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Tax Symposium: Capital Losses: Falling Short on Fairness and Simplicity

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CAPITAL LOSSES: FALLING SHORT ON FAIRNESS AND SIMPLICITY

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INTRODUCTION

The Tax Reform Act of 1986[1] ("TRA '86") struck a major blow for horizontal equity in the federal income tax system by equalizing tax rates between capital gains and ordinary income. In the process, TRA '86 greatly simplified the understanding, computation, and administration of tax treatment of capital gains and of capital loss carryovers. TRA '86 failed, however, to apply the principle of horizontal equity to net capital losses. Consequently, an unnecessary residue of complexity in the treatment of capital losses remains.

Fully effective in 1988, the capital gain and loss changes made by TRA '86 simplify the treatment of capital gains and losses chiefly in two respects. First, there is no tax rate differential between capital gains and other income for either individuals[2] or corporations.[3] Second, there is no practical distinction between long-term and short-term capital gains and between long-term and short-term capital losses.[4]

With respect to treatment of capital losses, TRA '86 distinguished between individual and corporate taxpayers, but allowed neither to deduct net capital losses in full. For individuals the treatment of capital losses was simplified and liberalized to some extent. An excess of capital losses over capital gains may be applied dollar for dollar against ordinary income up to a maximum each year of $3,000.[5] For corporations the treatment of capital losses was not changed. They are allowed in full against capital gains, but may not be applied against ordinary income.[6]

JUSTIFICATIONS FOR FULL CAPITAL LOSS ALLOWANCE

Fair treatment of capital gain and loss requires that each be treated the same as ordinary income and loss, respectively, because the economic benefit from a dollar of capital gain is the same as the economic benefit from a dollar of ordinary income, and a dollar of capital loss has the same economic effect as a dollar of ordinary loss.[7] There is no intrinsic

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1. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).
2. I.R.C. § 1(j) (West Supp. 1988).
3. *Id.* § 1201(a).
4. *But see id.* §§ 584(c)(1),(2) (relating to common trust funds), 1212 (loss carrybacks and carryforwards), 1222-23 (definitions and holding period rules), 1233 (short sales).
5. *Id.* § 1211(b).
6. *Id.* § 1211(a).
7. *See generally* D. BRADFORD, BLUEPRINTS FOR BASIC TAX REFORM 5 (rev. 2d ed. 1984) (setting forth proposal that adopts an "integration concept," whereby capital gains realized upon sale or exchange of assets are taxed fully after allowing a step-up

difference between capital assets and other assets that justifies special treatment for either capital gains or capital losses. Taxpayers invest in capital assets to profit from their use or their eventual disposition. Such assets may yield current income through rents, royalties, dividends, or interest. Even those assets held for personal use — homes, pleasure boats, etc. — yield imputed income to their owners. Capital assets held for eventual profit through sale at a gain really are being held for sale even though they escape the narrower classification of inventory or property held for sale to customers in the ordinary course of a trade or business.[8] The thinness of the distinction between capital assets and business assets is demonstrated by the anomalous treatment in section 1231 of the Internal Revenue Code (the "Code") of depreciable assets and land used in a trade or business.[9]

Unlimited allowance of capital losses may be justified in theory even when net capital gains are given favorable tax treatment.[10] Certainly, theoretical justification exists for unlimited allowance of capital losses when capital gains are fully taxed at the same rate as ordinary income. It is no longer possible to defend restrictions on the allowance of capital losses by arguing that such treatment is justified because it is parallel to the treatment given capital gains.[11]

The parallel treatment argument was specious from its outset except in the case of gains and losses realized by the same taxpayer. Restriction of one taxpayer's use of an economic loss cannot be justified by pointing to another taxpayer's benefit from special treatment of capital gains. An extreme example is the unfortunate individual who has one large capital loss in a lifetime and no present or foreseeable capital gains. Even if this taxpayer should live long enough to recoup the loss through small annual deductions of the unused capital loss carryforward each year,[12] such recoupment will not accurately reflect the current cost of the initial loss to the taxpayer.

Deduction of capital losses has not always been restricted, even when capital gains were given favored tax treatment. Deduction of capital losses was allowed in full from the Revenue Act of 1918[13] until the Revenue Act of 1924,[14] though capital gains were initially accorded favored treatment under the Revenue Act of 1921.[15]

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in basis for price level rises and realized capital losses are fully deductible against ordinary income).

8. *See* I.R.C. § 1221(1) (1982) (inventory exception to definition of "capital asset").
9. *See infra* text following note 55.
10. *See* Warren, *The Deductibility by Individuals of Capital Losses under the Federal Income Tax*, 40 U. CHI. L. REV. 291, 295 (1973).
11. The parallel treatment argument was used by the Committee on Ways and Means in its Report on the Revenue Act of 1924. *See* H.R. REP. NO. 179, 68th Cong., 1st Sess. 57 (1924).
12. *See supra* note 5 and accompanying text.
13. Revenue Act of 1918, Ch. 18, § 214(a)(5), 40 Stat. 1057, 1067 (1919).
14. Revenue Act of 1924, Ch. 234, § 208(c), 43 Stat. 253, 263.
15. Revenue Act of 1921, Ch. 136, §§ 206, 214(a)(5), 42 Stat. 227, 232-33, 240.

WHY CONGRESS DID NOT GO ALL THE WAY

In 1986 Congress made relatively minor changes for individuals in the application of capital losses against ordinary income and in the application of unused capital loss carryovers.[16] For the most part, Congress left intact the elaborate machinery for defining capital assets, for distinguishing short-term from long-term capital gains and losses,[17] and for computing capital gain or ordinary loss on business assets in section 1231.[18] Congress also retained an array of other provisions that, because of the extinct tax rate differential between capital gains and ordinary income, have virtually no justification in policy.[19]

Congress had several reasons for its decision not to eliminate the elaborate capital gain and loss and section 1231 machinery which would have simplified the Code. First, Congress intended to provide a token of the sincerity of its promise that if ordinary income tax rates should be increased above the levels set in TRA '86, the capital gain tax rate would not be increased.[20] Congress provided this token by establishing a maximum capital gain tax rate of 28% (plus the 5% notch rate where applicable).[21] For corporations, Congress established an alternative tax on capital gains with a maximum rate of 34% (plus the 5% notch rate where applicable), applicable if the corporate ordinary income tax rate is higher.[22] Neither of these provisions are operative after 1987, because the marginal ordinary income tax rate for individuals would not exceed 28% (plus the notch rate), and the corporate ordinary income tax rate would not exceed 34% (plus the notch rate).

Congress could just as well have included its promise (i.e., not to raise the tax rate on capital gains if the rate is raised on other types of income) in the Conference Committee Report instead of the Code. Such a promise written into the Code is no more binding on the next Congress than are the provisions setting the individual and corporate tax rates on ordinary income. Perhaps the drafters could have achieved simplification by suspending the capital gain and loss and section 1231 machinery, separating it from the operative Code provisions, so that a later Congress could implement it if and when an increase of ordinary income tax rates without an increase in capital gain tax rates was considered desirable.

A second reason for retaining the capital gain and loss and section 1231 machinery in the Code was the particular importance of such retention for industries covered by section 631 — timber and coal and iron ore

16. Pub. L. No. 99-514, § 301(b)(1), 100 Stat. 2085, 2217 (1986).
17. I.R.C. § 1222 (1982 & West Supp. 1988).
18. *Id.* § 1231.
19. *See infra* notes 49-55 and accompanying text.
20. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS. II-106 (Comm. Print 1987); GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, H.R. CONF. REP. No. 841, 94th Cong., 2d Sess. II-106 *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4194.
21. I.R.C. § 1(j) (West Supp. 1988).
22. *Id.* § 1201(a).

leasing — that had capital gain treatment (via section 1231) by fiat either for items that otherwise would not meet the definition of capital assets or for transactions that would not meet the definition of sales or exchanges.[23] If section 631 were eliminated along with the capital gain and loss and section 1231 provisions, and if Congress later decided to reestablish favored tax treatment for capital gains, these industries might have to convince Congress again of the validity of their cases for capital gain treatment.

One reason for retaining the cumbersome machinery in the Code may have been simply lack of time. Prior to the conference agreement, the House version of the 1986 bill eliminated the alternative tax on capital gains for corporations, but retained the deduction for individuals of a percentage of net long-term capital gains.[24] The Senate version of the bill, on the other hand, retained the alternative tax for corporations but eliminated the special capital gain deduction for individuals.[25] It was not until the conferees agreed to equalize capital gain and ordinary income tax rates both for corporations and for individuals that it became possible to eliminate provisions in the Code that applied to both types of taxpayers. Although lack of time perhaps excused failure to complete the eradication in 1986, this is not an acceptable long-term excuse.

A substantive reason for retaining at least part of the capital gain and loss structure after the tax rate differences were removed was a fear that taxpayers would take undue advantage of an opportunity to realize capital losses to offset ordinary income while not realizing their capital gains.

THE CHERRY-PICKING PROBLEM

The fundamental difference between most types of ordinary income and most capital gains and losses is that the taxpayer usually controls the timing of realization of capital gains and losses. Taxpayers have a similar degree of control over the timing of realization of income or loss on land used in a trade or business. Requirements of consistency in cost recovery[26] restrict taxpayer control of timing of realization with respect to depreciable assets prior to disposition, but taxpayers can control the timing of the disposition itself and, thus, final realization of gain or loss.

Taxpayer control over realization of capital losses has generated fear that the allowance of capital losses to offset ordinary income without limitation will prompt taxpayers to let their potential gains accumulate without realization while realizing their capital losses to avoid taxes on ordinary income. In the jargon of tax policy theorists and tax specialists, this is "cherry-picking."

23. *Id.* § 631.
24. H.R. REP. NO. 426, 99th Cong., 1st Sess. 10, 233 (1985).
25. S. REP. NO. 313, 99th Cong., 2d Sess. 169 (1986).
26. I.R.C. §§ 167, 168 (West Supp. 1988).

Cherry-picking certainly will occur to some degree if capital losses are allowed without limitation. It occurred in a more sophisticated and lucrative context with losses on section 1231 assets before enactment of the five-year lookback provision in 1984.[27] The five-year lookback requires ordinary income treatment of section 1231 net gain for a year to the extent that section 1231 net losses for the previous five years have not already been used to offset other section 1231 gains. Straightforward cherry-picking of section 1231 assets to realize ordinary loss has not upset tax policymakers in the same way that the potential for cherry-picking of capital losses has.

Cherry-picking really is not an outrageous tax avoidance practice. It involves taking into account for tax purposes admitted economic losses that the taxpayer has suffered. If some tax losses do not reflect genuine economic loss (as with loss realized on the sale of property after a date-of-death basis step-up), legislation dealing with the specific abuse is more appropriate than denial of tax relief for all capital losses.

THE STEP-UP IN BASIS STUMBLING BLOCK

Unlimited allowance of capital losses cannot be justified so long as the present tax-free step-up in basis of appreciated assets at death remains in effect.[28] If unlimited capital losses are combined with the step-up in basis at death, the taxpayer who has both capital gains and capital losses can realize the losses to offset other income and let the gains accumulate unrealized until death, so that the gains escape income tax altogether.

One attempted solution to the problem created by the disposition of property at death was the 1976 provision for a carryover of the decedent's basis.[29] The opposition that led to the demise[30] of this carryover basis approach stemmed from two sources. First, taxpayers and tax planners had simply grown accustomed to escaping tax by holding appreciated property until death and were unwilling to give up the advantage. Second, there were sincere fears of the potential liability imposed on executors for failing to compute carryover basis correctly and for failing to allocate high and low basis assets fairly among distributees. These fears prompted opposition by the American Bar Association to the carryover basis provision.[31] The 1976 carryover basis provision was further hampered by the complexity of transitional rules that, ironically, were motivated by a desire to impose the change with the least possible dislocation.

27. I.R.C. § 1231(c) (Supp. II 1984 & West Supp. 1988), added by Tax Reform Act of 1984, Pub. L. No. 98-369, § 176(a), 98 Stat. 494, 709.
28. I.R.C. § 1014(a) (1982).
29. I.R.C. § 1023 (1982), added by Tax Reform Act of 1976, Pub. L. No. 94-455 § 2005(a), 90 Stat. 1784, 1872.
30. Section 1023 of the Code was repealed by Pub. L. No. 96-223 § 401(a), 94 Stat. 299 (1980).
31. 65 A.B.A.J. 304, 341 (1979).

A simpler solution would be to treat death as a realization event for the decedent.[32] Transfer of property at death appears to be an appropriate occasion for recognition of income (or loss) to the decedent, because such time is optimal for closing all deferred accounts of the decedent. An exception should be made for transfers to a surviving spouse, which exception would be consistent with the treatment of such transfers by estate and gift tax provisions. Basis should carry over in that case, however, as it does in the case of an interspousal gift made during the donor's life.

Conceivably, transfer by gift also could be an occasion for realizing gain or loss, but carryover basis has worked reasonably well in the case of gifts. In any event, treating a gift as a realization need not be a prerequisite to consistent treatment of capital gains and losses.

MARK-TO-MARKET PROPOSALS

Some opposition toward allowing the taxpayer to time his realization of capital losses to offset other income probably stems from a belief that unrealized gains and losses should be taken into account annually. Such belief is part of the Haig-Simons definition of the ideal income tax base.[33] This definition has been accepted as the ideal with a surprising lack of critical analysis. One critic who does recognize the impracticality of its general application has noted that, logically, the second best tax system is not necessarily the system that comes closest to the Haig-Simons definition.[34] Nevertheless, Haig-Simons as the ideal has received more acceptance than it deserves.[35]

Market value of property is determined by either current yield or anticipated demand or a combination of these two factors. The current yield itself is taxed presently.[36] To the extent that the value of property is determined by current yield, taxation of both current yield and accretion in value of the underlying asset that is a reflection of the yield would be unfair. Except in the case of collectors' items, to the extent that an asset's appreciation in value has not been accompanied by a commensu-

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32. Hickman, *Capital Gains and Simplification*, Federal Income Tax Simplification (ALI-ABA) 223, 239 (1979).

33. "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." H.C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

34. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 983 (1967).

35. *See, e.g.*, D.F. BRADFORD, BLUEPRINTS FOR BASIC TAX REFORM 5 (rev. 2d ed. 1984) ("Under the broadest concept of an income tax base, capital gains that represent an increase in real wealth would be taxed even though not realized by sale or exchange of the asset. Similarly, capital losses, whether realized or not, would be subtracted in full from all sources of income in computing the tax base.")

36. Municipal bond interest is one legislative exception. I.R.C. § 75 (1982 & West Supp. 1988).

rate current yield, the owner of the asset has received no benefit beyond a feeling of satisfaction at having made a shrewd investment.

An unrealized gain unaccompanied by current benefit is, in common terminology, a "paper profit." Entirely aside from the administrative problems of annual valuation involved in applying the Haig-Simons definition, the principal problem with such definition is the absence of any benefit to the owner that justifies the imposition of an income tax on an unrealized accretion in value. Thus, the theoretical basis for this component of the Haig-Simons definition of income is at least questionable.

Some commentators have proposed taking into account in the tax base appreciation or depreciation in market value of investment assets that have easily ascertainable market values.[37] This concept, called "mark-to-market," was initially advanced in pursuit of the Haig-Simons ideal.[38] Since the enactment of TRA '86, however, the use of mark-to-market for a limited category of assets has been proposed as one way of reducing the potential for cherry-picking sufficiently to permit unlimited allowance of capital losses.[39] The proposal is to mark property to market if it is "marketable," a characteristic of stocks and bonds listed on stock exchanges or publicly traded in the over-the-counter market.[40] Publicly traded stocks and bonds may include those issued by corporations or partnerships already identified by registration under the Securities Exchange Act of 1934, as amended.[41]

The limited mark-to-market proposals are flawed in several respects. First, as discussed earlier, taxation of unrealized appreciation under the Haig-Simons definition of income is of questionable validity.

Second, the imposition of a tax on unrealized appreciation and the limitation of such imposition to a designated type of investment asset would create a serious bias in capital markets. The bias against stock of publicly held corporations would be particularly acute. Because of the double taxation of dividend income, such stock is already under a tax handicap compared with debt obligations, stock of S corporations, stock of closely held C corporations that do not declare significant dividends, and interests in partnerships that are not taxed as corporations. Singling out investment in publicly held corporations for mark-to-market treatment would undermine the United States securities market.

Third, taxation of unrealized appreciation in securities would put

37. *See* Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967) [hereinafter Slawson]; Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STANFORD L. REV. 857 (1982) [hereinafter Note, *Realizing Appreciation Without Sale*].

38. Note, *Appreciation Without Sale*, *supra* note 37, at 858.

39. Ginsburg, Canellos, Levin, Eustice, *Reexamining Subchapter C: An Overview and Some Modest Proposals to Stimulate Debate*, INVITATIONAL CONFERENCE ON SUBCHAPTER C 3, 6 (1987).

40. *Id.*

41. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, 892 § 12, codified as amended at 15 U.S.C. § 78*l* (1982 & West Supp. 1988).

the taxpayer in a position of having to liquidate a substantial portion of his investment in order to pay the tax. This forced liquidation would create an unfair hardship and would have an artificial, adverse effect on the market price of the securities. This prospect alone would deter closely held expanding companies from making public offerings of their stock. A hypothetical illustration is the case of one individual who owns all the outstanding stock of a corporation — one million shares with a basis of $1 per share. The corporation has bright prospects, and a public offering by the corporation of an additional one million shares could yield $10 per share. If the effect of the public offering is to bring the stock under a mark-to-market regimen, the market value of $10,000,000 for the original shareholder's stock would produce a $9,000,000 taxable gain based on the unrealized appreciation of his stock. At a 28% tax rate, the cost in taxes of the corporation's public offering to such an individual would be over $2,500,000.

Finally, the mark-to-market concept might be unconstitutional. In *Eisner v. Macomber*,[42] the Supreme Court assumed that realization was necessary for a constitutional tax on income.[43] The precedent is old, perhaps even obsolete. In TRA '86, Congress adopted a mark-to-market method of dealing with a special abuse situation: the taxation of futures contracts held by the taxpayer at the close of the taxable year.[44] The courts could uphold mark-to-market in these limited circumstances as constitutional. They could nevertheless decide under *Eisner* that, because unrealized appreciation is not income and thus is not encompassed by the sixteenth amendment, so that a tax imposed on broad-based mark-to-market is a direct tax that requires apportionment.[45]

THE REVENUE COST OF FAIRNESS

How serious would the revenue loss be if capital losses were allowed in full? Losses on section 1231 assets already qualify under the tax system for ordinary loss treatment if they exceed gains on section 1231 assets.[46] If retention of appreciated assets until death were no longer to be rewarded by tax-free step-up in basis to market value, a major inducement to realize losses and to allow gains to accumulate unrealized would be eliminated. The revenue gain from taxation of unrealized gain at death might exceed the revenue cost of unlimited allowance of capital losses.

In a period of prosperity and generally rising price levels, the volume of capital losses is not likely to be large. Even though prosperity periodically fades and the Dow Jones average drops occasionally, experi-

42. 252 U.S. 189 (1920).
43. *See id.* at 213-15. *See also* Helvering v. Independent Life Ins. Co., 292 U.S. 371, 378 (1934) (dictum).
44. I.R.C. § 1256 (1982 & West Supp. 1988).
45. U.S. CONST. art. I, § 9, cl. 4.
46. I.R.C. § 1231(a)(2) (West Supp. 1988).

ence for the past half-century indicates that stock price levels will continue to rise. The trend toward higher and higher stock prices is not a function of prosperity or of "inflation" in a strict sense. Instead, it appears to be the result of institutional factors that override fluctuations in the level of utilization of productive capacity. When the level of economic activity drops as prices continue to rise, "stagflation" is said to occur.[47] Whatever the name, the prospect of rising price levels should minimize concern about the revenue cost of allowing capital losses in full.

If cherry-picking by investors who, with capital gains as well as losses, might take the losses against other income and let the gains accumulate unrealized is perceived as a serious revenue loss threat, there is a way to alleviate such threat. Taxpayers who derive immediate economic benefit from the appreciation in their capital assets by borrowing against them while realizing net capital losses can be required to include in income (with appropriate basis adjustments) the excess of their loan proceeds over the basis of their assets mortgaged or pledged to secure the loans.[48]

COUNTERPRODUCTIVE CAPITAL LOSS RESTRICTIONS

Code provisions that were enacted originally to deny capital gain benefits to certain types of gains survive after TRA '86 only to prevent taxpayers from offsetting capital losses against these gains. These provisions affect a significant number of taxpayers and tend to be complex and difficult to administer.

One example is section 341, which denies capital gain treatment to gain on the sale, exchange, or liquidation of so-called collapsible corporations. This provision now exists largely as a trap for those who mistakenly assume that section 341 no longer applies now that capital gains are taxed at ordinary income tax rates. The provision still applies, however, to preclude gain on collapsible corporation stock from being offset by capital losses. If Congress previously intended that section 341 treat shareholder gain as ordinary income and enforce a double tax on value increases generated at the corporate level, repeal of the *General Utilities* doctrine[49] in 1986 has assured a tax on appreciation of corporate assets at the corporate level in a taxable liquidation.[50]

Four provisions in subchapter K, which deal with partnerships, now operate only to preclude use of capital losses to offset gains arising from

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47. SAMUELSON, ECONOMICS 825 (9th ed. 1973).
48. *Cf. Tax Treatment of Real Estate*, 1977: *Panel Discussions on the Subject of General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 507, 526 (statement of Adrian W. DeWind), 571 (statement of Jerome Kurtz) (1973) (making similar suggestion, not designed to be limited to net realized capital losses, for real estate tax shelters).
49. General Util. & Operating Co. v. Helvering, 296 U.S. 200 (1935).
50. I.R.C. §§ 311(b), 331 (1982 & West Supp. 1988).

transactions between partners and their partnerships. First, section 707(b)(2) provides that when a sale of property occurs between a partner and the partner's controlled partnership, if the property is not a capital asset in the transferee's hands, then any gain recognized on the transaction shall be considered ordinary income.[51] This provision now merely precludes eligibility of gains that might otherwise be capital gains for offset by capital losses.

Second, section 724 provides that property contributed by a partner to a partnership will retain its character in the hands of the partnership.[52] This provision applies to unrealized receivables, inventory, and capital assets that later produce losses. Presently, the only effect of the provision is to restrict the transferee partnership's creation of capital gain or ordinary loss. This restriction reduces the amounts of income that may be offset by capital losses at the partnership or partner level.

Third, section 735 controls the character of gain or loss on disposition of property that has been distributed by a partnership if the property was an unrealized receivable or an inventory item in the hands of the partnership.[53] The provision prevents conversion of such items into capital assets before their disposition and thus prevents offset by capital losses against gain on such disposition.

Finally, section 751 provides that an amount received by a partner from sale or exchange of a partnership interest, to the extent attributable to unrealized receivables or to inventory items that have appreciated substantially in value (called "hot assets"), is considered an amount realized from the sale of property that is not a capital asset.[54] Section 751 provides the same treatment when a distribution in kind to a partner results in that partner's receipt of either more or less than his pro rata share of the unrealized receivables or of the substantially appreciated inventory. In either event, the transaction is considered an exchange with the partnership for the disproportionate amount, and gain to the partner or partnership that disposes of a share in the hot assets is treated as ordinary income. This complex provision now serves only to limit the amount of capital gain eligible to be offset by capital loss from other sources.

The risk of cherry-picking in conjunction with realized gains on collapsible corporation stock or on transactions between partners and their partnerships is minimal. Certainly, the risk is not sufficient to justify retention of provisions as complex and difficult to administer as sections 341 and 751. The American Law Institute's Federal Income Tax Project on Subchapter K had this to say about the complexity of section 751(b):

> Section 751(b) is extraordinarily complex. It constructs hypothetical exchanges of capital and non-capital assets in situations

51. *Id.* § 707(b)(2).
52. *Id.* § 724.
53. *Id.* § 735.
54. *Id.* § 751.

where an actual exchange has not occurred. This rule was criticized as complex by the 1957 Advisory Group, which recommended its repeal. That group analyzed § 751(b) before the category of unrealized receivables was greatly expanded by the addition of such pervasive items as § 1245 recapture, § 1250 recapture, etc. As a result of that expansion, it is difficult to imagine a non-pro rata partnership distribution to which § 751(b) does not apply. If the reports of noncompliance with § 751(b) are correct, the continuance of such a provision must have an adverse bearing on taxpayer respect for the law.[55]

VESTIGIAL SECTION 1231

Section 1231 was designed to allow favorable capital gain tax rate treatment of net gains on sales of long-term business assets while retaining ordinary loss treatment of net losses on such assets. First, a determination is made as to whether long-term gains from the sale or exchange of property used in the taxpayer's trade or business exceeded losses from these transactions. If gains from involuntary conversions exceed involuntary conversion losses, these gains and losses are included with the business asset gains and losses from sales and exchanges. If the gains exceed the losses, both gains and losses are treated as capital gains and losses. If the losses exceed the gains, both gains and losses are treated as ordinary income and losses. If section 1231 losses exceed section 1231 gains, their treatment as ordinary gains and losses permits the net excess of losses to offset ordinary income from other sources.

Section 1231 still functions to ameliorate the general restriction on the use of capital losses not directly covered by section 1231 by permitting them to be used to offset net long-term gains on business assets. Thus, a taxpayer with net section 1231 gains can time realization of capital losses to offset the section 1231 gains. This cherry-picking has been possible since enactment of the 1939 Code predecessor to section 1231. The offset is more valuable now that long-term capital gains are taxed at ordinary income tax rates, but the principle remains unchanged. Allowance of capital losses in full against ordinary income would not be more beneficial to taxpayers for transactions now covered by section 1231. Such allowance would, however, permit the entire section 1231 machinery to be dismantled, simplifying the Code to that extent.

ADDITIONAL CANDIDATES FOR SIMPLIFICATION

A whole range of Code provisions exist merely to provide exceptions to the general definition of capital losses. None would be necessary if capital losses were allowed without restriction on the same basis as ordi-

55. American Law Institute, *Proposals on the Taxation of Partners*, FEDERAL INCOME TAX PROJECT, SUBCHAPTER K 51 (1982) (footnotes omitted).

nary losses. The following Code provisions could be eliminated or, in the case of section 1221, retained only for use in special situations:

1. Section 165(g)(3) allows a parent corporation to treat loss on worthless stock and securities of a subsidiary as ordinary loss.[56] This provision would be unnecessary if capital losses were allowed in full, because the worthless stock losses would be allowed whether or not they were ordinary losses.

2. Paragraphs (1) and (2) of section 584(c) classify as separate from ordinary income of common trust funds the short-term and long-term gains and losses from the sale or exchange of capital assets of such funds for purposes of inclusion in the fund participants' taxable income.[57] The distinction between "long-term" and "short-term" has no present function, and the separate classification of capital gains and losses assigned to the fund participants will have no function if capital losses are allowed in full.

3. Section 631 provides that profits on the cutting of timber, disposal of timber with a retained interest in the underlying property, and disposal of coal and iron ore in return for royalties are to be treated as sales or exchanges.[58] The effect of "sale or exchange" characterization is to treat the amounts received as gain on the sale or exchange of section 1231 assets. Taxation of capital gains at the same rates as ordinary income has eliminated the tax rate advantage that formerly inured from classification of timber, coal, and iron ore income as income derived from section 1231 asset sales. The only residual effect of section 631 is to include this income in the section 1231 mix and thus to expand somewhat the amount of income that is eligible to be offset by capital losses from other sources. If capital losses are allowed in full, section 631 will have no effect and can be eliminated.

4. Paragraphs (1) and (2) of section 702(a) require that each partner take into account separately his partnership share of short-term and long-term capital gains and losses.[59] The distinction between short and long-term no longer has any consequence and separate accounting for capital assets may be discontinued entirely if capital losses are allowed in full.

5. Section 818(b)(2) contains a rule for applying section 1221(2) to an insurance company.[60] In effect, the rule is that depreciable property or real property used in a trade or business shall be considered a capital asset if the trade or business is not the insurance business. The provision now has no direct consequences with respect to capital gains. The effect, however, is to treat gains on business assets used in a non-insurance business as eligible for offset by capital losses and to treat losses on assets

56. I.R.C. § 165(g)(3) (1982 & West Supp. 1988).
57. *Id.* § 584(c).
58. *Id.* § 631.
59. *Id.* § 702(a)(1), (2).
60. *Id.* § 818(b)(2).

used in a non-insurance business as capital losses that may not be used to offset ordinary income.

6. Section 1221 defines the term "capital asset."[61] If capital losses are allowed in full, this definition will be unnecessary except to exempt gain on certain capital assets by non-resident aliens[62] and possibly to retain the special treatment of charitable contributions of capital gain property.[63]

There are provisions in the Code that contain cross-references to all or parts of the capital asset definition.[64] If section 1221 is repealed, these provisions can be served just as well by a definition in section 7701 that will embody the present language of paragraphs (1) and (2) of section 1221.

7. Paragraphs (1), (2), (3), and (4) of section 1222 contain the definitions of long-term and short-term capital gains and capital losses.[65] The distinction between "long-term" and "short-term" no longer has any tax consequences either for capital gains or for capital losses. If capital losses are allowed in full, all four paragraphs can be eliminated.

8. Section 1223 contains rules governing determination of the holding period of property for purposes of distinguishing short-term from long-term gains and losses.[66] As with the definitions of short-term and long-term gains and losses in section 1222, these holding period rules can be eliminated with respect to capital assets. If capital losses are allowed in full, permitting elimination of section 1231, such rules can be eliminated altogether.

9. Section 1233 treats gains and losses from short sales as gains and losses from the sale or exchange of capital assets in some circumstances.[67] Section 1233(b) treats certain losses as long-term capital losses. If capital losses are allowed in full against ordinary income, section 1233 can be eliminated.

10. Section 1234 characterizes gain or loss from options as either ordinary or capital gain or loss, depending on the character of the optioned property.[68] Loss from failure to exercise an option is treated as loss from a sale or exchange, which has the effect of characterizing the loss as capital loss if the underlying asset is a capital asset. If the underlying asset is a section 1231 asset, however, the loss might be treated as

61. *Id.* § 1221.
62. *Id.* § 871(a).
63. *Id.* § 170(b)(1)(C).
64. *See, e.g.*, I.R.C. §§ 56(a)(6)(A), 170(e)(3)(A) (1982 & West Supp. 1988), §§ 263A(b)(2)(A), 267(f)(3)(B)(i), (iii), 367(a)(3)(B)(i) (1988), §§ 856(c)(2)(D), 857(b)(4)(B)(i) (1982 & West Supp. 1988), §§ 864(d)(3)(A), 865(h)(1) (1988), §§ 995(b)(1)(C), 1017(b)(3)(E)(i), 1092(a)(3)(B)(ii)(II) (1982 & West Supp. 1988), § 1362(d)(3)(D)(ii) (1988).
65. I.R.C. § 1222(1)-(4) (1982 & West Supp. 1988).
66. *Id.* § 1223.
67. *Id.* § 1233.
68. *Id.* § 1234.

ordinary loss. Section 1234 will be unnecessary if capital losses are allowed in full.

11. Section 1234A provides for capital gain or loss treatment of gain or loss from cancellation or lapse of a right or obligation with respect to personal property that is actively traded, such as commodities, and with respect to a futures contract of the type that is marked to market under section 1256.[69] This provision can be eliminated if capital losses are allowed in full, because the capital asset characterization no longer will have any consequences.

12. Section 1235 provides that a transfer of patent rights is to be treated as the sale or exchange of a long-term capital asset.[70] Treatment of the rights as having been held long-term now has no consequences. The capital asset characterization also will have no consequences if capital losses are allowed in full.

13. Section 1236 contains a special rule permitting dealers in securities to hold securities as capital assets in certain circumstances.[71] The provision will be meaningless if capital losses are allowed in full.

14. Section 1237 provides a semi-mechanical rule for determining when real property that is subdivided for sale is held primarily for sale to customers and when it is held as a capital asset.[72] The distinction no longer will be relevant if capital losses are allowed in full.

15. Section 1239 provides that gain on the sale of depreciable property between related taxpayers shall be treated as ordinary income.[73] The only current effect of the provision is to preclude use of capital losses to offset the ordinary gain. The provision will have no effect if capital losses are allowed in full.

16. Allowance of capital losses in full will make three provisions concerning small businesses unnecessary. Section 1242 provides for treatment of loss on stock in a small business investment company as ordinary loss.[74] Section 1243 also provides for ordinary loss treatment of loss on stock received pursuant to a conversion privilege of convertible debentures under the Small Business Investment Act of 1958.[75] Finally, section 1244 provides that, within certain limits, losses by the initial owners of stock of a small business company shall also be treated as ordinary loss.[76]

17. Sections 1245 and 1250 characterize a portion of gain on disposition of depreciated assets as ordinary income, thereby limiting the

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69. *Id.* § 1234A.
70. *Id.* § 1235.
71. *Id.* § 1236.
72. *Id.* § 1237.
73. *Id.* § 1239.
74. *Id.* § 1242.
75. Pub. L. No. 85-699, 72 Stat. 689 (1988)(codified at 15 U.S.C. §§ 661-697b (1976 & West Supp. 1988)).
76. I.R.C. § 1244 (1982 & West Supp. 1988).

amount of gain eligible to be offset by capital losses from other sources.[77] If capital losses are allowed in full, this function of sections 1245 and 1250 will disappear.

18. Section 1247(a) provides that if foreign investment companies elect to distribute income currently, net capital gain of these companies is determined and passed through to qualified investors.[78] The only consequence now is to enable shareholders to offset capital losses against the net capital gain passed through to such shareholders. The provision can be eliminated if capital losses are allowed in full.

19. Section 1271 deems amounts received on retirement of debt instruments as amounts received in exchange for such instruments.[79] The effect is to qualify these transactions for capital gain or loss treatment. The provision can be deleted if all distinctions in treatment between capital assets and other assets are removed.

CONCLUSION

TRA '86 improved horizontal equity by taxing capital gains at the same rates as other income, and it simplified day-to-day application of the capital gain and loss provisions for most individual taxpayers. The Code is still burdened, however, by capital gain and loss distinctions that still affect individual taxpayers who have substantial capital losses and corporations incurring any net capital losses.

The policy considerations behind retention of such distinctions justify neither this unfairness toward taxpayers with net capital losses nor the resulting complexity. 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.

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77. *Id.* §§ 1245, 1250.
78. *Id.* § 1247(a).
79. *Id.* § 1271.