WHAT ARE CAPITAL GAIN AND CAPITAL LOSS ANYWAY

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Loss Limitation

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I. INTRODUCTION

The latest developments pertaining to the taxation of capital assets (i.e., the very generous tax rates for capital gains,\(^1\) the significant increase in the immediate deduction of the cost of depreciable assets up to $100,000 annually,\(^2\) and the new provision that taxes dividends at the reduced capital gains tax rates\(^3\)) call, once again, for the study of the essence of this phenomenon. There are two major issues that should be studied. The first is the justification for preferred tax treatment.\(^4\) The discussions on this subject, however, tend to refer to the “capital gain” phenomenon in general terms, as if it is a uni-dimensional concept. Furthermore, though this issue was discussed extensively for the last eighty years or so, policymakers pay little attention to this line of discussion and continue providing those preferences regardless of issues of sound tax policy and tax equity.

I do not intend to discuss in detail the traditional arguments for or against these preferences. Rather, the purpose of this article is to discuss the second issue arising from the taxation of capital assets, namely, the definition for the phenomenon of capital gains and losses.

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that accentuates the “correct” economic analysis and endeavors to allow a better understanding of the rules dominating their treatment.

The available discussion in this area is much more limited. It is indeed quite difficult to find a clear and accurate definition for the term “capital gain.” Very few sources discuss what creates capital gain or explain the substantial distinctions between capital gain and ordinary income. The old and very practical metaphor about the fruits (ordinary income) and the tree (capital assets) is helpful, but not exhaustive. In some cases the courts have offered some common law solutions, but it seems to me that the matter deserves further

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6 Of course, the courts have already recognized the importance of the distinction between anticipated future ordinary income and the change in the actual value of the property. In Hort v. Commissioner, 313 U.S. 28 (1941), the taxpayer-landlord entered into an agreement with the tenant to terminate the lease. The taxpayer contended that the amount received in this transaction was a capital gain. The Court disagreed stating that the amount received to terminate the lease was a substitute for rent and therefore ordinary income.

This concept of “anticipation of income” was later refined in Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) and United States v. Dresser Industries, Inc., 324 F.2d 56 (5th Cir. 1963). In P.G. Lake, the taxpayer was a corporation engaged in the business of producing oil and gas and had a seven-eighths working interest in two commercial oil and gas leases. The facts were described as:

[the taxpayer] was indebted to its president in the sum of $600,000, and in consideration for his cancellation of this debt, the taxpayer assigned him an oil payment right in the amount of $600,000, plus interest at 3 percent per year on the unpaid balance remaining from month to month, payable out of 25 percent of the oil attributable to the taxpayer’s working interest in the two leases. At the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years.

P.G. Lake, 356 U.S. at 262.

The Supreme Court concluded that

[t]he substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

P.G. Lake, 356 U.S. at 266.

The Dresser court held that an exclusive right to the use of a patent is not only a capital asset, but its relinquishment for consideration does constitute a “sale or exchange” which qualifies it for capital gains treatment. In its opinion, the Dresser court noted that the Supreme Court’s opinion in P.G. Lake should not be read literally to mean that
I will try to offer a more analytical definition for capital gains and losses. Such definition, which relies on the economic process that creates the gain or loss, is based on a distinction between what I call “actual/genuine capital gain” and “disguised capital gain.” Such suggested analysis might change the traditional discussion and enable us to appreciate that the actual (genuine) capital gain component is much smaller than what we are normally accustomed to and, hence, the lock-in and risk-taking problems on the one hand, and the possibilities of “cherry-picking” losses on the other hand, are almost nonexistent. Furthermore, the analysis allows a better perception of the concept of realization. As a result this proposal may provide simple and practical solutions to most of the problems that exist in this area.

I shall concentrate on revealing the distinct components of capital gains and losses and discussing the underlying rationales for the realization requirement. This calls for an appreciation of the real magnitude of capital gain and reconsideration of some of the current rules, such as the capital loss limitations, the recapture provisions, and the ordinary treatment of losses on depreciable business assets.

It is important to understand how the gain (or loss) is created (i.e., the components of capital gain and the major causes of capital loss). I will try to offer an analytical definition of that phenomenon—a definition that differentiates between two components: an actual (genuine) capital gain and a disguised capital gain. This distinction enables us to realize that only the former should be classified, for income tax purposes, as capital gain. The latter is deferred or accumulated (retained) ordinary income. Such a distinction permits a more moderate approach concerning capital loss limitations. Finally, even when accepting the need for tax preferences for capital gains,

\[\text{Any money paid which represents the present value of future income to be earned is always taxed as ordinary gains. As a legal or economic position, this cannot be so. The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income.}\]

*Dresser Industries*, 324 F.2d at 59. *Dresser* differentiated between selling the right to earn income and selling the right to earned income; the latter being an ordinary income transaction. *Id.* Thus, *Hort, Lake*, and *Dresser* demonstrate courts' recognition of the distinction between actual capital gains (increase in value) and disguised capital gains (selling of the right to future income).
they should be limited to the actual (genuine) capital gains only.

II. THE ESSENCE OF CAPITAL GAINS AND CAPITAL LOSSES

The value of an asset is commonly determined based on the expected yield of future income, the estimated value of the asset as scrap at the end of its expected useful life (“salvage value”) and the estimated interest rate used to capitalize future income to present value.

Therefore, when a taxpayer sells an asset, the price she receives reflects her and the buyer’s estimations of anticipated income the sold asset is expected to generate. If current estimates match previous ones, the sale price will be similar to the purchase price originally paid. If the new estimation indicates a decline in income expected to be generated from the asset for any given reason, such as a decrease in the lifetime of the asset as compared with the period expected at day of purchase, it is likely that the taxpayer will incur a loss when sale of the asset takes place. If the estimation at the time of sale foresees an increase in the future stream of income the asset is expected to generate, it is likely that the taxpayer will profit from selling her asset. Put together, capital gain derives from the assumption that the estimated future income the asset is expected to yield is higher at the date of the sale than was anticipated in the past.

Hence, capital gain (or loss) is the difference between the present value of the total future income expected to be generated by the asset, as determined at the time of purchase, and the present value of the total future income expected to be generated by the asset, as determined at the time of sale. In other words, capital gain (or loss) is a product of a change in expectations that took place during the holding period with regard to the potential production of the sold asset.

7 If, however, the asset is a depreciable one—meaning that its value is decreased during the process of income production—the price received by the seller-taxpayer will reflect the decline in value taken into account using annual depreciation rates.

8 From this definition arises the claim that taxation of capital gain creates double taxation of income: a person wanting to buy an asset will take into account the taxes imposed on the asset and therefore will offer the seller a price that reflects amounts which will be deducted as tax in the future. In other words, the buyer shifts over the tax on the future income that the asset is expected to produce. Therefore, if we charge the seller with capital gains tax on the asset sold, the result is seemingly double taxation! For further discussion of the double taxation on capital gain, and negation of the argument, see infra Part IV.
For example: A person considers an investment in a nondepreciable asset (e.g., a bond) that is assumed to produce an annual yield of $10 for 3 years and which is to be redeemed at the end of the third year for its original cost. If the “market interest rate” is 10%, the cost of such an asset is $100. After one year, she collects the annual income and sells the asset for the same amount, $100, provided that the above assumptions have not changed. If there is a change in one of the above assumptions (i.e., a market interest rate increase or decrease, a change in the annual yield of income, or a change in the length of the production period), then she will have a capital gain or a capital loss. Assume now an alternative arrangement: namely, that the annual return is reinvested by the asset issuer and the investor will collect the proceeds at the end of the third year. If the above assumptions do not change, then when the investor sells the asset at the end of the first year for $110, her gain of $10 should not be classified as a capital gain but as ordinary income. The gain realized is not a result of a change in the estimated future income. It is actually the income yielded from the asset during the holding period. If, on the other hand, at the end of the first year, the market interest rate dropped to 9%, the investor could sell the asset for $112.028. The $12.028 realized as gain includes two distinct components: $10 is disguised capital gain, as discussed above, and should be taxed as regular income; $2.028 is actual (genuine) capital gain. This gain represents the change regarding the present value of the income the asset is expected to yield.

These examples enable us to draw a basic and significant distinction between capital income and capital gain. The former is income from capital consisting of realized proceeds generated by an asset during the taxable period it is held. The income is a result of

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9 In this article I assume there is such a phenomenon called “market interest rate” and I disregard the risk effect of each investment.

10 The present value of such a bond would be calculated as follows:

\[ \frac{10}{1.10} + \frac{10}{1.10^2} + \frac{10}{1.10^3} + \frac{100}{1.10^3} = 100 \]

11 Once again, the present value would be calculated as:

\[ \frac{10}{1.10} + \frac{10}{1.10^2} + \frac{100}{1.10^2} = 100 \]

12 For further discussion see infra Part III.A.2.

13 Under such an investment, the investor’s return at the end of the third year is $133.10 ($100 * 1.10^3). After one year the present value of the proceeds, discounted now for only two years, is $110 ($133.10/1.10^2).

14 Sales price of $110 – purchase price of $100.

15 As a result of the decrease in interest rate, the present value would be $112.028 ($133.10/1.09^3).
occurrences that have already taken place. Hence, it is certain. The taxpayer can decide whether to receive it in cash or to allow reinvestment of the realized return and wait for the actual cash receipt of the accumulated/compounded earning. No ex ante anticipations are involved. It is therefore ordinary income. The latter, on the other hand, refers to proceeds obtained from the sale of the asset, which is actually a realization of the increase in the anticipated income the asset is expected to yield in future years. Based on ex ante anticipations, it is uncertain, and is truly a capital gain.

Note, however, that capital gain represents neither the present value of the future stream of income when the asset is sold nor the accumulated income that the asset had produced in the past. Capital gain (or loss) represents the change in the anticipation that occurred during the holding period with regard to the future stream of income; a positive change produces a capital gain, a negative change produces a capital loss.

The same concept applies to depreciable assets, whether tangible or not, as well as financial assets including stocks and bonds, as will be shown.

The underlying concept of the above definition for capital gain is also applicable when one considers a depreciable asset. Capital gain (or loss) is the difference between the present value of the total future income expected to be generated by the asset, as determined at the time of purchase, and the present value of the total future income expected to be generated by the asset, as determined at the time of sale, deducting amounts representing capital recovery incurred by the taxpayer during the holding period. These deductions are called depreciation or amortization.

III. ACTUAL AND DISGUISED CAPITAL GAINS AND THE CAUSES FOR CAPITAL LOSSES

A. Financial Instruments

The value of securities is determined by two elements. The first is the capitalized future proceeds expected from the securities. The other is the realized undistributed (accumulated/retained) reinvested earnings. Hence, gain from the sale of securities may be derived from

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16 See infra Part III.B.
17 See I.R.C. § 197.
18 See supra notes 7-10. I disregard the risk factor.
The first component of a gain (or a loss) is the difference between the following two amounts: (a) the present value, calculated at the date of the sale, of the expected future proceeds of the securities and (b) the present value, calculated at the date of purchase, of the expected future proceeds of the securities. In other words, this element of the gain is created by the changes in the anticipation with regard to the potential proceeds the securities will produce, i.e., it is the actual (genuine) capital gain or “the actual component.” Changes in the expected proceeds can result from several factors, including, inter alia, a change in the market’s interest rate, the issuer’s current achievements as compared to past performance, a rise in the demand for the issuer’s products or the elimination of competitors from the market. In other words, an actual (genuine) capital gain is a market gain.

The second component of the gain is derived from the issuer’s reinvested profits during the holding period. Here, gain is produced by the increase in an issuer’s equity, representing the firm’s accumulated earnings that were not distributed yet as dividends or interest. It is not created by the market but by the taxpayer and other related parties. This second component is herein referred to as the “disguised capital gain,” “ordinary gain,” or “reinvested gain.”

When an investor sells securities at a gain, an accurate analysis should distinguish between these two different components that contribute to the growth or loss in value of a stock, bond, or other security. This distinction can be seen by isolating the “disguised capital gain” and identifying it as ordinary income. The rest of the gain is actual capital gain.

1. Stocks

   a. Triple Tax on Corporate Earning

   The argument concerning triple taxation is as follows: when a
shareholder realizes a gain by selling his stock, his disguised capital
gain has already been taxed at the corporate level. Taxing this 
component again would result in double taxation, which, due to the
capital gain tax, ultimately results in a triple tax on the corporate 
earning (as will be shown) as long as we maintain the current rules of 
capital loss limitations.

This concept is illustrated by the following example: suppose that 
during one year, John Doe invests $5000 in a C corporation, which is 
100% of the company’s stock. During that year, the company earns 
$1000 and pays corporate tax of 35%. The after-tax company profits 
are consequently $650. At the beginning of the second year, John 
Doe sells his stock for $6000. Under current law, John Doe should 
report a capital gain of $1000. Furthermore, suppose that a few weeks 
later, Joanne, who purchased the stock from John for $6000, receives 
a $650 dividend from the company. Under current law, Joanne must 
report the dividend as $650 of taxable income. Under such a system, 
the above corporate earnings of $1000 are triple-taxed!

In this example, total revenues collected by the Internal Revenue 
Service are:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate tax (35% * $1000)</td>
<td>$350</td>
</tr>
<tr>
<td>John’s capital gain tax (15% * $650)</td>
<td>$97.50</td>
</tr>
<tr>
<td>Joanne’s tax on dividend (15% * $650)</td>
<td>$97.50</td>
</tr>
<tr>
<td>Total tax paid</td>
<td>$545.00</td>
</tr>
</tbody>
</table>

As a result, the ultimate tax rate is 54.50%!^23

However, note that if Joanne sells her stock for $5350, she will 
realize a capital loss of $650!^24

Now let us turn to the accurate analysis:

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^22 Note that John’s total gain is $1000, but only $650 has already been taxed as the corporate earnings. The remaining $350 has never been taxed. The $350 is John’s earnings—not the corporation’s—and it is attributed to John’s decision to sell his stock at a given price. Hence, it should not be included within the gain that is subject to the “triple tax” on corporate earnings.

^23 Note that under the law prior to 2003 the taxes paid would have been significantly higher:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate tax (35% * $1000)</td>
<td>$350</td>
</tr>
<tr>
<td>John’s capital gain tax (28% * $650)</td>
<td>$182</td>
</tr>
<tr>
<td>Joanne’s tax on dividend (39.6% * $650)</td>
<td>$257.40</td>
</tr>
<tr>
<td>Total tax paid</td>
<td>$789.40</td>
</tr>
</tbody>
</table>

As a result, the ultimate tax rate would have been 78.94%!

^24 For further discussion of capital losses, see infra Part VII.
Using the proper calculation, at the end of the second year, John’s tax returns pertaining to the gain realized by the sale of the stock should read as follows:

| Total profits | $1000 |
| Dividend      | $650  |
| Capital gain  | $350  |

Suppose that a few days following the sale transaction, the company distributes its earning as a dividend. In the first scenario, Joanne, who purchased the stock for $6000, actually purchased two assets: the stock, including the right for future corporate earnings, and $650 of retained earnings. Consequently, she should report an original cost of $6000. Upon receiving the dividend, using the first example, she should report a capital recovery of up to $650, and the basis of her stocks will decrease correspondingly to $5350. However, if the stock’s market value rises to $7000, and Joanne sells it during the tax year but prior to reports of the company’s earnings during the second year, then the difference of $1650 should be her genuine capital gain.

The second scenario is similar to the first, except that the company distributes to Joanne a dividend of only $400. Using a similar approach, Joanne should report capital recovery of $400, and the basis of stocks purchased will be $5600. Selling her stocks for $7000 (as specified in the previous example) during the tax year but prior to reports of the company’s current annual earnings generated during the second year, she receives total earnings of $1400, which will be classified as follows: a capital recovery of $250 and a genuine capital gain of $1150. The basis of the stock is once again $5350.

The third example assumes that in addition to the $400 dividend mentioned above, the company distributes another $600 (a total of $1000 during the tax year). The source of this distribution is partly a dividend from profits accumulated during the previous year and partly a midterm dividend generated from profits earned during the second

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25 No need to add that the requirement dealing with the date the company’s profits are published is arbitrary when accounting for the company’s income, due to the fact that the company’s profits could accumulate on a daily basis rather than on an annual basis. However, the use of the tax year as a time frame, as strict as it may be, is an accepted functional compromise used in every income tax system.

26 Sales price of $7000 – adjusted basis of $5350.

27 Sales price of $7000 – basis of stocks purchased of $5600.
year. In this case, Joanne should report the following upon receiving the dividend:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recovery of Capital</td>
<td>$650^{28}</td>
</tr>
<tr>
<td>Dividend</td>
<td>$350</td>
</tr>
<tr>
<td>Total</td>
<td>$1000</td>
</tr>
</tbody>
</table>

As a result, the basis of her stock is $5350.$^{29}$

If she sells the stock for $6400^{30}$, her profit of $1050^{31}$ should be taxed as capital gain. The buyer’s original cost for the stock purchased is $6400.

### b. Measuring the Disguised Capital Gain on Stock

One should not overlook the practical problem concerning how the portion of disguised capital gains ought to be measured. This problem may be solved in rather simple fashion, by examining the corporation’s balance sheet and its tax return. The following is a suggested formula for accurate isolation and identification of the retained (and already taxed) corporate gains:

When a taxpayer disposes (sells) a corporate share (stock), the proceeds of the sale will be divided into two components: an actual (genuine) capital gain (or loss) and his relative (pro-rata) share of the “Retained Taxed Corporate Earning.”

The term “Retained Taxed Corporate Earning” refers to the corporate earnings accumulated within the corporation during the period which began at the end of the year before the taxable year in which the taxpayer acquired the sold share and ended at the end of the year prior to the taxable year the taxpayer disposed of the share, according to the corporate balance sheets. The total amount of the Retained Taxed Corporate Earning shall not exceed a limit, which is the corporate taxable income during that period minus the corporate tax and any dividend paid by the corporation for and out of these profits and any other exempt income the corporation had during the

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^{28} Since the accumulated earnings of the corporation were $1000 and the corporate tax paid was $350, accumulated net earnings were only $650.

^{29} Purchase price of $6000 – recovery of capital of $650.

^{30} I assume that if she were able to sell the stock for $7000 after receiving a $600 “additional dividend,” she would be able to sell for only $6400, since she received an additional $600 as dividend.

^{31} Sales price of $6400 – new basis in stock of $5350.
above period of time.

As can be seen, the above formula begins with a general accounting term—corporate earnings—but ends with a safety net: the corporate taxable income minus the corporate tax and any dividend paid by the corporation for and out of these profits and any other exempt income the corporation had.

An example may illustrate the way this formula works:

Suppose Yuval bought 100 shares of X Corp, representing 10% of the company’s shares, in November 1998 for $920. The X Corp balance sheet is as follows:

<table>
<thead>
<tr>
<th>Taxable Year</th>
<th>Taxable income</th>
<th>Exempt Income (municipal bonds)</th>
<th>Corporate Tax (35%)</th>
<th>Dividend</th>
<th>Retained Earning (A+B) - (C+D)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>$800</td>
<td>$120</td>
<td>$280</td>
<td>$200</td>
<td>$440</td>
</tr>
<tr>
<td>1998</td>
<td>$760</td>
<td>-</td>
<td>$266</td>
<td>$52</td>
<td>$442</td>
</tr>
<tr>
<td>1999</td>
<td>$900</td>
<td>$220</td>
<td>$315</td>
<td>$320</td>
<td>$485</td>
</tr>
<tr>
<td>2000</td>
<td>$1000</td>
<td>$270</td>
<td>$350</td>
<td>$250</td>
<td>$670</td>
</tr>
<tr>
<td>2001</td>
<td>$1180</td>
<td>$340</td>
<td>$413</td>
<td>$600</td>
<td>$507</td>
</tr>
<tr>
<td>2002</td>
<td>$1100</td>
<td>$400</td>
<td>$385</td>
<td>$250</td>
<td>$865</td>
</tr>
</tbody>
</table>

Now assume that in August 2002 Yuval sells fifty shares for $634. His total gain is $174.\(^{32}\) His pro-rata share in the Retained Taxed Corporate Earning, under the above formula, is 5% of $2544\(^{33}\) or $127.20, which is, accordingly, his disguised capital gain. The rest of the gain ($46.80) is his actual (genuine) capital gain.

Note that the above formula takes into consideration all the adjustments needed to bridge the gap between the “accounting earning” and the tax accounting rules. In the same example, assume that the above corporation is using the cash method for tax purposes

\(^{32}\) The basis in fifty shares is $460 ($920 * 50%). Hence, the profit is $174 ($634 – $460).
\(^{33}\) Note that the earnings taken into consideration are those of 1997-2001; those of 2002 were ignored. The reason is practical: even though Yuval sold his shares in 2002, the last balance sheet available at the time of the sale is of 2001. So the formula represents a practical and workable concession, a lag of one year. For justification, refer to the tax benefit rule (“sometimes you lose, sometimes your gain”). See **Michael J. Graetz & Deborah H. Schenk**, *Federal Income Taxation Principles and Policies* 663-72 (4th ed. 2002); **Stephen F. Gertzman**, *Federal Tax Accounting* ¶ 12.05, at 12-36 (2d ed. 1993).
but the accrual method for its financial records. Thus, assume that in 1997 the above corporation had total earnings of $1520, $120 in tax exempt interest, $1400 received in cash, and $500 in receivables. Business expenses were $930: $600 paid in cash and $330 due next year. Hence, the corporate earnings are $1090 for financial purposes and $800 for tax purposes. Following the above formula, we reach the correct amount: we begin with the “corporate earnings” ($1090), but then, using the “safety net” limitation, we reach only the portion that was already taxed. Note, however, that the corporate exempt income was added, in this calculation, to the retained earnings. One may argue that the stockholders should also enjoy a tax exemption from this portion. This is a question of values and legislative priorities, however, and we need not deal with that here.

2. Bonds and Other Debt Assets

A similar approach should be applied with regard to debt assets. The following is an illustration of this concept using bonds. Assume Eliav purchases a bond redeemable in three years with a face value of $100 and an interest rate yield of 10%. With no changes in interest rates occurring during his holding period of the bond, Eliav can sell the bond for $100 within one year, provided that the yearly interest has been paid at the end of that year. However, if interest is accumulated, the sale price will be $110, with a gain of $10. In this example, profits earned ($10) should not be classified as capital gain, but rather as income, i.e., as interest or as a discount fee. Now,

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34 Note that the purpose of this formula is to enable the policymaker to identify the various elements of the shareholder’s gain. One may argue that the shareholder’s pro-rata share in the exempt interest should also be exempted when received as a dividend or realized as part of the shareholder’s capital gain, but this article does not comment on that position.


37 The total amount that will be paid at redemption is $133.10 ($100 * 1.10^3). The holder has to wait only two years to redeem the bond, hence, the present value of the bond is $110 ($133.10/1.10^2).

38 In order to simplify the above example, the present value of the interest at the end of three years was not taken into account.

39 For further discussion of the current law pertaining to Original Issue Discounts, see infra Part III.A.3.
assume that there has been a change in one of the factors, e.g., the market interest rate has decreased to 9%. Consequently, the bond’s value rises from $100 to approximately $112.028. If the bond is sold to Pat at this price, Eliav’s total profit of $12.028 resulting from the sale transaction should be categorized as follows: $10 as ordinary income (accrued interest) and the rest ($2.028) as capital gain.

Consequently, the following tax treatment should be offered to Pat, who purchased the bond from Eliav:

If Pat redeems the bond at the bond’s maturity for $133.10, $112.028 should be treated as capital recovery and $21.072 as ordinary income (interest). There is no capital loss.

If Pat receives at the end of each year an annual interest of $10, she should be allowed, in the first year, to consider $2.028 as capital recovery and the remaining $7.972 as ordinary income. In the second year of her holding period, the bond’s basis is $100, each interest payment she receives should be taxable income, and the $100 she collects at redemption should be an exempt capital recovery, without any capital loss.

It seems that this approach—distinguishing between “actual

---

40 Otherwise, the option faced by the buyer is to buy a bond with a yield of 9%. She will, therefore, be willing to pay $112.028 ($133.10/1.09^2).

41 Under the current law, Pat is to report an ordinary income (interest) of $33.10 and capital loss of $2.028, which is deductible only against capital gain. For a similar notion, see the discussion of the “Integration” solutions:

In response to transactions involving offsetting positions, the Code has in recent years required certain such positions, generally called straddles, to be integrated or netted for tax purposes. Accordingly, a taxpayer who holds positions in personal property that substantially diminish the risk of holding the positions separately is permitted to recognize loss on one position only to the extent that it exceeds the unrecognized gain on the other positions. Warren, supra note 19, at 474-76. See also I.R.C. §§ 246(c), 988(d), 1258. For a more general approach called the “schedular system,” see Robert H. Scarborough, Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax, 48 TAX L. REV. 677, 700 (1993).

42 Note though that it is arguable that the capital recovery should be prorated over the three years so the annual capital recovery during the three years is $0.676 ($2.028/3) and each year’s taxable income will be $9.324 ($10 – $0.676).

See generally, the fascinating debate whether capital recovery should be prorated between Douglas A. Kahn, Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?, 78 MICH. L. REV. 1 (1979), and Walter J. Blum, Accelerated Depreciation: A Proper Allowance for Measuring Net Income?!!, 78 MICH. L. REV. 1172 (1980), and then Douglas A. Kahn, Accelerated Depreciation Revisited—A Reply to Professor Blum, 78 MICH. L. REV. 1185 (1980).
capital gain” and “disguised capital gain”—mitigates the apprehension expressed by H. Simons: “[w]ith the rise of specialized investment trusts, the possibilities here are of no small proportions. ‘Convert your income into capital gains’ may well become a potent slogan for security salesmen of the future.” 43

3. Original Issue Discount 44

The distinction between the actual (genuine) and the disguised components of capital gain may help in understanding the rules pertaining to Original Issue Discount (OID), and in realizing that those rules provide accurate (and desirable) treatment.

OID occurs when a debt obligation (such as a bond, a note or any other evidence of indebtedness, including a written or oral agreement where one party provides current consideration in return for a promised consideration in the future) is issued at a “price” lower than the amount that is to be paid at maturity. The difference between the consideration paid at maturity and the consideration paid at the issuance is OID. 45

Before analyzing the treatment offered by the tax code, one should note that there is no essential economic difference between an issue at a discount and any other bond that pays interest, whether annually or on an accrual basis. Consider the following example: suppose that on January 1, 1997, the market interest rate was 6%. Corporation A offers three different types of bonds at an issue price of $1000. The first bond has a face value of $1000 and will pay interest of 6% annually over the next twenty years. The second bond has a face value of $1000 and is a zero coupon twenty-year bond with 6% annual interest. The third bond has a face value of $3207.14, will mature in twenty years, and is issued at a discount for $1000.

The first bond will pay the taxpayer $60 of interest annually and $1000 upon maturity. The second bond will pay $3207.14 at maturity—$1000 as capital recovery and $2207.14 as accrued interest. The third bond will pay its face amount of $3207.14, which equals the original issue price of $1000 plus the remaining $2207.14 as accrued interest.

If the taxpayer wishes to sell the bonds on December 31, 2002, she

43 HENRY C. SIMONS, PERSONAL INCOME TAXATION 153 (1938). On the latest developments and innovations, see Warren, supra note 19.

44 I.R.C. §§ 1272, 1273.

45 See GRAETZ & SCHENK, supra note 33, at 749-56; GERTZMAN, supra note 33, ¶ 11.02, at 11-9.
should receive the same price for any of them: $1060. In the case of
the first bond, this includes the $1000 face amount plus the 6%
interest for the first year, which will be paid immediately. As for
bonds two and three, the buyer will not receive the $60 (from the
issuer) immediately but will be compensated later since the postponed
interest is accrued. He will therefore be willing to pay the present
value of $3207.14 discounted for nineteen years: $1060.

Thus, assuming there is no change in the market interest rate, the
economic consequences are the same (overlooking the liquidity
offered by the first bond). An economic analysis shows that all of
these cases involve separate components: capital recovery and
interest. Accordingly, if there are no external changes (e.g., a change
in the market interest rate), there can be no actual (genuine) capital
gain.

An apparent difference does seem to exist when one considers the
possible outcomes of a sale of the instruments after two years on
December 31, 1998: the seller will receive $1060 for the first bond, but
$1123.60 for bonds two and three. Nevertheless, this does not reflect
an economic difference. The yield on the bonds is ultimately the
same. In addition to the $1060 the seller receives in year two from the
buyer for bond one, the seller also receives $60 of interest income in
year one for the bond. Assuming that the $60 was invested at 6%, its
value is $63.60 at the end of the year. Thus, the total yield is once
again $1123.60.

The similar economic outcomes lead to the conclusion that the tax
treatment of the three bonds should also be the same. Since a
taxpayer reporting on an accrual basis is required to report interest
annually regarding the second bond, similar treatment should be given
to the third bond. The OID rules confirm that there is no difference
between the two bonds. The OID rules also disregard the difference
between taxpayers reporting on a cash basis and those reporting on an
accrual basis.

The Deficit Reduction Act of 1984 added sections 1271 through
1278 and modified section 483. These added sections realize two

\[\frac{3207.14}{1.06^{19}}\].

\[\frac{3207.14}{1.06^{18}} = 1123.60.\]


\[\text{Id. at sec. 41, 98 Stat. at 531-48, 553-55. See Michael J. Graetz, Federal Income Taxation Principles and Policies 957-58 (2d ed. 1988).}\]
main objectives: OID is taxed as regular income rather than as capital gain, and OID receives treatment equivalent to that of a bond paying a market rate of interest.

Section 1272 sets the method by which OID is to be recognized for obligations issued after July 1, 1982. Roughly, recognition involves the following procedure. First, the debt instrument’s “yield to maturity” is determined by calculating the interest rate that will cause the issue price to rise and reach the redemption price. The yield must be constant over the entire term of the debt. If the loan involves payment of a fixed rate of interest over the entire term of the debt, such as in loans with indefinite maturities payable on demand, then the yield to maturity is the specified interest rate. Next, the length and number of accrual periods (defined in section 1272 as a period of six months or shorter from the date of the original issue) are determined. The amount of OID allocable to each accrual period is then computed using the yield to maturity. OID is then allocated to each day in an accrual period (these periods do not exactly match tax years). OID allocated to the final accrual period is any excess left, thus ensuring that all OID is taken into account.

OID, which the taxpayer must recognize, increases the basis in the obligation. This leads to a reduction of capital gain if and when the obligation is sold. In the above example, bond three involves OID in the amount of $2207.14. After one year, the taxpayer is required to recognize $60 as regular income. As a result, her basis in the obligation is no longer $1000, but $1060. If she sells the bond for $1100, $40 and not $100 is taxed as capital gain (the actual capital gain

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51 Pub. L. No. 98-369, sec. 41, 98 Stat. 494, 531-48, 553-55 (1984). The Deficit Reduction Act of 1984 did not change the policy that existed before in § 1232, other than providing for reduction of abuse and tax shelters. Under section 1232, repealed by the Act of 1984 and replaced by sections 1271-72, the Internal Revenue Code (Code) demanded that OID be reported ratably over the period between the dates of issue and maturity. This allowed the sale of deep-discount bonds to tax exempt organizations that were indifferent to income overstatement and, as a consequence, the issuers of the bond enjoyed interest deductions greater than the accrual of interest, even before any cash payment was made to the bondholder. See Graetz, supra note 50, at 953-55 (2d ed. 1988); Gertzman, supra note 33, ¶ 11.01[2][a], at 11-7 to 11-8. The old provisions were also limited in scope.


53 I.R.C. § 1272.

54 For a detailed and accurate explanation, see Gertzman, supra note 33, ¶ 11.02[3][a], at 11-17 to 11-25.

55 I.R.C. § 1272(a)(5). See also Gertzman, supra note 33, ¶ 11.02[3][a], at 11-20 to 11-21.
component).

It is worth noting that sections 1271 and 1272 prevent the conversion of ordinary income into capital gain when there exists the intent to call the instrument before maturity at the time of original issue.\footnote{I.R.C. §§1271, 1272.} If the instrument is called prior to the date of maturity for its value at the date of maturity, a portion of the OID has not been allocated. If such intent is present, the gain realized on the sale or exchange of the instrument that does not exceed unaccrued OID will be regarded as ordinary income.\footnote{GERTZMAN, supra note 33, ¶ 11.02[2][a], at 11-13 to 11-14.}

One can see that in this matter of OID taxation, the Internal Revenue Service’s policy exemplifies the proposed definition in this article. It embodies a correct distinction between actual (genuine) and disguised capital gain and an identification of the real economic essence of the transactions. My claim is that OID taxation does not change the rules regarding realization. I discuss this matter below, offering a conceptual analysis of the realization requirement.\footnote{See infra Part VI.}

**B. Depreciable Assets**

As noted previously, gain from the sale of depreciable assets equals the difference between future income the asset was expected to yield at time of purchase minus depreciation deducted and the future income expected from the asset at time of sale.

One may argue that if we would allow only accurate depreciation deductions each year, then no capital gain or loss would occur. If this argument is valid, then the current recapture rules are justified. This argument overlooks the causes for the increase or the decrease of the asset’s value during the taxable year. The goal of recapture is to “correct the mistakes” that took place in the previous year's calculations of the annual taxable income and to compensate the tax authorities for the revenue lost during those years for the “excessive” depreciation deductions.

However, the current rules are too broad and sweeping. As discussed previously, the reasons for the change in the asset’s value may be classified into two major categories: events that already took place (ex post) and anticipation regarding the events that will occur in the future (ex ante). The underlying assumption under the current recapture rules is that if a depreciable asset is sold at a gain, the
annual depreciation taken during the holding period was too high. But this is not necessarily the case. It is possible that the annual depreciation was correct or should even have been greater than that deducted during the holding period. A change in the asset’s value might have occurred for reasons external to the asset’s production process (“external reasons”). These external reasons may derive from ex ante anticipations, such as a shortage of new assets in the market, an anticipated increase in price of the products the asset produces, or changes in the market interest rate. A change in the asset’s value might also have occurred for reasons considered “integral” to the production process. These reasons are based on ex post assumptions such as the actual wear and tear of the asset or its capability to produce more (or less) units of production than expected when bought.

The “external” reasons have nothing to do with the previous years’ depreciation. They represent an actual (genuine) capital gain and should be treated as capital gain. The “integral” reasons are the causes for the changes in the asset’s value that took place already (ex post causes), and should be considered disguised capital gain and recaptured as ordinary income.

How do we distinguish between the outcomes of these two different sets of reasons? Accurate analysis is not available. A practical solution is to calculate proper depreciation and adjust the value when the asset is sold. Since the taxpayer made annual depreciation deductions based on assumptions that produced a given market value which eventually proved erroneous, these errors can be fixed when the taxpayer realizes the asset by recalculating the accurate depreciation retroactively. This can be done by deducting the net gain that the taxpayer realizes at the sale from the cost of the asset in order to determine the tentative annual depreciation amount. The difference between the actual depreciation deductions and the tentative ones should be regarded as disguised capital gain and, hence, should be recaptured.

This concept is illustrated by the following example: suppose an asset is expected to yield a declining yearly business income in each of the next five years ($1137, $1061, $985.40, $909 and $833). Its value at the beginning of the sixth year is zero. Given an interest rate of 10%, the asset’s value at the beginning of the first year is around $3789.\(^{59}\) If we use a 20% straight-line depreciation, then the yearly depreciation

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\(^{59}\) The present value of the cash flow is calculated as follows:

\[
\frac{1137}{1.10} + \frac{1061}{1.10^2} + \frac{985.40}{1.10^3} + \frac{909}{1.10^4} + \frac{833}{1.10^5} = \$3789 \text{ (rounded)}
\]
will be around $758.\textsuperscript{60} Hence the annual business taxable income in the first year is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine cost</td>
<td>$3789</td>
</tr>
<tr>
<td>Business income</td>
<td>$1137</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$758</td>
</tr>
<tr>
<td>Taxable Business Income</td>
<td>$379</td>
</tr>
<tr>
<td>Book Value (&quot;basis&quot;)</td>
<td>$3031</td>
</tr>
</tbody>
</table>

Suppose that at the end of the first year we discover that the above estimation was “wrong” and it is now assumed that the asset will produce the above stream of income for another five years instead of four. With no other changes, the asset’s market value at the end of the first year, after the annual depreciation of $758, is once again $3789. Selling the asset at that time and price produces a gain of $758.\textsuperscript{61} Furthermore, it may be argued that, due to the new length of time, the annual depreciation should be around $631\textsuperscript{62} each year for six years. Hence, the annual income for the first year should be $506\textsuperscript{63} instead of $379.\textsuperscript{64} In addition, assume now that at the end of the first year we notice that the machine produces an annual return higher than was estimated, suppose an additional annual 10% higher than projected. The fair market value of the machine goes up to around $4168.\textsuperscript{65} In a

\textsuperscript{60} Assuming that calculating the depreciation this way (straight line: $3788.63/5) is correct. For different approaches, see supra note 42 and accompanying text.

\textsuperscript{61} This is due to the fact that of the sale price received, the taxpayer is entitled to deduct the asset’s purchase cost of $3789, which equals the projected income the asset was to generate during the first five years. Since the taxpayer has already deducted an amount of $758 as depreciation against income during the first year, she will have to deduct the depreciation amount from the original price to determine her new “basis” ("book value") in the asset. Otherwise, she will be deducting the same amount twice: once against capital gains and once against ordinary income. The “recapture” approach is based on the notion that deducting depreciation during the first year is “inappropriate” and, since it decreased the amount of taxable income, it should be recaptured and treated as ordinary income rather than capital gain. See, \textit{inter alia}, \textsc{graetz & schenk}, supra note 33, at 347-48, 570-71. My view is slightly different, as I explain below.

\textsuperscript{62} Machine cost of $3789 divided by six.

\textsuperscript{63} Business income of $1137 – the new six-year annual depreciation of $631.

\textsuperscript{64} Business income of $1137 – old annual depreciation of $758.

\textsuperscript{65} The increased cash flow over the five year period will result in a present value calculated as follows:

\[(1137 + 1137 \times 10\%) / 1.10 + (1061 + 1061 \times 10\%) / 1.10^2 + \]
more accurate capital recovery calculation, under the above new anticipation and the “new” length of the holding period, the annual depreciation should be, based on the amount spent,\textsuperscript{66} $631\textsuperscript{67}$ (the revised depreciation). Consequently, the ordinary taxable income in the first year should be $620\textsuperscript{68}$ instead of $379\textsuperscript{69}$. Yet both calculations for annual depreciation, which produced the $758 and $631, are based on uncertain assumptions. A practical tax system will not change the initial assumptions as long as the taxpayer has not realized the asset.

Assume now that the taxpayer disposes of the asset at the end of the first year for its market value of $4168. She realizes the following gain:

\begin{itemize}
  \item Sale price: $4168
  \item Cost: ($3789)
  \item One year depreciation: $758
  \item Basis ($3031)
  \item Gain $1137
\end{itemize}

On the other hand, the calculation of the taxpayer’s business annual taxable income is based on the deduction of the amount that is considered as her capital recovery. As we showed above, her real capital recovery under the current system ($758) was higher than it should be under the “revised depreciation” ($631). Hence, her reported taxable income ($493\textsuperscript{70}) was smaller than the more accurate amount ($620), which is produced by the revised depreciation. We may argue that the difference between these two figures, $127,\textsuperscript{71} is

\begin{equation}
  ($985.40 +$ 985 \times 10\%)/1.10 + ($909 + $909 \times 10\%)/1.10 + \left(\frac{833 + 833 \times 10\%}{1.10}\right) = 4168 \text{ (rounded)}
\end{equation}

\textsuperscript{66} The depreciation should be based on the amount actually spent by the taxpayer and not on the “new appreciated basis.” If the taxpayer would have paid tax on the unrealized gain, then she should be allowed to include the notional price in the new basis of the machine. Tax symmetry requires that once the appreciation amount is taxed, it should be treated as an amount spent by the taxpayer in her capacity as the holder-buyer of the asset. See the “mark to market” rules, Warren, \textit{supra} note 19, at 474. \textit{See also} I.R.C. § 475(a).

\textsuperscript{67} The notion that the depreciation should be based on the new market value of $694.67 ($4168/6) is correct only if we tax the taxpayer on her unrealized gain. Otherwise, no deduction is allowed for any amount higher than the actual amount spent by the taxpayer.

\textsuperscript{68} (Business income of $1137 times 1.10) – annual depreciation of $631.

\textsuperscript{69} Business income of $1137 – annual depreciation of $758.

\textsuperscript{70} Gross income of $1,251 – depreciation of $758.

\textsuperscript{71} More accurate taxable income of $620 – reported taxable income of $493.
deferred current income and is deferred only as a matter of practical concession. Once the taxpayer realizes the asset, we can straighten up her taxable income and get rid of the “mistakes” (deficiencies) we made due to the practical concessions.

The total gain she made by selling the machine for $4168 is indeed $1137. If the above definition for capital gain is followed, under the “revised depreciation” we may reclassify the total gain of $1137 into two types of income. There is ordinary income of $127 (defined above as “deferred income”). This component of the gain is a result of the concession we made regarding the annual depreciation. The rest of the gain ($1010) is indeed capital gain, since it has been created due to two changes in the previous estimations: the length of the productive period and the amount of the annual stream of income in the future. Under the current law, the total amount of $758 is recaptured and taxed as ordinary income and the difference between $1137 and $758 is considered capital gain.

So far, the above discussion of the revised depreciation has been based on the assumption that the reasons for the asset’s increase are known and, in particular, that the original and new length of the productive period can be calculated easily. However, in real life it is almost impossible to assume that the taxpayer and the tax authorities use these calculations. Reality leads us to change the way we observed the above discussion and to use a second best solution, i.e., one based on narrower yet more concrete assumptions. Suppose the only things the taxpayer knows is that she bought the asset for $3789, that the asset yielded gross income of $1251 during the first year, that the statutory rate of depreciation is 20%, and that she was offered the amount of $4168 for selling it at the end of the first year. Her nominal gain is still $1137. The “second-best revised depreciation” formula to identify the “deferred current income” component is as follows. Once the taxpayer sold the asset with a gain, that gain has to have an impact on the real economic cost of the asset. We know now, ex post, that her real cost of the machine was the actual cost minus the net gain she made on the machine. This new reconstructed cost should be the basis for the depreciation (“the second-best revised depreciation”). The difference between these two ways of recapture is that the revised depreciation is based on ex ante anticipation and the second-best revised depreciation is based on ex post assumptions that do not involve uncertainty.

72 Sale price of $4168 – new basis of $3031. The new basis is purchase price of $3789 – one year depreciation of $758.
In the above example, the net gain\textsuperscript{73} should reduce the real economic cost of the asset for depreciation purposes. Instead of an annual depreciation of $758,\textsuperscript{74} we know now, ex post, that the depreciation had to be only $621.\textsuperscript{75} The difference between the annual depreciation and the newly determined depreciation is $137 and is the “deferred current income” that should be recaptured after the taxpayer sells the asset and realizes the gain (“the second-best revised depreciation”). In other words, out of $1137, $137 represents the disguised capital gain and the remaining $1000 is actual capital gain.

The American system is more practical and simpler, yet too sweeping. Under Code section 1245, from the total gain (in the above example, $1137), all the amounts previously deducted as depreciation ($758) are recaptured as ordinary income and the rest of the gain ($379) is considered capital gain.

C. Selling Assets at a “Reduced Price”

Suppose Selma has real property with a book value of $3,800,000 in 1996. On December 1, 1996, she rents it out for a long period of time for $500,000 and collects the entire amount in advance. The rent is to begin on January 1, 1997. On December 15, 1996, when the asset’s book value is $3,800,000 and the market value is $5,000,000, she sells the asset to Brian. However, since the asset was rented out with rent paid in advance, Selma (the seller) gives Brian (the buyer) a “discount” of $500,000 and collects only $4,500,000. Her total gain from both transactions (renting and selling) is $1,200,000.

Such a transaction can be analyzed in one of the two following ways (each of which leads to different tax results):

According to the first approach, one would say that Selma sold the asset for $4,500,000. Hence, out of her total profit of $1,200,000, $700,000 is capital gain and the $500,000 discount is ordinary income, which is taxed at the time of actual receipt of the rent. Brian’s cost of the property for both depreciation based on income the asset will generate and gain at the time of sale is $4,500,000.

\textsuperscript{73} Since I assume that the gain should reduce the real economic cost of the machine, I take into consideration only the net gain after tax, since the tax itself is paid by the taxpayer and does not reduce the real cost.

\textsuperscript{74} Initial cost of $3789 divided by five years.

\textsuperscript{75} (The initial cost of $3789 – net gain for the year of $682) divided by 5. Assuming a tax rate is 40% with no tax preferences to the capital gain, the net gain for the year was $682. The net gain was total gain of $1137 \times (1 – tax rate of 40%).
The other approach is based on the assumption that Selma sold the asset for $5,000,000. Since the rent was paid for a period of time when Selma will no longer be the owner of the property, the payment she received from the renter on December 15, 1996 cannot be her income. She received it as Brian’s agent. Accordingly, when Selma sold the asset to Brian, she owed Brian $500,000. In return Brian owed Selma the amount of $5,000,000 for buying the property. By paying only $4,500,000, Brian simply offset Selma’s debt. Under these assumptions, the total gain is actually Selma’s capital gain. Brian’s cost for any tax purposes is $5,000,000, which enables him to take higher depreciation deductions. In addition, Brian should include the $500,000 rent as his income. Therefore, Brian’s income from rent in this discussion is zero.

Assume now that the rent is for ten years and begins on December 1, 1998 (the annual rent is thus $50,000). With no other changes in the above assumptions, we may conclude that the “discount” Selma gives to Brian is only $400,000. Hence, out of the total gain of $1,200,000, $400,000 is ordinary rent and $800,000 is capital gain, whereas the transaction price is still $5,000,000!

Note that if capital gain is taxed as ordinary income, the differences between the two approaches become insignificant for Selma. If capital gain is exempt or enjoys a lower tax rate, the meaning of the difference is quite clear. Furthermore, this analysis changes Brian’s tax returns. Under the first approach, Brian will be able to defer the rent he actually received—as a “discount”—for a period depending on the asset’s depreciation.

It is clear, however, that regardless of the choice between the two alternatives suggested above, one must discern between two distinct

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76 There is no need to discuss the different ways of reporting the prepayment of a rent. The basic rule is that rent payments are included in income in the year of actual or constructive receipt without regard to the period to which the rent relates. GERTZMAN, supra note 33, ¶ 3.02[3][d], at 3-30 to 3-31 & nn.112-13; see also SIMONS, supra note 43, at 115-25; William F. Hellmuth, Homeowners Preferences, in COMPREHENSIVE INCOME TAXATION 163 (Joseph A. Pechman ed., 1977); Donald B. Marsh, The Taxation of Imputed Income, 58 POL. SCI. Q. 514 (1943). Also not discussed are the various ways of dealing with changing a previous year’s tax return and the “tax benefit rule.” GERTZMAN, supra note 33, ¶ 9.06, at 9.38.

77 For simplicity’s sake, assume zero interest rate, and hence no present value calculations.

78 She has already received two years’ worth of rent totaling $100,000 (2 * $50,000).

79 One may doubt the above conclusion and calculations since they ignore the fact that these transactions may affect the fair market value of the asset.
components of the gain. One component is actually rent and, whether received by the buyer or the seller, should be classified as ordinary income. The other component is actual (genuine) capital gain.

This analysis, as this article attempts to point out, should be extended towards other areas of taxation.

IV. DOUBLE TAXATION OF CAPITAL GAIN?

A. Does Income Tax on Future Income Cause Double Taxation?

The above discussion may lead to the conclusion that taxation of capital gain on the one hand, and taxation of income derived from the asset on the other, results in double taxation. The double taxation argument is as follows: the price a buyer of a capital asset is willing to pay already accounts for the fact that the future income derived from the asset will be taxed later in the future. In other words, the buyer is ready to pay a lower price to the seller, and the seller is thus taxed indirectly. Additional tax on the seller’s capital gain results in double taxation of the same income and maybe even on the same taxpayer.

The distinction between disguised capital gain and actual (genuine) capital gain may help to refute this argument as well. As shown, the double taxation problem is a real one for the “disguised portion” and calls for reconsideration of the sweeping capital loss limitations. This is not the case concerning actual (genuine) capital gain. In this sense, one may easily refute the double-taxation argument, since it is unfounded with regard to actual (genuine) capital gain, whether the sold asset is depreciable or nondepreciable.

1. Depreciable Assets

A simple proof that no double taxation occurs due to the taxation of actual capital gain is demonstrated by the fact that the seller offers the same price for the asset, regardless of whether her future income will be tax free or fully taxable, as long as we have a comprehensive tax system.

In a world without tax, we saw earlier that the present value

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80 See the discussion of these two topics, supra Part III.A.
81 See the discussion of the double taxation of the retained earning-dividend distribution, supra Part III.A.1.a.
82 See infra Part VI.
83 I am indebted to Professor Alvin C. Warren for that demonstration.
Capital Gain and Capital Loss

(using a discount rate of 10%) of five annual payments of $1137, $1061, $985.40, $909, and $833 is $3789. When taking into account the income tax the buyer will pay in the future, we find that the present value does not change at all (it remains $3789) because the discount rate should also be reduced from the pre-tax rate (10%) to the net rate of return (6%, if we assume a 40% tax rate):

All amounts are in dollars

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Gross Income</td>
<td>1137</td>
<td>1061</td>
<td>985.40</td>
<td>909</td>
<td>833</td>
<td>3789.25</td>
</tr>
<tr>
<td>B Depreciation (20%)</td>
<td>758</td>
<td>758</td>
<td>758</td>
<td>758</td>
<td>758</td>
<td>3789.25</td>
</tr>
<tr>
<td>C Taxable Income (A-B)</td>
<td>379</td>
<td>303</td>
<td>227.40</td>
<td>151</td>
<td>75</td>
<td>3789.25</td>
</tr>
<tr>
<td>D Income Tax (C * 40%)</td>
<td>151.60</td>
<td>121.20</td>
<td>90.96</td>
<td>60.40</td>
<td>30</td>
<td>3789.25</td>
</tr>
<tr>
<td>E After tax cash flow (A-D)</td>
<td>985.40</td>
<td>939.80</td>
<td>894.44</td>
<td>848.60</td>
<td>803</td>
<td>3789.25</td>
</tr>
<tr>
<td>F Present Value (6%) (E)</td>
<td>929.62</td>
<td>836.42</td>
<td>750.99</td>
<td>672.17</td>
<td>600.05</td>
<td>3789.25</td>
</tr>
</tbody>
</table>

A different dimension of the double taxation argument, which may be refuted as well, is as follows. The sale price of the asset represents the present value of the future stream of income. Once capital gain from the sale of the asset is imposed, taxation of the actual stream of income at the hands of the buyer represents double taxation of the same income. Yet it is evident that this problem is prevented by allowing depreciation deductions as a means of capital recovery, since the cost of the asset purchased is fully amortized by the depreciation deductions. The issue is thus resolved. However, if there is a positive change in the projection of capitalized future income, it will eventually be taxed—paid for in part by the seller, and in part by the buyer, but double taxation does not occur.

A difficulty arises in cases where the depreciation rate determined is insufficient. Such an event is translated into deferring deduction of costs endured by the buyer. Practically speaking, the buyer is not entitled to deduct the original price paid. However, this is not related

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84 See I.R.C. § 67. Section 197 also allows amortization of acquired intangibles (e.g., goodwill or going concern value). I.R.C. § 197. See also Reuven S. Avi-Yonah, Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles, 55 TAX NOTES 981 (1992).

85 Using the above example (see text accompanying notes 60-75), after year one the seller is able to sell the machine for $4168 and realizes a gain of $1137 (sales price of $4,168 – new basis of $3031). In the following years, the buyer will realize $5417 ($1251 + $1167 + $1083 + $1000 + $916). Due to the depreciation deduction of $833.60 ($4168/5), her taxable income will be only $1249 [(1251 – $833.60) + (1167 – $833.60) + (1083 – $833.60) + (1000 – $833.60) + ($916 – $833.60)].
to the issue of capital gain tax imposed on the seller. The optimal solution is determining proper depreciation rates; the second best solution is to use the recapture rule when the asset is sold at a gain, and the negative recapture rule when it is sold at a loss.\textsuperscript{86} Note, however, that once the taxpayer disposes of the under-depreciated asset she will realize a loss, which the current system rightly treats as an ordinary loss rather than a capital loss.\textsuperscript{87}

2. Nondepreciable Assets

Suppose that in a world without tax, Yael bought stock that was expected to yield an annual income of $75 for an indefinite period of time. Since the interest rate when the asset was bought was 10%, Yael paid $750.\textsuperscript{88} After a while, the income increases to $100 and Tamar is willing to buy the stock from Yael for its present value, which is $1000.\textsuperscript{89}

Once a comprehensive income tax of 40\% is imposed (the same rate of 40\% is used for annual return and capital gain), the price of such an investment does not change: net annual income is $60 and the net rate of return is 6\%. Hence, Tamar is still ready to pay the same amount, $1,000.\textsuperscript{90}

Therefore, we conclude that under the above assumptions, the imposition of tax on Tamar's future income was not shifted by her to Yael, and thus no double taxation occurs.

\textbf{B. Taxing Capital Recovery as Income and the Capital Loss Limitation}

The real problem is indeed not the double taxation of capital gain, but rather the sweeping capital loss limitation rules. Consider the example used above\textsuperscript{91} where a nondepreciable asset, such as a bond, is purchased for a price higher than its face value due to a decline in the market interest rate (in the example used above, $112.028). The result is a situation where nominal income (e.g., $20 of annual interest over two years) received by the buyer includes “capital recovery” of $12.028. Redeeming the bond for $100 will generate a capital loss in

\textsuperscript{86} See I.R.C. §§ 1231, 1245, and the discussion infra Part VI.C-D.
\textsuperscript{87} See infra Part VI.B.
\textsuperscript{88} The annual income of $75 divided by interest rate of 10\%.
\textsuperscript{89} The annual income of $100 divided by interest rate of 10\%.
\textsuperscript{90} Net annual income of $60 divided by net rate of return of 6\%.
\textsuperscript{91} See supra notes 9-15 & 37-42 and accompanying text.
the same amount ($12.028) for the buyer. Thus, two problems arise. The first stems from advancing the date of tax payment—tax is imposed on interest during each of the first two years (on an accrual basis), while loss is recognized (if at all) only at the end of the second year (the $10 interest received at the end of the first year is taxed in full). The second problem stems from the inclination to classify the above-mentioned loss as capital loss, which is, under the current system, nondeductible against current income, and which originated from the sale of the asset. The solution for both issues is almost self-evident: the bond price of $112.028 is a result of the drop in interest rates from 10% to 9%. In order to calculate the interest and capital recovery for each payment the taxpayer will receive, we may use the statutory formula under Internal Revenue Code (Code) section 72.

Thus, out of total value $120 ($10 of earnings each year for the next two years plus $100 from the redemption price at the end of the second year), 93.357% of the total value represents capital recovery and the rest is ordinary income. Consequently, the buyer ends up with neither capital gain nor capital loss and the interest is fully taxed.

Yet, for practical reasons, such as the uncertainty regarding the market interest rate, the theoretical solution suggested may be unattainable. The difficulties arising may lead to using the second best solution, which in this case would allow the taxpayer to deduct capital loss (in our example $12.028) against income generated in the past from the asset sold. There is no need to add that both solutions lead to similar results with the only difference being the timing.

By using this suggested analysis we will be able to eliminate the “risk-taking” problem on the one hand, and yet prevent the erosion of the tax base of the highly diversified wealthy taxpayer by “cherry-picking” on the other, without shifting to a Haig-Simons system of

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92 See discussion against such limitations, infra Part VI.
93 I.R.C. § 72.
94 Initial investment of $112.02 divided by $120 equals the total amount to be received by the taxpayer (933567).
95 When using this solution, one could turn to section 7872(b) and use the applicable federal rate as a base for calculations (section 7872 deals with below market loans). I.R.C. § 7872. The statute dictates an interest rate that is considered to represent what parties dealing at arm’s length would have charged. GERTZMAN, supra note 33, ¶ 11.11[3][a], at 11-69 to 11-70.
97 The taxpayer will be able to choose a convenient date to dispose of the asset and realize a loss, which will offset regular taxable income. The common ground of
taxing unrealized gains.  

V. CAPITAL GAIN, ECONOMIC STAGNATION, AND A DEFINITION FOR REALIZATION

Some characteristics of capital gain are very well known. The first is a result of the fact that capital gain can be accumulated over several years. Realization of capital gain at one point in time creates major issues: calculating real profit during periods of inflation (the “Inflation problem”99) and higher tax rates in a progressive tax system (the “Bunching problem”). These problems can be easily solved without any tax preferences.100 The other sets of problems are related to the impact of capital gain taxation on the decisions of firms and investors.

A. Economic Stagnation: The Lock-In and the Risk-Taking Arguments

The most significant arguments in favor of tax preferences to capital gain are those based on the notion that any tax on capital gain may lead to economic stagnation.101 Businesses and investors are much more reluctant to realize their gains if they have to pay taxes. Hence, firms might choose not to replace an asset producing a lower rate of return if they take tax into account when calculating the cost of the new asset, which reduces its rate of return.102 Investors may prefer to hold on to old securities, stocks, and bonds that produce a lower

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98 Halperin, supra note 97.
100 See Beer, supra note 99; Halperin, supra note 97; Shuldiner, supra note 99.
101 Note, however, that “the efficiency effects of capital gains taxes, including the reduction in portfolio reallocations due to the lock-in effect and tax effects on risk taking and on the allocation of capital, are both important and rather complicated. . . .[T]here is considerable disagreement regarding the long-run effect on realizations. . .” George R. Zodrow, Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity, 48 TAX L. REV. 419, 423, 429-30 (1993). But see Vickrey, supra note 4.
102 See infra Part VI.B.
yield and avoid selling the assets and buying a more productive asset if they have to pay tax on their capital gains. Furthermore, taxing capital gain makes investors less willing to make risky investments because the tax reduces the expected return.

On the other hand, if capital gains are taxed as ordinary income, then one may argue that capital loss should be treated as ordinary loss and should be allowed as a deduction against any other income. This creates what is called the “cherry-picking” problem: the taxpayer will be able to choose a convenient date to dispose of the asset and realize a loss that will offset regular taxable income. The common ground of these problems and arguments is found in the realization requirement.

These problems have been discussed comprehensively and require no elaboration. Rather, these problems require an examination of whether the above-suggested analysis, which calls for a distinction between actual and disguised capital gain, changes the traditional discussion. Such an analysis may enable us to appreciate the true magnitude of the problems and gives a better understanding of the concept of realization. Using an analysis that distinguishes between actual and disguised capital gain, we see that the actual (genuine) capital gain component is much smaller than we are accustomed to and hence, the lock-in and risk-taking problems on the one hand and the possibilities to “cherry-pick” losses on the other are almost nonexistent.

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103 Suppose Gil owns a stock that yields 10% annually, was purchased at a price of $10, and has appreciated to a market value of $100 (derived from retained corporate earnings). Gil has an opportunity to purchase a different company’s stock with an expected annual yield of 12%. However, if a capital gains tax of 35% is imposed on his $90 gain from the transaction, Gil will be left with only $68.50 [$10 + ($90 * .65)] to invest in the new stock. Since the 12% return on the new stock yields a stream of income of only $8.22, Gil will choose not to replace his stock with the more productive asset. See Jane G. Gravelle & Lawrence B. Lindsey, Capital Gains, 38 TAX NOTES 397, 402 (Jan. 25, 1988). This “lock-in effect” may cause stagnation in the financial market, where replacement of inefficient investments by more productive ones is generally encouraged as a means of enhancing economic growth. See infra Part V.A.1.

104 See infra Part V.A.2.

105 See, e.g., Scarborough, supra note 41, at 680-81.


107 See supra note 4 references.
1. The Lock-In Effect

In general terms, the lock-in effect argument is based on the notion that taxpayers are reluctant to dispose of unproductive assets and to replace them with better ones just because they want to avoid taxation of the gain on appreciated assets. The economic stagnation caused by this effect reduces liquidity, deteriorates the mobility of capital, reduces beneficial replacement of old machinery, and causes significant fluctuation of prices in the financial and products markets.

2. The Risk-Taking Problem

In general terms, the risk-taking argument is based on the risk to rate of return ratio: the higher the risk, the higher the return expected by the investor. An ordinary tax on risky investments reduces the rate of return, thus discouraging investors from making those investments and consequently reducing economic growth. The limitations on deduction of capital losses—whose purpose is to limit “cherry-picking” opportunities—enhance this problem. Once again, the problem stems from the realization requirement. The problem may be alleviated if the “bunching” of income over time is prevented. Realization and taxation will thus be spread over time.

B. The Underlying Rationale of the Realization Requirement

Elimination of the realization requirement is not the solution proposed by this article. Rather, the concept of realization—its full and accurate meaning—should be analyzed carefully. The realization requirement is not merely a product of accounting principles, but rather one of the basic attributes of the income tax system. It

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108 As exemplified in supra note 103. See Cunningham & Schenk, supra note 96, at 344-46; see also supra notes 101-02.
109 G R A E T Z & S C H E N K, supra note 33, at 538.
110 Cunningham & Schenk, supra note 96.
111 Note that taxing nonrealized capital gain could solve the lock-in problem only when the accumulation of income by the asset is linear. Suppose John bought stock in Petro Corp. on January 1, 1990 for $100 a share and the market value remains the same until 1995. Joanne bought a similar stock on January 1, 1996 for $100 a share. Due to certain developments in the oil industry, the market value of the stocks went up to $140 a share. Both John and Joanne have the same nominal gain—$40 a share. In both cases the taxation of unrealized gain will not solve any problem.
112 For a different approach, see, inter alia, Vickrey, supra note 4.
represents a very clear choice—to prefer income over net wealth as the tax base. It derives from two of the four canons of a good tax system offered by Adam Smith: “[t]he tax . . . ought to be certain, and not arbitrary” (“the certainty criterion”) and “[e]very tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it” (“the convenience criterion”).

Even though theoretically speaking, net wealth is a better criterion for one’s economic ability, it involves too much uncertainty and inconvenience. In order to estimate the value of a person’s property we rely too much on ex ante anticipation: what is the anticipated stream of income? For how many years? What interest rate should be used for establishing its present value, and what will be the salvage value of the asset at the end of the usage period? In addition, if we tax a person on the present value of her future income, we run the risk that she will be forced to dispose of the asset in order to finance the tax payments. Hence, the policymakers turn to the “second-best” criterion: the actual and realized stream of income instead of the anticipated, potential one. This is the true purpose and essence of the realization requirement, which is not itself a value, but rather serves as an instrument in fulfilling the certainty and convenience criteria. In other words, the realization requirement is the distinction between income tax and property, or net wealth, tax. Based on the above discussion, property or net wealth tax is a tax on the future income discounted for its present value. In contrast, income tax is based on an occurrence that took place already—an actual and realized income as opposed to a potential or future uncertain income.

Therefore, I do not suggest giving up the realization requirement altogether. Rather, the optimal solution must involve careful application of the realization requirement, stressing the certainty and convenience criteria, which in some cases allow taxation of accumulated earnings (which, based on ex-post assumptions, have been realized), thus mitigating the problems discussed above. The distinction between “actual” (genuine) and “disguised” capital gain may help us in developing the optimal solution.


114 But see H. Simons’ criticism of Seligman’s justification of the realization requirement in SIMONS, supra note 43, at 85-89. Note that I do not base my argument regarding realization on Seligman’s separation doctrine.
I have emphasized that disguised capital gain is deduced from ex post occurrences and assumptions and does not involve ex ante anticipation. It should therefore be treated as ordinary realized income and should be taxed annually rather than be allowed to accumulate. Such income is not merely “potential” as far as the taxpayer is concerned. The taxpayer, when choosing a transaction in which to get involved, has the prerogative to choose in which fashion, and at what time, to receive his income in cash. Once the taxpayer makes his choices and fulfills his contractual obligations, income accrued is income earned and realized. The gain is certain, in terms of having the right to claim in due time, and the taxpayer’s convenience has also been taken into account. This will be discussed in detail below, and it will be shown that the problems of certainty, evaluation, and even annual reporting of the disguised capital gain, are quite insignificant and hence can be ignored. Therefore, there is no infringement of the realization requirement.

This is not the case with unrealized genuine capital gain, which involves ex ante assumptions and a great measure of uncertainty. Moreover, in this case, the taxpayer has no control (and had no control when choosing the transaction) over the terms of when and in what fashion to receive his income. Here, the realization requirement calls for allowing nontaxable accumulation, and taxation of the anticipated gain only when it is realized, i.e., when the asset is sold.

In other words, I propose to treat the disguised capital gain as realized ordinary income that should be taxed annually, while the actual (genuine) capital gain component should be taxed only when the asset is sold. Furthermore, capital losses caused by such taxed disguised capital gain should be deducted against ordinary income.

Such a proposal does not violate the certainty and convenience criteria. It also reduces the lock-in effect and the problem of risk taking (annual taxation of the disguised capital gain will considerably reduce the tax levied upon sale of the asset). Such a policy will also reduce the “bunching problem” and the “inflation problem.”

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115 See discussion infra Part VI.A.2 dealing with the treatment of a situation where sums accrued are not ultimately received.

116 See supra text accompanying note 113.
VI. DISGUISED CAPITAL GAIN AS REALIZED INCOME

A. The Actual Magnitude of the Lock-In Effect and the Risk-Taking Arguments

I should discuss here the same assets discussed earlier and demonstrate that corporate retained earnings, stock dividends, and accumulated interest should be, and can be, taxed on an annual basis, mainly because such taxation does not violate the realization requirement. Such retained income is realized at the end of the taxable year; its value is quite known and if estimations are at all required, these estimations are ex post rather than ex ante in nature.

1. Bonds and Other Debt Assets

Earlier in this article, I argued that the distinction between the actual (genuine) and disguised components of capital gain leads to the conclusion that there is no difference between a bond or debt asset yielding a fixed annual interest, financial instruments yielding an accrual of interest upon maturity, or obligations issued at a discount. All three require recognition of an annual interest to be taxed at the end of each year. The unavoidable question was also raised: does this policy (which is offered by the OID rules as well) infringe upon the realization requirement? Can we say that interest yet to be received, or the part of the obligation to be paid at maturity, has been realized?

There seems to be no doubt that a taxpayer using the accrual method of accounting should be required to report accrued interest on an annual basis for tax purposes. As previously discussed,\(^\text{117}\) the OID rules, as well as this article, call for such treatment regardless of the accounting method used. This fits my proposed definition of the realization requirement. The interest accrued is indeed disguised capital gain. It is certain. It involves no ex-ante anticipations or risk taking. Analyzed according to the underlying rationale for the realization requirement,\(^\text{118}\) there has indeed been realization by the taxpayer. Having fulfilled her obligations, the income is no longer merely “potential.” She can without difficulty or any element of uncertainty claim the sums accrued, provided there has not been a change in the market interest rate or other external expectation.\(^\text{119}\) If

\(^{117}\) See supra Part III.A.3.
\(^{118}\) See supra Part V.B.
\(^{119}\) One problem is whether my claim that there has been realization fulfills the
she has already been required to report annual interest accrual as regular income, by selling the bond, she will have no capital gain whatsoever.

For example, suppose a taxpayer purchases a bond for its face amount of $1000. The bond will pay an accrued interest of 6% (which is also the market interest rate) at the date of maturity in twenty years. At the end of year one, $60 should be taxed as regular income and the taxpayer’s basis in the asset is increased to $1060. Thus, when she sells the bond for $1060 (the rise in price represents the retained interest which has already been accrued), there is no gain to be taxed.

As a consequence, it is obvious that the taxpayer need not worry about risk-taking and there is hardly a reason for the lock-in effect to exist. It is true that, if upon sale of the bond, we were to tax the $60 in the example as regular income ($1060 minus the original price of $1000) rather than as capital gain (recognizing that it is disguised capital gain), we would intensify the lock-in effect. But if we accept that the $60 has been realized as regular income upon its accrual, and taxed accordingly, there is no cause for the lock-in effect to take place. The taxpayer faces no further taxation upon sale of the bond (unless there has been an external change, which may cause actual capital gain of a smaller amount).

Needless to say, if the taxpayer reports her income on a cash method basis, we could accept that as long as she has not received the interest she may not be required to include the interest in her taxable income. Yet, when she sells the bond for $1060, the $60 should be regarded as ordinary income and not as capital gain.

I have shown that the analysis proposed is reflected in the OID rules with regard to bonds and other debt assets. I will argue that this analysis is also relevant regarding stocks. The same distinction between actual (genuine) and disguised capital gain should be used, and the same definition of realization should apply.

"convenience" criterion. One may rightfully argue that such a conclusion, which disregards the element of liquidity, may put the taxpayer in a situation where he has no ready cash with which to pay his taxes, and is thus forced to sell the instrument. This problem is not entirely uncommon (it exists, for example, with regard to inventory). My opinion is that the convenience criterion is fulfilled through the fact that the taxpayer had the prerogative to choose the transaction and could control the time and fashion in which to receive the interest payments. The convenience criterion should not be stretched further. Any further change is a policy choice and should be made by the legislature.
2. Stocks

I emphasized the problem of triple taxation of corporate earnings. This problem can and should be avoided. The solution involves recognizing that a corporation’s retained earnings are certain, and, again, involve no ex-ante anticipation or risk. The profits accumulated have been realized by the taxpayer by way of appreciation in value of his stock. Essentially, we can regard the situation as a dividend distribution (income realized by the stockholder) followed by reinvestment in the firm’s stocks. There is no reason to postpone taxation until the dividend is declared or distributed. The portion of appreciation in stock value which represents retained earnings of the corporation should be taxed. As a result, the lock-in effect is again eliminated, or at least marginalized. The taxpayer faces no additional taxation upon sale of his stock, other than that of actual (genuine) capital gain or loss—caused not by change in the firm’s equity, but by external, market reasons.

No doubt, the above claim is not absolute and not entirely precise. Retained earnings are not always so certain as far as the taxpayer is concerned. Diminution may occur, whether due to external changes or to a reduction in the company’s productivity, which causes a change in equity. We shall see that this problem is not unique and may easily be solved. Consider the following example: Inbal invests $100 in company A’s stock, assuming an annual yield (after corporate tax is taken into account) of 10%. After six years, retained earnings of $60 have raised the value of her stock to $160. In year seven, the

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120 This proposal calls for a change in taxation of corporate earnings. Such a change may achieve three important objectives: (1) prevention of deferral of tax (appreciation in a stock’s value due to accumulation of retained earnings is income realized by the stockholder), (2) reduction of the lock-in effect, and (3) abrogation of the triple tax on corporate earnings. For other opinions calling for taxation of retained corporate earnings, see, inter alia, Canada, 2 Report of the Royal Commission on Taxation 181 (1966); Canada, 4 Report of the Royal Commission on Taxation 6-9, 28-30, 535 (1966); Herwig J. Schlunk, I Come Not to Praise the Corporate Income Tax, But to Save It, 56 Tax L. Rev. 329 (2003); Alvin C. Warren, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter’s Study of Corporate Tax Integration, 1993 Am. Law. Inst. 117-28.


122 For the sake of simplicity, these calculations disregard compound interest.
company’s annual yield falls to 5%. As a result, the original capital investment once worth $100 is now worth only $50 and the stock’s value is $110. Inbal now sells her stock. According to the current rules, Inbal will be taxed for $10 of capital gain when she sells the stock.\footnote{Sales price of $110 – purchase price of $100.} No taxation will occur prior to the sale. One can easily see the dilemma that arises: taxation of the gain may lead to the lock-in effect, while exemption means disregarding income actually earned.

My analysis enables a different approach: Inbal has been taxed annually for $60,\footnote{Six years times annual dividend of $10.} which she had earned as dividend over the last six years. This amount is deemed to have been reinvested, and the book value of her stock after six years is $160. The devaluation to $110 represents an actual (genuine) capital loss of $50,\footnote{Sales price of $110 – book value of stock after six years of $160.} realized upon sale of the stock. This loss should be treated according to the regular capital loss limitations.\footnote{I.R.C. §§ 1211, 1212. See also infra Part VII.}

However, the following problem remains: the $60, on which Inbal has been taxed, has not actually been received. Retained earnings taxed and ultimately not received (in this example, $60) may be treated as a bad debt, which can be deducted against any income. This solution involves merely the application of section 166 of the Code,\footnote{I.R.C. § 166. See also supra note 121 and accompanying text.} and proves that we are not dealing with a unique problem or a deviation from the theoretical model.

3. Stock Dividends

Ever since the much-celebrated decision of \textit{Eisner v. Macomber},\footnote{Eisner v. Macomber, 252 U.S. 189 (1920).} the debate whether common stock dividends should be taxed has lived on. This question will be examined devoid of constitutional debates and definitions and will be examined as a question of whether realization has occurred. The argument is that the dissenting opinion offered by Justice Brandeis is consistent with the proper definition of realization, as was discussed above, and provides a correct observation from an economic standpoint.

The majority opinion in \textit{Macomber}, written by Justice Pitney, held that stock dividends could not be treated as income.\footnote{Id. at 219. Presently, Code section 305 exempts stock dividends from tax, with some exceptions. \textit{See, e.g.}, MARVIN A. CHIRELSTEIN, \textsc{Federal Income Taxation: A...}
opinion stressed that in terms of property, nothing was taken away from the corporation or gained by the shareholder. The taxpayer received nothing out of the company’s assets for his separate use and benefit. A stock dividend is a capital increase, but not income. Justice Brandeis’ dissent argued that ultimately we are looking at a two-step process: a cash distribution followed by a purchase of additional shares by the shareholder. “[W]hether a dividend declared payable from profits shall be paid in cash or in some other medium is... wholly a matter of financial management.” The dissenting opinion stressed that a distribution, whether in cash or in kind, should be treated similarly. It has been noted that the true question, essentially, was indeed a question of similarities: is a distribution of a stock dividend more like a situation in which a corporation chooses not to distribute its accumulated earnings or more like a cash dividend (followed by a purchase of new shares)?

The analysis proposed in this article, according to which retained corporate earnings represent disguised capital gain that should be taxed as ordinary income—whether accumulation or sale of the asset—supports the dissenting opinion. The retained corporate earnings should be taxed, if not upon accumulation annually, then definitely upon distribution of a stock dividend. Of course, any retained earnings that the taxpayer was taxed on should be added to the stock’s original price.

B. Depreciable Assets and Discount Assets

One may argue that with regard to other assets, such as depreciable assets or discount assets, the analysis above does not solve or alleviate the risk-taking problems or the lock-in effect. By selling the asset, with the view of replacing it, the taxpayer must consider his

LAW STUDENT’S GUIDE TO THE LEADING CASES AND CONCEPTS ¶ 5.02 (9th ed. 2002).
130 Eisner, 252 U.S. at 212.
131 Id. at 211.
132 Id. at 212.
133 CHIRELSTEIN, supra note 129, ¶ 5.02, at 75 (discussing Judge Brandeis’ dissent in Eisner v. Macomber).
134 Eisner, 252 U.S. at 227 (Brandeis, J., dissenting).
135 Id.
136 CHIRELSTEIN, supra note 129, ¶ 5.02, at 78.
137 One should note that a cash dividend also does not make the shareholder richer. Stock worth $110 prior to the distribution due to accumulated corporate earnings will drop to $100 following the payment of a $10 dividend. Id.
tax costs as well, and a recapture of excessive depreciation deductions (and taxation as regular income)\(^ {138} \) may make the transaction unattractive.

With regard to this topic, several factors should come into consideration:

1. The Magnitude of the Lock-In Effect

Gravelle and Lindsey have noted that: “. . .there is an additional benefit that accrues on sales of depreciable assets that tends to lower the lock-in effect. The sale of a depreciable asset, while resulting in a capital gains tax to the seller, increases the tax basis for depreciation purposes for the buyer.”\(^ {139} \)

In other words, when considering replacement of a depreciable asset, especially in situations where the right to deduct depreciation deductions has been exhausted, the capital gains tax considerations (which make the investment more expensive) are at least partially offset by regaining the right to deduct depreciation. While the seller may no longer deduct depreciation (in the seller’s hands, income produced by the asset is fully taxed), in the hands of the buyer, the right is renewed. In this case, considerations of tax symmetry call for taxation of the transactions in order to prevent the loss of tax proceeds to the government.

As a result, the lock-in effect in many cases will not come into effect and certainly does not pose a problem of the same magnitude as financial assets whose value has appreciated.

2. Efficiency and Equity Consideration and the Lock-In Effect

One may argue that any tax levied on the public may hinder economic growth and business efficiency.\(^ {140} \) There is no limit to such arguments. For example, under certain assumptions, ordinary income tax may create a negative incentive to work, especially when the law of diminishing marginal returns comes into effect.\(^ {141} \) Yet in a

\(^ {138} \) See supra Part III.B.

\(^ {139} \) Gravelle & Lindsey, supra note 103, at 402.

\(^ {140} \) For the basic argument about the excess burden (or the deadweight loss) of any tax, including the income tax, see, inter alia, HARVEY S. ROSEN, PUBLIC FINANCE 283-305, 316-19 (6th ed. 2002); JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 518-570 (3d ed. 2000).

\(^ {141} \) In economic terms, whenever the substitution effect is greater than the income effect, reduction of real wages as a result of imposition of tax leads to a
progressive tax system, individuals should pay tax according to their relative “abilities.” An important canon of a good tax system is: “[t]he subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.” \footnote{SMITH, supra note 113, at 888.} In the observation or neglect of this maxim exists what is called tax equity or tax inequity. Allowing further benefits to income classified as ordinary infringes upon the equity criterion. \footnote{I leave the issue of “ability” versus “benefit” out of this article. See, inter alia, Richard A. Musgrave, *Equity and the Case for Progressive Taxation*, in 9 Tax Justice: The Ongoing Debate (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002). For a general discussion of horizontal and vertical equity, see, inter alia, MURPHY & NAGEL, supra note 113; TAX JUSTICE: THE ONGOING DEBATE (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002); Kevin A. Kordana & David H. Tabachnick, *Tax and the Philosopher's Stone*, 89 Va. L. Rev. 647 (2003).} The income has accumulated, in the case of depreciable assets, due to excessive depreciation deductions, which create a deferral of tax, a benefit in itself. At any rate, if preferential treatment is restricted to capital gain, we must be accurate in identifying the actual (genuine) capital gain. \footnote{Should the policymakers decide to allow a capital gains preference in this case, it is my opinion that the correct method is that of a general roll over, see I.R.C. § 72, reserved for the actual capital gain component only. Naturally, this reduces the scope of the preference, and the infringement of principles of equity will also be minute.}

Considerations of undesirable economic consequences such as the lock-in effect are important when tax policy is decided. Nevertheless, such considerations cannot justify an inconsistent policy or inaccurate identifications and classifications of certain gains. Once a gain has been identified as ordinary income, arguments such as the lock-in effect cannot be conclusive. Lock-in considerations should be reserved for actual (genuine) capital gain only. Fear of such an effect is a less-binding consideration once we have identified income as disguised capital gain, which is ordinary income deferred as a concession.
VII. CAPITAL LOSSES, RECAPTURE AND “NEGATIVE RECAPTURE” AND CHERRY-PICKING

A. The Extent of the Capital Loss Limitation

Sections 1211 and 1212 of the Code limit the possibilities of offsetting capital losses. Losses may be offset only against capital gains (individual taxpayers, unlike corporations, are entitled to offset capital losses against ordinary income up to a ceiling of $3000 annually). Excess or unused capital loss in a given year can be carried forward to the following years without time limitation (corporations are limited to a “carry-back” of three years and/or a “carry-forward” of five years).

The main purpose of this limitation is the prevention of “cherry-picking,” the realization of capital losses in order to reduce taxes on ordinary income while retaining assets that have unrealized capital gain. If cherry-picking were possible, taxpayers could obtain optimum tax treatment regardless of the effect on their overall economic position or the economic substance of their transactions.

This is undoubtedly a worthy cause. But is such a sweeping limitation really necessary? One must consider the apparent disadvantages, in particular, an effect similar in nature to the lock-in effect. A rational taxpayer will not realize a capital loss until a tax year arrives when he is in a position to benefit from this loss; namely, where he has considerable capital gain (and where offsetting the loss may carry him to a lower tax bracket). An unwillingness to realize capital loss, even where there is no economic efficiency to continue holding the asset, may lead to economic stagnation and inefficiency, as well as other undesirable results like the lock-in effect.

Returning to the analysis, one can see that the actual magnitude of the capital loss limitation should not be so sweeping. It should be limited only to actual capital losses, while a disguised capital loss should be allowed to offset regular income. This mitigates the loss limitation significantly within the business community.

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145 I.R.C. §§ 1211, 1212.
146 I.R.C. § 1211(b).
147 I.R.C. § 1212. For further discussion, see, inter alia, KAHN, supra note 121, at 642-44.
148 GRAETZ & SCHENK, supra note 33, at 551.
149 For a comprehensive discussion about the limitations and cherry-picking, see, e.g., Scarborough, supra note 41.
The following discussion will illustrate several examples where the true scope of the limitation should come into effect.

**B. Limitations on Capital Losses, Cherry-Picking and Offsetting Ordinary Loss Against Disguised Capital Gain**

The above analysis offers a better, more consistent solution that significantly decreases the magnitude of cherry-picking of losses on the one hand, and is fairer and more accurate on the other. The idea is to allow the taxpayer to deduct the capital loss against the disguised capital gain (as discussed above, retained interest on a bond and retained corporate earning on sale of stock, etc.) and against the ordinary income that caused the loss (as discussed above regarding selling a stock at a loss after receiving a dividend, a bond after collecting interest, etc.).

There is no reason why in this situation the taxpayer should not be allowed to offset capital loss realized (due to the distribution of the dividend) against the dividend received. Similarly, the taxpayer should be allowed to offset capital loss (due to collecting interest) against the interest received. These actions, together with the “at risk” and “passive activity” limitations, eliminate the problem of cherry-picking.

**C. The Underlying Rationale for the Recapture Rule, Its Deficiency, and a More Accurate Approach**

As was indicated above, the underlying rationale for the recapture provision of Code section 1245 is that it derives from the practical concession found in the depreciation system: the purpose of the depreciation deductions is to keep the taxpayer’s annual capital recovery untaxed. The accurate annual capital recovery involved a great deal of ex ante anticipation in order to determine the asset’s value at the beginning and at the end of each taxable year. The statutory annual depreciation rates acknowledge these difficulties and embody practical concessions.

The recapture rules are aimed to take care (ex post) of the “mistakes” caused by inaccurate deductions of depreciation made by the taxpayer during the previous holding period. Hence, when a

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150 See the example infra Part VI.A.2. Also consider the application of such a rule on “mark to market,” (section 1256). See Warren, supra note 19, at 474.

151 I.R.C. § 465. For further discussion, see KAHN, supra note 121, at 472-80.

152 I.R.C. § 469. See also KAHN, supra note 121, at 304-19, 479.
capital asset is disposed of at a gain, we may conclude that during the holding period the taxpayer deducted too much capital recovery and consequently reduced her ordinary income too much during those taxable years. Instead of going back to the previous tax years and changing the taxable income retroactively, we add the “missing” ordinary income to the taxable income in the year of disposal.\textsuperscript{153}

D. Section 1231 Option and a “Negative Recapture”

Generally speaking, Code section 1231 allows real and depreciable property used in a trade or business to yield capital gain when disposed of at a gain but an ordinary loss when disposed of at a loss.\textsuperscript{154} While this may seem to be a unique option, which enables the taxpayer to enjoy the best of both worlds, it may be explained in two ways. The first explanation is based on historical facts: this option originated in 1942, during the Second World War. Its goal was to provide favorable treatment to disposition of ships and other property used during the war that had increased significantly in value because of the war.\textsuperscript{155} Yet it is difficult to believe that this phenomenon would last for more than sixty years without a better and more updated explanation.

The other explanation (that may only apply to depreciable assets\textsuperscript{156}) is based on principles of tax symmetry and embodies a mirror image of the recapture provision. I call it here a “negative recapture rule,” i.e., the same underlying rationale discussed above, for the recapture rule should also be applied when the asset is sold at a loss. The loss indicates that during the holding period the annual depreciation deductions were evidently too low, and consequently the annual income was too high. When the asset is disposed of, it is time to straighten up the previous years’ mistakes and to compensate the taxpayer for paying too much income tax by allowing him an ordinary loss deduction.

\textsuperscript{153} Similar solutions are found in the treatment of bad debts and prepaid income and are embodied in the “tax benefit concept.” Fidelity-Philadelphia Trust Co. v. Commissioner, 23 T.C. 527 (1954); see also I.R.C. § 111.

\textsuperscript{154} I.R.C. § 1231.

\textsuperscript{155} \textit{See}, \textit{inter alia}, GRAETZ & SCHENK, \textit{supra} note 33, at 556.

\textsuperscript{156} It goes without saying that the definition of the term “depreciable asset” is not clear enough and is quite unsatisfactory. For example, is a section 197 asset a depreciable asset? It is quite difficult to accept the idea that even though a taxpayer is allowed to depreciate such an asset and recapture as ordinary income the amount of gain over the adjusted basis (section 1245), he is not entitled to the ordinary loss treatment if the asset is sold at a loss. \textit{See} I.R.C. §§ 179, 190, 193, 197, 1245.
E. Capital Loss—Summary and Conclusions

I have argued that there is no justification for limiting the offsetting of losses caused principally by a distribution of ordinary income such as a dividend or interest. As is the case with “negative recapture,” a loss stemming from inadequate deductions of depreciation should not be considered entirely as a capital loss. Rather, the loss should be added to the asset's tentative cost to determine which part of it is actually an ordinary loss. Both of these conclusions lead us to the realizations that the scope of cherry-picking is very narrow and that therefore the use of a general capital loss limitation is too sweeping and unnecessary.

VIII. Conclusion

The principal analysis offered in this article involves identifying and distinguishing between two essentially different components of capital gains and losses. The first one is what I term disguised capital gain. Such a gain does not involve any changes in the anticipations regarding the asset’s yield in the future; it is based entirely on ex post occurrences, and is essentially ordinary income and should be taxed accordingly. The second component, which deserves special adjustments, is what I term actual (genuine) capital gain. It is derived as a consequence of a change in the expectations regarding the future stream of income from the asset occurring during the holding period, which is reflected in a change in the asset’s present value. This portion involves ex ante anticipation. As a rule of thumb, I suggest that the former component is an internal one, because it is created by the taxpayer’s or related parties’ decisions or actions. The latter is an external one, created by market forces.

I have shown the importance of a correct distinction between the two components and the identification of capital recovery, namely when dealing with financial instruments, bonds, depreciable assets, and sales at a discount.

I have shown that a comprehensive tax system may prevent double taxation of capital gains. With regard to depreciable assets, the buyer should be allowed to deduct, as a means of capital recovery, the total amount that he paid, thus amortizing his cost. A positive change in the projection of capitalized future income will be taxed eventually and will be paid for in part by the buyer and in part by the seller, according to the proposed formula. Thus, the tax is not shifted and double taxation does not occur. The solution regarding
nondepreciable assets involves renouncement of the sweeping scope of
the capital loss limitations.

I have proposed a more accurate approach for the realization
requirement, one stressing the certainty criterion and allowing annual
taxation of accrued disguised capital gain, thus mitigating risk-taking
and lock-in arguments (which are important considerations only when
dealing with actual (genuine) capital gain). Realization by a taxpayer
reporting on a cash-basis should not be different from that of a
taxpayer reporting on an accrual basis. Both have realized income
once they have fulfilled their obligations in the transaction. Accrued
interest or retained earnings of a corporation should thus be treated as
realized income. If they do not ultimately reach the hands of the
taxpayer, the taxpayer should be able to deduct a “bad debt.”

When a taxpayer sells a depreciable asset at a gain, we can usually
conclude that she was allowed to deduct during her holding period
annual depreciations that were too high (keeping annual capital
recovery untaxed involves ex ante anticipation). By way of practical
concession, upon sale of the asset, the missing ordinary income—
which should have been taxed annually—is added to income in the
year of disposal. Likewise, when the taxpayer sells the asset at a loss,
this is not entirely a capital loss. The loss should be added to the
asset’s tentative cost. The difference between the total taxable
income during the holding period, under the lower depreciation, and
the tentative taxable income during the same period should be treated
as an ordinary loss; only the remainder is capital loss. Basically, the
rationale regarding recapture of depreciation deductions must also
allow negative recapture.

My analysis also allows reduction in the scope of the capital loss
limitations. Limiting the deduction of capital losses to the extent of
capital gains should be limited itself to merely the actual (genuine)
capital gain component. Disguised capital losses should be allowed to
offset any ordinary income stemming from the asset, which caused the
loss. Correct analysis will show that possibilities of cherry-picking are
nearly nonexistent.