Taxing 'Capital' Gains
By Dr. Mason Gaffney

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Taxing "Capital" Gains

Mason Gaffney, 2/95

Many modern Georgists despise the income tax and all its elements. When there is movement toward exempting any form of income from the tax, they favor it by reflex, as though they were helping wipe out all income taxes. This is a mistake. What happens, rather, is that other forms of income get taxed higher.

The income taxes (personal and corporate, Federal and state) actually tap land rent, and could tap a lot more. They do so imperfectly, as we keep preaching, but it's an imperfect world of choices among reachable alternatives. George himself, writing on "Practical Politics," acknowledged that "Even the income tax ... is in all respects better than a tariff" (PFT, p.323). He goes on to write that internal excises are just as bad as tariffs, so he clearly would rank sales taxes, VATs, GSTs, *et hoc genus omne*, as "in all respects worse than an income tax." Georgists in Congress, with George in the gallery, extended themselves to get land rents included in the income tax act of 1894. This is why the Supreme Court ruled the law unconsitutional, to answer which the 16th Amendment was passed (1913). Later Georgists, including Congressman Henry George, Jr. (D-Brooklyn), molded the early Federal income tax (Act of 1916) to focus it on property income and spare wages and salaries. As long as we have an income tax, let's focus it on land rents and unearned increments, as Georgists did in the Wilson administration. It took two generations of subversion to undo the good work they did then.

It would make Georgist sense to exempt honest labor from the tax, but it makes no sense to give preferential exemption to land income while raising the tax on work. "Capital gains" is a term of art used to blind us to the fact that many such gains are really unearned increments to land values: they are land gains hiding under the skirts of capital.

It would also make sense to allow capital gains preferences or exemptions for <u>productive</u> gains, e.g. the sale of an innovative business built up by plowing back profits into real capital, technology, or goodwill. Many tax advisers, available to both Parties (like economists Joseph Stiglitz or Lester Thurow), propose exactly such <u>targeting</u>. What is needed is wider public support and understanding, such as articulate Georgists could supply. We are the ones who are supposed to understand the difference between earned and unearned incomes; to wield the scalpel instead of the meat-axe. Let's get with it. Professional help is available to guide us in keeping takers of unearned rents from wrapping themselves in the flag of productive capitalists.

We should also understand how most of the rent from income property is converted into capital gains. Here is how it's done.

Owners depreciate buildings for income tax so much too fast that the depreciation offsets all the net rent, for several years. Thus there is no tax due. Fast depreciation even shelters a good deal of other income, as well. Then owner A sells to owner B for the real value, which by now is much higher than the remaining undepreciated tax value, called "basis." Owner B then gets to step-up the basis to what he paid, and depreciate the building (and usually much of the land value too, illegally) all over again: thus, B pays no tax on rent, either. The only tax levied is when A sells to B: A is taxed on the excess of sales price over "basis." This excess is taxed as a capital gain. This is the only way the rent gets taxed at all. If we exempt such gains in whole or part we are exempting land rents from the income tax, while poor Joe Sixpack with his W-2 Form gets soaked to the max.

There is more, a lot more, on how land income escapes the full fury of the income tax rates such as are levied on workers and simple savers. Rent-takers will continue to escape so long as Georgists shut their eyes to Federal tax issues and sulk in their self-righteousness. The income tax is not the first-best way to tap land rents, but the prudent person ranks alternatives. If we can't get first best we should still prefer second best to third, fifth, and umpteenth best, which is what we will get if we turn our backs, and shut our minds to what goes on.

Grumping from the peanut gallery won't cut it. Organized landlords are at work every day to relieve themselves of whatever little taxes they still pay, and then to get subsidies piled on subsidies, shamelessly. You should see the new tax and subsidy schemes they bring forth constantly: taxes on workers, subsidies for predatory rent-takers. There is no end to what they claim; only organized, informed, articulate Georgists can shine the light on their brazen demands. Then politicians will curb them because the public will demand it.

EXCERPTS FROM

LAND VALUE GAINS AND THE CAPITAL GAINS TAX, by Mason Gaffney, Nov. 18, 1989

...The property tax is the best means to tap rent, but it is not the only means. Income taxes socialize billions of land rent, and unearned increments, and could socialize much more. ...Landowners' strategy has long been to secure property tax relief by raising income taxes, while converting the income tax into mainly a payroll tax.

...The maligned corporation income tax is a tax purely on property income. In the 1960s new capital achieved partial de facto exemption via fast write-off. Expensing is tantamont to total exemption. If we tax the profits of property, and relieve new capital, what is being taxed but land rent?

In 1986 Congress eliminated the most Georgist feature of income taxation, viz. the preferential treatment of new investment in real capital formation. The three changes were: 1) Repeal of Investment Tax Credit. 2) Lengthening tax lives. 3) Decelerating depreciation pathways. These changes have raised the effective tax rate on most new investment.

The effect of closing these three loopholes for new investment is much the same as broadening the property tax base to include buildings, plant and equipment, etc. When combined with lowering the maximum tax rate, it is the same as shifting the tax off land and onto new buildings and other capital. Fast write-off (accelerated depreciation, expensing, et al) equals tax relief to stimulate investment in, and creation of, real new capital.

Before 1986 a high-bracket professional — physician, lawyer, or actor — could avoid the effects of high marginal tax rates by investing in certain kinds of real new capital: buildings, equipment, machines, rolling stock, furnishings and fixtures, trees, vines, or livestock. This did make for overcapacity in certain kinds of capital...Today that professional is better off buying up old capital and land. Corporations are moved to join the merger-mania which creates no new wealth at all. This poses worse problems, like overpricing land, and pricing median investors out of the market. It also tends to reduce saving and domestic capital formation.

What are "capital gains"? The 1986 tax reform was a massive shift of income tax liabilities off land (by lowering the top rates), and onto new investment (by decelerating write-off) Its only saving grace, from the viewpoint of Georgist incentive and redistributive taxation, was eliminating the preferential lower tax rate on capital gains.

Corporate shares also yield "capital" gains. What makes these shares rise is the rise in value of corporate assets. A large share of corporate assets consist of land. ... When the purpose of Congress is really to encourage new investment, fast write-off of new capital is the obvious tool. ... The main effect of untaxing land gains, on the other hand, is simply to redistribute wealth and overprice land.

(Gaffney, continued) Deducting costs of buying and holding. ... The IRS code still says land is different. When an investor buys land under an old grove, or old building, the Code says he must allocate his basis between the depreciable capital and the non-depreciable land. ... Reams of evidence have been published finding assessors' allocations consistently understate land values relative to building values... Most remarkable, land is written off again and again, every time taxable property changes hands. The new owner again overallocates his basis to depreciable capital, setting himself up to depreciate the land again. ... The writer has often urged the need for a Federal Board of Equalization, to correct local underassessment of land and prevent the depreciation of land.

... About $327 billions of capital gains were reported in 1986. It is only a trace of what is there, however. Most capital gains are never realized. Landowners defeat recoupment in at least seven ways: deferring sales indefinitely; stepping up basis at death; being non-resident aliens; giving bequests; excluding part of gains; recouping at lower tax rates; and recouping in devalued dollars.

... Cap rates fell after 1986 because Congress decelerated cost recovery on new investments, lowering the opportunity cost of capital. There has been a massive shift of tax burdens off land onto new capital, and labor. The corresponding shift of asset values is real. Nevertheless there is no denying much of the nominal gain when land is sold is phantom income. The problem must be faced and indexing faces it, in what seems a reasonable way.

... Land yields phantom income only when the title is sold for a "capital gain." Depreciable assets yield phantom income in the ordinary course of use in production or for rental. ... Old trucks sell for nearly nothing, and have no basis left to index anyway. Old buildings sell for something mainly because they stand on good land. Old buildings retain an undepreciated basis to index mainly because land is not depreciable. ...The ordinary cash flow of land, or ground rent, includes no phantom income because there is no depreciation. ...Land is vulnerable only if title is sold, which is the taxable event. Indexing is designed specifically to protect land from that one potential liability to share the common burden of inflation. ... Land is more than a defensive refuge from inflation: it gains what others lose.

One reason for downtaxing gains is to spare homeowners. Indexing would be especially targeted to relieve homeownership because the capital in homes is not depreciable and is never eroded below its historical basis. ... Owner occupied houses are not depreciable, but they depreciate anyway. ... The rich live in appreciating neighborhoods, where gains are a normal expectation.

...Some kinds of capital serve as media for storing up rents. Capital has been described as stored-up labor, but some kinds are mostly stored-up land rent. Timber is one example; breeding cattle another. All are treated as "capital" assets in the tax code.

BACKGROUND ON CAPITAL GAINS

On March 14, 1995, a major Contract with America component, legislation for $189 billion in tax cuts over five years passed the House Ways and Means Committee, chaired by Rep. Bill Archer (R-Tex). According to Congressional Quarterly, the House will take up the bill in early April, 1995. It almost certainly will pass the Republican-controlled House under the leadership of Contract with America author, House Speaker Rep. Newt Gingrich (R-Ga.) Of special interest to Georgists is the capital gains part of the tax cuts bill.

Congressional Quarterly 11-19-94, pg. 3342

Capital Gains. The contract set off the debate with its proposal to cut the capital gains tax (the tax paid on the profits from the sale of stocks, bonds, real estate, art and other items) by 50%. Currently 100% of a capital gain is taxed. Capital gains generally would receive the favorable rate only if the item generating the gain had been held for at least one year.

The contract also proposes indexing capital gains so that the price paid for the capital investment would be adjusted for inflation. Currently, there is no inflation adjustment.

In capital gains debates, the estimators repeatedly have said that a capital gains tax cut would result in a loss in revenues. Preliminary estimates by Joint Taxation Com. of the contract's effect on revenues show it would increase revenues in the first couple of years after it was enacted but would lose $120 billion over 10 years.

CQ, NOV. 19, 1994, pg. 3377

Job Creation and Wage Enhancement Act The bill: * Provides a 50% capital gains rate cut and prospectively indexes capital gains to account for inflation. * Increases the value of investment depreciation to equal the full value of original investment. * Allows small businesses to deduct the first $25,000 worth of investment each year. * Clarifies the home office deduction. * Empowers taxpayers to designate a portion of their tax liability to a public debt reduction fund. * Requires Congress to report the cost of mandates it imposes on state and local governments. * Reduces the paperwork burden imposed on American business 5%. * Requires federal agencies to complete regulatory impact analysis. * Limits the government's ability to impose undue burdens on private property owners.

Provisions of Capital Gains Reform. The Job Creation Act allows individuals to exclude from taxes 50% of capital gains income, effectively halving the rate. Under the bill, individuals in the 15% income tax bracket would pay an effective

(CQ 11-19-94, continued) capital gains tax rate of 7.5%, those in the 28% bracket would effectively pay 14%, and those in the top bracket of 39.6% would pay 19.8% on capital gains. Corporations would pay a 17.5% capital gains rate. In addition, individuals may deduct any capital loss with respect to the sale or exchange of a principal residence. The bill indexes the basis of capital assets for inflation (prospectively) so taxes are not paid on illusory earnings.

Beloit Daily News "House Com..." 3-9-95

...As the contract promised, the Ways and Means measure would also reduce the capital gains tax rate paid by people who sell land and other property, and create more generous individual retirement accounts.

USA Today "...Tax Questions" 3-10-95 Home Sale. Tax law gives you a one-time, $125,000 exclusion on gains from the sale of a house if you're 55 or older. So if you have a $200,000 gain on your home sale, you can use the exclusion to reduce your taxable gain to $75,000.

USA Today 3-10-95 "Tax Cut Scam..."

The GOP plan outlined by Archer would hand out $500-per-child tax credits, but the poorest working families can't use them; they pay no income taxes to take credits against. Meanwhile, capital gains and estate tax cuts would go mostly to the top fifth of taxpayers.

USA Today 3-10-95 "Republican tax cut ..."

The sweeping package of tax cuts unveiled by House Republicans Thurs. would make balancing the federal budget in seven years much harder to achieve. Advertised as a 5-year plan that would save taxpayers cash, but cost the Treasury $189 billion, the GOP package of individual and business tax cuts would cost $400 billion over seven years, $700 billion over 10 years. ... Reductions in the capital gains tax rate will help businesses and investors, creating jobs and boosting the economy.

...A new alternative 25% rate would be set for net capital gains of a corporation. That and provision allowing individuals to deduct 50% of net capital gains would cost $31.7 billion.

Church Women United "Act", 6-12-90, "Taxes..."
Distribution of Tax Savings from Capital Gains Cut by 1990 Income Groups

80% — $100,000 & over	5% — $75 - $100,000
7% — $50 - $75,000	8% — $20 - $50,000
5% — Less than $20,000	

INTERMOUNTAIN FRONTIER, Winter 1987-88, "Capital Gains Tax: Short Cut to LVT?" by H. W.(Colin) Bonner

The front page of the fall issue of I.F. features a piece on land speculator Frank Aires, who is selling his holdings in Ariz. & Calif....His land is assessed as "agricultural" land at 60 cents per acre, and is valued from $20,000 to $70,000 per acre. His property taxes on the now over 25,000 acres therefore amount to around $5,000 per year. If he makes a 100% profit when he sells, and if (without knowing the original purchase price, not mentioned in I.F.), we assume an original value of $20,000 per acre, he will ultimately net $20,000 per acre, or $500 million. By levying 28% capital gains tax, the federal government will ultimately collect around $14 million, or 2800 years worth of property taxes! The capital gains tax is much more powerful than land value taxation for collecting land rent in capitalized form, in advance, just like a landlord.

USA TODAY SNAPSHOTS 1-3-91, Taxing Capital Gains

Although the maximum income tax rate became 31% Tues., the top rate on capital gains fell to 28%.

Capital Gains rates (source: Am. Cncl. for Capital Formation, Joint Tax Com.)

1942 - 25.0%	1952 - 26.0%	1955 - 25.0%
1970 - 29.5%	1971 - 32.5%	1972 - 35.0%
1978 - 28.0%	1981 - 20.0%	1987 - 28.0%
1988 - 33.0%	1991 - 28.0%	

BUS. WEEK 5-19-73, "Vt. Tough Tax on Quick Land Deals"

The Green Mountain State of Vermont is attacking fast-buck land speculators with a controversial capital gains tax. Brainchild of Gov. Thomas Salmon, the new tax bites hard on profits from selling parcels of undeveloped land of at least one acre, if the seller has held them for less than six years. It is aimed at out-of-state speculators who have been buying up Vt. farms and forests for quick resale to subdividers and investors dealing in recreational land...

Enactment of the tax by the Republican-dominated Vermont legislature follows through on Dem. Gov. Salmon's campaign promise to reduce local property taxes and discourage land deals that threaten Vermont's rustic character. The gains tax is hurting speculators, and it could raise up to $3 million a year.

N.W.Stoner 3/17/95

Milw. Jrnl. 10-22-89 "...Wealthy ...Tax Free in '87"

Of 529,460 couples and individuals who reported total income above $200,000 on returns filed in 1987, 595 paid no tax, says an IRS report. Those 595 had income averaging $600,000; two out of every three had capital gains averaging $490,000 each.

An additional 33,805 of the over $200,000 earners paid tax at an effective rate of less than 15%, typically less than a middle-income family would pay. Almost 3,000 paid less than 10%.

The rich were able to avoid taxes by reporting big losses on farm and partnership investments; by racking up large capital gains, 60% of which were excluded from taxation; by claiming itemized deductions averaging $262,000, and by using the credit for taxes paid abroad.

...The report showed that the number of people with annual incomes over $200,000 grew from 370,430 on returns in 1985 to 529,460 a year later. The chief reason apparently was a a big sell-off of investments in 1986 to avoid a higher capital gains tax that took effect in 1987.

USA TODAY 1-12-90 "Sides ...Gains Tax"

Democrats want to "target" stocks and bonds for the tax break; Republicans want to include real estate and timber... The House approved a bill cutting the top rate to 19.6% through 1991 and then protecting from taxation gains attributable to inflation.

MJ 5-19-91 "Moody, Kasten ...Farmers' Cap. Gains Taxes"

...The legislation under consideration is designed to help farmers, who often are unable to invest in retirement accounts during their farming years because most profits are reinvested in the farm. Farmers often rely on the sale of the farm to provide for retirement, but a big chunk of the proceeds is wiped out under current law because the sale is considered a capital gain and is taxed at the regular income tax rate, usually 28%. The proposals would allow farmers to transfer the proceeds from farm sales into individual retirement accounts. An IRA is taxed only as funds are withdrawn, usually at a lower tax rate because a retiree's income is not large.

USA TODAY 9-4-90 Rep. Newt Gingrich, House Min. Whip

A recession will lower the value of property...If a recession drives property values down, it will drive the cost of the savings and loan scandal up even more... Economist Gary Robbins estimates that the capital gains cut proposed by Sens. Kasten and Mack and Edwards will save the government over $19 billion by raising the value of its S&L real estate.

Senator _____
Senate Office Building
Washington, D.C. 20510

Central Switchboard: 1-202-224-3121

Senate Membership — 104th Congress

Republicans	**53**
Democrats	**47**
Freshmen	**11**

The only Senate question mark remaining is in California. Incumbent Democrat Dianne Feinstein emerged with a narrow lead over Republican Michael Huffington, but more than 500,000 absentee ballots are being tallied. Huffington refused to concede, despite media projections that declared Feinstein the winner. Freshmen are designated with a #, seats that switched parties with a †, and 1994 winners are in *italic*.

Alabama
Howell Heflin (D)
Richard C. Shelby (R)

Alaska
Ted Stevens (R)
Frank H. Murkowski (R)

Arizona
John McCain (R)
Jon Kyl (R) # †

Arkansas
Dale Bumpers (D)
David Pryor (D)

California
Dianne Feinstein (D)
Barbara Boxer (D)

Colorado
Hank Brown (R)
Ben Nighthorse Campbell (D)

Connecticut
Christopher J. Dodd (D)
Joseph I. Lieberman (D)

Delaware
William V. Roth Jr. (R)
Joseph R. Biden Jr. (D)

Florida
Bob Graham (D)
Connie Mack (R)

Georgia
Sam Nunn (D)
Paul Coverdell (R)

Hawaii
Daniel K. Inouye (D)
Daniel K. Akaka (D)

Idaho
Larry E. Craig (R)
Dirk Kempthorne (R)

Illinois
Paul Simon (D)
Carol Moseley-Braun (D)

Indiana
Richard G. Lugar (R)
Daniel R. Coats (R)

Iowa
Charles E. Grassley (R)
Tom Harkin (D)

Kansas
Bob Dole (R)
Nancy Landon Kassebaum (R)

Kentucky
Wendell H. Ford (D)
Mitch McConnell (R)

Louisiana
J. Bennett Johnston (D)
John B. Breaux (D)

Maine
William S. Cohen (R)
Olympia J. Snowe (R) # †

Maryland
Paul S. Sarbanes (D)
Barbara A. Mikulski (D)

Massachusetts
Edward M. Kennedy (D)
John Kerry (D)

Michigan
Carl Levin (D)
Spencer Abraham (R) # †

Minnesota
Paul Wellstone (D)
Rod Grams (R) #

Mississippi
Thad Cochran (R)
Trent Lott (R)

Missouri
Christopher S. Bond (R)
John Ashcroft (R) #

Montana
Max Baucus (D)
Conrad Burns (R)

Nebraska
Jim Exon (D)
Bob Kerrey (D)

Nevada
Harry Reid (D)
Richard H. Bryan (D)

New Hampshire
Robert C. Smith (R)
Judd Gregg (R)

New Jersey
Bill Bradley (D)
Frank R. Lautenberg (D)

New Mexico
Pete V. Domenici (R)
Jeff Bingaman (D)

New York
Daniel Patrick Moynihan (D)
Alfonse M. D'Amato (R)

North Carolina
Jesse Helms (R)
Lauch Faircloth (R)

North Dakota
Kent Conrad (D)
Byron L. Dorgan (D)

Ohio
John Glenn (D)
Mike DeWine (R) # †

Oklahoma
Don Nickles (R)
James M. Inhofe (R) # †

Oregon
Mark O. Hatfield (R)
Bob Packwood (R)

Pennsylvania
Arlen Specter (R)
Rick Santorum (R) # †

Rhode Island
Claiborne Pell (D)
John H. Chafee (R)

South Carolina
Strom Thurmond (R)
Ernest F. Hollings (D)

South Dakota
Larry Pressler (R)
Tom Daschle (D)

Tennessee
Fred Thompson (R) # †
Bill Frist (R) # †

Texas
Phil Gramm (R)
Kay Bailey Hutchison (R)

Utah
Orrin G. Hatch (R)
Robert F. Bennett (R)

Vermont
Patrick J. Leahy (D)
James M. Jeffords (R)

Virginia
John W. Warner (R)
Charles S. Robb (D)

Washington
Slade Gorton (R)
Patty Murray (D)

West Virginia
Robert C. Byrd (D)
John D. Rockefeller IV (D)

Wisconsin
Herb Kohl (D)
Russell D. Feingold (D)

Wyoming
Alan K. Simpson (R)
Craig Thomas (R) #

SENATE CO

Finance

New size: 11 Republicans, 9 Democrats

Old size: 11 Democrats, 9 Republicans

Chairman: Bob Packwood, R-Ore.

Republican Members	Democratic Members
Bob Packwood, Ore.	Daniel Patrick Moynihan, N.Y., ranking
Bob Dole, Kan.	Max Baucus, Mont.
William V. Roth Jr., Del.	Bill Bradley, N.J.
John H. Chafee, R.I.	David Pryor, Ark.
Charles E. Grassley, Iowa	John D. Rockefeller IV, W.Va.
Orrin G. Hatch, Utah	John B. Breaux, La.
Alan K. Simpson, Wyo.	Kent Conrad, N.D.
Larry Pressler, S.D.	**Bob Graham, Fla.**
Alfonse M. D'Amato, N.Y.	**Carol Moseley-Braun, Ill.**
Frank H. Murkowski, Alaska	
Don Nickles, Okla.	

Boldface denotes new committee members; asterisk denotes freshmen.