, Working Paper No. 27705, 2020) (using data from the 1980–2016 period to estimate behavioral elasticities and finding that the revenue-maximizing tax rate on capital is between 38% and 47%, mostly assuming linear responses).

281. If the revenue-maximizing rate is about 30% (or even higher), per Sarin et al., *supra* note 17, at 2, then going below that is undesirable. Note that this assumes that the welfare-maximizing rate is also about 30% or higher.

282. *See supra* note 1 and accompanying text; *see also* Saez & Zucman, *supra* note 17.

It seems that, under current law, the general consensus is that rates should be increased to about 30%.[283] Should Congress do away with capital gains altogether and impose a maximum rate beyond 30%, then they would likely find themselves with the same types of problems which existed in the 1910s and early 1920s and which gave rise to the capital gains preference. If 30% is indeed the optimal top rate, then it seems like proposals like those of Senators Warren[284] and Sanders[285] go too far by imposing tax rates of well over 40%, while the top 25% capital gains tax rate under the Build Back Better Act (H.R. 5376) is still too low.[286] The benefit of rate changes is that they involve minimal effort, but their issue is that they leave distortions and inefficiencies in the tax code unchanged.

The second option is to change some of the serious but easy-to-fix issues with the capital gains tax, including stepped-up basis at death and charitable giving, both of which can be used to escape capital gains taxation altogether.[287] There would be many benefits to eliminating these easy loopholes, primarily that it would increase the amount of capital gains subject to tax. In doing so, the optimal rate would change, such that the top optimal rate under this slightly changed system would be higher than the assumed optimal rate of 30% under current law.[288] Though exactly how high is entirely speculative, it may be 40% or even 50%.[289] The problem is

283. Sarin et al., *supra* note 17, at 2.

284. *See* Team Warren, *supra* note 20; *see also* Jordan McDonald, *These Are the Taxes Elizabeth Warren Has Proposed in the 2020 Race*, CNBC (Oct. 5, 2019, 9:30 AM) https://www.cnbc.com/2019/10/05/these-are-the-taxes-elizabeth-warren-has-proposed-for-2020.html.

285. *See* Friends of Bernie Sanders, *supra* note 20.

286. *See* Build Back Better Act, H.R. 5376, 117th Cong. § 138202 (2021) (addressing increase in capital gains rate for high income earners).

287. This point is likewise made by Summers, *supra* note 22. For stepped-up basis at death see, e.g., Michael J. Graetz, *"Death Tax" Politics*, 57 B.C. L. Rev. 801 (2016). For charitable giving, see, e.g., Ross Gittell & Edinaldo Tebaldi, *Charitable Giving: Factors Influencing Giving in U.S. States*, 35 Nonprofit & Voluntary Sector Q. 721 (2006); Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 Tax L. Rev. 1 (2002).

288. *See* Sarin et al., *supra* note 17, at 2.

289. The magnitude of the behavioral response depends on the exact legal structure of the tax code. If it is less porous, and capital gains taxes are harder to avoid, then people will be hit regardless of the tax. Hence, a larger tax generates more revenue with less distortion. *See supra* Part III, Section

that political volatility makes those rates unlikely to be binding. If there is fluctuation between higher and lower rates, then taxpayers would simply know to harvest losses during the high tax periods and trigger gains during the lower-tax periods.[290] This intermediate option does involve structural tax reform, but by targeting low-hanging high-impact loopholes, it should be relatively simple.[291] A capital gains preference would still likely make sense because of its impact on savings, but the tax avoidance story would become a much less important facet of the debate.[292] Such incremental but high-impact reforms seems like the best path precisely because of large potential impact coupled with its relatively ease.

The third option involves eliminating the realization requirement and hence dramatically reconceptualizing the tax system. This would end deferral, which is one of the most significant problems with the capital gains tax today and which featured prominently in the story behind the inception of the capital gains preference. One option to eliminate much of the benefit of deferral comes directly from the discussions leading up to the enactment of the capital gains preference in 1921: apportioning gains across an asset's holding period and applying the rate which applied each year, regardless of the applicable rate in the year in which the asset was sold.[293] Such an approach would be administratively difficult for both taxpayers and the revenue service, since it would involve constantly updating tax liabilities from prior years because of graduated

III.B. The welfare maximizing rate is a very hard one to figure out, since it involves heavy assumptions as to consumption and savings. *See* BANKS & DIAMOND, *supra* note 224, at 548.

290. This would have a similar effect to that explored in *supra* Section III.B.

291. Again, this appears to be the preferred approach of Summers. *See supra* note 22.

292. One of the most extensive reports on taxation, the 2010–11 Mirrlees Review, recommends that capital should be taxed at graduated rates lower than those on wage income in part because of tax noncompliance issues. *See* Alan J. Auerbach, *The Mirrlees Review: A U.S. Perspective*, 65 NAT'L TAX J. 685 (2012); BANKS & DIAMOND, *supra* note 224.

293. The entire benefit would not be ended here since a taxpayer would not be paying interest on taxes accrued in earlier years. To that end, there is still a lock-in effect. *See generally* Halperin & Warren, *supra* note 272.

rates, and is ultimately the reason it was not adopted in 1921.[294]

A subset of this last option is a wealth tax, which has recently received a windfall of academic and political attention both in the United States and abroad.[295] Some of the current popularity of a wealth tax can be attributed to Piketty famously advocating for a more progressive tax system in his book, *Capital in the 21st Century*.[296] He writes that "the [optimal] top tax rate in the developed countries is probably above 80 percent" on incomes for the top 1% or 0.5% of earners.[297] He further notes that the United States is large enough to implement such a policy by itself and argues:

> The evidence suggests that a rate on the order of 80 percent on incomes over $500,000 or $1 million a year not only would not reduce the growth of the US economy but would in fact distribute the fruits of growth more widely while imposing reasonable limits on economically useless (or even harmful) behavior.[298]

In addition to an income tax on capital, Piketty recommends the implementation of a wealth tax.[299] He notes that a wealth tax may be more effective since it would be harder to avoid than an income tax,[300] and that it would increase incentives to efficiently allocate capital.[301] There have been many responses to Piketty's work, but his claims regarding an 80% capital gains tax coupled with a wealth tax are readily explored here, especially since Congress imposed similar rates (less the wealth tax) between 1916 and 1921.[302]

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294. This would happen because of graduated rates. *See supra* Section II.B.

295. *See, e.g.*, Saez & Zucman, *supra* note 17; Scheuer & Slemrod, *supra* note 22; Kopczuk, *supra* note 253; Daniel Hemel, *Taxing Wealth in an Uncertain World*, 72 NAT'L TAX J. 755, 755–76 (2019). For the political dimensions, see sources cited *supra* note 20. For the international attention see ARUN ADVANI ET AL., WEALTH TAX COMMISSION, A WEALTH TAX FOR THE UK (2020) and related background papers.

296. PIKETTY, *supra* note 19, at 660.

297. *Id.* at 512–513.

298. *Id.* at 513.

299. *Id.* at 544. Piketty suggests rates of over 2% for €5,000,000.

300. *Id.* at 524.

301. *Id.* at 526–27.

302. *See, e.g.*, Daron Acemoglu & James A. Robinson, *The Rise and Decline of General Laws of Capitalism*, 29 J. ECON. PERSPS. 3 (2015) (pertinent to the

Under current law and without first changing the actual structure of the federal income tax, both the elasticity of capital gains literature and the history behind the enactment of the capital gains preference suggest that 80% rates are far from revenue or welfare maximizing. In fact, the capital gains preference exists almost entirely as a response to the perceived failure of tax rates on capital gains, which were almost as high as 80%. Moreover, there is extensive testimony that the 1917–1921 period was characterized by significant deferral at the shareholder level, as well as investment in tax-free sources, which is supported by IRS data. According to Alan Auerbach and Kevin Hassett, there is little support for adopting Piketty's rate structure, at least not without extensive structural tax reform, and the 1915–1925 period is yet more evidence against it.[303] As was discussed, a porous Code, easy avoidance mechanisms, and volatile tax policy (especially tax rates) can all contribute to large behavioral responses to high tax rates on capital gains.[304]

As for wealth taxes, they are far from a silver bullet. The European experience with wealth taxes has generally been regarded as a failure, with enforcement proving a first-order consideration.[305] Much like an income tax, a wealth tax's success will depend on its specific legal architecture.[306] The Ultra-Millionaire Tax Act before Congress, introduced by Senator Warren and seven others (including Senator Sanders), is strikingly sparse in terms of actual "legal" provisions rendering analysis difficult.[307] While a wealth tax along proposed rates would significantly increase the tax burden of ultra-wealthy Americans, which would typically result in massive behavioral responses, it

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discussion on wealth accumulation, inequality, and fairness). For a discussion of some of the criticisms and defenses of Piketty's work, see J. E. King, *The Literature on Piketty*, 29 REV. POL. ECON. 1 (2017) (one of the key criticisms regards enforcement).

303. Alan J. Auerbach & Kevin Hassett, *Capital Taxation in the Twenty-First Century*, 105 AM. ECON. REV. 38, 41 (2015).

304. For a discussion of political polarization, see Alan Abramowitz & Jennifer McCoy, *United States: Racial Resentment, Negative Partisanship, and Polarization in Trump's America*, 681 ANNALS AM. ACAD. POL. & SOC. SCI. 137 (2019).

305. *See* Scheuer & Slemrod, *supra* note 22, at 227; Slemrod & Kopczuk, *supra* note 17, at 93.

306. This point is likewise made by Scheuer & Slemrod, *supra* note 22, at 214–15.

307. *See generally* Ultra-Millionaire Tax Act, *supra* note 20.

would resolve the problem of taxpayers being able to choose when to realize taxable gains or losses and hence end the problem of deferral.[308]

However, ending realization and deferral through a wealth tax comes at the cost of other serious, likely first-order problems like valuation,[309] timing,[310] and questions of how such a tax would impact financial markets and the economy more generally.[311] Though wealth taxes have their proponents, it seems unlikely that an annual wealth tax would be an effective welfare-increasing policy choice for capital taxation. It would involve moving towards a relatively novel system instead of trying to fix the system that we know and which has worked to some extent for over a hundred years. Much of the recent scholarship on wealth taxes appears to share this skepticism,[312] and it is further unclear whether a wealth tax would even be constitutional.[313] Similarly, the final report of the United Kingdom's Wealth Tax Commission (2020) likewise ended up recommending against a recurring wealth tax, primarily because of enforcement and administrative concerns.[314] It may be better to combine some of the approaches of a wealth tax and an income tax, as is attempted in several types of retrospective capital taxation models developed by va-

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308. *Id.* The wealth tax would impose a 2% tax on net wealth between 50 million and 1 billion, then a total of 3% on all wealth above 1 billion.

309. For an overview, see Lindsay Pentelow, *UK Tax Valuation and Potential Wealth Tax* 5 (Wealth Tax Comm'n Background Paper No. 146, 2020); Jeffrey N. Pennell, *An Alternative to a Wealth Tax: Taxing Extraordinary Income*, 171 TAX NOTES FED. 891 (2021). *But see* Saez & Zucman, *supra* note 17, at 32–34. *See generally* Slemrod & Kopczuk, *supra* note 17, at 96.

310. *See, e.g.*, Andy Summers, *Ways of Taxing Wealth: Alternatives and Interactions*, 42 FISCAL STUD. 485–507 (2021); *see also* ADVANI ET AL., *supra* note 295, at 11.

311. *See* Saez & Zucman, *supra* note 17, at 36–38; Kopczuk, *supra* note 253, at 23–24.

312. *See, e.g.*, Summers, *supra* note 22; *see also* Kopczuk, *supra* note 253, at 22.

313. *See, e.g.*, Ari Glogower, *A Constitutional Wealth Tax*, 118 MICH. L. REV. 717 (2020); *see also* Erik M. Jensen, *Is a Tax on Wealth Constitutional?*, 36 J. TAX'N INVS. 79 (2019); Calvin H. Johnson, *A Wealth Tax Is Constitutional*, 38 ABA TAX TIMES 6, 6 (2019). *See generally* Dawn Johnsen & Walter Dellinger, *The Constitutionality of a National Wealth Tax*, 93 IND. L.J. 111 (2018); Brian Fletcher, *Con or Constitutional: An Analysis of the "Net Worth" Wealth Tax*, 54 CREIGHTON L. REV. 87 (2020).

314. ADVANI ET AL., *supra* note 295, at 8.

rious scholars.[315] Nevertheless a wealth tax, like any tax, will have to be judged based on its legal provisions. The devil will most certainly be in the details, but after a hundred years of the capital gains preference, it may be wise to stick with the devil that we know and somewhat understand over the one that we do not.

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315. *See* Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991); Alan J. Auerbach & David F. Bradford, *Generalized Cash-Flow Taxation*, 88 J. PUB. ECON. 957 (2004).