Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses

Michelle A. Cecil
University of Missouri School of Law, cecilm@missouri.edu

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TOWARD ADDING FURTHER COMPLEXITY TO THE INTERNAL REVENUE CODE: A NEW PARADIGM FOR THE DEDUCTIBILITY OF CAPITAL LOSSES

Michelle Arnopol Cecil*

Professor Cecil, believing that the current tax treatment of capital losses is fundamentally unfair and economically inefficient, offers a proposal to improve the capital loss limitation provisions of the Internal Revenue Code. Three tax concepts provoke the proposal: the progressivity of the current income tax structure, the notion that gains and losses are taxed only after they are realized, and the preferential treatment of capital gains.

The present limitations on the deductibility of capital losses are supported in theory by three justifications: parallelism, cherrypicking, and bunching. The author argues, however, that the Code is ill-equipped to meet parallelism concerns and that cherrypicking is not a problem that a capital loss limitation scheme should address.

Professor Cecil offers an alternative proposal for capital loss treatment that provides for parallel treatment of capital gains and losses by limiting the tax savings generated by capital losses to the tax rate applicable to capital gains. Professor Cecil argues that her proposal is superior to the current treatment of capital losses in light of fundamental fairness, economic efficiency, and political feasibility concerns. Further, the proposal benefits all taxpayers, regardless of income, and its added complexity results in fairness for all.

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* Associate Professor of Law, University of Missouri-Columbia School of Law. B.A., J.D., University of Illinois.

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I. INTRODUCTION

Nobody could possibly contend that the Internal Revenue Code (the Code)\(^1\) is a simple statute or one that is easy to comprehend. The Code contains more than 5.5 million words\(^2\) spanning over eight thousand pages in the United States Code.\(^3\) Moreover, the regulations promulgated by the Treasury Department to decipher the complex provisions of the Code fill six thick volumes,\(^4\) even though the print requires a magnifying glass to read. It has been estimated that taxpayers spend over five billion hours\(^5\) and two hundred billion dollars\(^6\) annually in their endless efforts to comply with the Code. Those provisions in the Code pertaining to capital gains and losses alone account for a significant amount of its complexity.\(^7\)

My tax professor in law school, Richard Kaplan,\(^8\) illustrated the sheer magnitude of the capital gain and loss provisions in my most memorable law school lecture. Prior to class, he had cut apart the Code, stapled each provision separately, and replaced the provisions in their binding so as to resemble the original volume. In class, Professor Kaplan explained that capital gains added significant complexity to the Code. “For example, without capital gains,” he proclaimed, “we wouldn’t need

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1. Except as otherwise noted, references in this article to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended.
8. Professor Richard L. Kaplan is a professor of law at the University of Illinois College of Law.
section 1245, dealing with recapture.\textsuperscript{9} And with that, he removed section 1245 from the Code, threw it in the air, and it fluttered to the floor. After repeating this exercise for the next twenty minutes with respect to the other Code provisions dealing with capital gains and losses, Professor Kaplan was standing knee-deep in the Code. The Code that remained at the end of this demonstration was a mere shadow of its former self.

Yet although the Code’s complexity is roundly criticized by politicians\textsuperscript{10} and the public alike,\textsuperscript{11} it is only through complexity that the Code can achieve fundamental fairness. For example, many would contend that the provisions governing social security taxation\textsuperscript{12} are quite dense and difficult to comprehend. The provisions could be simplified by merely taxing all social security benefits in full. But Congress long ago recognized that it would be fundamentally unfair if these benefits were taxable for those at lower income levels.\textsuperscript{13} As a result, Congress created

\textsuperscript{9} See I.R.C. § 1245 (1994).

\textsuperscript{10} A number of politicians have stated publicly that the Code is too complex and burdensome. For example, during a recent floor debate in the House of Representatives, Representative Cannon said that “[t]he current Tax Code puts an onerous burden on every American family. It is complex, confusing, corrupt, costly, and coercive.” 144 CONG. REC. H4668 (daily ed. June 17, 1998) (statement of Rep. Cannon). Similarly, during the same debate, Representative Riley said that “our Tax Code is a monstrosity. . . . It has become a Goliath that has to be slain. . . . Our Tax Code is too complicated and it is far too complex.” 144 CONG. REC. H4664 (daily ed. June 17, 1998) (statement of Rep. Riley); see also 144 CONG. REC. H4674 (daily ed. June 17, 1998) (statement of Rep. Hastert) (“The current tax code is . . . too complex, and too burdensome on America’s families.”).

\textsuperscript{11} In fact, many politicians have called for a repeal of the entire Code. “[O]nce and for all, let us eliminate 8000-plus pages in the Tax Code and replace it with a Tax Code that is going to say April 15 is another bright, spring day.” 144 CONG. REC. H4659 (daily ed. June 17, 1998) (statement of Rep. Schaefer); see also 144 CONG. REC. H4658 (daily ed. June 17, 1998) (statement of Rep. Johnson) (“The current Tax Code is complex, confusing, corrupt, costly, coercive and a lot of other Cs that I cannot think of. . . . We ought to also repeal the 16th Amendment of the Constitution [authorizing the income tax] . . . .”). Both the House of Representatives and the Senate considered proposed legislation during 1998 designed to terminate the tax code (except for Social Security) on December 31, 2002. See The Tax Code Termination Act, H.R. 3097, 105th Cong. (1998); S. 1673, 105th Cong. (1998).

\textsuperscript{12} For example, a 1998 article in \textit{The Washington Post} stated that “[t]he Internal Revenue Code . . . is clearly too complex. Built into it are dozens of preferences and traps, confusing both taxpayers and the Internal Revenue Service.” Albert B. Crenshaw, Tax Reformer: Beware of What You Wish For, WASH. POST, June 21, 1998, at H1; see also Crack the Tax Code, DENV. POST, Mar. 17, 1998, at B8 (“[T]he IRS is saddled with a tax code so bloated it baffles even the agency’s own accountants.”); Daniel J. Mitchell, Get Rid of U.S. Tax Code and Start Over, HOUS. CHRON., Mar. 15, 1998, at 1 (“Every year, without fail, more and more monkey wrenches are thrown [into the Code] until today there isn’t anyone who knows everything in the tax code or what it means. . . . [T]he tax code’s 5.5 million words are a nightmare of complexity that defies the understanding of the most proficient tax experts.”). See generally Jim Barlow, U.S. Tax System Is Made for Abuse, HOUS. CHRON., Apr. 16, 1998, at 1.

Even Shirley D. Peterson, former commissioner of the Internal Revenue Service during the Bush administration, has publicly criticized the Code’s complexity and called for its repeal. “The Internal Revenue Code is inordinately complex, imposes an enormous burden on taxpayers and thus undermines compliance with the law. . . . It is time to repeal the Internal Revenue Code and start over.” Shirley D. Peterson, Patchwork Won’t Help; It’s Time to Start Over, HOUS. CHRON., Sept. 24, 1995, at 1.

\textsuperscript{13} See I.R.C. § 86 (1994).

\textsuperscript{14} In 1983, Congress enacted the Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65. In § 121 of the Act, Congress amended the Internal Revenue Code of 1954 by adding a new section that specifically included social security benefits in income. Due to fairness concerns, however,
myriad exceptions to the rules governing social security taxation, thereby enhancing the complexity of the provisions. Complexity is inevitable because human circumstances and financial transactions take so many forms.

This article seeks to improve the fairness of the capital loss limitation provisions of the Code in a manner possible only through greater complexity. By way of background, capital gains are generally taxed to individuals at a maximum tax rate of 20%, even though under the progressive income tax system, individual taxpayers' other income, such as wages and investment income, can be taxed up to a maximum rate of nearly 40%. Capital gains realized by corporations, on the other hand, are taxed at the same rate as their other income; accordingly, there is currently no capital gains preference applicable to corporations.

The capital gains preference has been the subject of a contentious tax policy debate for several decades. Although critics of the preference have attacked it as antithetical to sound policy considerations, the preference nevertheless remains a cornerstone of the income tax system.


[begin quote]
by taxing only a portion of social security . . . the Committee's bill assures that lower-income individuals, many of whom rely upon their benefits to afford basic necessities, will not be taxed on their benefits. . . . The bill's method for taxing benefits assures that only those taxpayers who have substantial taxable income from other sources will be taxed on a portion of the benefits they receive.
[end quote]

14. See I.R.C. § 86(a)(1) (West 1988 & West Supp. 1998) (providing that if a taxpayer's modified adjusted gross income plus one-half of the social security benefits received during the year exceeds $25,000 ($32,000 in the case of married taxpayers filing a joint return and $0 for married taxpayers filing separate returns), the taxpayer must include in gross income the lesser of one-half of the social security benefits received during the year or one-half of such excess); § 86(a)(2) (West 1988 & West Supp. 1998) (providing that if a taxpayer's modified adjusted gross income plus one-half of the social security benefits received during the year exceeds $34,000 ($44,000 in the case of married taxpayers filing a joint return and $0 for married taxpayers filing separate returns), the taxpayer must include in gross income the lesser of (i) the sum of 85% of such excess plus the lesser of the amount determined under § 86(a)(1) or $4,500 ($6,000 in the case of married taxpayers filing a joint return and $0 for married taxpayers filing separate returns); or (ii) 85% of the social security benefits received during the year).

15. For a definition of what constitutes a capital gain, see infra note 98.

16. See I.R.C. § 1(h) (West 1994) (providing that ordinary income of individuals is taxed at a maximum rate of 39.6%). The concept of progressivity is explained and defended infra Part II.A. Moreover, certain types of capital gains, such as those arising out of the sale of collectibles, are taxed at a maximum rate of 28% (15% for taxpayers in the 15% tax bracket). See I.R.C. § 1(h)(5) (West Supp. Oct. 1998). For a complete discussion of the taxability of capital gains, see infra notes 98-123 and accompanying text.

17. See I.R.C. § 1(a) (1994) (providing that ordinary income of individuals is taxed at a maximum rate of 39.6%). The concept of progressivity is explained and defended infra Part II.A.

18. The maximum tax rate of corporations is generally taxed at a maximum rate of 35%. See I.R.C. § 11 (1994). The Code provides, however, that if the maximum tax rate applicable to corporations generally should ever exceed 35%, corporations' long-term capital gains will remain subject to a maximum tax rate of 35%. See I.R.C. § 1201 (1994).

19. See infra notes 104-07 and accompanying text.

20. For a more complete discussion of these concerns, see infra notes 104-23 and accompanying text.
based on two strong policy justifications. First, the capital gains preference provides some relief to the problem of "bunching," caused when a capital asset that has appreciated over a number of years is sold in a single taxable year, and the corresponding gain is bunched into the year of sale. Moreover, because capital gains are taxed only when taxpayers sell assets and "realize" those gains, taxpayers, in the absence of preferential tax rates, might be unwilling to sell assets and reinvest the proceeds in more economically productive ventures. This phenomenon, often referred to as the "lock-in effect," is based on the concept of economic efficiency and is perhaps the most compelling policy justification for the capital gains preference.

Congress long ago recognized that if it wanted to induce taxpayers to invest in risky undertakings, it would have to permit the deductibility of capital losses resulting from those investments. Because capital gains were taxed at preferential rates, however, Congress felt it unfair to allow capital losses to be deducted against ordinary income without limitation. Accordingly, with only one short-lived exception, there have always been limitations imposed on the deductibility of capital losses. Currently, individuals can offset their capital losses against their capital gains, plus up to $3,000 of ordinary income. Corporations can offset their capital losses only against their capital gains. These loss limitations have traditionally been justified on three policy grounds. First, they provide for parallel treatment of capital gains and losses. Second, loss limitations prevent a tax avoidance scheme known as "cherrypicking," in which taxpayers sell their capital loss assets and offset those losses against ordinary income while retaining their capital gain assets and

21. For a more complete discussion of the concept of bunching, see infra notes 108-14 and accompanying text.
22. The realization concept, also an important underpinning of the current income tax system, is discussed and defended infra Part II.B.
24. A more complete discussion of the lock-in effect as a policy justification for the capital gains preference is outlined infra notes 115-23 and accompanying text.
25. For a complete definition of a capital loss, see infra notes 124-26 and accompanying text.
26. See, for example, infra notes 136-38 and accompanying text for a discussion of allowing the deductibility of capital losses as an economic incentive to engage in risky investments. In addition, the history of the deductibility of capital losses is outlined infra notes 129-35 and accompanying text.
28. From 1918 until 1924, capital losses could be deducted against a taxpayer's income without limitation. See Revenue Act of 1918, ch. 18, § 214(a)(5), 40 Stat. 1057, 1067 (1919); see also infra notes 131-32 and accompanying text.
30. See id. § 1211(a).
31. The concept of parallelism is outlined infra notes 140-50 and accompanying text.
32. For a more complete discussion of the concept of cherrypicking, see infra notes 151-57 and accompanying text.
avoiding the imposition of tax on that gain. The third traditional policy justification for limitations on the deductibility of capital losses is “bunching,”33 where taxpayers’ capital losses have accrued over a number of years but are all realized in the year of sale.

I believe that the current loss limitation system is both fundamentally unfair to taxpayers and promotes economic inefficiency in the marketplace. The system is unfair because it is premised on the faulty assumption that all taxpayers with capital losses also have corresponding capital gains in their investment portfolios. Although this assumption might be true in the case of the wealthiest investors, a brief survey of my meager investment portfolio would suggest that the assumption is untrue in the case of a large number of middle-income investors.34 Accordingly, a loss limitation system that is designed in large part to resolve the problem of cherrypicking will be fundamentally unfair when applied to average taxpayers. Similarly, the loss limitation system often results in economic inefficiency because taxpayers have no incentive to sell their loss assets and reinvest the proceeds in more economically productive ventures unless they have assets with corresponding capital gains against which to offset those losses.35

Because the current limitations on the deductibility of capital losses are inherently flawed in these ways, this article creates a new paradigm for the deductibility of capital losses, one that is more fundamentally fair to all taxpayers and results in more economically efficient investment decision-making. This new paradigm is premised on the rather radical notion (radical at least in the small circle of tax scholars) that, although parallelism and bunching are sound policy justifications for a loss limitation system, cherrypicking is not a legitimate policy justification for limiting the deductibility of capital losses. Thus, this model would provide that capital losses could be offset against taxpayers’ other income; however, the tax savings generated by those losses would be limited to the tax rate applicable had the capital loss instead been a capital gain. For example, individuals in the 31% tax bracket with long-term capital losses would be entitled to offset those losses against their ordinary income, but the tax savings generated by those losses would be capped at the 20% rate applicable had the losses instead been long-term capital gains. Accordingly, in its simplest form, this paradigm would result in taxpayers paying an 11% tax on the ordinary income offset by those losses (the

33. See infra notes 158-60 and accompanying text for a complete discussion of the bunching concept.
35. In the absence of a current tax benefit from the sale of loss assets, a taxpayer is likely to retain the loss assets in the hope that they will increase in value. This principle is true unless the taxpayer can reinvest the proceeds from the sale of the loss assets in a venture that is certain to be profitable enough to offset the taxpayer’s economic loss. The concept of economic efficiency is discussed in greater detail infra notes 242-51 and accompanying text.
31% rate otherwise applicable to the income less the 20% rate applicable to long-term capital gains). This proposal not only creates a system that is more fundamentally fair and economically efficient for all taxpayers but also alleviates the problems associated with bunching of capital losses and creates true parallelism between capital gains and losses.

Part II of this article seeks to justify, from a policy perspective, three attributes of the current income tax system that underlie my capital loss proposal: progressivity, realization, and the capital gains preference. Part III then explores the current limitations on the deductibility of capital losses, with particular emphasis on the policies underlying these limitations. Finally, part IV proposes a new paradigm for the deductibility of capital losses. It begins by identifying problems inherent in the current deductibility scheme. It then proposes that capital losses be allowed to offset all types of income but only up to the tax rate that would have been imposed had the loss instead been a capital gain. The article attempts to justify the proposal on the grounds of fundamental fairness and economic efficiency. It also demonstrates the proposal's political feasibility, relying in part on a public choice theory model. The article further responds to the potential criticisms that the proposal benefits only wealthy taxpayers and adds further complexity to the Internal Revenue Code. It concludes that adopting a new paradigm for the deductibility of capital losses would provide a fairer and more economically efficient solution to the problems giving rise to the need for loss limitations that

36. There is, of course, a raging debate over whether the income tax should be replaced by a consumption tax. There are a number of different types of consumption-based taxes. Direct consumption taxes, such as the cash flow tax, impose a direct tax on individuals, based roughly on their consumption. On the other hand, indirect consumption taxes, including value-added taxes and retail sales taxes, are borne indirectly by individuals because the taxes are paid by businesses, which presumably pass the cost on to consumers. See Deborah L. Paul, The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?, 76 N.C. L. REV. 151, 181 (1997). The general feature common to all consumption taxes is that they do not impose any tax burden on savings or investments. See MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 198 (1997).

A national sales tax has been defined as "a tax on final sales by retail businesses to consumers." THE AM. INST. OF CERTIFIED PUB. ACCOUNTANTS & MARTIN A. SULLIVAN, CHANGING AMERICA'S TAX SYSTEM: A GUIDE TO THE DEBATE 4 (1996) [hereinafter CHANGING AMERICA'S TAX SYSTEM]. In 1997 alone, three separate proposals calling for a national sales tax were introduced in Congress. See S. 163, 105th Cong. (1997); H.R. 1439, 105th Cong. (1997); H.R. 1541, 105th Cong. (1997).

have plagued legislators since the inception of the income tax at the begin-
ing of this century.

II. DEFENDING PROGRESSIVITY, REALIZATION, AND THE CAPITAL
GAINS PREFERENCE: A BRIEF POLICY PERSPECTIVE

The proposal for the deductibility of capital losses contained in part IV of this article is premised on three attributes of the present tax sys-
tem: a progressive tax rate structure, the concept that gains and losses are not taxed until they are "realized," and the preferential tax treatment of capital gains. Each of these topics has generated volumes of tax literature over the years, and I will not rehash the debates in each of these areas. Nevertheless, I feel compelled to justify these three tax concepts, if only briefly, inasmuch as my proposal is premised on their continued viability.

A. Progressivity

Under a progressive income tax structure, tax rates increase as taxable income increases. Accordingly, wealthy taxpayers will not only pay more taxes on an absolute dollar basis but also pay a higher percentage of income into the tax coffers. Recently, several legal scholars have called for a flat tax, which would rid the tax system of its progressive characteristics. Although political campaign rhetoric may foster public support for a flat tax, its adoption is unlikely at best for the reasons outlined below.

37. The definition of progressivity is more complex than is alluded to here. For an in-depth discussion of the meaning of progressivity, see Donna M. Byrne, Progressive Taxation Revisited, 37 ARIZ. L. REV. 739, 742-47 (1995). Most commentators ultimately agree, however, that when we speak of progressivity, we generally mean that tax rates increase as we move up the income scale. See id. at 742.

38. For example, when I was earning big bucks as an associate in a large law firm, much of my income was taxed at a rate as high as 36%. Now, as a law professor earning a paltry salary, I pay no more than 28% of my income to Uncle Sam.


40. Milton Friedman first proposed the flat tax in 1962, but it received little attention at that time. See generally MILTON FRIEDMAN, CAPITALISM AND FREEDOM 161-89 (1962). In 1995, House Majority Leader Dick Armey captured the attention of the American public by introducing a flat tax proposal in Congress entitled "The Freedom and Fairness Restoration Act." See H.R. 2060, 104th Cong. (1995). Under Representative Armey's flat tax proposal, "individuals pay a wage tax at a flat rate.... All capital income—interest, dividends, capital gains, and so on—[is] untaxed.... Every itemized deduction and every tax credit allowed under current law would be repealed under the Flat Tax." CHANGING AMERICA'S TAX SYSTEM, supra note 36, at 88.

In his September 22, 1995, presidential announcement speech entitled "A New Conservative Vision," Steve Forbes introduced his flat tax proposal as follows:
The American income tax rate structure has been progressive since the inception of the income tax in 1913. The two historic policy justifications favoring progressivity have been based on "ability to pay" and "redistribution of wealth" principles. Each of these concepts will be examined in turn.

1. Ability to Pay

Early case law upheld the constitutionality of progressivity and justified it as the natural extension of the fundamental principle that taxpayers are to be taxed according to their "ability to pay." Thus, in Commissioner v. Obear-Nester Glass Co., the Seventh Circuit stated that "[t]he great argument which resulted in this country's adoption of an income tax, and the fundamental principle upon which that tax is still based, is that individuals will be taxed according to their ability to pay."
Following these early cases, both subsequent case law and the legal literature remained relatively silent on the merits of progressivity.

In 1952, Professors Blum and Kalven, then mere neophytes at the University of Chicago Law School, published what was to become the seminal piece in the progressivity debate. In their article, *The Uneasy Case for Progressive Taxation*, the authors relied, at least in part, on notions such as ability to pay, benefit, and sacrifice to conclude that "[t]he case for progression, after a long critical look, thus turns out to be stubborn but uneasy."48

The argument most commonly posited against using ability to pay as a policy justification for progressivity is that progressivity creates a disincentive to be productive, thereby decreasing work effort.49 Accordingly, when tax rates are progressive, this disincentive to work decreases ability to pay, thereby creating a vicious circle. I believe, however, that this argument does injustice to the intelligence of most taxpayers. We understand that, as our income rises, possibly through increased work effort, the percentage of tax that we will pay on that income will also rise; nevertheless, our efforts are still rewarded because we retain the bulk of those earnings even after taxation. Moreover, we understand that it is not so much the increasing tax rates caused by progressivity that might create a disincentive to work; rather, high tax rates generally could create the same disincentive. Thus, even under a flat tax system, if all income is taxed at a high rate, say 70%, this would create a far greater disincentive to work than the progressive structure that is in place now, where the highest tax rate can reach 40%.50 Therefore, it is not progressivity that creates a disincentive to work; instead, it is high marginal tax rates generally.51

Others have criticized the use of ability to pay as a philosophical justification of progressivity under more fundamental notions of individual autonomy and equality. For example, Professor Schoenblum of Vanderbilt recently suggested that ability to pay has become so widely accepted by tax scholars that "[t]hey tend to assume uncritically that there is a direct relation between ability to pay and fairness."52 He suggests that "[s]uch a view is obviously in conflict with basic liberal concepts of individual autonomy, private property, and the equal treatment of all persons by the state."53 Professor Schoenblum concludes that ability to pay

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48. Id. at 519.
50. See I.R.C. § 1 (1994) (providing that the highest individual income tax rate is 39.6%).
51. See, e.g., Byrne, supra note 37, at 755.
52. Schoenblum, supra note 42, at 235.
53. Id.
can be justified, if at all, under the broader concept of utilitarianism, or the impact of progressivity across society.\textsuperscript{54} Accepting, as I do, Professor Schoenblum's criticism that ability to pay cannot, in a vacuum, justify progressivity, I am then forced to ask whether it is fair to ask individuals who earn more to pay a higher percentage of their earnings to the government for the greater social good. This question leads to the second, and more persuasive, argument in favor of progressivity: redistribution of wealth.

2. Redistribution of Wealth

Perhaps because of the comprehensiveness of the progressivity article written by Professors Blum and Kalven, few academics devoted much time or energy to the discussion of progressivity until the mid-1980s, when the debate was rejuvenated by the "anti-progressive, or 'flat tax' movement."\textsuperscript{55} This recent tax scholarship, however, has focused far less on ability to pay as a policy justification for progressivity and, instead, has reinvigorated the notion of distributive justice, first raised in the Blum and Kalven article,\textsuperscript{56} as the leading policy justification underlying progressivity.\textsuperscript{57} Under notions of distributive justice, progressivity can be viewed as a means of reducing economic inequalities by redistributing wealth from the rich to the poor:

[I]n the end it is the implications about economic inequality which impart significance and permanence to the issue and institution of progression. Ultimately a serious interest in progression stems from the fact that a progressive tax is perhaps the cardinal instance of the democratic community struggling with its hardest problem.\textsuperscript{58}

Although the current genre of tax scholars employs a wide variety of policy perspectives, each scholar ultimately concludes that the case for progressivity can best be justified under redistribution of wealth principles. For example, Professors Bankman and Griffith combine an optimal tax structure theory with a welfarist theory of distributive justice to con-

\textsuperscript{54} See id. at 236. Professor Schoenblum in fact concludes that utilitarianism cannot, in the end, justify progressive taxation. See id. at 236-42.
\textsuperscript{56} See Blum & Kalven, supra note 47, at 518-20.
\textsuperscript{57} See Bankman & Griffith, supra note 49, at 1966; see also Marjorie E. Kornhauser, The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction, 86 MICH. L. REV. 465, 490-97 (1987) [hereinafter Kornhauser, A Typical Male Reaction]. It is interesting to note that when Professor Kornhauser wrote her article in 1987, she observed that advocates of progressivity that had come before her had defended the concept far less on its redistributive powers than on the equitable notion of ability to pay. See id. at 465 n.3. Thus, it has been a relatively recent phenomenon that tax scholars have begun to explore redistribution of wealth principles as the primary policy justification of progressivity. For a discussion of the popularity of the progressivity of the income tax based on its potential for redistribution of wealth, see Charlotte Crane, Shifting from an Income Tax to a Consumption Tax, in TAXING AMERICA 146, 147-48 (Karen B. Brown & Mary Louise Fellows eds., 1996).
\textsuperscript{58} Blum & Kalven, supra note 47, at 520.
clude that, because progressivity redistributes income from the rich to the poor, "the case for progressive taxation appears to be far less uneasy than has been claimed."  

Similarly, Professor Kornhauser has written a series of articles justifying progressivity using traditional notions of feminist jurisprudence. In these articles, Professor Kornhauser suggests that progressivity can be supported under a feminist "ethos of care," which she defines as "a perception of one's interconnectedness with, and responsibility to, others." Thus, under Professor Kornhauser's view, progressivity is valuable because it offers society a relatively painless way to take care of those who are less fortunate. More specifically:

The progressive income tax is a good way to reaffirm our nation's sense of community against the pulls of individuality. It acknowledges a commitment and sense of responsibility to the other members of our society. Without this sense of connectedness and obligation we lose our sense of identity as a nation.

Finally, Professor Byrne examines whether progressivity can be justified, at least in part, under traditional philosophical notions of equalitarianism set forth by John Rawls and Ronald Dworkin. She suggests that "[i]f the theoretical structure supporting progressivity is made of pillars such as equal distribution [Rawls] and distinctions between wealth arising from luck and ambition [Dworkin], perhaps the case for progressivity is not so uneasy." Professor Byrne concludes that the progressivity debate should focus not only on traditional economic arguments for and against progressivity but should be expanded to also include a discussion of legal philosophers' arguments for distributive justice and fairness "that seem to give progressive taxation its instinctive appeal."

These brief synopses provide but a glimpse of the myriad arguments being made in favor of progressivity under notions of redistribution of wealth and distributive justice. Yet whether one accepts progressivity under a feminist ethos of care, Rawlsian equalitarianism, a welfarist theory of distributive justice, or simply because it feels right intuitively, it is clear that distributive justice principles best illustrate the case for pro-

64. Byrne, supra note 37, at 789.
65. Id. at 742.
66. See Blum & Kalven, supra note 47, at 418 (stating that, like most, they find the notion of progressivity congenial).
gressivity. And although progressive taxation will continue to have its strong critics, it nonetheless appears that progressivity will remain a touchstone of the income tax system.

**B. The Realization Concept**

One of the first and most fundamental concepts that law students in a basic income tax course learn is that gains and losses are taxed only when they are "realized." Realization typically occurs when an asset is sold, exchanged, or otherwise disposed of by taxpayers. Because taxpayers can carefully time when they will be taxed on their gains and losses, if at all, tax scholars have for years attacked the realization concept as antithetical to an ideal income base.

Over half a century ago, two noted economists attempted independently to define what would constitute an ideal and comprehensive income tax base. These economists, Robert Haig and Henry Simons, concluded that income should be defined as the sum of a taxpayer's consumption plus any changes in his net worth over the relevant accounting period. Under the Haig-Simons definition of income, tax deferral would be impermissible; therefore, any appreciation in the fair market value of an asset would be taxed each year as it accrues, rather than waiting until the asset is sold, and the gain is realized.

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67. Proponents of the flat tax, for example, are the most outspoken critics of progressivity. See supra notes 39-40 and accompanying text.


69. See I.R.C. § 1001 (1994) (providing rules for determining calculation of gain or loss on sale of property). Even the definition of realization, however, is less than clear. Although a discussion of how the realization concept has evolved over time is beyond the scope of this article, it is discussed in some detail in Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 10-14 (1992).

70. When property is acquired by bequest, devise, or inheritance, the basis of the property in the hands of the recipient will generally be its fair market value at the date of decedent's death (unless a statutorily provided alternative valuation date is chosen), rather than the decedent's original basis in the property. See I.R.C. § 1014(a) (West 1988 & West Supp. 1998). Thus, this basis (as adjusted) will be used to determine the recipient's gain or loss when the property is later sold or exchanged. See I.R.C. §§ 1001, 1011 (1994); see also Hess v. United States, 537 F.2d 457, 462 (Ct. Cl. 1976). Accordingly, any unrealized gain attributable to the period during which the decedent held the property escapes tax permanently. See, e.g., Shaviro, supra note 69, at 16.

71. See, e.g., Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45, 48 (1996); see also BRADFORD, supra note 36, at 5; Shakow, supra note 7, at 1114-18.


73. See Land, supra note 71, at 48.
Nevertheless, the realization requirement, like progressivity, has been a mainstay of the Code almost since the Code’s inception in 1913. Although the realization concept can be justified on several policy grounds, each centers around the fundamental concept of administrative feasibility. It is simply impracticable to tax gains annually as they accrue because of the valuation and liquidity problems associated with such a tax. Moreover, such an accrual system would require that the government compensate a taxpayer for losses as they accrue as well, an approach that would not only be impossible to administer but would lead to ridiculous results. These three primary policy justifications for realization—liquidity, valuation, and loss refunds—will be explored briefly.

1. The Problem of Liquidity

If taxpayers are required to pay income tax on unrealized gains as they accrue (a system often called an accretion-type tax), they will be faced with the dilemma of being required either to sell the asset that has produced the gain to pay the tax or to find an outside income source with which to pay the tax. This problem of liquidity has long been one of the primary justifications of the realization concept. The Code, whenever

74. The realization requirement first became a part of the Code in 1924 and was codified as § 202(b) of the Internal Revenue Code of 1924. Although the requirement has been relocated to numerous other Code sections throughout the years, it consistently has remained a part of the Code’s structure. Today, the realization requirement is contained in I.R.C. § 1001(a)-(b). See I.R.C. § 1001(a)-(b) (West 1988 & West Supp. 1998). For a more complete discussion of the history of the realization concept and arguments marshaled against it, see Zelinsky, supra note 68, at 866-79.

75. It is important to understand that not all tax scholars accept administrative feasibility as enough of a justification to abandon Haig-Simons in favor of realization. See, e.g., Mary Louise Fellows, A Comprehensive Attack on Tax Deferral, 88 MICH. L. REV. 722, 724-28 (1990); see also Land, supra note 71, at 59-73.

76. See Shakow, supra note 7, at 1113-14.

77. See, e.g., Andrews, supra note 36, at 1113.

78. As Professor Andrews, who favors a consumption-based personal income tax, admitted, in cases such as small farm owners, other owners of family businesses, elderly homeowners with small fixed incomes, and speculative investors heavily committed to a single project—the necessity of paying tax on unrealized appreciation might work a substantial hardship. It might compel the liquidation of part or all of an investment at a price below what it would otherwise be worth, because the sale is forced. Moreover, a taxpayer may be discouraged from making vigorous selling efforts with respect to a small part of his investment, because of the adverse tax effect on the valuation of his remaining holdings if he secures a favorable price. A tax on unrealized appreciation might therefore tend to discourage investment in illiquid and risky ventures. Andrews, supra note 36, at 1143; see also Walter J. Blum, A Handy Summary of the Capital Gains Arguments, 35 TAXES 247, 254-55 (1957).

Conversely, other commentators are less sympathetic to the liquidity argument. For example, one author, who has proposed taxing gains inherent in publicly traded stock annually as they accrue, recognizes that his proposal would force some shareholders to liquidate portions of their investments to pay the resulting taxes. See David Slawson, Taxing as Ordinary Income the Appreciation of Publicly Held Stock, 76 YALE L.J. 623, 646 (1967). The author, however, dismisses this liquidity problem as a cost of investment: “It is immaterial that [the investor] might have preferred not to sell, even at an appreciated price. Tax assessments limit everyone’s ability to invest, and there is nothing in the situation of the public shareholder to justify giving him any special considerations.” Id. at 646-47.

79. See BRADFORD, supra note 36, at 73-74; see also Zelinsky, supra note 68, at 889 (“Along with
possible, attempts to match the imposition of a tax with the receipt of income with which to pay that tax.\textsuperscript{80} As one scholar aptly stated:

The income tax appears to be politically acceptable largely because it is based on ability to pay. This ability to pay depends on liquidity as well as net worth. A system that taxes increases in net worth without regard to liquidity will disrupt the affairs of taxpayers far more than a system that simply scoops up some of the cash when it appears at the time of sale.\textsuperscript{81}

Moreover, it is widely accepted that mere appreciation in the value of an asset is a "paper profit" that can easily be wiped out in subsequent years.\textsuperscript{82} In fact, Henry Simons, a principal architect of the Haig-Simons definition of an ideal income tax base,\textsuperscript{83} noted that "[t]he realization criterion is not only indispensable to a feasible income-tax system but relatively unobjectionable in principle where it results only in postponement of assessment, or in cancellation of earlier 'paper profits' against subsequent paper losses."\textsuperscript{84} Thus, from the standpoint of administrative feasibility, the realization concept can be justified on the need for liquidity.

2. The Valuation Issue

A second practical problem arising from an accretion-type tax is that such a system would require that assets be valued annually to determine the amount to be included in, or deducted from, gross income.\textsuperscript{85}
Although valuation might be easily accomplished with respect to certain types of assets, such as publicly traded stock,\textsuperscript{86} annually valuing assets such as farms or equipment would be not only prohibitively expensive but also inaccurate.\textsuperscript{87} Valuation is not an exact science,\textsuperscript{88} therefore, it seems unfair to require taxpayers to calculate their income taxes on the basis of such annual valuations.\textsuperscript{89} Again, Professor Simons himself recognized the administrative nightmare that would result from such annual valuations. "Outright abandonment of the realization criterion would be utter folly; no workable scheme can require that taxpayers reappraise and report all their assets annually; and, while this procedure is implied by the underlying definition of income, it is quite unnecessary to effective application of that definition."\textsuperscript{90}

Other highly regarded tax scholars have similarly conceded that valuation difficulties present an insurmountable obstacle to complete adherence to the Haig-Simons definition of an ideal income tax base. For example, admitting that taxing unrealized appreciation would create unacceptable valuation and administrative problems, Professor Bittker has concluded that "[s]uch concessions . . . are adjustments to practicality, rather than an integral part of the [Haig-Simons] definition."\textsuperscript{91}

3. \textit{Loss Refunds}

A third justification for a realization-based income tax system is the concept of loss refunds. Recall that under the Haig-Simons model of an

\begin{footnotesize}
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\item Indeed, some commentators have proposed that appreciation inherent in publicly traded stock be taxed annually because valuation does not provide an obstacle to taxation. See, e.g., Daniel Halperin, \textit{Saving the Income Tax: An Agenda for Research}, 24 \textit{Ohio N.U. L. Rev.} 493, 502 (1998); Slawson, \textit{supra} note 78, at 626, 644-47 (arguing that, by taxing appreciation inherent in stock annually as it accrues, investors would have no tax disincentive to selling that stock and investing it in more profitable ventures, thereby eliminating the so-called lock-in effect). Others would go even further, requiring most, but not all, assets to be valued and taxed annually. See, e.g., Shakow, \textit{supra} note 7, at 1118-67.
\item See \textit{Andrews, supra} note 36, at 1141-42; Land, \textit{supra} note 71, at 55-58.
\item See, e.g., \textit{Andrews, supra} note 36, at 1141-42 ("[V]aluation is a matter of reasonable ranges rather than discrete figures."); Land, \textit{supra} note 71, at 56-57 ("Except for assets that are publicly traded or can be readily converted to cash . . . valuation is an exercise in make believe.").
\item See \textit{BRADFORD, supra} note 36, at 73 (stating that for assets other than publicly traded stocks and securities, "the costs and problems of evaluation [sic] would be formidable, and the enforcement problems would be substantial"); see also Deborah L. Paul, \textit{Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax}, 3 \textit{Fla. Tax Rev.} 1, 6 (1996).
\item \textit{SIMONS, supra} note 72, at 207-08. Similarly, Professor Andrews has conceded that "[a]ny change that would make computation of tax liabilities depend generally on the valuation of investment assets would represent an enormous transformation in the tax from a practical operating viewpoint." \textit{Andrews, supra} note 35, at 1142; \textit{see also Land, supra} note 71, at 57-58.
\item \textit{Bittker, supra} note 82, at 932; \textit{see also} Halperin, \textit{supra} note 86, at 499 ("Most likely the retention of the realization requirement . . . is explained by a desire to minimize valuation and liquidity problems . . . ."); Zelinsky, \textit{supra} note 68, at 879 ("Valuation concerns have traditionally been identified as underpinning the rule of realization . . . .").
\end{enumerate}
\end{footnotesize}
ideal income tax base, tax deferral is impermissible.\textsuperscript{92} Thus, under a true accretion-type tax system, an increase in income, defined as the sum of consumption plus changes in net worth, would be subject to tax at the end of the taxpayer's annual accounting period. It follows, then, that a decrease in income over the taxpayer's annual accounting period would require the government to return the unfortunate taxpayer's losses in the form of a tax refund.\textsuperscript{93} From a practical perspective, the concept seems administratively infeasible at best;\textsuperscript{94} such a refund program would strain government revenues, perhaps to the breaking point.\textsuperscript{95}

Most tax scholars simply assume that under an accretion-type tax, losses would be nonrefundable; that is, taxpayers who have overall losses for the year would not receive refunds from the government on account of those losses.\textsuperscript{96} Accordingly, there is little by way of academic literature or empirical studies addressing the concern over loss refunds as a policy justification for retaining the Code's realization requirement. Yet the practical concerns associated with requiring the government to reimburse taxpayers for their losses under a true accretion-type tax scheme, coupled with the valuation and liquidity problems outlined above, justify the need for a realization-based income tax.\textsuperscript{97}

\section*{C. The Capital Gains Preference}

Under the Code, long-term capital gains for individuals are taxed at preferential rates.\textsuperscript{98} Beginning on January 1, 1998, the retroactive effec-

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\textsuperscript{92} See supra notes 72-73 and accompanying text.

\textsuperscript{93} See MARTIN DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 166 (1968); see also Fellows, supra note 75, at 803-04; Land, supra note 71, at 92. The time-adjusted-realization-event-tax (TARET) model proposes just such a loss refund system, based upon the Haig-Simons model of an ideal income tax base. See Fellows, supra note 75, at 728, 741. "TARET's promise of increased fairness and economic neutrality depends on its ability ... to identify the appropriate tax rate and interest rate factors to determine the tax liability (or refund) due when a realization event occurs." Id. at 741. For a comprehensive list of scholars discussing a TARET model of taxation, see Fellows, supra note 75, at 728 n.16.

\textsuperscript{94} See id. Professor Fellows argues, however, that the lost revenue occurring as a result of such loss refunds might well be offset by increased revenues realized by the government on account of taxing unrealized gains. See id.

\textsuperscript{95} See id. Professor Fellows argues, however, that the lost revenue occurring as a result of such loss refunds might well be offset by increased revenues realized by the government on account of taxing unrealized gains. See id.


\textsuperscript{97} Scholars have posited a number of arguments against a realization-based income tax. The first criticism, the so-called lock-in effect, is discussed infra notes 115-23 and accompanying text. Others include added complexity to the Code, as well as vertical and horizontal equity concerns. For a comprehensive discussion of the arguments against realization, see Land, supra note 71, at 48-54.

\textsuperscript{98} A capital gain is defined as a gain resulting from the sale or exchange of a capital asset. See I.R.C. § 1222(1)-(4) (West 1988 & West Supp. 1998). A long-term capital gain results when the asset being sold or exchanged has been held by the taxpayer for more than one year. See I.R.C. § 1222(3) (West 1988 & West Supp. 1998). Although the holding period for long-term capital gains is currently one year, Congress has tinkered with the holding period frequently and, as recently as 1997, the holding period was 18 months. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788. By contrast, short-term capital gains are taxed at ordinary income rates. See I.R.C. § 1(h) (West 1988 & West
tive date of the IRS Restructuring and Reform Act of 199899 with respect to capital gains, the preferential tax rate for long-term capital gains for most taxpayers is 20%. For individual taxpayers in the 15% tax bracket, however, any long-term capital gains will generally be taxed at a 10% rate.100 The Code also provides that the 20% rate will be reduced to 18% for assets acquired after December 31, 2000, and held for a period of more than five years.101 Similarly, the 10% capital gains rate will be reduced to 8% with respect to assets that have been held for more than five years and are sold after December 31, 2000.102

Unlike individuals, corporations are not entitled to any preferential tax treatment for their long-term capital gains. Thus, if corporations sell capital assets held for more than one year, any gains resulting from those sales will be taxed at the same rates as ordinary business income.103

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100. See I.R.C. § 1(h) (West 1988 & West Supps. 1998 & Oct. 1998). The preferential tax rates accorded long-term capital gains were greatly complicated by the 1997 Act. For example, long-term capital gains arising out of the sale of § 1250 property (generally depreciable real property) are taxed at a 25% tax rate rather than the general 20% tax rate accorded long-term capital gains but only to the extent that the depreciation that is claimed with respect to the property is not recaptured as ordinary income (referred to as “unrecaptured § 1250 gain”). See I.R.C. § 1(h) (West 1988 & West Supps. 1998 & Oct. 1998); I.R.C. § 1250 (1994). Similarly, long-term capital gains arising from the sale of collectibles that have been held for more than one year are taxed at a 28% tax rate instead of the normal 20% long-term capital gains rate. See I.R.C. § 1(h)(5) (West 1988 & West Supps. 1998 & Oct. 1998). The definition of collectibles for purposes of this provision is found in I.R.C. § 1(h)(6) (West 1988 & West Supps. 1998 & Oct. 1998). With respect to taxpayers in the 15% tax bracket, however, both the 25% rate applicable to the sale of § 1250 property and the 28% rate applicable to the sale of collectibles are reduced to 15% to ensure that taxpayers are not required to pay tax at a higher rate on the sale of capital gain property than on their ordinary income. See id. § 1(h).

The 1997 Act had also provided that long-term capital gains resulting from the sale or exchange of capital assets held for more than one year but not more than 18 months would be taxed at a 28% rate rather than a 20% rate. This portion of the 1997 Act was repealed by the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 5001(a)-(b), 112 Stat. 685. Accordingly, as of January 1, 1998, all gains resulting from the sale or exchange of capital assets held for more than one year, other than those arising from the sale of collectibles or § 1250 property, are taxed at the 20% (or 10%) tax rate outlined in the text. See IRS Restructuring and Reform Act § 5001(a)-(b). The reason for the 1998 amendments, which took effect less than one year after the passage of the 1997 Act, was to reduce the complexities created by the 1997 Act. See 144 CONG. REC. H5353 (daily ed. June 25, 1998) (statement of Rep. Archer) (“[W]e reduce the complexity that 16 million Americans endured when they filled out their... capital gains forms. By changing the holding period from 18 months to 12 months, we bring greater simplicity to the lives of taxpayers.”); see also 144 CONG. REC. S7658 (daily ed. July 8, 1998) (statement of Sen. McCain).


102. See id. § 1(h)(2)(A). It is interesting to note the disparity between the tax reduction applicable to long-term capital gains taxed at the 20% rate versus the 10% rate. With respect to the former, the capital assets must have been acquired after December 31, 2000, and for the latter, such assets need only be sold after December 31, 2000. Whether this disparity was intentional is not clear from the 1997 Act’s legislative history.

103. See I.R.C. § 11 (1994). Generally, most corporations find their income taxed at a flat rate of 35%. See id. Section 1201 provides, however, that the long-term rate applicable to corporations’ capi-
Whether capital gains should be taxed at preferential rates has been the subject of a tax policy debate for many years. Although a number of commentators have rejected the capital gains preference as antithetical to sound tax policy, I believe nevertheless that continued recognition of the preference provides a solution to the problems of "bunching" and "lock-in" and thus is supported by sound policy justifications. The problems of bunching and lock-in will be discussed next.

I. Bunching

The concept of bunching arises directly out of the realization provisions outlined previously. Recall that, primarily because of administrative feasibility concerns, capital gains or losses are "realized" only when taxpayers sell or exchange capital assets. Accordingly, if taxpayers hold capital assets for a number of years, any gains resulting from sales of those assets will often reflect appreciation that has accrued over those years. This cumulative gain, however, is taxed entirely in the year of sale. Because the tax system is progressive, taxpayers could be forced into a higher marginal tax bracket as a result of including several years' worth of gain in income in the year of sale.
As early as 1932, the Treasury Department recognized the problem bunching posed and considered alternatives designed to remedy it, such as allowing taxpayers to spread gains over a number of years, as well as excluding capital gains from income altogether:

The principal argument against taxing capital gains rests on the grounds that such gains, unlike other income, may have accrued over several years; and that to tax such gains at progressive rates in the particular year in which they are realized is to impose an undue and inequitable burden. This argument has much force. It will be observed, however, that it does not apply at all to gains from the sales of property which has been [sic] held a year or less, and is not much more persuasive as to property held 2 years. Nevertheless, the argument is sufficiently sound to suggest that, if the assets have been held more than 1 or 2 years, steps should be taken either to spread the profit in some way over the years during which the taxpayer owned it, or to provide for the taxation of the profit at some flat rate.110

The current capital gains preference is designed to remedy this bunching problem by taxing capital gains at a lower rate than ordinary income. This preference is, however, a relatively imprecise remedy to the bunching problem.111 As noted in the Treasury Department’s statement set forth above, the gain might have accrued fully in the year of sale, thus not causing any bunching of gains over a period of years.112 Nonetheless, taxpayers would still be entitled to take full advantage of the capital gains preference. Similarly, many taxpayers who enjoy large capital gains are relatively wealthy and, therefore, find that their income is taxed at the highest marginal tax rate even without including the capital gains in income.113 For these taxpayers, the progressive tax system does not force
them into a higher tax bracket. Yet, despite the concerns that some critics have expressed regarding the imprecision of the capital gains preference, the preference does relieve the burden of bunching in a number of cases.

2. The Lock-In Effect

Although the capital gains preference attempts to alleviate the bunching problem, perhaps a more compelling policy justification for its continued viability is its resolution of what most commentators term the lock-in effect. Because gains from the sale of capital assets are not taxed until the assets are sold and the gains are realized, taxpayers fully control the timing of this realization event. Taxpayers can postpone realizing their capital gains either until they are in a lower tax bracket or until the government has reduced tax rates. They can also avoid tax on the gain altogether by keeping the asset and transferring it to their heirs at death. Thus, the lock-in effect results from taxpayers' reluctance to sell their assets and incur a tax liability on those sales.

If left unremedied, the lock-in effect creates two sets of adverse economic consequences. First, the lock-in effect results in less revenue for the government.

This is because the question of whether or not a capital gain will be realized is entirely within the discretion of the taxpayer. If the rates are too high, taxpayers will not dispose of their property. This will result in the Government losing not only income taxes, but also stamp taxes on transfers of property.

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114. See generally Andrews, supra note 36, at 1132-33 (suggesting that if the real problem with capital gains was in fact bunching, “the sensible remedy would be one of spreading or averaging total income over a period of years”). “Such a remedy would have no value or effect for regular capital gain repeaters or for regular high-bracket taxpayers, who probably are the biggest beneficiaries of the present provisions.” Id. (footnotes omitted).

115. See, e.g., Cunningham & Schenk, supra note 34, at 344 (“The most serious argument in favor of a capital gains preference is premised upon the so-called lock-in effect.” (footnote omitted)); Snoe, supra note 105, at 77.

116. See I.R.C. § 1014 (1994). Under this provision, when a decedent transfers an asset to an heir, the heir generally receives the asset with a basis equal to its fair market value at the time of the decedent's death. See id. Accordingly, any appreciation in the asset at the time of death will never be taxed. See supra note 70. Studies indicate that approximately one-half of all capital gains are never taxed because of this stepped-up basis at death. See, e.g., MERVYN A. KING & DON FULLERTON, THE TAXATION OF INCOME FROM CAPITAL 221 (1984); see also Cunningham & Schenk, supra note 34, at 344.

117. See, e.g., Snoe, supra note 105, at 76-77; see also Cunningham & Schenk, supra note 34, at 344 (“The lock-in effect describes an investor's reluctance to incur a tax on realization of gains; it is a direct consequence of prior decisions to impose a realization requirement and not to tax gains at death.” (footnote omitted)).

Second, the lock-in effect prevents the flow of capital to its best economical use.119 As one scholar explained:

A sophisticated person would compare the financial return of selling the asset, paying the income tax . . . and investing the net proceeds in a profitable manner against retaining the asset, forgoing tax liability, and receiving less than the optimum return on the retained asset. As part of this calculus, the taxpayer would also consider that recognition of all realized gain could be avoided by holding the asset until death and passing the property to heirs or devisees with a stepped-up basis.120

Because the lock-in effect often prevents taxpayers from investing their assets in new or productive enterprises, it results in economic inefficiency in the marketplace.121

Accordingly, inasmuch as we want to encourage taxpayers to sell less profitable assets and invest the proceeds in more economically productive assets, we must eliminate the lock-in effect that results from the realization concept discussed previously.122 The capital gains preference is the primary vehicle to accomplish this goal.123 A capital gains preference reduces the tax burden associated with the sale or disposition of as-

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119. See id.; S. Rep. No. 75-1567, at 6 (1938), reprinted in 103 Internal Revenue Acts of the United States 1909-1950, supra note 23, at 6 (“An excessive tax on capital gains freezes transactions and prevents the free flow of capital into productive investments. The effect of the present system of taxing capital gains is to prevent any individual with substantial capital from investing in new enterprises. This is most unfortunate . . . .”); see also Cunningham & Schenk, supra note 34, at 344-46; Snoe, supra note 105, at 76-78.

120. Snoe, supra note 105, at 76-77 (footnotes omitted). For example, suppose T holds Asset #1 with a basis of $100 and a value of $500 in a world with a flat 25% tax on income. The expected yield on this investment is 10% or $50. T has the opportunity to invest in Asset #2 which has an expected yield of 12%. If T sold Asset #1, he would pay $100 in taxes, leaving only $400 to invest in Asset #2. Because a $400 investment in Asset #2 has an expected yield of only $48, T will not change investments. The toll charge prevents T from diversifying his portfolio.

Cunningham & Schenk, supra note 34, at 344.

121. See H.R. Rep. No. 77-2333, at 29 (1942), reprinted in 108 Internal Revenue Acts of the United States 1909-1950, supra note 23, at 29; see also Smith, supra note 109, at 125; Andrews, supra note 36, at 1134 (“It is economically inefficient to have a tax that gives people an incentive not to make otherwise desirable changes in investments.”). For a more complete discussion of economic efficiency, see infra notes 242-51 and accompanying text.

122. Of course, this solution presupposes that taxpayers will reinvest their assets in other investments. See Andrews, supra note 36, at 1134.

123. See Popkin, supra note 109, at 154-55. Many commentators have also suggested that eliminating the stepped-up basis at death is a critical second step to eliminating lock-in. See Cunningham & Schenk, supra note 34, at 347; see also Snoe, supra note 105, at 82 (suggesting that eliminating the stepped-up basis at death is one option for eliminating lock-in). Although I agree with this proposal, I believe that reducing lock-in effect during taxpayers' lives via the capital gains preference is also necessary.

It is interesting to note that the provision allowing the stepped-up basis at death was repealed by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872, but the repeal never became effective. The effective date of the repeal was postponed in the Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2763, 2884. The provision was ultimately repealed in the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401, 94 Stat. 229, 299, which reinstated the stepped-up basis provisions.

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sets, thereby increasing the likelihood that taxpayers will sell their less profitable investments and reinvest the proceeds in more profitable ventures, despite the imposition of a capital gains tax. Even with such a tax, this reinvestment of assets would prove economically efficient.

I will concede the point made by many critics of the capital gains preference that it is an imperfect solution to the problems of bunching and lock-in. I contend, however, that until we can eliminate the administrative burdens that require maintaining the concept of realization, the capital gains preference must remain an integral part of the income tax system.

III. CURRENT LOSS LIMITATIONS: A CONCEPTUAL FRAMEWORK

Only after accepting the continued viability of progressivity, realization, and the capital gains preference, which together create the need for loss limitations generally, can we turn to the primary focus of this article: the deductibility of capital losses. This part of the article examines the current system for limiting the deductibility of capital losses and outlines the policy justifications proffered in favor of such limitations.

The scheme for determining whether sales or other dispositions of property result in capital losses rather than ordinary losses is identical to the scheme for determining capital gains. Thus, the property disposition must qualify as a sale or exchange,124 and the asset sold or exchanged must qualify as a capital asset.125 If the capital asset has been held for one year or less, the resulting loss would be a short-term capital loss; conversely, an asset held for more than one year would produce a long-term capital loss.126

When individuals sell or otherwise exchange property and the transaction produces short- or long-term capital losses, such losses can be deducted on the individual’s income tax return only to the extent of the individual’s capital gains plus up to $3,000 of ordinary income.127 Corpo-

125. See id. A capital asset is defined in I.R.C. § 1221 to include all property, except five categories of noncapital assets: (1) stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business; (2) depreciable personal property or real property, if used in the taxpayer’s trade or business; (3) copyrights, literary, musical, or artistic compositions, letters or memoranda created by the taxpayer; (4) accounts or notes receivable generated in the taxpayer’s trade or business; and (5) certain publications of the U.S. government. See I.R.C. § 1221 (1994); see also Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 215-16 (1988). It has long been held that the definition of a capital asset should be construed narrowly so that capital gain or loss treatment is only given in situations generally involving the realization of appreciation or depreciation over a long period of time. See, e.g., Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130, 134 (1960).
127. I.R.C. § 1211(b) provides:
In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of—
(1) $3,000 ($1,500 in the case of a married individual filing a separate return), or
rations, on the other hand, can deduct their short- or long-term capital losses only to the extent of capital gains.128

The Code has always imposed limitations on the deductibility of capital losses, with the exception of a brief six-year period following World War I. In fact, under the first Internal Revenue Code, capital losses were not deductible at all.129 In 1916, capital losses were first allowed as a deduction but then only to the extent of capital gains.130 The Revenue Act of 1918 allowed for full deductibility of capital losses,131 and this full deductibility continued until 1924. At that time, limitations on the deductibility of capital losses were again imposed, and these limitations provided that only 12.5% of an individual's capital losses could be used as credits against the individual's income tax liability.132 Moreover, the 1924 Act also amended the Code to provide that individual taxpayers could deduct capital losses only to the extent of capital gains.133 In 1934, Congress again amended the Code to provide that all taxpayers could deduct capital losses against capital gains plus $2,000 of ordinary in-

(2) the excess of such losses over such gains.
I.R.C. § 1211(b) (1994).

It is important to note that, for any loss of an individual taxpayer to be deductible at all, it must qualify as a trade or business loss, an investment loss, or a casualty loss. See I.R.C. § 165(c) (West 1988 & West Supp. 1998); see also Lemons v. Commissioner, 74 T.C.M. (CCH) 522, 533 (1997).

128. I.R.C. § 1211(a) provides that "[i]n the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges." I.R.C. § 1211(a) (1994).

For both individual and corporate taxpayers, the Code provides an elaborate mechanism for offsetting capital losses against capital gains. First, short-term capital losses are offset against short-term capital gains, and long-term capital losses are offset against long-term capital gains. See I.R.C. § 1222 (5)-(8) (West 1988 & West Supp. 1998). If this original netting process results in a net gain on one side (short-term, for example) and a net loss on the other side (long-term, for example), then the net short-term capital gain is offset against the net long-term capital loss. See id. § 1222 (9)-(11).

For corporate taxpayers, any net long- or short-term capital losses remaining after this complete netting process cannot be deducted in the current year but can be carried back three years and forward five years and deducted against capital gains in those years, subject to the same netting process. See id. § 1212(a)(1). For individual taxpayers, any net long- or short-term capital losses remaining after the netting process can be used to offset up to $3,000 of the taxpayer's ordinary income, with net short-term capital losses being first used to offset the ordinary income before net long-term capital losses can be used as an offset. See I.R.C. § 1211(b) (1994). Any unused losses can be carried forward to future years indefinitely and can be deducted in those years, subject to the same limitations. See I.R.C. § 1212(b) (West 1988 & West Supp. 1998).

129. See Act of Oct. 3, 1913, ch. 16, § 2(B), 38 Stat. 114, 167. For a detailed history of the deductibility of capital losses from the inception of the income tax until 1948, see Wells, supra note 98, at 12-32.


[under existing law, in transactions entered into for profit but not connected with the taxpayer's business or trade, only the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom can be deducted. The proposed bill changes the provision of existing law to allow the entire loss in such transaction to be deducted.]

Id.


133. See id. § 206(a)(2), 43 Stat. at 260; see also Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 791, 818 (recodifying this limitation as I.R.C. § 117(a)(2) (1928)).
come. Although Congress has tinkered with the deductibility of capital losses since 1934, the general scheme of allowing capital losses to offset capital gains plus some dollar amount of ordinary income has remained relatively constant since that time.

It is generally agreed that permitting the deductibility of capital losses is necessary if the government is attempting to induce taxpayers to invest in risky undertakings. For example, a seminal study undertaken by two prominent economists, Evsey Domar and Richard Musgrave, demonstrated that if capital losses were allowed to be deducted in full, such deductibility would encourage taxpayers to engage in risk-taking to a greater extent than if no tax were imposed on capital gains or losses. As one noted capital loss scholar has stated, Domar and Musgrave's "basic conclusion that proportional taxation with loss offsets encourages risk-taking is now widely accepted by economists." Yet capital losses have been deductible in full for only a brief six-year period during the history of the income tax. Accordingly, it is reasonable to ask what policy considerations, if any, justify limiting the deductibility of capital losses. Three policy justifications have been advanced over the years in support of these limitations: parallel treatment of gains and losses, cherrypicking, and bunching. Each justification will be examined briefly.

A. Parallel Treatment of Capital Gains and Losses

Because taxpayers receive preferential tax treatment on their capital gains, Congress long ago determined that it would be incongruous to allow capital losses to offset ordinary income, which is generally taxed at a higher rate. Therefore, to counterbalance the preferential tax rate accorded capital gains, it was necessary to provide an overall limitation on the deductibility of capital losses, balancing the total tax benefit granted

135. For a more in-depth discussion of the history of the limitations on deductibility of capital losses, see Alvin C. Warren, Jr., The Deductibility by Individuals of Capital Losses Under the Federal Income Tax, 40 U. CHI. L. REV. 291, 291-92 (1973), and also CRS REPORT, supra note 98.
136. See, e.g., DAVID, supra note 93, at 140 ("[T]he deductibility of losses has a profound effect on the willingness of private investors to undertake risky investments."); SMITH, supra note 109, at 151 ("[D]eductibility of losses is an effective way to use government power to offset inherent barriers against particular forms of investment which it has desired to encourage on social or economic grounds."); see also Warren, supra note 135, at 297-98 ("[T]axpayers would be more willing to take substantial risks, subjecting any profit to the possibility of taxation, if losses could be deducted from other income.").
137. See Evsey D. Domar & Richard A. Musgrave, Proportional Income Taxation and Risk-Taking, 58 Q.J. ECON. 388 (1944), reprinted in IX READINGS IN THE ECONOMICS OF TAXATION, supra note 72, at 493, and in RICHARD A. MUSGRAVE, PUBLIC FINANCE IN A DEMOCRATIC SOCIETY 108 (1986); see also Warren, supra note 135, at 299 ("In addition, the tax savings made possible by the deferral of currently deducting losses while postponing gains could make risk taking even more attractive than the Domar-Musgrave hypothesis would indicate." (footnotes omitted)).
139. See supra note 27 and accompanying text.
to taxpayers on their capital gains and losses. As Professor Smith, a former deputy to the Secretary of the Treasury, concluded, "it is reasonable that if capital gains are given a more liberal tax treatment than ordinary income, capital losses should be treated less liberally than ordinary losses."  

Although it seems inherently logical for there to be parallel tax treatment between capital gains and losses, it becomes problematic to implement this parallelism in practice. As noted scholar Alvin Warren concluded, the inherent difficulty arises because those engaged in the debate have not agreed on the definition of what constitutes "parallel" treatment. Professor Warren suggested three alternative types of capital gain and loss parallelism.

The first type of parallelism, and that currently employed in the Code, is "inclusion/deduction parallelism," in which the dollar amount of capital gains included in income equals the dollar amount of capital losses deducted from income. As discussed previously, the current system of income taxation provides that capital losses can be used to offset only capital gains plus up to $3,000 of ordinary income for individual taxpayers. Thus, the current system roughly approximates this inclusion/deduction parallelism, but the addition of $3,000 of capital loss that can offset ordinary income slightly skews the treatment of gains and losses. Commentators have defended this type of parallelism on the grounds that "capital losses provide deductions from income to the same extent that capital gains give rise to inclusions in income."  

The primary criticism of inclusion/deduction parallelism is its failure to account for the possibility that taxpayers might have realized true economic losses and yet are unable to receive any tax benefits because they do not have corresponding capital gains against which to offset the losses. Accordingly, this type of parallelism can be attacked on both fundamental fairness and economic efficiency grounds.

A second type of parallel treatment of capital gains and losses, referred to by Professor Warren as "liability/savings parallelism," provides generally that the amount of tax savings resulting from the deduction of a capital loss against income should equal the tax liability resulting from the inclusion of a capital gain in income. Citing a Treasury Department study, Warren explained that the problem inherent in liability/savings parallelism is that it could only be accomplished by use

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140. SMITH, supra note 109, at 149.
141. See Warren, supra note 135, at 304.
142. See id. at 304-07.
143. See id. at 305.
144. 1 AMERICAN LAW INST., FEDERAL INCOME TAX STATUTE: FEBRUARY 1954 DRAFT § X232(c), at 345 (1954); see also Warren, supra note 135, at 306.
145. See infra Part IV.B.
146. See Warren, supra note 135, at 304.
147. See id.
of a flat rate tax or through a tax credit:

Assuming for the moment that ordinary income does not fluctuate, realizing net capital gains of a sufficient magnitude would push a taxpayer into a higher tax bracket while realizing net capital losses of a sufficient magnitude would put him into a lower bracket. Consequently, equal amounts of gain and loss could have different degrees of tax impact: because of the graduated rate structure, realization of a net gain could result in a greater increase in tax liability than the reduction in tax liability occasioned by realization of an equivalent net loss.\(^4\)

Although Professor Warren and the Treasury Department correctly recognized the inability to effectuate liability/savings parallelism under the then-current tax scheme without using a tax credit, the Code today does not present the same barriers. Because capital gains are generally taxed at a flat rate of 20% irrespective of the taxpayer’s marginal tax rate on ordinary income,\(^5\) the problems associated with implementing a parallel tax scheme using liability/savings parallelism disappear under the current Code. The proposal outlined in part IV of this article designs just such a model.

The third type of parallel treatment of capital gains and losses presented in Warren’s article is “accrual/realization parallelism.”\(^6\) This type of parallelism treats capital gains and losses as if they had been taxed under an accrual-type tax system (as the gains and losses accrue each year) rather than under a realization system. It is subject to the same criticisms waged against an accrual- or accretion-type tax system generally, as outlined in part II of this article. Thus, to achieve true parallelism, taxpayers would be required to obtain a valuation of their assets each year so that gains and losses that have accrued with respect to each asset could be determined annually. The administrative complexities associated with such a system would render it nearly impossible to implement.

Thus, although tax scholars have been unable to agree which type of parallelism best justifies the imposition of limitations on the deductibility of capital losses, it is relatively well settled that parallel treatment of capital gains and losses generally remains a primary policy justification for such limitations.

\(^{148}\) Id. at 305 (citing U.S. TREASURY DEP’T, FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES 59-69 (1951)).

\(^{149}\) Of course, this tax scheme is not correct with respect to taxpayers in the 15% bracket, whose capital gains are taxed at a flat rate of 10%. See supra notes 100-02 and accompanying text. Nevertheless, the fact that a flat tax rate is imposed on capital gains irrespective of income levels, with this limited exception, would make it easier to surmount the barriers associated with liability/savings parallelism outlined in the Warren article. See infra Part IV.

\(^{150}\) See Warren, supra note 135, at 306-07.
B. Cherrypicking

Many tax scholars argue that the most compelling policy justification for placing limitations on the deductibility of capital losses is to limit "cherrypicking" by taxpayers. As discussed above, taxpayers can control the realization of capital gains and losses by carefully timing the date of a sale or exchange of their capital assets. Without a limitation on the deductibility of capital losses, taxpayers could postpone realizing their capital gains while, at the same time, selling their capital loss assets and using those losses to offset their ordinary income. This selective realization of capital losses, but not capital gains, is termed cherrypicking in tax parlance.

As early as 1924, Congress recognized that cherrypicking was indeed a drain on tax revenues. In the legislative history of the Revenue Act of 1924, which imposed significant limitations on the deductibility of capital losses, one group proposing that capital gains and losses be disregarded altogether in calculating taxable income observed the following:

In support of the contention that losses in the sales of capital assets are employed as deductions from taxable income in a much greater measure than are the gains from the sale of capital assets added to taxable income, we cite the following table presented to the Ways and Means Committee of the House of Representatives by Under-secretary of the Treasury S. Parker Gilbert, at a hearing held before that committee of the Sixty-Seventh Congress, fourth session, on H. R. 13412, on Monday, January 8, 1923. [The chart, which is omitted here, analyzes the aggregate incomes of the fifty largest individual taxpayers for 1920, together with taxes paid thereon.]

It will be observed that this summary of the income of the 50 largest tax payers [sic] for the taxable year 1920, showing gross income of $99,914,000, establishes that of this income, $1,500,000 results in the sale of capital assets whereas deductible losses on the sale of capital assets amount to $11,650,000. This indicates that at least this type of taxpayers [sic] do not take their capital gains in taxable form, but frequently keep the property and allow the gains to accumulate. On the other hand, when they have capital losses,
such taxpayers take them advantageously in order to reduce taxable income.\textsuperscript{155}

Moreover, the Code provision permitting a stepped-up basis of appreciated assets at death exacerbates the cherrypicking problem.\textsuperscript{156} Because, in the absence of loss limitations, taxpayers can recognize capital losses currently while never recognizing capital gains and can escape recognition altogether through the stepped-up basis provisions, the need for loss limitations becomes even greater.\textsuperscript{157}

\subsection*{C. Bunching of Capital Losses}

The final, often overlooked, policy justification for imposing limitations on the deductibility of capital losses is the concept of bunching. Just as with capital gains,\textsuperscript{158} losses can accrue over a number of years. Yet because of the realization concept, taxpayers realize their losses all at once in the year of sale. Large capital losses realized in a single taxable year could enable taxpayers to reduce taxable income enough to move into a lower tax bracket. As Professor Blum explained, "[l]ike capital gains, capital losses frequently develop over many years. If taxpayers had free rein in choosing the year of deduction by selecting the time of realization, they would be in a position to take their losses in high tax years and their gains in low ones."\textsuperscript{159} For this reason, Congress has always considered loss limitations to be necessary to offset this "bunching" effect.

Thus, the three primary policy justifications most often posited in favor of limiting the deductibility of capital losses are parallelism, cherrypicking, and bunching. Yet tax scholars cannot agree on the extent to which each of these concepts actually justifies the imposition of loss limitations.\textsuperscript{160} The section that follows begins by critically analyzing these policy justifications for limiting the deductibility of capital losses and then proposes an alternative scheme for imposing loss limitations that better comports with the true reasons giving rise to the need for such limitations.

\begin{itemize}
\item\textsuperscript{156} See I.R.C. § 1014 (1994); see also supra note 116 and accompanying text.
\item\textsuperscript{157} See Blum, supra note 78, at 254 (arguing that allowing taxpayers to recognize losses while deferring the realization of gains "would stack the odds too much in favor of taxpayers; and the whip-sawing potential would be unconscionably great if unrealized gains escaped tax at death"). See generally Peel, supra note 153, at 422.
\item\textsuperscript{158} See supra notes 108-14 and accompanying text.
\item\textsuperscript{159} Blum, supra note 78, at 254. Under certain circumstances, however, taxpayers could have an incentive to spread, rather than bunch, their losses. For example, a taxpayer with a large loss who is consistently in the highest tax bracket might want to use only enough of the loss to offset income in that highest bracket, retaining the remaining loss to do the same in future years. Nevertheless, bunching of losses into a single tax year remains a problem in a large number of cases.
\item\textsuperscript{160} See, e.g., Calvin H. Johnson, \textit{Commentary: Deferring Tax Losses with an Expanded § 1211}, 48 \textit{TAX L. REV.} 719, 720-21 (1993); Scarborough, supra note 96, at 680-81; Warren, supra note 135, at 300-16.
\end{itemize}
IV. A NEW PARADIGM FOR THE DEDUCTIBILITY OF CAPITAL LOSSES

Studies have demonstrated that capital losses must be deductible in some form as an economic incentive to encourage taxpayers to invest in risky ventures.161 Risk investment, in turn, fuels economic growth.162 The few tax scholars who have critically analyzed the capital loss limitations all agree that the current system is flawed and in need of radical revision.163 Some call for the complete deductibility of capital losses without limitation;164 others propose an accretion-type tax system in which gains and losses would be taxed annually.165 These proposals, however, fail in one of two respects. Those advocating full deductibility of capital losses do not comprehensively account for the policy considerations underlying the need for capital loss limitations generally. Conversely, those proposals that seek to move to an accretion-type tax, although possibly justified in a theoretical world, fail to accept the practical limitations that make those proposals completely unworkable in the real world.166

This part of the article designs a new paradigm for the deductibility of capital losses, one that is both administratively feasible and also addresses the underlying policy justifications for the imposition of loss limitations. It begins by addressing those problems inherent in the current loss limitation system, focusing primarily on how the current system inadequately treats the policy concerns of parallelism and cherrypicking.167 It then sets forth a new proposal for limiting the deductibility of capital losses.

161. See supra notes 136-38 and accompanying text.
162. See, e.g., SMITH, supra note 109, at 125; see also infra notes 242-44 and accompanying text.
163. See, e.g., Fellows, supra note 75, at 802 ("T]he limit on the amount of capital losses that a taxpayer may deduct in one year should be abandoned."); Peel, supra note 153, at 432 ("The Code is still burdened, however, by capital gain and loss distinctions that still affect individual taxpayers who have substantial capital losses . . . ."); Scarborough, supra note 96, at 701 ("T]he current capital loss limitation both fails to control selective realization of losses, and thus encourages certain types of risky positions, and discourages other types of risky positions by creating unusable losses."); Warren, supra note 135, at 292 ("This article discusses the appropriate tax treatment for capital losses realized by individual taxpayers, given the current preferential treatment of capital gains . . . .").
164. See, e.g., SIMONS, supra note 72, at 209 ("T]here should be no limitations whatever upon the deduction of bona fide losses . . . . One-sided restrictions as to losses are too ridiculous and inequitable for serious consideration."); Peel, supra note 153, at 432 ("Virtually all of the complications can be eradicated if Congress is willing to take the additional step of allowing capital losses in full in the same manner that ordinary losses are now treated."); Warren, supra note 135, at 297 ("T]he primary rationale for making capital losses fully deductible is in the economic incentive for risk taking it would provide.").
165. See, e.g., Fellows, supra note 75, at 737 (suggesting that the first step in determining tax is to "[e]stimate the accretion or decretion in an asset's market price for each period the taxpayer held (or produced) the asset, based on its value at the time of the realization event").
166. As discussed earlier, even Henry Simons, a principal architect of the ideal income tax base, recognized the administrative unfeasibility of moving away from a realization-based tax system. See SIMONS, supra note 72, at 207-08; see also supra notes 75-97 and accompanying text.
167. The current loss limitation system addresses the policy concern of bunching in a haphazard way, overcompensating for bunching under certain circumstances (such as when the loss accrued over a relatively short period of time) and undercompensating for the problem in other situations. Nevertheless, the present system does alleviate bunching in a large number of cases. Accordingly, I believe that the present system, although subject to certain criticisms with respect to bunching, is not inherently flawed in that respect; therefore, I do not attack it in this section.
losses, justifying the proposal on both policy and feasibility grounds. Finally, this part will respond to potential criticisms that might be waged against the new capital loss paradigm, including that it benefits wealthier taxpayers and adds further complexity to the Code.

A. Problems Inherent in the Current Loss Limitation System

Recall that under the current loss limitation system, individual taxpayers can deduct their capital losses to the extent of their capital gains plus up to $3,000 of ordinary income; corporations, on the other hand, can deduct losses only to the extent of capital gains. Congress justifies the provisions allowing all taxpayers, both corporate and individual, to offset capital losses against capital gains on the grounds that such a limitation provides parallel treatment of gains and losses, prevents cherry-picking, and eliminates any advantage caused by the bunching of losses in a single tax year. The discussion that follows, however, demonstrates that the current system falls short of the mark in alleviating these policy concerns.

1. Parallelism

As discussed previously, the current capital loss limitation system is roughly based on the concept of inclusion/deduction parallelism, in which the dollar amount of capital gains included in gross income equals the dollar amount of capital losses deducted from gross income. The current system only roughly approximates inclusion/deduction parallelism because it allows up to $3,000 of capital losses to offset an individual taxpayer's ordinary income. Congress justifies this provision on fairness grounds—it prevents hardship in the case of individuals having only a small amount of income and sporadic losses. Yet the very existence of this $3,000 de minimis provision undermines, at least in part, the concept of inclusion/deduction parallelism upon which the current loss limitation system is based.

Moreover, under this type of parallelism, taxpayers can deduct their capital losses only if they have capital gains with which to offset them. Thus, a principal criticism of inclusion/deduction parallelism is that taxpayers who have engaged in risky investment ventures and incurred true economic losses are unable to receive any tax benefits on account of those losses if they have not also realized corresponding capital gains. As

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168. See I.R.C. § 1211(a)-(b) (1994). For a more complete discussion of the current limitations on the deductibility of capital losses, see supra notes 127-28 and accompanying text.
169. See supra notes 140-60 and accompanying text.
170. See supra notes 140-50 and accompanying text for a discussion of the three types of parallelism.
a result, inclusion/deduction parallelism can lead to economic inefficiency in two distinct ways. First, taxpayers whose investments resulted in capital losses without any offsetting capital gains would be disinclined to sell the loss property and reinvest the proceeds from the sale in more economically productive ventures. If taxpayers are not entitled to receive any tax benefits on account of those losses, they would likely decide to keep assets invested in the loss venture until the taxpayers have capital gains against which to offset those losses in the hope that the investments might turn around and become more profitable in the future.

Second, because taxpayers recognize that their capital losses are economically worthless in the absence of offsetting capital gains, they might choose not to invest in risky ventures that might produce losses at all. This would be an unfortunate result because risk investments spur economic growth in society.172

The final concern stemming from the concept of parallelism, as reflected in the current loss limitation system, is that it is inconsistent with traditional notions of fundamental fairness. Recall that under the guise of parallelism, limitations are placed upon the deductibility of capital losses to compensate the government for allowing capital gains to be taxed at reduced rates.173 Yet, under the current capital gain and loss system, the deductibility of capital losses is limited even in those numerous situations in which capital gains are not accorded preferential treatment. For example, if corporations realize long-term capital gains, they will be taxed on those gains at the same rates that apply to their ordinary income.174 But if those corporations incur capital losses, those losses can be deducted only against their capital gains,175 despite the fact that the government lost no revenue when the corporations included capital gains in gross income.

Similarly, in the Tax Reform Act of 1986,176 Congress eliminated all preferential tax rates previously accorded capital gains; even individuals' capital gains were taxed at the same rates as their ordinary income.177 Even though this system was in place for several years,178 individuals

172. See Smith, supra note 109, at 125.
175. See id. § 1211(a).
178. Although the Tax Reform Act of 1986 generally took effect in 1987, the two-tier tax rate system (15% and 28%) did not become fully effective until 1988. From 1988 until 1990, capital gains were taxed at the same rates as ordinary income. In 1990, as part of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11101, 104 Stat. 1388, 1403-04, Congress added the 31% tax bracket for
were still subject to limitations on the deductibility of their capital losses. Thus, individuals recognizing only long-term capital gains would pay tax on those gains at the same rate as any ordinary income, thereby depriving the government of no lost tax revenue. Conversely, individuals recognizing only capital losses were generally unable to deduct those losses,\textsuperscript{79} ostensibly to protect the government’s tax revenue base. This sort of asymmetrical treatment of gains and losses is clearly inconsistent with notions of fundamental fairness upon which the concept of parallelism is based.\textsuperscript{80} Accordingly, although parallelism remains a viable policy justification for loss limitations generally, the inclusion/deduction parallelism embodied in the present system is quite flawed. The proposal contained in the next section of this article is based on the concept of liability/savings parallelism, which provides a richer and more economically sound policy justification for capital loss limitations.\textsuperscript{181}

2. \textit{Cherrypicking}

Although the lack of parallelism is a real concern that needs to be addressed by loss limitations, the foregoing discussion illustrates that the current loss limitation system is ill-equipped to meet parallelism concerns. Conversely, although the system is well-designed to eliminate cherrypicking, cherrypicking is not a problem that a loss limitation system should address.

Recall that cherrypicking is a shorthand term for the concern that taxpayers can postpone the realization of their capital gains while currently realizing their capital losses and offsetting them against other income.\textsuperscript{182} Although it is undisputed that some taxpayers engage in cherrypicking, there are four reasons why the practice should not be the basis ordinary income, even though the maximum capital gains tax rate remained at 28%, thereby creating a maximum capital gains preference of 3%. Then, in 1993, as part of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13201(a), 107 Stat. 312, 457-59, Congress added two additional tax brackets for individual taxpayers, the 36% and 39.6% brackets, thereby creating a maximum capital gains preference of 11.6%.

179. Of course, taxpayers could offset up to $3,000 of those capital losses against ordinary income, but that hardly balances out the inequities inherent in the system.

180. The fact that Congress retained limitations on the deductibility of capital losses even in the absence of parallelism concerns strongly suggests, of course, that Congress views cherrypicking, discussed supra notes 151-57 and accompanying text, as its primary concern. I disagree, however, for the reasons outlined in the following section.

Some commentators might argue that the present tax system does not reflect parallelism generally. For example, if a taxpayer sells his vacation home or boat at a gain, he is required to include that gain in income. On the other hand, if the same taxpayer sells the vacation home or boat at a loss, he has suffered a personal loss under the Code and cannot deduct that loss against any of his taxable income. See I.R.C. § 165(c) (West 1988 & West Supp. 1988). Yet, the fact that certain aspects of the present Code evidence fundamental unfairness and a lack of parallelism under certain circumstances should not be an argument against striving for parallelism generally.

181. See infra notes 232-34 and accompanying text.

182. For a more complete discussion of cherrypicking, see supra notes 151-57 and accompanying text.
upon which a loss limitation system, like the one currently in place, is structured.

First, capital losses are real economic losses.\(^\text{183}\) Even Congress recognizes that "[t]he losses [investors] have suffered are decidedly real losses.... The shrinkage in the value of these investments is in every sense of the word a true loss actually sustained by the investor."\(^\text{184}\) If the Haig-Simons notion of an ideal income tax base defines income as a taxpayer's consumption plus changes in net worth over time, implicit in that definition is the notion that true economic losses reduce a taxpayer's income. Thus, limiting the deductibility of capital losses to encourage taxpayers to sell their gain-producing property is antithetical to the Haig-Simons ideal income tax base.\(^\text{185}\) Moreover, to the extent that an argument can be made that a capital loss is not a true economic loss in a particular case, Congress has expended considerable time and energy to disallow the deductibility of those losses as sham losses.\(^\text{186}\)

The second and perhaps even more compelling argument against using cherrypicking as a policy justification for loss limitations is that the concept of cherrypicking assumes that taxpayers have both capital losses and capital gains and are selectively realizing their losses while postponing the realization of their gains. In reality, however, not all taxpayers have both unrealized capital gains and capital losses in their investment portfolios. It violates notions of fundamental fairness to design a loss limitation system applicable to all taxpayers that is aimed at modifying the behavior of only a fraction of those taxpayers.\(^\text{187}\) Moreover, if one of

\(^{183}\) Schedular selective limitations generally disallow deductions for true economic costs as well as for tax preferences. For example... the capital loss denies deductions for losses that, considered in isolation, unquestionably are economic. The argument that selective limitations move us further from Haig-Simons conformity plainly is more difficult to make when the disallowed deduction is a tax preference.


\(^{185}\) See Warren, *supra* note 135, at 293 (noting that under the Haig-Simons definition of income, "capital losses are negative income, just as capital gains are positive income").

\(^{186}\) See, e.g., I.R.C. §§ 465 (1994) (the at-risk rules); 469 (the passive loss rules); 704(d) (the partnership basis limitation rules); 1091 (the wash sales rules). In addition, as Professor Warren recognized, even though the tax laws have been quick to respond to taxpayers' creative attempts to manufacture fictitious capital losses, the problem of sham losses arises irrespective of whether the losses are unlimited in deductibility or can be offset only against capital gains. See Warren, *supra* note 135, at 309.

\(^{187}\) As early as 1932, the Treasury Department recognized that a provision permitting capital losses to be deducted only against capital gains was unjust as it applied to the myriad taxpayers who had no capital gains with which to offset such losses:

\[W\]e do not know how to remedy that particular abuse [of allowing taxpayers to use their capital losses to offset ordinary income without selling their capital gain property] without doing some injustice, and I am afraid some people have got to suffer because of the general abuse of the privilege by many other taxpayers.

*Rhe Revenue Act of 1932: Hearings on H.R. 10236 Before the Senate Comm. on Fin.,* 72d Cong. 31 (1932) (statement of Ogden L. Mills, Secretary of the Treasury), *reprinted in 10 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950, supra note 23, at 31; see also Peel, *supra* note 153, at 419 ("Restrict-
the overarching goals of the capital gain and loss system is to promote investment, preventing unfortunate investors who fail to realize offsetting gains from deducting capital losses would certainly have a negative impact on that goal. 188

When tax scholars justify cherrypicking as a policy concern underlying the need for loss limitations, they paint an idyllic picture in which taxpayers have the best of both worlds: using losses to offset income currently, while at the same time postponing any tax on the income inherent in appreciated property. Yet in reality there is, in fact, a serious risk associated with the game of cherrypicking. Consider, for example, this all-too-real example of the risks inherent in cherrypicking. I purchased stock in Compaq Computers in 1997. It appeared to be a solid investment; the stock crept slowly upwards so that by the end of 1997, I had a sizable gain (that is, sizable for me) in my investment. I decided not to sell the stock at the end of that year because I did not want to include the gain in income in 1997. During 1998, Compaq decided to expand through acquisition, and the costs associated with those acquisitions took a toll on its stock price. Thus, during 1998, I saw my stock steadily decrease in value, reminding me of the clear risks associated with cherrypicking. Although I am happy to report that my investment appears to be rebounding, it is a myth to suggest that taxpayers who engage in selective realization of their losses without a corresponding realization of their gains do achieve the best of both worlds. There is a significant downside to cherrypicking, and that risk should act as a deterrent to such behavior in most circumstances.

Finally, cherrypicking is not an appropriate policy basis for loss limitations because it is not the underlying problem. Cherrypicking is instead the result of three interrelated causes that work together to form the root of the evil that is cherrypicking. First, although not all capital gains arise out of the sale of stock or other securities, it has been estimated that 85% of all capital gains come from these sources.189 Accordingly, one of the underlying problems giving rise to cherrypicking is that corporations traditionally have failed to distribute their corporate earnings on a regular basis.190 If the income tax laws can be better designed to penalize corpo-

188. See, e.g., Land, supra note 71, at 51. Professor Land believes that disallowing the deductibility of capital losses against ordinary income: is not merely offensive to notions of horizontal and vertical equity; it also makes investing riskier. The tax law promises deferral and a favorable rate to investment winners, but denies a tax benefit to the losers. This magnification of risk should be a serious concern to those who want the tax law to promote investment. Id.; see also Scarborough, supra note 96, at 681 ("[T]he problem of unusable losses is a problem of behavior distortion; the limitation may discourage certain investments and risk management techniques.").

189. See SIMONS, supra note 72, at 157 n.4.

190. See id. at 157; see also CURTIS J. BERGER & PETER J. WIEDENBECK, CASES AND MATERIALS ON PARTNERSHIP TAXATION 15 (1989) ("On average, U.S. corporations distribute less than half of
rations for retaining their earnings rather than distributing them to shareholders, there would be little taxpayer incentive to engage in cherrypicking because there would be little, if any, gain inherent in taxpayers' stock, as all of the corporation's profits would be taxed currently to its shareholders in the form of dividends. Similarly, the realization concept, discussed previously, coupled with the stepped-up basis at death, are the real problems that cause taxpayers to engage in cherrypicking. And although scholars have called for the elimination of the stepped-up basis at death for a number of years, the realization concept will remain firmly embedded in the income tax system for purposes of administrative feasibility. It is entirely possible that many of the concerns associated with cherrypicking would be alleviated by encouraging corporations to distribute their profits currently and eliminating the stepped-up basis at death.

This section has taken the somewhat controversial position that cherrypicking should not be a compelling policy justification for imposing limitations on the deductibility of capital losses. As noted earlier, many scholars argue that the principal justification for eliminating capital losses is to prevent cherrypicking. I have demonstrated, however, that cherrypicking, which is an inherently risky undertaking, is based on the faulty assumption that all taxpayers have both unrealized losses and gains. In addition, disallowing the deductibility of true economic losses to taxpayers having no capital gains will discourage investment, which is contrary to one of the principal goals of the capital gains preference generally. Finally, attacking two of the underlying causes of cherrypicking, undistributed corporate earnings and the stepped-up basis at death, should go a long way toward alleviating this negative taxpayer behavior.

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191. There are, of course, mechanisms currently in place in the Code to encourage corporations to distribute their earnings annually, such as the accumulated earnings tax and the personal holding company tax, in which a corporation's undistributed earnings and undistributed personal holding company income, respectively, are taxed at the highest individual rates. See I.R.C. §§ 531, 541 (1994). Yet these provisions, as currently designed, merely act as a trap for the unwary. Savvy tax planners can work around them.


193. See supra notes 68-97 and accompanying text.

194. See I.R.C. § 1014 (1994); see also supra notes 116-17 and accompanying text.

195. See supra note 123.

196. For a more complete discussion of the need for realization for purposes of administrative feasibility, see supra notes 75-97 and accompanying text.

197. See, e.g., Kahn, supra note 151, at 57-58; Scarborough, supra note 96, at 680-81.
B. Designing a Better Loss Limitation System

Because the present loss limitation system is inherently flawed, it needs to be repealed and replaced with a new system that is more theoretically sound. This new system must further the twin policy considerations of parallelism and the avoidance of bunching. Moreover, the system should be fundamentally fair to all taxpayers and encourage investor risk-taking by promoting economic efficiency. Finally, such a system must be politically feasible; that is, it must be designed in such a manner that it has a reasonable likelihood of success in Congress. Otherwise, this proposal, like so many others that have come before it, will be relegated to a mere law review citation rather than being a foundation upon which the tax system is improved.

This section proposes a new paradigm for limiting the deductibility of capital losses. The proposal itself is really quite simple; in application, however, the proposal adds further complexity to the already cumbersome Internal Revenue Code. The complexity concern is addressed at the end of this article.198

Under this proposal, capital losses could be used to offset any type of income, including wages and investment income taxed at ordinary income rates; however, the benefits that taxpayers derive from deducting these losses against income otherwise taxed at ordinary rates would be capped at the tax rate applicable had the capital losses instead been corresponding capital gains. Two simple examples illustrate this basic premise.

In the first example, assume that T, a single taxpayer, purchased 100 shares of stock of Widget Corporation for $10,000 on January 2, 1997. By June of 1998, T's stock in Widget had dropped in value to $6,000, and he sold the stock at that time, realizing a $4,000 long-term capital loss.2
During 1998, T earned $75,000 in wages from his job and had no other income. Ignoring any deductions to which T would otherwise be entitled (for ease of calculation), his wage income would be taxed at a maximum rate of 31% for 1998. Thus, had T's $4,000 long-term capital loss instead been a long-term capital gain, it would have been taxed at a flat 20% rate.210 Accordingly, under this new loss limitation paradigm, T's $4,000

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198. See infra notes 282-91 and accompanying text.
199. When I speak of capital losses throughout the remainder of this article, I refer only to those capital losses that are otherwise deductible under § 165(c) of the Code. See I.R.C. § 165(c) (West 1988 & West Supp. 1998). Thus, losses incurred on the sale or exchange of a personal-use asset, such as a recreational boat or vehicle or a principal residence, which are not currently deductible under § 165(c), would not be deductible under my proposal. The issue of whether such losses should be deductible is a full and robust topic best left to another day and article.
200. Because the Widget stock was held for the production of income, it was a capital asset in T's hands. See I.R.C. § 1221 (1994). Moreover, because T's disposition of the stock constituted a sale or exchange of the capital asset, the resulting loss was a capital loss. See id. § 1222. Finally, T had held the Widget stock for more than one year before disposing of it; therefore, the resulting capital loss was long term in nature. See I.R.C. § 1222(4) (West 1988 & West Supp. 1998).
201. Recall that not all long-term capital gains are taxed at a 20% rate for taxpayers in the 28%
loss could be used to offset $4,000 of his wage income, but the benefit of this offset would be capped at a 20% tax savings. Therefore, because T's wage income would otherwise have been taxed at a 31% rate, T would be required to pay an 11% tax on that income (representing the differential between the 31% ordinary income rate on that $4,000 less the 20% rate accorded to long-term capital gains). 202

In the second scenario, assume the same facts except that T purchased his Widget Corporation stock on January 2, 1998, instead of January 2, 1997. Thus, when T sold his stock in June of 1998, his resulting $4,000 capital loss was short-term rather than long-term in nature. 203 Had this $4,000 short-term capital loss instead been a $4,000 short-term capital gain, the gain would have been taxed at T's otherwise applicable ordinary income tax rate of 31%. Accordingly, under the new loss limitation paradigm, T would be entitled to offset the $4,000 capital loss against his ordinary income in full without incurring any additional tax liability. This result seems intuitively correct because, had the short-term capital loss instead been a short-term capital gain, it would have been taxed at ordinary income rates and received no preferential tax treatment. Under such circumstances, allowing the short-term capital loss to be deductible in full promotes the policy goal of parallelism, as discussed in the sections that follow. 204

1. Added Complexity Attributable to a Progressive Tax Rate Structure

The foregoing illustrations demonstrate that the basic structure of the proposal is relatively straightforward to apply. Its complexity is, in large part, a direct result of the progressivity of the tax rate structure. For example, consider a taxpayer who has a relatively large long-term capital loss and whose ordinary income otherwise falls near the bottom of a tax bracket. Such a taxpayer could find that her loss offsets income that tax bracket or above. For example, long-term capital gains arising out of the sale of collectibles are taxed at a 28% rate, while unrecaptured § 1250 gain is taxed at a 25% rate (for taxpayers in the 15% tax bracket, both types of gain are taxed at a 15% rate). See supra notes 98-100 and accompanying text. Moreover, the general 20% long-term capital gains rate is reduced to 18% for assets acquired after December 31, 2000, and held for more than five years (with a similar reduction to 8% for long-term capital gains otherwise taxed at 10%). See supra notes 101-02 and accompanying text. These varying rates will also add significant complexity as this proposal is applied to the unlimited combinations of capital assets that taxpayers sell each year. Of course, this added complexity is attributable not to the proposal set forth in this article but instead to the differing capital gains rates established in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788. Whether these differing capital gains rates can be justified from a policy standpoint is an interesting question, again best left to another article.

202. Considering how much intuitive sense this proposal makes, it is astonishing that no tax scholar has seriously considered such a proposal before. For a passing reference to this notion nearly 40 years ago, see Smith, supra note 109, at 150; see also U.S. Treasury Dep't, Federal Income Tax Treatment of Capital Gains and Losses 103 (1951).

203. The resulting loss was a short-term capital loss because T had held his capital asset for one year or less prior to its sale. See I.R.C. § 1222(2) (West 1988 & West Supp. 1998).

204. See infra notes 228-41 and accompanying text.
spans two tax brackets, resulting in a portion of the loss being taxed at one tax rate and the remainder at a slightly higher rate.205

Similarly, recall that a taxpayer in the 15% tax bracket will find that her capital gains are taxed at a maximum rate of 10%.206 If a taxpayer otherwise in the 15% bracket suffers a long-term capital loss, calculations under this proposal become more complicated, again because of the progressivity of the tax rate structure. Had the long-term capital loss instead been a gain, the gain would have been taxed at a 10% rate but only to the extent that it “filled up” the taxpayer’s 15% tax bracket. The remaining capital gain would have been taxed at a maximum rate of 20%.207 Yet because the taxpayer is only in the 15% tax bracket, offsetting a portion of her income at a 20% rate would require a subsidy from the government, which this proposal does not suggest.208 Accordingly, this loss limitation scheme is modified in this circumstance to provide that the tax rate differential paid by the taxpayer on a long-term capital loss is equal to the difference between the taxpayer’s ordinary income and the tax rate applicable to the loss had it instead been a gain in the 15% tax bracket. Thus, a taxpayer in the 15% bracket would offset his ordinary income with the long-term capital loss up to a maximum tax savings of 10% because, had the loss instead been a gain in the 15% tax bracket, it would have been taxed at a maximum rate of 10%.209

205. For example, assume that T, a single taxpayer, sells her stock and realizes a $10,000 long-term capital loss. Ignoring any applicable deductions for ease of calculation, if T’s taxable income (without taking into consideration the loss) is $120,000 and the top of the 31% tax bracket is $115,000 for single taxpayers, $5,000 of the loss will offset income in the 36% tax bracket, while the remaining $5,000 loss will offset income in the 31% tax bracket. If this loss had been a gain and thus taxed at a 20% rate, under this proposal T would be required to pay an 11% tax on $5,000 of income offset by half of the capital loss (the 31% otherwise applicable tax rate minus the 20% tax rate applicable to long-term capital gains), and T would also be required to pay a 16% tax on the $5,000 of ordinary income offset by the other half of the capital loss (36% minus 20%). A very large long-term capital loss could span three or four tax brackets, requiring a taxpayer to make separate calculations with respect to that portion of the loss offsetting income in each separate tax bracket.

206. See I.R.C. § 1(h) (West 1988 & West Supps. 1998 & Oct. 1998); see also supra note 100 and accompanying text.


208. As discussed supra notes 92-97 and accompanying text, although governmental subsidies and refunds might be theoretically sound under traditional notions of an ideal income tax, they are administratively unfeasible.

209. For example, assume that taxpayer T is a single individual who earns $24,000 per year. Assume further that the top of the 15% tax bracket for single taxpayers is $25,000. If T suffers a $5,000 long-term capital loss on the sale of Widget Corporation stock, $1,000 of that loss (assuming no deductions for ease of computation) would have “filled up” T’s 15% tax bracket had the loss instead been a gain. Thus, $1,000 of the $5,000 long-term capital loss would offset T’s $24,000 salary at a maximum tax savings of 10%. T would be required to pay tax at a 5% rate on that $1,000 of ordinary income offset by the loss (15% ordinary income tax bracket less the 10% maximum long-term capital gain rate). Because the remaining $4,000 loss, had it instead been a gain, would have been taxed at a maximum rate of 20%, it would be incongruous to allow T to offset income otherwise taxed in the 15% tax bracket with a loss valued at a 20% tax rate. Accordingly, under this proposal, that additional $4,000 loss could offset $4,000 of T’s ordinary income at the 10% rate otherwise applicable to long-term capital gains in the 15% tax bracket. Thus, T will pay a 5% rate differential on the entire $5,000 loss because, had it instead been a gain in the 15% tax bracket, it would have been taxed at a 10% preferential rate.
Additional complexities arise when a taxpayer's long-term capital loss offsets income both in the 15% tax bracket and the 28% tax bracket. For example, assume that our single taxpayer, T, earns $28,000 in 1998, and the maximum amount of income that could be earned in the 15% tax bracket for a single taxpayer in 1998 is $25,000. If T suffers an $8,000 long-term capital loss in 1998, and the loss had instead been a gain, it would have been taxed at a maximum rate of 20%, because T is in the 28% tax bracket. Yet only $3,000 of that loss is offsetting income in the 28% tax bracket; the remaining $5,000 loss is offsetting income in the 15% tax bracket. Accordingly, the proposal suggests that in such a situation, the loss limitation calculation be broken into two parts. First, the $3,000 loss that offsets T's income in the 28% tax bracket, had it instead been a gain, would have been taxed at a maximum rate of 20%. Therefore, the ordinary income offset by that $3,000 loss should be taxed at a rate of 8% (the 28% rate otherwise applicable to ordinary income less the 20% maximum long-term capital gains rate). The remaining $5,000 loss, however, now offsets income in the 15% tax bracket, and a long-term capital gain for a taxpayer in the 15% tax bracket would be taxed at a maximum rate of 10%. Thus, T's income that is offset by this $5,000 loss should be taxed at a maximum rate of 5% (the 15% tax bracket otherwise applicable to ordinary income less the 10% maximum long-term capital gains rate).

2. Application of the Netting Process to the Proposal

The proposal would also retain a portion of the netting process, whereby long-term capital losses first offset long-term capital gains and short-term capital losses first offset short-term capital gains before being allowed to offset other income. Retention of this portion of the netting process would actually simplify the application of the proposal under certain circumstances. Consider, for example, a taxpayer in the 36% tax bracket with a long-term capital gain of $8,000 and a long-term capital loss of $5,000. Netting the $5,000 loss against the $8,000 gain would result in a long-term capital gain of $3,000 taxed at a rate of 10% (the 36% rate otherwise applicable to ordinary income less the 10% maximum long-term capital gains rate). If the gains exceed the losses under the § 1231 netting process, any remaining gains will be taxed at the 36% rate. Thus, the proposal would do nothing to change the § 1231 netting process; however, if long-term capital gains and losses result from this netting process, my proposal would then apply to limit the deductibility of the long-term capital losses. It should be noted, though, that because long-term capital losses will first be netted against long-term capital gains, as set forth in this section, and inasmuch as the gains by definition have already exceeded the losses under the § 1231 netting process, application of the proposal will merely result in the long-term capital losses being completely offset by the long-term capital gains.

210. This proposal is unaffected by the netting process prescribed in § 1231 of the Code. See I.R.C. § 1231 (1994). That section generally provides that gains and losses from the sale, exchange, or compulsory or involuntary conversion of property used in a taxpayer's trade or business and held for more than one year be netted together; if the gains exceed the losses after this netting process is completed, then all of the individual gains and losses will be treated as long-term capital gains and losses. If, on the other hand, the losses exceed the gains as a result of this netting process, then each gain and loss will be treated as an ordinary gain and an ordinary loss, respectively. See I.R.C. § 1231(a)(1)-(2) (West 1998 & West Supp. 1998). This proposal would do nothing to change the § 1231 netting process; however, if long-term capital gains and losses result from this netting process, my proposal would then apply to limit the deductibility of the long-term capital losses. It should be noted, though, that because long-term capital losses will first be netted against long-term capital gains, as set forth in this section, and inasmuch as the gains by definition have already exceeded the losses under the § 1231 netting process, application of the proposal will merely result in the long-term capital losses being completely offset by the long-term capital gains.

211. For a complete discussion of the netting process, see supra note 128.
in a net $3,000 long-term capital gain. Thus, none of the loss would be offset against the taxpayer's ordinary income. Yet, the result to the taxpayer is the same as it would have been absent the netting process; in both cases, the taxpayer used his long-term capital loss to offset income otherwise taxed at a 20% rate.\textsuperscript{212}

The portion of the netting process, however, that allows a taxpayer to offset net long-term capital losses against net short-term capital gains is antithetical to the policies underlying this proposal and, thus, would be repealed under it.\textsuperscript{213} This is because the netting process allows long-term capital losses, generally taxed at a 20% rate had they instead been gains, to offset short-term capital gains otherwise taxed at ordinary income rates. Under this article's proposed approach, if this portion of the netting process were to remain, it would result in a lack of horizontal equity between taxpayers; two taxpayers with equal incomes and equal long-term capital losses would be treated differently, simply because one taxpayer fortuitously had a short-term capital gain against which to offset the loss, while the other taxpayer did not.\textsuperscript{214} Similarly, the portion of the netting process that requires taxpayers to offset net short-term capital gains against net long-term capital losses should also be repealed for the same reason.\textsuperscript{215}

\textsuperscript{212} This is true because, had the taxpayer had no long-term capital gains, he would have offset the loss against $5,000 of ordinary income otherwise taxed at a 36% rate; however, he would have been required to pay a 16% tax on that income (the 36% ordinary income rate less the 20% rate applicable to long-term capital gains).

\textsuperscript{213} It is interesting to note that this repeal of "cross-netting" was proposed once in 1938 but did not find its way into the law. \textit{See} S\textsc{ubcomm. Of C\textsc{omm. On W\textsc{ays & M\textsc{eans}}, 75t\textsc{h C\textsc{ong.}}, R\textit{eport On A P\textit{roposed R\textit{evision Of The R\textit{evenue L\textit{aws}} 48 (Comm. Print 1938), reprinted in 21 I\textit{nternal R\textit{evenue A\textit{cts Of The United States}} 1909-1950, supra note 23, at 48. The Report states that [t]he other and major change consists in the fact that the individual would be deprived of the privilege of using short-term capital losses to offset long-term capital gains and vice versa. Your subcommittee believes that the adoption of this recommendation will remove another substantial defect in the existing law as it applies to capital gains and losses, a defect which has had a serious detrimental effect upon the revenue. \textit{Id.}, reprinted in 21 I\textit{nternal R\textit{evenue A\textit{cts Of United States}} 1909-1950, supra note 23, at 48.}

\textsuperscript{214} For example, Taxpayer A and Taxpayer B are both in the 28% tax bracket, and both have a long-term capital loss of $10,000. Taxpayer A also has a short-term capital gain of $10,000, while Taxpayer B does not. Thus, if this portion of the netting process were retained, Taxpayer A would be entitled to offset his $10,000 long-term capital loss against his $10,000 short-term capital gain, with a resulting tax savings of 28% (because short-term capital gains are taxed at ordinary income rates). Taxpayer B, on the other hand, would offset his $10,000 long-term capital loss against his ordinary income but would be required to pay an 8% tax on the $10,000 of income offset by that loss (the 28% tax rate otherwise applicable to ordinary income less the 20% tax rate applicable to long-term gains). Accordingly, Taxpayer A is in a better position than Taxpayer B simply because of the fortuitous circumstance that he had an offsetting short-term capital gain. Of course, this disparate tax treatment violates traditional notions of horizontal equity (that similarly situated taxpayers should be treated similarly). For a more complete discussion of the concept of horizontal equity, see \textit{infra} notes 235-37 and accompanying text.

\textsuperscript{215} This portion of the netting process violates horizontal equity because a taxpayer with a net short-term capital loss who fortuitously has a net long-term capital gain is required to first offset the short-term loss against the long-term gain, even though, had the loss instead been a gain, it would have been taxed at ordinary income rates and is instead offsetting income that would have been taxed at a preferential capital gains rate.
3. Ordering of Capital Losses

When taxpayers have both short-term and long-term capital losses in a taxable year (after netting them against corresponding capital gains), the order in which those losses are offset against ordinary income under this proposal can have a dramatic impact on a taxpayer's ultimate tax liability under certain circumstances. Consider, for example, a somewhat implausible scenario in which single taxpayer T has a $20,000 long-term capital loss and a $20,000 short-term capital loss in 1998 and earns $20,000 in that year. Ignoring any possible deductions, if T were permitted to offset his short-term capital loss against his wages before using his long-term capital loss, then the short-term capital loss would offset the wages in full, and T would have no tax liability for the year because the short-term capital loss, had it instead been a short-term capital gain, would have been taxed at ordinary income rates. Conversely, if T were instead forced to offset his long-term capital loss against his ordinary income first, he would have to pay a 5% tax on that income, because the loss, had it instead been a gain, would have been taxed at a 10% rate instead of the 15% rate otherwise applicable to his ordinary income. Under current law, T would be entitled in both situations to carry over the unused $20,000 capital loss to future years, where it would retain its character as either a short-term or long-term capital loss. Nevertheless, a tax savings in the current year is almost always preferable to a tax savings in a future year; thus, the order of deductibility of the short-term and long-term capital losses is still of paramount importance to T.

A similar situation in which the ordering of capital losses can result in very different tax liabilities to the taxpayer occurs when the short-term and long-term capital losses, when taken in combination, place the taxpayer in a lower effective tax bracket. For example, in the previous example, assume that T earned $35,000 in 1998 and had a $10,000 long-term capital loss and a $10,000 short-term capital loss. Assume further that the maximum income level in the 15% tax bracket for a single taxpayer in 1998 was $25,000. If T could use his short-term capital loss first to offset his ordinary income, the loss would reduce his taxable income to $25,000. Then, applying T's $10,000 long-term capital loss, T would be required to pay only a 5% tax on the $10,000 of ordinary income offset by that loss (15% ordinary income rate less the applicable 10% maximum long-term capital gains rate). Conversely, if T were first required to use his long-term loss to offset ordinary income, the $10,000 of income offset by that loss would be taxed at a rate of 8% (the 28% rate application...
THE DEDUCTIBILITY OF CAPITAL LOSSES

ble to ordinary income less the 20% maximum long-term capital gains rate). This same phenomenon would occur if T's income straddled, for example, the 31% and 36% tax brackets. Thus, in each of these scenarios it becomes necessary to determine how to order the deductibility of short- and long-term capital losses.

The proposal resolves this difficult dilemma by providing that short-term capital losses be used before long-term capital losses. This solution is favorable to taxpayers (a position the government tends to disfavor) yet can also be justified on sound policy grounds. When taxpayers realize that they have made imprudent investment choices, liquidating those investments at the earliest possible moment and reinvesting the proceeds in more prudent investments is an economically sound decision because it puts the money toward its highest and best use. As a capitalist society concerned with true economic growth, we encourage this type of economic efficiency in the marketplace. Thus, by allowing taxpayers to offset short-term capital losses against ordinary income first, the proposal encourages this type of economically efficient investment behavior.

The final ordering issue concerns the sequence in which long-term capital losses resulting from the sale of assets that would have produced long-term capital gains taxed at varying rates, such as collectibles and assets held for more than five years and purchased after December 31, 2000 should be used to offset a taxpayer's ordinary income. The Treasury Department has already provided guidance on this issue in another context. In Notice 97-59, the Treasury Department stated that in the section 1231 context, if capital gains were required to be recaptured as ordinary income under that section's lookback rule, those gains subject to the highest tax rate would first be recharacterized as ordinary income. The other remaining gains would be recharacterized in descending order of applicable tax rates.

The proposal outlined in this article adopts the ordering rules established in Notice 97-59 but as applied to losses rather than gains. Thus, losses resulting from an individual's sale of collectibles would first be used to offset ordinary income because, had the losses instead been gains, they would have been taxed at the highest long-term capital gains rate of 28%. Next, losses resulting from the sale of general capital assets would be applied to reduce ordinary income because these losses

218. For a more complete discussion of why this proposal promotes economic efficiency, see infra notes 242-51 and accompanying text.
219. For a discussion of the differing capital gains rates applicable to these assets, see supra notes 100-02 and accompanying text.
222. These would generally be gains from the sale of collectibles, which are taxed at a 28% rate. See I.R.C. § 1(h)(5) (West 1988 & West Supps. 1998 & Oct. 1998). These ordering rules are generally quite favorable to taxpayers in the § 1231 context.
224. See I.R.C. § 1(h)(5).

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would have been taxed at a preferential rate of 20% had they been gains.\textsuperscript{225} Finally, capital losses resulting from the sale of capital assets purchased after December 31, 2000, and held for more than five years would reduce the taxpayer's income because such losses would have been taxed at an 18% rate had they been gains.\textsuperscript{226} Although these ordering rules are generally not favorable to taxpayers when applied to losses (rather than gains, as in Notice 97-59), they are adopted by analogy in this proposal for purposes of consistency, a goal that should be sought in statutory drafting whenever possible.\textsuperscript{227}

C. Policy Justifications for the Loss Limitation Proposal

This new paradigm for limiting the deductibility of capital losses is more theoretically sound than its predecessor in every sense. First, the paradigm is premised on liability/savings parallelism rather than inclusion/deduction parallelism.\textsuperscript{228} Accordingly, it is more fundamentally fair than the current system because, unlike the current system, it does not assume that taxpayers with capital losses have corresponding capital gains with which to offset those losses. Similarly, the new paradigm is more economically efficient; it allows taxpayers with true economic losses to recoup those losses and use the resulting proceeds to invest in more profitable ventures. Accordingly, the new paradigm permits taxpayers to put their money to its highest and best use, thereby spurring economic growth. Finally, the paradigm is not only theoretically sound but also, based on current public choice theory, has a reasonable likelihood of success in the political arena. The discussion that follows thus justifies the new loss limitation paradigm on the grounds of fundamental fairness, economic efficiency, and political feasibility.

\textsuperscript{225} See id. § 1(h)(1)(C). Note that there is no reference to a loss resulting from the sale of § 1250 property because gains from the sale of § 1250 property are taxed at a rate of 25% only to the extent that the gain represents unrecovered § 1250 gain. There would be no such gain inherent in the sale of § 1250 property at a loss; thus, no 25% capital losses would ever offset income. See I.R.C. § 1(h)(7) (West Supp. Oct. 1998).

\textsuperscript{226} See I.R.C. § 1(h)(2)(B) (West 1988 & West Supps. 1998 & Oct. 1998). For taxpayers in the 15% tax bracket, losses resulting from the sale of collectibles would also be used first to offset ordinary income because, had the losses instead been gains, the losses would have been taxed at a 15% rate. Next, losses resulting from the sale of general capital assets would be used to offset ordinary income because general capital gains would have been taxed at a 10% rate. Finally, losses resulting from the sale of capital assets that are sold after December 31, 2000, and held for more than five years would offset ordinary income because such losses, had they instead been gains, would have been taxed at an 8% rate. See generally id. § 1(h)(2)(A).

\textsuperscript{227} Cf., e.g., ABNER J. MIKVA & ERIC LANE, AN INTRODUCTION TO STATUTORY INTERPRETATION AND THE LEGISLATIVE PROCESS 24 (1997) ("A statute should be read to avoid internal inconsistencies.").

\textsuperscript{228} For a complete discussion of these concepts, see supra notes 140-49 and accompanying text.
I. Fundamental Fairness

One of the cornerstones of the income tax system is that it is based on fundamental fairness for all taxpayers. When Congress passed the landmark Tax Reform Act of 1986, the Act was premised on notions of fundamental fairness:

The perception of fairness may be as important as fairness itself as a goal of tax policy. The United States was once justly proud of the taxpayer morale of its citizens. With media coverage of tax shelters now commonplace and talk of “beating the system” prevalent in conversation, taxpayers increasingly view the tax system as unfair and wonder why they should pay taxes. One of the primary goals of the Treasury Department study of fundamental tax reform is the reversal of this threatening trend. Adoption of fairer tax rules would have a multiplier effect, as increased fairness would lead to an improved perception of fairness and, in turn, to better compliance.

Yet despite the fact that the income tax system is purportedly based on fundamental fairness notions, the current scheme for limiting the deductibility of capital losses is anything but fair for many taxpayers. Because the current loss limitation scheme is designed primarily to discourage the tax avoidance scheme of cherrypicking, its foundation is based on inclusion/deduction parallelism. As discussed previously, under inclusion/deduction parallelism, the dollar amount of capital gains included in the taxpayer’s income equals the dollar amount of capital losses deducted from the taxpayer’s income. This type of parallelism assumes that taxpayers with capital losses also have corresponding capital gains and recognizes that they will be forced to sell the gain property to offset their capital losses. Thus, although the present loss limitation system is well designed to prevent cherrypicking by taxpayers with capital gains and losses, it denies nearly any loss deduction for taxpayers with true economic losses unfortunate enough not to have corresponding capital gains with which to offset those losses.

232. See supra notes 143-44 and accompanying text.
233. Of course, individual taxpayers can offset capital losses against a measly $3,000 of ordinary income. See I.R.C. § 1211(b) (1994). On the other hand, for corporations that are allowed to deduct capital losses only against capital gains, the current system could deny them any deductibility of their legitimate economic losses. Moreover, even for taxpayers with capital gains and capital losses in their portfolios, requiring those taxpayers to sell capital gains property to offset their capital losses could require them to liquidate a profitable investment, thereby undermining economic efficiency in the
The new loss limitation paradigm set forth in this article, on the other hand, is premised on notions of liability/savings parallelism. Under this type of parallelism, the tax savings resulting from deducting a capital loss against ordinary income should equal the tax liability resulting from the inclusion of a capital gain in income. This proposal does just that. It first recognizes that parallelism, which attempts to counterbalance preferential capital gains rates by limiting the deductibility of capital losses, is a sound policy justification for loss limitations generally. It then designs a system for limiting those losses that is premised on the only fair type of parallelism, liability/savings parallelism. Because the new paradigm allows taxpayers to offset their capital losses against any type of income, it is more fundamentally fair to all taxpayers, even those who do not have corresponding capital gains. Yet because the proposal caps the tax savings at the rate otherwise accorded capital gains, it thus balances the total tax benefit granted to taxpayers on their capital gains and losses.

It is a well-established principle of tax law that for a tax system to be equitable, or fundamentally fair, it must at a minimum achieve horizontal equity. Of course, defining when taxpayers are in equal positions is often difficult. For example, two single taxpayers earning identical amounts will have different tax burdens if one taxpayer owns a home while the other rents a home. This is so because Congress has decided to encourage home ownership by allowing deductions for interest paid on a home mortgage and not allowing a deduction for rent paid on a principal residence. Thus, taxpayers with identical income levels are not equally situated if there is a valid policy justification for treating the two taxpayers differently.

marketplace. For a discussion of the economic efficiency arguments supporting the new loss limitation paradigm, see infra notes 242-51 and accompanying text.

234. Although the proposal outlined in this article promotes fundamental fairness for all taxpayers, it does not render all taxpayers better off than they are under the current system. For example, a taxpayer who has only a $3,000 long-term capital loss can fully deduct that loss against $3,000 of ordinary income under I.R.C. § 1211(b) (1994). Under the new proposal, the taxpayer could still offset the loss against ordinary income, but there would be a tax cost for doing so equal to the difference between the taxpayer’s marginal tax rate applicable to ordinary income and the 20% rate applicable to capital gains. Thus, even though the proposed loss limitation scheme is more fundamentally fair for all taxpayers, that does not mean that all taxpayers benefit under the proposal.

235. See, e.g., 1984 TREASURY REPORT, supra note 231, at 14 (“A tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair.”); Richard A. Musgrave, ET, OT and SBT, 6 J. PUB. ECON. 3, 4-5 (1976), reprinted in RICHARD A. MUSGRAVE, PUBLIC FINANCE IN A DEMOCRATIC SOCIETY 260, 260-61 (1986); see also Stuart Rosow, The Treasury’s Reform Proposals: Not a Fair Tax, 3 YALE L. & POL’Y REV. 58, 61 (1984). Of course, an equitable tax system must also achieve vertical equity, in which taxpayers having differing income levels “pay differing proportions of their income in tax.” Id.; see also MUSGRAVE, supra, at 261. The current system’s progressive tax rate structure is said to achieve vertical equity, although not all scholars have accepted this conclusion. See, e.g., Rosow, supra, at 62.


237. See I.R.C. § 163(h)(3) (West 1988 & West Supp. 1998). One could certainly argue that there is no valid policy justification for encouraging home ownership over home rental, but that contention is beyond the scope of this article.
ers differently by, for example, allowing expenses of only one taxpayer to be deducted against his income.

Under the current loss limitation system, two equally situated taxpayers with identical income levels and capital losses could experience quite different tax burdens simply because one taxpayer had capital gains against which to offset his capital losses and the other taxpayer did not. Because there is no policy justification for penalizing a taxpayer for lack of capital gains, the current system clearly violates notions of horizontal equity.

Conversely, the proposal set forth in this article satisfies horizontal equity by eliminating this unwarranted distinction between taxpayers. It is a more equitable system than the system currently in place, thereby promoting fundamental fairness and encouraging taxpayer compliance with the tax laws.

The new loss limitation paradigm also promotes notions of fundamental fairness in other ways. For example, under the current system, even though short-term capital gains are taxed at ordinary income rates, short-term capital losses are nevertheless limited in deductibility and often must be used under the netting process to offset long-term capital gains, otherwise taxed at preferential rates. Under the new proposal, however, short-term capital losses need only be netted against short-term capital gains. Any unused loss resulting from this netting process can offset ordinary income in full. This scheme promotes notions of fundamental fairness because, unlike the current system, it recognizes the differences inherent in the taxation of short-term and long-term capital gains. It simply makes intuitive sense that if capital gains are taxed at ordinary income rates, corresponding losses should be entitled to offset ordinary income in full. Moreover, recognizing that fundamental fairness concerns apply to the government as well, the converse is true with respect to long-term capital losses. Under the current system, long-term capital losses can offset short-term capital gains otherwise taxed at ordinary income rates. Because the new proposal permits long-term capital losses to offset only long-term capital gains before offsetting ordinary income at a reduced rate, it protects the government against lost revenue resulting from long-term capital losses offsetting short-term capital gains in full.

Finally, the new loss limitation paradigm alleviates the bunching problem caused when losses accruing over a number of years are consolidated into the single year of sale. Because a large capital loss realized in a single tax year could, under certain circumstances, enable taxpayers to move into lower tax brackets, the proposal accounts for such a windfall by capping the tax savings generated by the loss at the tax rate otherwise accorded capital gains. Moreover, to the extent that the loss is a

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238. See I.R.C. § 1222 (1994); see also supra note 126 and accompanying text.

239. For a more complete discussion of the bunching concept, see supra notes 158-60 and accompanying text.
short-term capital loss, the proposal recognizes that bunching is not a problem to be remedied\(^{240}\) by allowing the loss to offset ordinary income in full with no tax liability differential. Although the current loss limitation system also attempts to alleviate the bunching problem, it again does so only for taxpayers who have capital gains with which to offset their losses.\(^{241}\)

2. Economic Efficiency

I begin this section with a seemingly obvious assumption but one that does not appear to have been taken into consideration in creating the current loss limitation system: economic growth is positive and should be encouraged.\(^{242}\) Economists have long recognized that to encourage economic growth, taxpayers must invest in risky undertakings:\(^{243}\) "[R]isk investment is especially important for economic growth . . . Special taxation [of capital gains and losses] is advocated to increase the total amount of capital, to encourage its [use] in more risky investments, and to prevent successful investments from being frozen into their existing form."\(^{244}\) Because every investment, and particular a risky investment, involves the possibility that taxpayers will suffer losses, investments will not be made unless taxpayers determine that the possible return on their investments is sufficiently high to offset the risk of possible losses.\(^{245}\) As discussed previously, two noted economists, Domar and Musgrave, have demonstrated that allowing capital losses to be offset in full would encourage taxpayers to invest in riskier ventures than if losses could not be deducted.\(^{246}\)

To encourage taxpayers to undertake risky investments, thereby stimulating economic growth, a loss limitation system must be economically efficient. When I use economic efficiency in this context, I am referring to the basic economic principle that resources are being used efficiently when they are employed in their highest and most valuable use.\(^{247}\)

\(^{240}\) This is so because the taxpayer would have held the property for one year or less under I.R.C. § 1222(2) (West 1988 & West Supp. 1998), thereby causing no bunching of losses that accrued over many years into the year of sale.

\(^{241}\) It is recognized that, if bunching were the primary policy justification for limiting the deductibility of capital losses, both the proposal outlined in this article and the current tax system would be imprecise means by which to alleviate the bunching problem. See, e.g., Snoe, supra note 105, at 71; see also Cunningham & Schenk, supra note 34, at 328. A more precise remedy for the bunching problem would be to require that capital losses accruing over several years be deducted ratably over those years. See, e.g., Andrews, supra note 36, at 1132-33 (proposing such a solution with respect to the bunching problem inherent in taxing capital gains).


\(^{243}\) See id. at 109-10; see also supra notes 136-38 and accompanying text.

\(^{244}\) See POSNER, supra note 107, at 9. The concept of economic efficiency is, of course, far more
The current loss limitation system is not economically efficient because taxpayers are encouraged to retain economically unproductive assets (loss assets) until they have assets with gains to sell so that the gains can be used to offset those losses.\(^{248}\) Thus, the current system is economically inefficient because it discards taxpayers from investing their resources in such a manner as to produce the highest value. Conversely, because the new loss limitation system proposed in this article does not depend on the existence of capital gains as a prerequisite to the deductibility of capital losses, it encourages losses to be taken as soon as taxpayers determine that their investments are economically unfeasible.\(^{249}\) Because taxpayers can use their capital losses to offset income currently, they can more readily reinvest the proceeds in more profitable ventures, thereby putting their assets to their highest and best use.

Economic efficiency has also been promoted in the tax law through the use of economic neutrality. The Treasury Department recently stated that its foremost tax reform goal is to promote economic neutrality.\(^{250}\) By using the concept of economic neutrality, "the Treasury manifests its judgment that the tax system should not interfere with a free market economy, which tends 'to allocate economic resources to their most productive uses.'"\(^{251}\) The new loss limitation paradigm set forth in this article promotes economic neutrality because it permits investors to decide complex than is stated in the text of this article. Economists have separately classified at least three different types of economic efficiency. "Under the Kaldor-Hicks definition of efficiency, a change from one state of affairs to another is efficient if the winners could compensate the losers." Patrick B. Crawford, The Utility of the Efficiency/Equity Dichotomy in Tax Policy Analysis, 16 VA. TAX REV. 501, 519 (1997); see also Edward J. McCaffery, Slouching Towards Equality: Gender Discrimination, Market Efficiency, and Social Change, 103 YALE L.J. 595, 636 (1994) ("The Kaldor-Hicks standard holds that a given allocation of resources is efficient if the gains to the winners are large enough such that the winners could compensate the losers and still be better off."). Most commentators recognize that the Kaldor-Hicks definition of efficiency is the most commonly used notion of efficiency in law and economics literature. See POSNER, supra note 107, at 13; McCaffery, supra, at 636.

The second notion of economic efficiency is Pareto superiority. "A Pareto-superior transaction is one that makes at least one person in the world better off and no one worse off." POSNER, supra note 107, at 12. Thus, Pareto superiority is similar to Kaldor-Hicks efficiency, except that those who have benefited from a change in the law actually compensate those who lose as a result of such a change. See McCaffery, supra, at 638.

The final type of efficiency often used by economists is Pareto optimality. "A state of affairs is Pareto optimal when no change from such a state is possible that results in one person being better off without making another person worse off." Crawford, supra, at 516; see also McCaffery, supra, at 638.

When the term "efficiency" is used in this article, the concept of Kaldor-Hicks efficiency is being employed. Those taxpayers who stand to benefit from the more favorable deductibility of their capital losses are not being forced to compensate the "losers," those who might be required to pay more in taxes to offset the revenue loss resulting from the proposal. Thus, although Pareto superiority could be met with this proposal because "the winners could compensate the losers," POSNER, supra note 107, at 13, the proposal does not call for such direct compensation.

248. In the absence of a current tax benefit from the sale of loss assets, taxpayers will likely retain the loss assets in the hope that they will turn around and become profitable.

249. Accordingly, the loss limitation paradigm set forth in this article comports with the admonition of Domar and Musgrave that the current tax system should be modified so as to allow for more favorable loss offsets for every type of investor. See MUSgrave, supra note 137, at 111.


251. Rosow, supra note 235, at 64 (quoting 1984 TREASURY REPORT, supra note 231, at 13).
whether it is economically efficient for them to sell their loss assets and reinvest the proceeds in other ventures, wholly apart from tax considerations.

3. Political Feasibility

Current legal literature contains a vast and ever-increasing number of proposals to reform the income tax system. The sheer number of articles concerning tax reform is a tribute to the growing notion that reform is still necessary. Many proposals calling for a change in the current tax system, however, have little chance of ever being adopted by Congress. Such proposals may indeed illustrate inequity or inefficiency in the tax system but do not have even a remote chance of becoming law because they fail to demonstrate adequately how to solve the problems they address. Such proposals tend to be academic exercises in theory and logic rather than workable solutions that Congress might adopt.

The political journey that a good proposal takes before it becomes law is long and difficult, in large part because the proposal must satisfy the desires of interest groups. Public choice theory, which studies the application of economic theory to political processes, has examined the use of political power wielded by interest groups as a means for understanding the legislative process. In this section, I use public choice theory to demonstrate that the loss limitation paradigm set forth in this article is more than just an academic daydream; rather, it is politically feasible and can be used to improve the income tax system.

Recognizing that interest groups play a dominant role in shaping legislation, two noted political scientists pioneered a new theoretical


253. Tax scholars have long recognized that the proposed changes to the income tax system most seriously considered are the ones advocating incremental changes to the system rather than those arguing for fundamental and wholesale changes to the law. See, e.g., Shakow, supra note 7, at 1111.


255. In his book on public choice theory, Dennis Mueller defined public choice theory as "the economic study of nonmarket decisionmaking, or simply the application of economics to political science." DENNIS C. MUELLER, PUBLIC CHOICE 1 (1979); see also Paul, supra note 36, at 176 ("[P]ublic choice theory urges that . . . lawmakers' desires to promote their self-interests place disproportionate influence in the hands of small, well-organized interest groups.").

256. Over 50 years ago, political scientists argued that the influence of interest groups on the legislative process was indeed a profound one. See, e.g., ROBERT A. DAHL, WHO GOVERN? DEMOCRACY AND POWER IN AN AMERICAN CITY 5 (1961) (arguing that interest groups govern the political system); EARL LATHAM, THE GROUP BASIS OF POLITICS: A STUDY IN BASING-POINT
model for determining the likelihood that a proposed piece of legislation would ultimately be passed by Congress, based primarily on the influence of interest groups in the legislative process.\textsuperscript{257} These political scientists, James Q. Wilson and Michael Hayes, hypothesized that the level of interest group activity on either side of a proposed piece of legislation would vary depending upon whether the costs associated with the proposed legislation and the benefits to be derived from the legislation were concentrated in a small group or widely distributed throughout society.\textsuperscript{258}

The model, which I refer to as the Wilson-Hayes Transactional Model, is divided into four quadrants.\textsuperscript{259} In the first quadrant, both the costs associated with a proposed piece of legislation and the benefits to be derived from it are widely distributed throughout society.\textsuperscript{260} The authors argue that in this quadrant, interest groups are not likely to be well formed on either side of the legislation because of the free rider problem;\textsuperscript{261} that is, why should interest groups expend valuable resources to oppose a particular piece of legislation when society as a whole will effortlessly benefit from their opposition? The model also suggests that, because legislators are motivated primarily by their desire to be reelected,\textsuperscript{262} proposed legislation falling within the first quadrant has a low likelihood of success because legislators would gain few, if any, votes from interest groups by passing such legislation.\textsuperscript{263}


\textsuperscript{258} See Hayes, supra note 257, at 65; Wilson, supra note 257, at 331-32.

\textsuperscript{259} See Hayes, supra note 257, at 65; Wilson, supra note 257, at 332-37. The Wilson-Hayes Transactional Model is also referred to as the Wilson/Hayes Matrix.

\textsuperscript{260} For a more complete discussion of when the costs and benefits associated with proposed legislation are widely distributed or narrowly concentrated, see Hayes, supra note 257, at 65-66; see also Wilson, supra note 257, at 331-32.

\textsuperscript{261} See Hayes, supra note 257, at 90.

\textsuperscript{262} See id. at 93; Doernberg & McChesney, supra note 252, at 946; see also Paul, supra note 36, at 176. It is important to note that some scholars criticize the assumption that legislators are principally motivated by the desire for reelection. See, e.g., Paul, supra note 36, at 178 ("[T]he assumption that a legislator's self-interest consists exclusively of attaining reelection overlooks that legislators often have other goals, such as enhancing their personal prestige, wealth, and career prospects, and improving the public welfare.").

\textsuperscript{263} See Hayes, supra note 257, at 120-26. But Wilson points out that if the benefits to the public are material, such as an increase in social security benefits, legislators have some incentive to increase
Proposed legislation that would have concentrated benefits to a small group of society, with the costs of such legislation being distributed widely throughout society, falls into the model's second quadrant.\(^{264}\) The authors posit that proposed legislation falling within this quadrant will have strong interest group activity in favor of the legislation (by that concentrated group seeking to benefit from the legislation) with little or no interest group activity in opposition because the general public has little, if any, incentive to organize a strong opposition.\(^{265}\) Thus, legislation falling within the second quadrant has a strong likelihood of success in Congress because legislators would be rewarded (through political campaign contributions\(^{266}\) and votes at reelection\(^{267}\) for passing such legislation and yet would not alienate any interest groups opposing the legislation. According to Hayes, transactions in which there are concentrated benefits and distributed costs “are consensual because losers are outside the legal process, perhaps even unaware that they are threatened by the legislation.”\(^{268}\)

The model's third quadrant contains proposed legislation in which the benefits are widely distributed throughout society, but the costs are borne by a small group, such as environmental legislation.\(^{269}\) As one would expect, the model suggests that little interest group activity would form in support of the legislation, but there would be strong interest group activity opposing the legislation.\(^{270}\) Accordingly, proposed legislation falling within this quadrant would have little likelihood of success in the legislative process because legislators would gain few votes or economic support from passing the legislation and would risk losing considerable support from the interest groups opposing the legislation.\(^{271}\)

\(^{264}\) See HAYES, supra note 257, at 66; WILSON, supra note 257, at 333.

\(^{265}\) See HAYES, supra note 257, at 66 (“Concentrated benefits combined with widely distributed costs will tend to produce distributive subgovernments characterized by strong clientele support and no permanent organized opposition.”); WILSON, supra note 257, at 333 (“Programs that benefit a well-defined special interest but impose, or appear to impose, no visible costs on any other well-defined interest will attract the support of the organizations representing the benefited group and the opposition of none . . . .”); see also Paul, supra note 36, at 176 (“[C]ollective action problems subvert the ability of members of the diffuse general public to communicate their views to legislators.”).

\(^{266}\) See Doenenberg & McChesney, supra note 252, at 914.

\(^{267}\) See supra note 262 and accompanying text.

\(^{268}\) HAYES, supra note 257, at 99.

\(^{269}\) See id. at 102.

\(^{270}\) See WILSON, supra note 257, at 334 (“When a specific, easily identifiable group bears the costs of a program conferring distributed benefits, the group is likely to feel its burdens keenly and thus to have a strong incentive to organize in order that their burdens be reduced or at the very least not increased.”).

\(^{271}\) See HAYES, supra note 257, at 102-08. Hayes notes, however, that if a political issue such as pollution captures the public interest, public interest groups will form in favor of the proposed legislation. But because the public is relatively uninformed, symbolic gestures, such as the creation of regulatory agencies designed to act in the public interest, often satisfy proponents' demands. At the same time, legislators have satisfied the strong interest groups opposing the legislation by not enacting tough regulatory legislation. See id. at 103-04, 107; see also WILSON, supra note 257, at 335.
Finally, the model's fourth quadrant contains proposed legislation where both the costs and benefits associated with the legislation are concentrated in small groups. The model posits that strong interest groups would form both in favor of and in opposition to such proposed legislation. Accordingly, legislators would be unlikely to pass such legislation for fear of alienating the group in opposition; yet, in an effort to appease the group favoring such proposed legislation, legislators would likely provide that group with some form of symbolic victory by, for example, proposing that the issue be resolved through agency regulation.

Under the Wilson-Hayes Transactional Model, the loss limitation proposal contained in this article would likely be classified as having concentrated benefits and distributed costs. The obvious benefit from this proposal is that capital losses can often be deducted at an earlier point in time than under the current system, allowing taxpayers to reinvest the tax savings, thereby increasing their net worth. The tax benefits derived from the new loss limitation paradigm are likely to be concentrated in corporations and middle- and upper-income taxpayers who can afford to invest in the stock market and other risky ventures, such as limited partnerships. Accordingly, the Wilson-Hayes Transactional Model would classify these benefits as concentrated.

The costs of the proposal, on the other hand, would be widely distributed. The tax savings that those benefiting from the proposal would enjoy would reduce aggregate tax revenue. To compensate for this lost tax revenue, Congress would be required either to broaden the income tax base by taxing sources of income that are currently untaxed (or reducing or eliminating deductions) or to increase tax rates generally. Accordingly, the costs associated with this proposal would be widely distributed throughout society.

Because this new loss limitation proposal would enjoy concentrated benefits and distributed costs, the proposal would have a very high probability of success in the legislative process under the Wilson-Hayes Transactional Model.
Transactional Model. According to Hayes, "Congress will allocate freely under such circumstances. In the absence of attentive opposition groups, there are no significant electoral costs associated with explicit allocation." Thus, although no model can accurately predict the outcome of legislation in every circumstance because of the complexities inherent in the legislative process, these widely accepted principles of public choice theory indicate that the proposal set forth in this article does, indeed, have a realistic chance of becoming law.

D. Potential Criticisms of the Proposal

Like any other proposed change in the law, this new loss limitation scheme could be subjected to criticism. The two major criticisms that might be waged against this proposal are that it benefits only wealthy taxpayers and that it adds significant complexity to the Code. This section of the article addresses these potential criticisms with the intent of alleviating the concerns upon which they are based.

First, because the ability to invest is seen as the purview of only wealthy taxpayers, any proposal aimed at reducing the capital gains rate or improving the deductibility of capital losses will be subject to the criticism that it benefits only the wealthy. It is no doubt true that taxpayers at the lowest income levels cannot afford to invest in risky ventures, such as the stock market or limited partnerships, which produce deductible capital losses. It is likely that any capital losses suffered by these taxpayers will be with respect to personal use assets, such as their cars or homes. These losses are, of course, nondeductible. There has, however, been significant media attention in recent years to the phenomenon that middle-income taxpayers are investing in the stock market in ever-increasing numbers. Accordingly, the image that the stock market is accessible only to the wealthy is no longer accurate.

If one accepts the notion that it is no longer just wealthy taxpayers who might suffer deductible capital losses, then it is fair to ask whether middle- or upper-income taxpayers would benefit more from the proposal in this article. For the reasons set forth below, I believe that middle-income taxpayers are far more likely to benefit from this proposal than are the wealthiest taxpayers, thereby negating the argument that the proposal favors only the wealthy.

278. See, e.g., *id.* at 159.
279. See I.R.C. § 165 (1994); see also *id.* § 262.
First, because middle-income taxpayers are less likely to afford to hire financial planners and other investment advisors, these investors will often have less perfect investment information than their wealthier counterparts. Accordingly, middle-income taxpayers will be more likely to suffer investment losses due to poor investment decisions. Moreover, with smaller investment portfolios, middle-income investors are less likely than wealthier taxpayers to have capital gains against which to offset those losses, a critical feature under the current loss limitation system. Both the likelihood of more capital losses and fewer capital gains against which to offset them indicate that middle-income investors would enjoy a greater benefit from the new capital loss limitation scheme than would upper-income taxpayers. Moreover, as one tax scholar noted, even if "the objection is that folks like J. P. Morgan would get away without paying taxes, the question of the appropriate treatment of losses is begged by an ad hominem polemic against the wealthy."281

Finally, should a monetary emergency arise, such as a sudden illness, wealthier taxpayers would likely have a sufficient cash reserve available to meet such an emergency. Middle-income taxpayers, on the other hand, could be forced to liquidate their investments to generate sufficient cash to meet the monetary crisis. And if the crisis occurred during a down market, such investors would suffer capital losses in situations where wealthier taxpayers would not. Thus, each of these scenarios suggests that this new loss limitation paradigm is at least as likely to benefit middle-income taxpayers as it is those in the upper-income tax brackets.

The second criticism that might be waged against this proposal is that it adds complexity to an already overburdened Code. At the outset I will concede that the new loss limitation scheme would, in fact, add a certain amount of complexity to the Code. Accordingly, the remainder of this discussion will focus on why complexity is at worst inevitable and at best, even desirable.

A cursory glance at earlier versions of the Code should convince a reader that the tax code has steadily become more complex. The desire to simplify the Code is not a new idea. Thomas Adams once stated that he would "vote for simplicity and inequality, selecting many simple taxes at light rates rather than more equitable but more complex taxes at heavier rates."282 However old the desire for tax simplification might be, attempts at broad scale simplification of the Code have failed miserably. For example, one of the three principal goals of the Tax Reform Act of 1986 was to create a simpler tax system.283 Yet, the Tax Reform Act of

281. Warren, supra note 135, at 310 (footnote omitted).
283. See S. REP. NO. 99-313, pt. 2, at 3-4 (1986), reprinted in 1986-3 C.B. Vol. 3, at 3-4; see also 1984 TREASURY REPORT, supra note 231, at 15 ("An important goal of the Treasury Department study of fundamental tax reform is simplification. During June of 1984, the Treasury Department held
1986 did not achieve the simplification that its drafters had so desired. Several explanations for this failure have been offered. One of the most persuasive arguments, and one that echoes Adams' dilemma, is that attempting to satisfy the dual goals of the equitable distribution of tax burdens and the need for achieving certainty in determining one's tax liability necessarily leads to complexity. "Complexity is a bi-product of a tax regime's reconciliation of the lofty aspiration to distribute tax burdens equitably and the mundane requirement that the tax be susceptible to administration and compliance." It is simply impossible to achieve simplification in a complex society.

Moreover, empirical data suggest that "complication of a tax regime is correlated with the amount of tax revenue that the regime raises." Thus, the federal income tax system, which raises and often redistributes significant revenue each year, is likely to be more complex simply because the stakes are so high. In addition, the specific needs demanded by special interest groups and lawmakers' drafting competence (or incompetence) also add to the Code's complexity.

In the final analysis, complexity is inevitable in a politically based tax system that often succumbs to interest group pressure. More importantly, complexity may even be desirable because it promotes the dual goals of equity and certainty. Until the goals of raising revenue and implementing public policy are divorced from the Code, an unlikely occurrence, the Code will retain its complexity in all its grandeur.

V. CONCLUSION

In a society aimed at promoting economic growth, capital losses must be deductible in some form to encourage taxpayers to undertake

hearing on fundamental tax reform in seven U.S. cities. One of the themes repeated most frequently by citizens appearing at those hearings was the need for simplification of the income tax.

284. See Paul, supra note 36, at 163-73; see also SIMONS, supra note 72, at 157 ("If the main purpose of the income tax to secure an equitable, progressive distribution of tax burdens among individuals . . . .").

285. SIMONS, supra note 72, at 155.


288. See, e.g., Bittker, supra note 7, at 2 ("When such a tax [the income tax] is imposed on tens of millions of taxpayers at rates yielding tens of billions of dollars, only an incorrigible optimist could expect the kind of simplicity that can be achieved with a poll tax . . . . Income taxation entails a high level of irreducible complexity.").

289. See id. at 176-77 ("[S]ince tax simplicity is not an ideal that is likely to develop its own independent constituency, complicated, intractable, and incoherent legislation is likely to ensue, according to the public choice view, as self-promoting politicians pander to the special interests by sprinkling loopholes throughout the federal income tax without any regard for the costs imposed on the rest of society.").

290. See, e.g., McCaffery, supra note 286, at 1304-07; Paul, supra note 36, at 164.

291. See Paul, supra note 36, at 163. But see McCaffery, supra note 286, at 1268, 1284-87 (arguing that complexity often fails to promote equity).
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risky investments. Yet, in part because capital gains are taxed at preferential rates for valid policy reasons, it has long been agreed that Congress must limit the deductibility of capital losses to counterbalance this tax preference.

The current loss limitation system is designed not to provide parallel treatment of capital gains and losses but rather to encourage taxpayers to realize their capital gains earlier than they might otherwise desire. As a result, it promotes economically inefficient investment decision-making and treats similarly situated taxpayers differently, thereby violating traditional notions of fundamental fairness and horizontal equity.

The new loss limitation paradigm proposed in this article provides for parallel treatment of capital gains and losses by limiting the tax savings generated by capital losses to the tax rate applicable to capital gains. Because taxpayers need no longer wait to sell their loss property until they generate offsetting gains, the proposal promotes economic efficiency by encouraging taxpayers to put their resources to their highest and best use. Moreover, the proposal is fairer than the current system because taxpayers are no longer treated differently for tax purposes simply because one taxpayer has fortuitously generated capital gains against which to offset her losses.

This paradigm would add a modest amount of additional complexity to the Code. Complexity is not only inevitable in a complex society but desirable because it promotes the equitable distribution of tax costs and benefits and provides certainty for taxpayers when handling their financial affairs. Surely the benefits of efficiency and equity resulting from this proposal outweigh any costs of additional complexity.