

CAPITAL GAINS AND ORDINARY DEDUCTIONS: NEGATIVE INCOME TAX FOR THE WEALTHY

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I. INTRODUCTION

Perhaps nearly everyone is well aware of the tax magic embodied in the term "long-term capital gain."¹ For reasons or for lack of reasons which are beyond the scope of this article,² only one-half of this kind of income is subject to the federal individual income tax.³ Thus, if an individual has a long-term capital gain (LTCG) of \$200, he is allowed a deduction under section 1202 (a "section 1202 deduction"⁴) of \$100, and he pays tax at the regular rates on \$100, or one-half of the LTCG.

On the other hand, probably considerably fewer people realize the possibility of not paying any tax on a LTCG and also utilizing the transaction which produces the gain to *reduce* the tax on other income; hence, a negative income tax. This happy situation occurs if the taxpayer is able to deduct all of the costs of producing LTCG while paying tax on only one-half of the total receipts. If this can be done, a little simple arithmetic establishes that even a profit-making taxpayer will show a loss for tax purposes unless he makes a 100 percent profit. For example, if it cost a taxpayer \$140 to produce \$200 of LTCG, and only \$100 of the \$200 "gain" is taxable, he will show a \$40 tax loss despite his \$60 economic profit.⁵ He will break even

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¹ A long-term capital gain is gain on the sale or exchange of a capital asset held for more than six months. Int. Rev. Code of 1954, § 1222(3). See also § 1222(7). [All citations to sections in this article are to sections of the Internal Revenue Code of 1954, as amended to date of publication, unless otherwise indicated.]

² For a discussion of the pros and cons of allowing capital gain treatment, see Blum, A Handy Summary of the Capital Gains Arguments, 35 Taxes 247 (1957).

³ Prior to the Tax Reform Act of 1969, P.L. No. 91-172 (December 30, 1969) [hereinafter cited as Act], the maximum LTCG rate was 25% which meant that taxpayers above the 50% bracket, in effect, excluded more than ½ of their LTCG. In fact, the 70% bracket taxpayer paid tax on only about 36% of his gains. This state of affairs is limited by the Tax Reform Act to \$50,000 per taxpayer, and is generally ignored in the discussion which follows. Act, § 511(b). Compare Int. Rev. Code of 1954, § 1201(b) prior to and following the Tax Reform Act of 1969.

⁴ The deduction under § 1202 is limited to ½ the amount by which net long-term capital gain (excess of long-term gains over long-term losses) exceeds the net short-term capital loss (excess of short-term losses over short-term gains). Int. Rev. Code of 1954, § 1202.

⁵ LTCG = 200
½ Taxable = 100
Deduction = 140
Net loss = 40

if his selling price is \$280, and will show a tax profit only if his LTCG exceeds \$280 (i.e., is more than twice the costs).

Since this tax loss reduces the tax paid on other income, the taxpayer, in effect, receives a subsidy from the government for his willingness to make a profit in certain activities. For example, if a 70 percent bracket taxpayer incurs \$140 in costs in order to produce a capital asset which can be sold at \$200, and he is subject to capital gains tax on his net profit, he contributes \$21 to the cost of government.⁶ On the other hand, if he can manage to deduct this \$140 in costs against his ordinary income, and pay a tax at capital gains rates on the entire \$200 of receipts, he achieves a tax reduction of at least \$28 in addition to his \$60 economic profit. Thus, a \$140 deduction, offsetting taxable income to that extent, reduces the tax of the 70 percent bracket taxpayer by \$98 ($70\% \times \$140 = \98). As compared to this \$98 saving, the \$100 of the \$200 LTCG which is taxed causes a tax increase of only \$70 ($70\% \times \$100 = \70). The difference, or \$28, is the negative income tax on the \$60 economic profit.⁷

This article will explore how this situation arises, and will discuss various efforts to deal with it, particularly the attempt in the Tax Reform Act of 1969 to deal with farm losses and interest. It perhaps should be mentioned at this point that the emphasis on the negative income tax aspects of the ordinary deduction—capital gain dichotomy should not be taken as an indication that a problem does not exist if a tax gain actually results. Such a taxpayer pays on only a small part of his real income, improperly excluding more than one-half of his LTCG.⁸

II. THE ORIGIN OF THE PROBLEM

Ordinarily the expenditure of cash does not result in a current tax deduction if this cash is used to purchase an asset of continuing value. For example, if a taxpayer purchases stock, he has not suffered

⁶ The gain is \$60 ($\$200 - \140) of which $\frac{1}{2}$, or \$30, is taxable. The tax on \$30 to this taxpayer is \$21 ($70\% \times \$30 = \21).

⁷ The savings could be as much as \$48 if the alternative tax described in note 3 were available. On the other hand, in some cases the minimum tax provision, section 56, and the maximum tax on earned income provision, section 1348, can have the effect of substantially increasing the effective rate of tax on capital gains. It would seem that in the majority of cases, however, the result would be as stated in the text. For a more detailed discussion of this negative tax, see Davenport, *A Bountiful Tax Harvest*, 48 *Texas L. Rev.* 1, 5-9 (1969).

⁸ For example, assuming costs of \$140 and a selling price of \$300, the tax picture is as follows:

LTCG	= \$300
$\frac{1}{2}$ Taxed	= \$150
Cost	= \$140
Taxable Income	= \$10

Ten dollars is, of course, only $\frac{1}{16}$ of the \$160 economic gain.

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a loss by the decline in his cash position because the cash is replaced by the stock. The cost of the stock is "capitalized" and the profit on sale is determined by reducing the selling price by the acquisition cost. For example, if stock with a cost of \$140 is sold for \$200, the net gain is first determined to be \$60 and, if it is a LTCG, then one-half, or \$30, will be subject to tax.

It is not always easy to see, however, what expenses should be treated as part of the cost of an asset and capitalized, as opposed to being currently deductible. In general, the tax law follows accounting principles in distinguishing between a current expense and a cost that must be capitalized or deferred. A cost would be deferred for accounting purposes if it produces a benefit that continues into future accounting periods. Thus, the entire cost of a building or of a three-year fire insurance policy would not immediately be charged as an expense.⁹ However, suppose "growth" stock which pays no dividends is purchased with borrowed funds in the hope that the stock will appreciate and be sold at a LTCG. Obviously the original cost of the stock will offset the eventual gain; but what about the annual interest cost on the borrowed funds? For accounting purposes the interest would generally be considered a current expense because it enables the borrower to have use of the funds for the current year only. It has been so treated for tax purposes.

Similarly, a taxpayer would pay taxes on vacant real estate, and interest on the money borrowed to purchase it, only because he expects to make a profit on eventual sale or development of the land. He would look to these expected costs and his initial purchase price in total in determining the likelihood of a profit once he reaches the income-producing stage. On the other hand, for accounting purposes those costs may be said to be used up in the current period and hence would be expensed—not capitalized.

In other circumstances, a cost deemed attributable to a particular period will not in fact result in decline in the value of the asset. The most common example of this type of cost is depreciation, particularly on buildings. For example, assume a building cost \$100 and is deemed to have a useful life of ten years. For accounting purposes, generally a \$10 depreciation deduction will be allowed each year reflecting the gradually diminishing value of the building. Suppose, however, that after five years the building is sold for \$70. Should the \$20 difference between the selling price and its \$50 depreciated cost be a LTCG on sale?

Furthermore, in many areas, through legislation or administrative

⁹ See generally Treas. Reg. § 1.263(a) (1965); *Graves, Capital Expenditures v. Current Deductions*, 37 *Taxes* 1126 (1959).

fiat the tax law is more generous than generally accepted accounting principles in allowing costs to be deducted currently. For example, the cost of raising a cow or a horse, or planting trees or vines, does not reflect an economic loss, but is a mere transformation of funds from cash into an animal or a tree. Yet, under the Treasury regulations such costs are currently deductible¹⁰ and are not merely an offset to the LTCG if the grove or breeding animal is later sold. Expenditures for soil conservation, fertilizer and land clearing are by statute¹¹ currently deductible even though they improve the value of the land for a continuing period.

These examples typify the kinds of costs which are treated as current expenses. The fact that some of these costs are incurred solely to enable an asset to be sold at a LTCG is the basis from which the problems discussed below arise.

III. WHAT IS WRONG

As can be seen from the examples discussed above, in many cases the taxpayer is allowed a deduction merely by transforming value from one form to another even though there is no decline in his overall net worth. This deduction allows him to offset his current income and, in effect, to defer the reporting of such income until the unrelated asset is sold. To illustrate, assume a taxpayer with a salary of \$50 in 1970 incurs costs of \$50 in raising a cow. If the cost of the cow is deducted in 1970, the taxpayer will show no income in that year. If the cow is sold in 1971 for \$60, the taxable income will be \$60 even though the actual profit on the cow is only \$10. In effect, the salary income of \$50 has been deferred to the time the cow is sold.

This deferral of income and the consequent deferral of tax can be an advantage, of course, even if the income is eventually reported as ordinary income because, in effect, the taxpayer receives an interest-free loan from the government of the tax otherwise due. This indicates the importance of allowing the deduction only in the proper period. One of the efforts made in that direction culminated in Section 216 of the Tax Reform Act which added a new Section 278 to the Code. Section 278 is apparently intended to require capitalization of costs attributable to the planting and development of any citrus grove until the time the trees begin to bear fruit¹² and thus, arguably, prescribes a proper rule for the capitalization of costs in the citrus industry.

¹⁰ Treas. Reg. § 1.162-12 (1961). See also Treas. Reg. § 1.471-6(a) (1960). The administrative rule concerning citrus groves was modified by § 216 of the Act. See Int. Rev. Code of 1954, § 278.

¹¹ Int. Rev. Code of 1954, §§ 175, 180, 182.

¹² This provision was adopted on the Senate floor pursuant to an amendment introduced by Sen. Holland of Florida, 115 Cong. Rec. 15954-5956 (daily ed. Dec. 6, 1969).

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Whatever the merits of the capitalization approach, one must recognize the difficulty of achieving anything approaching total success in eliminating the negative income tax by this method. For one thing, it is often difficult to establish the correct period for deduction. In the case of depreciation, for example, it is obviously a burden to measure accurately the decline in value or usefulness over a period of time. In other areas, such as interest to carry growth stock or vacant land, one can argue that the interest should not be capitalized since it is of benefit for the current year only, and does not necessarily increase the value of the investment. Technicalities such as these limit the viability of the capitalization approach. Moreover, even where a technical argument cannot be made for a current deduction, an emotional appeal will often carry the day. Efforts to eliminate part of the benefits that farmers derive from the use of the cash method of accounting, which cannot be used by any other producing industry, have been attacked, apparently without embarrassment, as attempts to discriminate against farmers.¹⁸ These attacks have unfortunately been almost completely successful and it is difficult to predict much likelihood of success for a more extensive effort to require farmers to capitalize costs. For these reasons tax reform efforts have, at least in part, assumed the possibility of deferral, and have concentrated on eliminating the double whammy of ordinary deductions and capital gain.

Not everyone will admit, of course, that the combination of ordinary deductions and capital gains presents a problem that needs solving. Some taxpayers have argued that since the expenses were properly deducted (according to the Internal Revenue Code) when incurred, and since the income is of the type granted LTCG treatment, it is correct to treat the entire proceeds as a LTCG without any offset for the previously deducted costs. Whatever its superficial appeal, this argument is totally unconvincing when the results of its application are examined. The expenses incurred, including, for example, feed for livestock, maintenance of groves, and interest to carry stock or land, are a necessary cost of building up or carrying the property, and must be incurred to earn the income. Some of these expenses may not be capitalized for accounting purposes. Arguably, this correctly allocates expenses to the proper period. However, if this approach is wrong, that is, the expense is shown in one year and the related income in another, the only error for financial reporting

Apparently it was done at the behest of current grove owners who feared that the favorable tax treatment was causing overproduction and bringing down prices.

¹⁸ See Hearings on Tax Reform Before the House Ways and Means Comm., 91st Cong., 1st Sess., pt. 6, at 2037 (1969) (Testimony of Claude M. Maer, Jr. on behalf of the National Livestock Tax Committee).

purposes is a mismatching in terms of time. The correct total income is shown. This is the result for tax purposes also if the income is ordinary income. However, if the income is capital gain, the result is an incorrect reporting of total income due to the fact that the amount of gain entitled to be taxed only to the extent of one-half is incorrectly magnified. The result, in many cases, is a negative income tax. Thus, the concept of capitalization has much greater importance for tax purposes, particularly when capital gains are involved, than it does for accounting purposes, and it seems clear that different principles may be needed as a guide.

Capital gains treatment has been justified as a needed incentive to the investment of capital by permitting the taxpayer to retain more of the fruits of his risktaking. Whether or not one agrees with this claim, it seems impossible to assert that not only must the taxpayer be allowed to keep 100 percent of his profits, but that he also must be paid to undertake the investment by a reduction of tax on other income. All that should be required is capital gain treatment for actual gains.¹⁴ This necessitates offsetting the gain by all of the expenses which are incurred in order to earn it regardless of the time such expenses are otherwise deducted.

Two possible solutions to the problem of the improper measurement of the LTCG and the resulting negative income tax have emerged in tax legislation over the past nine years. One is the more traditional recapture approach, and the other is a new idea referred to herein as the capital deduction approach.¹⁵ The latter first appeared in the Tax Reform Act of 1969 in the Senate's treatment of farm losses, and survived in the Act's treatment of the interest expense.

IV. RECAPTURE AND EDA

The recapture approach simply treats receipts as ordinary income up to the amount of the deductions taken; only the excess over that amount is capital gain. Thus, returning to the original example

¹⁴ It may be claimed that the use of capital gains as an averaging device could support the current rules. For example, the present law may not work imperfectly in the case of an individual who took the deductions at the 20% bracket and would be taxed on the income at a 70% rate if not for LTCG treatment. The simple answer is that these taxpayers are not the ones who make the most use of the LTCG treatment itself and certainly are not the ones who make use of the tax shelters described herein. If averaging beyond the five-year period now provided in the Code, §§ 1301-1305, is needed, certainly a method can be developed which avoids the unfortunate results described in the text.

¹⁵ Not to be overlooked are attempts to cut down on the type of transactions granted capital gain treatment. See, e.g., Act, § 212 amending Int. Rev. Code of 1954, § 1231(b)(3) to increase the required holding period to two years before cattle and horses held for draft, breeding, dairy or sporting purposes are entitled to LTCG treatment.

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of a \$140 cost and a \$200 selling price, under the recapture approach, \$140 would be ordinary income and \$60 would be LTCG. It will be noted that the \$60 capital gain equals the amount of gain that would be reported had the \$140 been capitalized.

Legislative efforts at recapture have centered around the depreciation deduction and generally date back to the addition of Section 1245 by the Revenue Act of 1962.¹⁶ Under this section, gain on section 1245 property (generally personal property and real property other than buildings used as an integral part of manufacturing)¹⁷ is ordinary income to the extent of depreciation deductions previously taken. Less successful have been efforts to deal with the more serious problem involving real estate. A detailed study of the recapture rules with respect to real estate, as found in Section 1250 of the Code, is beyond the scope of this article. It should be noted, however, that the total failure of the 1962 legislation, and the tokenism of that of 1964, were in some part redeemed by the 1969 Act. We are still, however, a long way from full recapture.¹⁸

The 1969 Act extended the recapture principle to farm operations. Thus, soil and water conservation and land clearing expenses are recaptured if the property to which they relate is disposed of within ten years of its acquisition.¹⁹ More important, and what principally concerns us here, is the variation of recapture reflected in the new requirement that certain persons engaged in the business of farming who fail to adopt an accrual method of accounting, maintain an excess deductions account (EDA).²⁰

In the case of an individual and some subchapter S corporations, no addition is made to the EDA unless the taxpayer has nonfarm

¹⁶ See, however, Int. Rev. Code of 1954, § 1238 as originally added by § 216(c) of the Revenue Act of 1950, 74 Stat. 941, 81st Cong., 2nd Sess. (1950).

¹⁷ Int. Rev. Code of 1954, § 1245(a)(3).

¹⁸ For a discussion of the development of § 1250, see Senate Comm. on Finance, Tax Reform Act of 1969, S. Rep. No. 91-552, 91st Cong., 1st Sess. 211-15 (1969) [hereinafter cited as Senate Rep.]; Tucker, Analysis of Real Estate Investment Strategies Under the New Tax Law, 32 J. Taxation 184 (1970). The Commissioner has also been reasonably successful in upholding the proposition that § 377 of the Int. Rev. Code of 1954 (permitting non-recognition of gain on the sale of assets in connection with the complete liquidation of a corporation) does not prevent recognition of ordinary income to the extent that items previously expensed are sold. See, e.g., *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir. 1969) (towels, etc. held for rental); *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970) (feed for livestock). It is not clear whether, assuming some of these items were capital assets, the courts would apply similar principles to require that, in the case of a taxable sale, ordinary income be recognized to the extent of deductions previously claimed. The *Anders* case specifically held that an item which is fully deducted as an expense does not take on the same characteristics as an item which is depreciated. Query what result if the full cost is recovered by way of depreciation and the asset has a two-year life?

¹⁹ Int. Rev. Code of 1954, § 1252 as added by § 214 of the Act.

²⁰ Int. Rev. Code of 1954, 1251(b) as added by § 211 of the Act.

adjusted gross income in excess of \$50,000 for the taxable year, and then only to the extent that his farm net loss exceeds \$25,000.²¹ While this exclusion makes EDA largely ineffective, this aspect of the problem will not be dealt with here. Rather, we are concerned with the effect of EDA assuming it were more widely applicable. For this reason the exclusion will generally be ignored in the illustrations, and the reader is warned that any description of statutory provisions contains only that detail deemed necessary for this discussion, and is not designed to be complete or for use in planning transactions.²²

As indicated above, and more fully discussed elsewhere,²³ the permission granted to those engaged in the business of farming to use the cash basis and ignore inventories (even though the "production of merchandise is an income producing factor"),²⁴ and the allowance of LTCG on the sale of some farm assets, principally breeding animals and trees or vines, has spawned numerous arrangements to allow the wealthy investor who has never seen a farm to purchase an interest in such animals or trees. These investors, of course, are seeking the beneficial combination of current ordinary deductions and capital gain, appropriately deferred. This is an obvious case for application of recapture, but extending the concept to "farmers" takes some ingenuity. In a nonfarming industry, the amount of depreciation on its capital assets, building and equipment can be reasonably allocated to each asset, and recapture on the sale of the asset is equal to the amount of the depreciation deductions which have been taken with respect to it. In a breeding operation, since all of the costs of raising a cow have been deducted, the recapture analogy would require that the sale price of the cow be treated as ordinary income to the extent that it reflects such costs. However, the ostensible reason for allowing farmers to use the cash rather than the accrual method is that the allocation of feed, labor, and other costs to particular animals or trees is not feasible. While one may doubt the validity of this argument,²⁵ surely if we could not for political reasons require certain farmers to allocate costs to animals or trees as required by the accrual method, we could not mandate the same sort of record keeping for recapture purposes.

²¹ Int. Rev. Code of 1954, § 1251(b)(2)(B).

²² See Davenport, *Farm Losses Under The Tax Reform Act of 1969: Keepin' 'Em Happy Down on the Farm*, *supra*, for a more detailed discussion.

²³ See Davenport, *A Bountiful Tax Harvest*, 48 Texas L. Rev. 1 (1969); House Comm. on Ways and Means, *Tax Reform Studies and Proposals*, U.S. Treas. Dept., 91st Cong., 1st Sess., pt. 2, at 152-68 (1969). The Treasury studies supported a disallowance of farm deductions to the extent that they exceeded farm income (including capital gains). This "capitalization" approach was also embodied in bills introduced by Sen. Metcalf and others. See, e.g., S.500, 91st Cong., 1st Sess. (1969).

²⁴ Treas. Reg. § 1.446-1(a)(4)(i) (1965); § 1.471-1 (1960).

²⁵ See Davenport, *supra* note 23, at 14-18.

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The solution proposed in the Act, by which recapture is extended to farmers, is the excess deduction account which in effect treats the entire farm operation as one asset. Thus, the amount of deductions attributable to farming in excess of the ordinary income from farming (i.e., the "excess deductions" or "farm net loss") is added to the EDA,²⁶ and the account is reduced by any farm net income earned in subsequent years (i.e., the excess of ordinary income over deductions).²⁷ The EDA, generally the excess of total deductions taken over total ordinary income reported, measures the amount of potential conversion of capital gain into ordinary income on the sale of property (referred to as "farm recapture property") which would otherwise produce capital gain.²⁸ If any income on the sale of such property is converted, the EDA is reduced by a like amount.²⁹

Thus, all costs deducted (less ordinary income reported) are potentially subject to recapture on the sale of any asset. In effect, it is assumed that costs are incurred to produce asset values and, to the extent of these costs, the proceeds are merely a recovery of capital and not income. Once costs have been recovered, the amount received is true gain and is eligible for LTCG treatment, if otherwise permitted by the Code. While the result may be only rough justice in a particular case, the approach does not seem unreasonable. Nevertheless, differences between the overall EDA approach and item by item recapture should be noted. For example, if a cow costs \$140 to raise, the amount of ordinary income on the sale of the cow would, under an item by item approach, be limited to \$140 regardless of the sale price of the cow. Under EDA, however, the potential recapture does not depend upon the cost of the particular cow in question but rather on the excess of ordinary deductions over ordinary income for the entire operation. Therefore, if the cow were sold for \$200, the taxpayer could recapture as much as \$200 (even though \$60 actually consisted of profit as far as the cow alone is concerned) because he has, for example, deducted \$60 to raise another cow, which he has on hand or, more seriously as far as the farmer is concerned, which was lost or destroyed. Conversely, a taxpayer who has had an excess of ordinary income over deductions derived from the sale of other farm products may not have a balance in his EDA and would, therefore, be entitled to LTCG on the full \$200 received on the sale of the cow. Such a taxpayer retains the negative income tax benefit with

²⁶ Int. Rev. Code of 1954, § 1251(b)(2)(A), (e)(2).

²⁷ Int. Rev. Code of 1954, § 1251(b)(3)(A). It is also reduced by the amount of any deductions determined not to have resulted in a tax benefit.

²⁸ Int. Rev. Code of 1954, § 1251(c). For the definition of farm recapture property see Int. Rev. Code of 1954, § 1251(e)(1).

²⁹ Int. Rev. Code of 1954, § 1251(b)(3)(B).

respect to the cow alone (he deducts \$140 and reports only \$100 [$\frac{1}{2}$ of \$200] in income), although he is prevented by EDA from achieving a negative income tax on the overall farm operation.

In any event, the extension of the recapture principle to the farm area pointed up some problems not previously given much attention, especially the treatment of certain nontaxable transactions, namely gifts, transfers at death, corporate reorganization, organization of corporations or partnerships, like-kind exchanges and involuntary conversions. Under section 1245 (or 1250), these transactions do not result in recapture of depreciation previously taken even if the value of the property at that time is in excess of its depreciated cost.⁸⁰ However, except in the case of transfers at death, where a new basis is acquired, the amount of potential recapture remains, either by retaining the taint in the asset in the hands of the transferee or, in the case of a like-kind exchange or involuntary conversion, transferring the taint to the asset acquired by the transferor.⁸¹ It may be noted, therefore, that a taxpayer could claim all depreciation deductions on real estate against high-bracket income and then, shortly before sale, transfer the property to a low-bracket child who would be taxed on the ordinary income at a much lower tax cost.

This "wrong taxpayer" problem was apparently not considered serious under sections 1245 or 1250. Perhaps, in part, this derives from the acceptance of the original depreciation deductions as valid with the only effort being to eliminate the mismatching of capital gain and ordinary deductions. On the other hand, in the farm area one is no doubt troubled by the fact that the impropriety of allowing the deductions in the first place is compounded by allowing the person claiming the deduction to avoid recapture.

Whether or not the *wrong* taxpayer problem is deemed to be important, EDA raises a serious question of the availability of recapture from *any* taxpayer. In the case of depreciation, the amount taken can follow the asset, but as discussed above, the EDA does not relate to a particular asset but rather to the farm operation as a whole. How then does one deal with a transfer, and in particular a partial transfer of the farm business?

The 1963 Treasury proposal for an EDA may have suggested that gain be recognized on any disposition.⁸² One wonders if such a seemingly harsh approach (e.g., it could have taxed a gift of a horse to a child) could have been adopted; but in any event it was not seriously pressed. Short of this approach, perhaps the best result in

⁸⁰ Int. Rev. Code of 1954, § 1245(b).

⁸¹ See Int. Rev. Code of 1954, § 1245(a)(2); Treas. Reg. § 1.1245-2(a)(4).

⁸² See Hearings on the President's 1963 Tax Message Before the House Comm. on Ways and Means, 88th Cong., 1st Sess. 144-46 (1963).

terms of protecting the revenue would be for the EDA not to attach to any one taxpayer, but rather to be available where needed, that is, whenever the transferor or transferee makes a sale. This solution has some obvious, and many not so obvious complexities which will not be belabored here, and was rejected in favor of following section 1245 where feasible.

In fact, despite the difference between depreciation and EDA, in many instances the section 1245 approach can be followed with little or no modification. Thus, in the case of transfers at death, there is no recapture and the transferee gets a new basis free of taint.⁸³ If substantially all of the property of a corporate taxpayer is transferred to another corporation in a reorganization, and all tax attributes are passed to the transferee pursuant to section 381, the EDA can follow the assets.⁸⁴ Dispositions of farm property by the transferee would then be subject to conversion into ordinary income. Transfers to and from partnerships can be dealt with by keeping the EDA account at the partner level, and not requiring recognition on a transfer to a partnership if the transferor's interest in the partnership is attributable to farm recapture property.⁸⁵ Potential capital gain on the sale of farm recapture property by a partnership would be ordinary income to a partner with an EDA whether such account was derived through the partnership, from the partnership assets prior to their transfer, or in another business. Thus, the taxpayer who obtained the benefit of the original deduction continues to bear the possible stigma of conversion of LTCG even though he transfers his interest to a partnership. For similar reasons, no special rule is needed in the case of a like-kind exchange or involuntary conversion so long as the taxpayer merely substitutes new farm recapture property for the disposed of property.⁸⁶

Transfers of farm property can occur, however, in other types of transactions (traditionally given nonrecognition treatment under section 1245) where the taxpayer may or may not retain other farm property which could be denied capital gains treatment because of the presence of an EDA. If the individual (or corporation) transferred all of his farm property to a corporation in a section 351 transaction, one could justify a requirement that the EDA be assumed by the transferee, perhaps because recapture from the wrong taxpayer is better than no recapture at all. If this were done and the transferee

⁸³ Int. Rev. Code of 1954, § 1251(d)(2).

⁸⁴ Int. Rev. Code of 1954, § 1251(b)(5)(A). This treatment also applies to certain bankruptcy reorganizations under Int. Rev. Code of 1954, § 371, and certain railroad reorganizations under Int. Rev. Code of 1954, § 374.

⁸⁵ Int. Rev. Code of 1954, § 1251(d)(5).

⁸⁶ Int. Rev. Code of 1954, § 1251(d)(4).

corporation then sold the farm recapture property, it would recognize ordinary income to the extent of the transferor's EDA. However, suppose instead of continuing to operate the corporation, the transferor sells his stock. Should the transferor be able to realize capital gain on the sale of the stock of the corporation whose value has been built up by ordinary deductions? Moreover, suppose only a portion of farm property is transferred in the section 351 transaction, how much, if any, of the EDA should be transferred? Weighing these considerations, it was apparently considered more important to deny capital gains treatment to the taxpayer who has claimed the ordinary deductions. Thus, in the case of a transfer to a controlled corporation, the transferor retains the EDA, the stock becomes farm recapture property, and a sale of the stock could be ordinary income.⁸⁷

In the event of a gift of the taxpayer's entire farm recapture property, there would be no reason why we would want him to retain his EDA, and it clearly should be assumed by the donees. This may suggest that in the event of a partial gift, the EDA should be divided pro rata. This idea would be satisfactory if the EDA were equal to the potential recapture. However, since there is no addition to the EDA until the annual farm loss exceeds \$25,000, it is almost impossible for this equality to occur. Thus, to protect the revenue it is necessary for the EDA to be attached to whomever among the donor and the donees will make sales of farm recapture property. Moreover, it would be an administrative burden to allocate the EDA in the event of a small gift. Perhaps reflecting the primary concern with the person who received the benefit of the deductions, the House bill required the donor to retain the EDA unless he made a gift of more than 80 percent of his farm recapture property.⁸⁸ The conferees apparently felt this made the rules too easy to avoid and required a transfer of the EDA account if the potential recapture involved in the property transferred in any one-year period is more than 25 percent of the total potential recapture in all of the donor's property immediately prior to the first gift.⁸⁹ If there is such a substantial gift, the EDA is divided among the donor and all donees in proportion to

⁸⁷ Int. Rev. Code of 1954, § 1251(d)(6). Interestingly, the stock becomes farm recapture property even if the § 351 transaction in question is the first part of a divisive reorganization. A subsequent distribution by the transferor to shareholders pursuant to § 355 would trigger the EDA and, despite the fact that this is ordinarily a non-recognition transaction, the distributing corporation would recognize ordinary income subject to the limits of § 1251. While one could argue whether or not this is a proper result, a transaction of this type would not be common, and it was apparently felt that further refinement of the rules was not essential.

⁸⁸ Int. Rev. Code of 1954, § 1251(b)(5)(B), as proposed to be added by § 211(a) of the Act. See H.R. 13270, 91st Cong., 1st Sess. (1969) (as passed by the House).

⁸⁹ Int. Rev. Code of 1954, § 1251(b)(5)(B).

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the potential recapture in the property retained by the donor and transferred to each of the donees involved.

In summary, these rules seem reasonable but are neither simple nor completely protective of the revenue.⁴⁰ Moreover, it is undoubtedly true that the detailed rules designed for nontaxable transfers made EDA more susceptible to charges that it was too complex than it otherwise would have been. Thus, while EDA eventually emerged from the conference deliberations and became part of the 1969 Act, it did not survive Senate consideration of the bill.

V. CAPITAL DEDUCTIONS

The Senate Finance Committee met the argument that EDA was too complex by rejecting it in favor of the adoption of a "Limitation on Deductions Attributable to Farming."⁴¹ The committee report gives the following explanation of this action:

The basic problem which arises in connection with farm losses is that the deductions with respect to property, which gives rise to capital gain income when sold at a subsequent date, are currently deducted from ordinary income. In most cases, the effect of this is to give the deductions twice the value for tax purposes of the income to which they relate. Although the recapture approach of the House bill is one way to deal with this problem, the committee believes that a less complex and more direct approach is desirable. Accordingly, the committee has replaced the House provision . . . with limitation on the deduction of farm losses which has the effect of converting the tax value of farm losses back to the same proportion as the income to which they relate.⁴²

Thus, subject to certain tolerances,⁴³ the Senate bill provided that for a cash basis taxpayer the allowable deductions attributable to the business of farming could not exceed the sum of the ordinary income from the business plus one-half of the excess deductions. The amount not allowed would be carried forward to succeeding taxable

⁴⁰ For a summary of the House provision which was generally adopted in the final bill, see H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 2, at 39-46 (1969) [hereinafter cited as House Rep.].

⁴¹ Section 211 of the Act. See H.R. 13270, 91st Cong., 1st Sess. (1969) (as passed by the Senate); see Senate Rep. at 95.

⁴² Senate Rep. at 96-97.

⁴³ The Senate carried forward the \$25,000-\$50,000 exclusions of the House bill. Thus individuals with nonfarm adjusted gross income of less than \$50,000 were not subject to the limitation, and individuals could take deductions up to the amount of their farm income plus \$25,000 without limitation. In addition, so-called special deductions (such as interest, taxes and casualty losses) could be deducted in full. See Senate Rep. at 97.

years without limit, and would be allowed in any year in which the ordinary income from farming exceeded the deductions, to the extent of one-half of such excess. The amount of capital gain had no effect on the allowance of deductions. The example below will explain the operation of this provision ignoring the tolerances described in note 43.

EXAMPLE 1

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
Farm Income	50	40	60	100
Farm Deductions	80	60	20	90
<i>Deductions Allowed</i>				
Current year: Amount of Farm Income	50	40	20	90
½ of excess deductions	15	10		
Carryover allowed: ½ of excess of income over deductions			20	5
Total Allowed	65	50	40	95
Carryover	15	10	(20)	(5)
Total Carryover	15	25	5	0

The carryover is allowed only to the extent of one-half of the net income because one-half of all deductions are allowed without regard to the amount of net income. What is being allowed through the carryover is the disallowed half of the deductions. As can be seen from the example, in the four-year period total income and deductions are the same (250), permitting all deductions to be claimed.

Thus, while deductions are allowed in full to the extent that the taxpayer at any time realizes ordinary income from farming, deductions in excess of such income are cut in half. Since this corresponds to taxation of only one-half of the amount of LTCG, I will refer to this new concept as capital deductions. Its result is the same as EDA and recapture in limiting the amount of LTCG to the true economic profit.

EXAMPLE 2

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Total Farm Income	150	150	150
Deductions	150	150	140
Economic Income	0	0	10
<i>Tax Computation</i>			
Ordinary Income	0	40	40
Capital Gain	150	110	110
Less: one-half	75 75	55 55	55 55
Total Income	75	95	95

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Deductions Allowed

Amt. ordinary income	0	40	40
One-half remainder	<u>75</u> <u>75</u>	<u>55</u> <u>95</u>	<u>50</u> <u>90</u>
Taxble Income	0	0	5

Five dollars, the taxable income in Year 3, is one-half the economic income, indicating that LTCG treatment is available to this extent. In Years 1 and 2 there is no economic income and hence, no capital gain benefit.

As the following example illustrates, the primary difference between EDA and the Senate approach is a matter of timing. However, the Senate bill may be more favorable, ignoring the impact of timing, if ordinary income is realized at a later time.

EXAMPLE 3

	Year 1		Year 2		Year 3	
Ordinary Income	80		50		60	
LTCG			20			
Deductions	100		50		40	
	EDA	SEN	EDA	SEN	EDA	SEN
Ordinary Income	80	80	70*	50	60	60
1/2 LTCG			10			
Total Income	<u>80</u>	<u>80</u>	<u>70</u>	<u>60</u>	<u>60</u>	<u>60</u>
Deductions						
Allowed	100	90**	50	50	40	50***
Net Income						
(loss)	<u>(20)</u>	<u>(10)</u>	<u>20</u>	<u>10</u>	<u>20</u>	<u>10</u>

* Reflects conversion of \$20 due to EDA established by \$20 farm loss in Year 1.

** One-half of excess of deductions over income is not allowed but is carried forward.

*** Carryover of \$10 from Year 1 is allowed since ordinary income exceeds deductions by \$20.

Overall there is an economic gain of \$20 which under EDA is reported in full for tax purposes. Under the Senate bill only \$10 is reported reflecting the eventual benefit of the \$20 LTCG in Year 2.

At the end of Year 1, when no capital gain has been realized, EDA puts the taxpayer in a better position because the full deduction is allowed. At the end of Year 2, when there is a break-even position, both provisions show a break-even for tax purposes. It should be noted, however, that the Senate bill would have allowed ordinary losses to be claimed in full whenever ordinary income was realized regardless of intervening capital gains. Thus, in Year 3, when total ordinary income (190) equals total ordinary deductions (190), the carryover of 10 is allowed in full, and the taxpayer gets the benefit of the long-term capital gain derived in Year 2. At the end of Year 2

he does not get this benefit, not because his LTCG is converted into ordinary income as in EDA, but because his deductions in excess of ordinary income have been converted into a capital deduction that is allowed only to the extent of one-half. The difference can be seen by comparing the results at the end of Year 2. Both the Senate bill and EDA produce neither a gain nor a loss for the two years combined, but under the Senate bill the total of income and deductions for the two years is 140, while under EDA it is 150.

The Senate believed this approach was "simpler"⁴⁴ because the deprivation (disallowance of a full deduction) came first, and the possible benefit (full allowance if ordinary income was realized) later. Thus, the taxpayer is motivated to keep records, and has no incentive to engage in a variety of tax-free transactions to shift the recapture to another person or avoid it entirely. If, for example, a taxpayer with an existing carryover made a gift of all of his farm property to his children, the possibility of the full deduction would be lost forever.⁴⁵

While it may be arguable whether motivation to keep records in actual fact makes a provision simpler from the point of view of the taxpayer, it is unquestionably true that the absence of the need to deal with tax-free transfers made the statutory draft much shorter and greatly reduced the possibility of avoidance. Nevertheless, the capital deductions approach was not the approach selected by the Conference Committee to be included in the 1969 Tax Reform Act with respect to farm losses.

VI. CONFERENCE ACTION ON FARMS AND INTEREST

Apparently indicating congressional unwillingness to do very much about the farm loss loophole, the Conference Committee rejected the Senate approach in favor of the milder excess deductions account. However, the capital deduction approach survived in the Tax Reform Act in the treatment of interest.⁴⁶

As indicated above, the ordinary deduction-capital gains problem arises in connection with taxpayers borrowing to invest in unproductive land or growth stock. The interest on such loans is deductible in full, and income on sale is capital gain, without any offset for the interest cost. Congress was concerned that 72 of the famous 154 taxpayers with adjusted gross income in 1966 in excess of \$200,000 who paid no tax⁴⁷ relied heavily on the interest deduction, and it was

⁴⁴ Senate Rep. at 96-97 (1969).

⁴⁵ Presumably a carryover would have been allowed to a successor corporation in a corporate reorganization to which § 381 of the Code applies. See Senate Rep. at 98.

⁴⁶ Int. Rev. Code of 1954, § 163(d) as added by § 221 of the Act.

⁴⁷ See House Rep., pt. 1, at 1, 9.

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determined to do something about it.⁴⁸ The House disallowed a deduction for "investment interest" to the extent it exceeded "net investment income" (a "capitalization" approach)⁴⁹ but the Senate, at the urging of the Treasury⁵⁰ among others, deleted the House provision.

The Treasury's concern relates to the fact that the interest provision, similar to the farm loss remedies discussed above, treated all investments as a composite. As noted above, a farmer with substantial ordinary income from his farm business could avoid the impact of EDA on that part of his business which produced capital gains. Thus, generally the individual with a combined breeding and grain operation could retain the benefit of the negative income tax on the breeding portion of his business, which benefit would generally be denied to the individual whose sole farm business was breeding animals.

The same kind of discrimination arises in the operation of the interest provision with respect to individuals who borrow to finance all or a substantial portion of their investments, as contrasted with those who have substantial capital of their own. For example, assume both *A* and *B* decide to borrow \$1,250,000 at 8 percent interest to purchase vacant land which they believe has great appreciation potential. *A* has no income other than a large salary which he consumes annually. *B*, however, receives \$100,000 of dividend income each year. Since *B*'s dividends equal his \$100,000 annual interest cost, and since the limitation as enacted would apply to investment interest (interest incurred or continued to carry property held for investment) in excess of investment income, only *A* has a problem. This is the case even though *B* actually borrowed to purchase the land and perhaps more significantly, assuming *B* were allowed to allocate his borrowing to the stock investment or a portion thereof, even though the current value of the stock producing the \$100,000 dividends is substantially in excess of the indebtedness of \$1,250,000 (at a 4 percent return, for example, the stocks would be worth \$2,500,000). Thus, although *B*'s income from the investment made with borrowed funds is less than the interest, no interest is disallowed. *B*, therefore, can combine the deduction of interest in excess of such income and the LTCG on the sale of the stock purchased with borrowed funds to show a tax loss even though he has a profit on the transaction.

The Treasury's position essentially was that while *A* was being treated properly, it was unfair to disallow the interest deduction as

⁴⁸ House Rep., pt. 1, at 9, 72.

⁴⁹ Section 221 of the Act. See H.R. 13270, 91st Cong., 1st Sess. (1969) (as passed by the House).

⁵⁰ Hearings Before the Senate Comm. on Finance, Tax Reform Act of 1969, 91st Cong., 1st Sess. 576-77 (1969) (Testimony of Asst. Secy. Cohen); Senate Rep. at 305-06.

to him unless some means were devised to reduce *B*'s excessive tax benefits. Various means were explored and rejected for reasons of complexity or difficulty of administration, but the Conference Committee decided to deal with *A* anyway and worry about *B* later. However, the effective date was postponed for two years to give the Treasury and others time to develop alternative solutions.⁵¹

The provision adopted by the Conference Committee was a modified version of the Senate farm loss provision rather than the full disallowance of excess interest which appeared in the House bill. The Act, in order to limit its application to real abuses gives all taxpayers a free deduction of \$25,000 of investment interest.⁵² However, for the purpose of this article, in the interest of simplicity, this free ride will be ignored.

The amount of investment interest allowed as a deduction is limited to the sum of:

(A) the amount of net investment income as defined in the Code;⁵³

(B) net LTCG on property held for investment;

(C) $\frac{1}{2}$ of the remainder of such interest.

(A) and (C) will be recognized as the total of farm deductions allowed in the Senate bill. The effect of (B) will be discussed below. Any amount of disallowed interest is carried forward and can be deducted in a subsequent year to the extent of one-half of the excess of net investment income over investment interest.⁵⁴ Up to this point, the carryover is the same as that found in the Senate bill. However, it is further provided that the carryover be reduced by the amount of the section 1202 deduction allowed to the taxpayer.⁵⁵ Moreover, to the extent that a deduction is allowed under (B), an equal amount of capital gain is converted into ordinary income.⁵⁶

The effect of this rule and the carryover reduction is to equalize the capital deduction and recapture approaches by permanently treating the interest deduction as a capital deduction when it results in capital gain being earned. Unlike the Senate farm rule, it does not provide the taxpayer with the opportunity to convert the interest paid into an ordinary deduction whenever ordinary income is produced, regardless of the amount of intervening capital gain. Thus, if the Senate farm provision had worked this way in Example 3 above, the

⁵¹ Act, § 221(b). In the meantime, excess investment interest is treated as a preference for the purpose of the Minimum Tax for Tax Preferences, Int. Rev. Code of 1954, § 57(a)(1) as added by § 301 of the Act.

⁵² Int. Rev. Code of 1954, § 163(d)(1)(A).

⁵³ Int. Rev. Code of 1954, § 163(d)(3)(A), (B) and (C).

⁵⁴ Int. Rev. Code of 1954, § 163(d)(2)(A).

⁵⁵ Int. Rev. Code of 1954, § 163(d)(2)(B).

⁵⁶ Int. Rev. Code of 1954, § 163(d)(5).

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carryover would have been eliminated in Year 2, and the total income reported over the three-year period would have been 20, the same amount as under the EDA approach. There are reasonable arguments for either approach and we need not pause here to discuss them since the essential validity of the capital deduction route is unchanged whichever method is followed.⁵⁷

VII. EVALUATION OF CAPITAL DEDUCTION AS COMPARED TO RECAPTURE

As discussed above, capital deduction militates against tax avoidance by transfers or by failure to keep adequate records. It prevents a taxpayer from claiming a deduction and shifting the onus of recapture to a lower-bracket taxpayer. In addition, it reduces the benefit of the deferral by allowing only one-half of the deduction in the initial year. For these reasons it is preferable to recapture; but the question naturally arises whether this partial disallowance can be supported when accounting principles, for example, would permit the deduction, such as interest, to be taken when incurred. It is submitted that allowance of only one-half of the deduction can be justified (even if it would be admitted for the sake of argument that a full disallowance would be improper or undesirable) because of the fact that it achieves symmetry with the taxation of only one-half of LTCG. Thus, it seems that the capital deduction approach should be preferred to recapture when:

- (1) it is reasonably certain that the taxpayer's purpose in entering the transaction is to realize a long-term capital gain, or
- (2) it is likely that this is the taxpayer's purpose and general accounting principles would suggest that the expenditure be disallowed in full (capitalized).

Since only one-half of LTCG is subject to tax, it is only reasonable to allow just one-half of expenses to be deducted when a taxpayer intends to produce only capital gain income. If, contrary to the taxpayer's expectations, ordinary income is in fact realized, the full amount of the deductions becomes allowable when such realization occurs. The capital deduction approach also would seem to be proper when the transaction results in a loss in that it permits one-half of the loss to be deducted, thus corresponding to the amount of income that would be taxable if the transaction had produced LTCG. For example, if the taxpayer's costs in raising a breeding animal were

⁵⁷ The author believes that the Act's treatment of capital gain under the interest provision is clearly correct. The more liberal treatment of "farmers" under the Senate bill is perhaps justified because of the uncertainty of whether a "farmer" is actually seeking capital gain and the greater possibility of irregularity in the earning of farm ordinary income.

\$140, the deduction would be limited to \$70. If the animal were sold for a LTCG of \$100, \$50 would be taxed. The net loss for tax purposes, \$20 (\$70 - \$50) is one-half of the economic loss of \$40 (\$140 - \$100).

It may be noted that if the \$140 were capitalized, the sale would result in a capital loss of \$40. Since a capital loss can generally be used only to offset a capital gain, the tax value of the loss is only \$20 since a LTCG of \$40 would produce only \$20 of taxable income.⁵⁸ In effect, therefore, the capital deduction approach reaches the same eventual result as would be reached if the expense were required to be capitalized and taken into account in computing capital gain or loss, while at the same time allowing the proper portion of the deduction to be claimed in the year the expense is incurred.⁵⁹

VIII. CONCLUSION

Having examined the results of the various solutions to the negative income tax problem, it is appropriate to consider the propriety of the action taken in the Tax Reform Act of 1969.

The author would support the use of the capital deduction approach for investment interest for the first of the two reasons given above. The provision would seem to apply principally to investors in the stock market and in vacant land. The dividend income to the former would almost certainly be less than the cost of borrowing; the latter, of course, have little or no current return unless the property is developed. Both are hoping that the purchased assets will appreciate in value and produce LTCG. Hence, their costs are clearly capital costs.

It may be noted that the investment interest provision would also apply to lessors of realty or personalty under a net lease resulting in current tax losses (those with gains are not troubled by the investment interest provision). Because of the inadequacies of section 1250 in achieving recapture, and the appreciation potential in most realty, it would seem that real estate investors with current losses would ordinarily be seeking capital gain on sale rather than future rent increases. Therefore, the provision properly applies. Equipment les-

⁵⁸ A long-term capital loss retains its full value to the extent it is used to offset a short-term capital gain which is otherwise taxed in full.

⁵⁹ The following example shows how this occurs in a transaction producing a gain.

Selling Price	\$200
Cost	140
If cost is capitalized profit	60
Deducting $\frac{1}{2}$ for LTCG amount of income reported is	30
Similarly, if the entire \$200 is entitled to LTCG resulting in reported income of	100
A net gain of \$30 will be shown if only $\frac{1}{2}$ of the cost of \$140 is deducted	70
	\$30

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sors, who have to contend with section 1245, may have a better case on this ground although they hardly would seem to be abused by the tax law; their plight will not be pursued here although it may be noted that since accelerated depreciation is not taken into account in computing investment expenses,⁶⁰ equipment lessors may perhaps have enough net investment income to permit the deduction of interest paid.

In the farm area, it is more difficult to assert that the eventual goal is capital gain. The capital gain abuse has generally been limited to breeding livestock and trees. Efforts to distinguish other farm operations from these would be difficult, particularly where there is an integrated business. Moreover, a breeder could realize substantial ordinary income, and the trees could be retained until they bear fruit which is then sold for ordinary income. Nevertheless, the capital deduction approach can be supported on the second ground set forth above—the immediate deduction on the cash basis is improper, and, in light of the real capital gain potential, effective measures to deal with it are needed. Since it is hard to object to the validity of requiring capitalization of costs, this milder approach is clearly justified. The small operator who might legitimately claim to have difficulty with the accrual method can be excluded from the potential disallowance of deductions by legitimate tolerances. For the large operator who expects ordinary income and who in the unusual case would be denied a deduction for real losses, the unlimited carryover prevents hardship. If that is insufficient, however, he has the option of using the accrual method. Particularly in light of the real difficulty under EDA of handling tax-free transfers, the Senate approach would have been preferable to the solution adopted.

It is not intended to suggest that capitalization of costs or denial of LTCG on sale would not be a better solution to some of the problems discussed herein, but until this millennium is achieved, it is the author's view that the capital deduction approach is worthy of serious consideration in what should be the continuing effort to deal with the double benefit of ordinary deductions and capital gains. Moreover, there should be a strong presumption in favor of this solution, as compared to recapture, whenever it appears that the transaction is clearly intended to produce capital gains; or, if capital gains is less certain, if it can also be established that the immediate deduction is not in accord with ordinary accounting principles.

⁶⁰ Int. Rev. Code of 1954, § 163(d)(3)(C).