A Comparison of Japanese and American Taxation of Capital Gains

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Member of the Class of 1991

I. INTRODUCTION

A nation's tax code is one of the most important variables affecting any business decision. How taxpayers invest their resources is often determined by the tax consequences of their investment options.¹ Investment is responsible for increased productivity, whether in the form of research and development, new plants and equipment, or improved training for workers. Ultimately, only growth in productivity increases the standard of living.

In the United States, a heightened concern for the economic consequences of tax policy has coincided with an acute awareness that our economy is in a state of relative decline.² The economic growth rate of our major trade competitor, Japan, has consistently outpaced the growth in the American economy.³ While the American economy has been expanding at 2 percent to 2.5 percent or less each year, Japan's economy has managed to grow at a rate of 4 percent or 5 percent.⁴ Japan has achieved this level of success because it allocates a full quarter of its gross national product (GNP) to investment in new factories, equipment, and research. The United States, in contrast, allocates only one-eighth of its GNP for such investments.⁵ American policymakers recognize the need to stimulate higher levels of domestic investment. Specific proposals, however, have proven divisive.⁶ Within this context, the capital gains tax

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⁴ N.Y. Times, Nov. 18, 1990, § 3, at F13, col. 2.
⁵ Id.
⁶ See N.Y. Times, Jan. 8, 1990, at A1, col. 6 (describing the partisan debate over proposal to stimulate investment by cutting the capital gains tax rate.)
has once again come to the forefront of American political debate.  

Japan’s level of investment has been the result of a very deliberate national commitment to achieving high growth. Reduced taxation for capital gains has been a centerpiece of Japan’s postwar economic policy. Rather than follow the Japanese example, however, the United States has chosen to pursue the opposite course. With the Tax Reform Act of 1986, the capital gains tax was increased to a level of parity with other forms of income. While Congress retreated from this policy somewhat in 1990 by enacting a very limited preference for capital gains, this measure falls far short of the extensive preferences accorded by the Japanese system.

This Note will analyze both the Japanese and American approaches to capital gains taxation, and will weigh the relative merits of each system, placing an emphasis on potential reforms of American tax law. This Note will then propose legislation for the United States which draws on the experiences of both nations while eliminating many of the serious political and economic problems which are inherent in the current law of capital gains taxation.

II. CAPITAL GAINS TAXATION IN THE UNITED STATES

A. History

The concept of taxing the gains that result from the appreciation of capital assets has always been problematic for American tax policymakers. Although the owner’s wealth has increased, such gains have traditionally been characterized as distinct from the more conventional forms of income such as salary, interest, or dividend payments.

In 1872 the Supreme Court held in Gray v. Darlington that capital

10. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11101(c), 104 Stat. 1024. Congress set a maximum rate of 28% for capital gain as opposed to 31% for ordinary income. This provision is discussed infra.
13. Id.
14. 82 U.S. 63 (1872).
gain was not income within the meaning of the Civil War Income Tax Act.\textsuperscript{15} The petitioner had purchased treasury bonds in 1865 and sold them four years later at a profit of twenty thousand dollars. The Civil War Income Tax Act called for a levy on all "gains, profits, and income" for the year.\textsuperscript{16} Despite the statutory language, Justice Field, writing for the majority, held that mere advance in value in no sense constitutes the gains, profits, or income specified by the statute.\textsuperscript{17} It constitutes and can be treated merely as increase of capital, and therefore does not fall within the statutory definition of taxable income.

The sixteenth amendment, which empowers Congress to tax income directly, contains no comprehensive definition of taxable income.\textsuperscript{18} Consequently, the Income Tax Act of 1916\textsuperscript{19} was challenged as unconstitutional in \textit{Merchant's Loan and Trust Co. v. Smietanka}\textsuperscript{20} because it attempted to tax capital gains as income. The plaintiff, who was acting as the trustee of a large portfolio of appreciated stocks and bonds, contended that it had not earned taxable "income" when it merely sold one piece of property in order to buy another. It argued that the trust's financial position remained unchanged by such a transaction and that "the change in form by the conversion does not make any change in substance."\textsuperscript{21} The Supreme Court rejected these arguments and held that capital gains were in fact taxable income within the meaning of both the Income Tax Act and the sixteenth amendment.\textsuperscript{22}

The holding in \textit{Merchant's Loan} merely shifted the debate to Congress.\textsuperscript{23} Within a year of the Court's ruling, Congress enacted legislation which provided for a reduced tax rate on capital gain proceeds.\textsuperscript{24} Congress intended to alleviate the so-called bunching effect.\textsuperscript{25} Bunching of income occurs when the profit realized from the sale of property, which has appreciated over years or even decades, is taxed all at once in the

\textsuperscript{16} \textit{Id.} at 478.
\textsuperscript{17} 82 U.S. at 65.
\textsuperscript{18} The sixteenth amendment states only that "The Congress shall have power to lay and collect incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. \textsc{Const.} amend. XVI.
\textsuperscript{20} 255 U.S. 509 (1921).
\textsuperscript{21} \textit{Id.} at 511.
\textsuperscript{22} \textit{Id.} at 521-22. Interestingly, in England, the argument that capital gains were not income was widely accepted during the first half of the twentieth century. R. \textsc{Magill}, \textsc{Taxable Income} 82-103 (1945). It was not until 1965 that capital gains were finally made taxable under British tax law. Finance Act, 1965, pt. III.
\textsuperscript{23} R. \textsc{Magill}, \textit{supra} note 22, at 111.
\textsuperscript{25} \textit{See, e.g.}, R. \textsc{Goode}, \textsc{The Individual Income Tax} 199 (1964).
year of sale, usually at a high marginal level because of the progressive 
tax rates. Congress believed that the bunching effect caused a substantial 
restraint on the sale of capital assets. For example, the Ways and Means 
Committee reported:

The sale of capital assets is now seriously retarded by the fact that 
gains and profits earned over a series of years are under the present law 
taxed as a lump sum (and the amount of surtax greatly enhanced 
thereby) in the year in which the profit is realized . . . . In order to 
permit such transactions to go forward without fear of a prohibitive 
tax, the proposed bill . . . adds a new section . . . [placing a preferential 
rate on gains from the sale or disposition of capital assets].

Implicit in the committee's analysis is a recognition that taxing capi-
tal gains at a reduced rate would encourage investors to sell their appre-
ciated assets, thereby creating taxable transactions. Taxing a larger 
number of sales at a lower rate could produce almost as much revenue, 
and possibly more, than a higher tax on a smaller number of sales.

Congress also believed that several factors required capital gains to 
be treated as a separate category of income, deserving of special treat-
ment: capital gains may result merely from a continuation of the same 
investment in a new form; capital gains may represent nothing more than 
inflationary increases in the cost of an asset; and capital gains may have 
accumulated over such a long time that it would be unfair to tax the 
entire gain in the year of sale. For example, an investor may sell a 
building and use the proceeds to buy a virtually identical building at a 
different location. A property held for an exceptionally long time may 
sell for four or five times its original purchase price; yet, in inflation ad-
justed dollars, it may actually be worth less than the purchase price. In 
these situations, it seems unfair to fully tax the gain from the sale.

For these reasons, as well as a desire to stimulate taxable transac-
tions and increase revenues, Congress favored capital gains. It was not 
until later that stimulating investment became the preeminent justifica-
tion for preferring capital gains.

Despite a generally prevailing consensus that capital gains should be 
favored, there has been considerable debate over how this treatment 
should be structured. Congress has periodically changed the specific

27. This is essentially a description of the so-called Laffer Curve. See, e.g., E. BROWNING & J. BROWNING, PUBLIC FINANCE AND THE PRICE SYSTEM 452-54 (3d ed. 1987).
29. See, e.g., Slawson, Taxing as Ordinary Income the Appreciation of Publicly Held Stock, 76 YALE L.J. 623 (1967).
terms of the capital gains law as its emphasis on the various justifications has shifted. Thus, the law has been in a state of flux since the early 1920s. In 1921 the maximum rate was 12.5 percent and an asset had to be held for over 2 years to qualify for the reduced rate. By 1934 the formula involved a sliding scale in which the percentage of gain taxed was inversely related to the number of years the asset had been held. Under this plan, capital gains received no preferential treatment unless the property sold had been held for over one year. Thereafter, the percentage of gain included in income declined the longer the taxpayer owned the asset, reaching a minimum of thirty percent after ten years. In 1942 the sliding scale was eliminated and a maximum ceiling was placed on gain from the sale of property that had been held over six months.

As the balance between economic philosophies and various political factions shifted, so did the capital gains tax rate. Between 1942 and the mid-1980s the holding period went from six months to nine months to one year, and then back to six months again. Furthermore, both the rates of taxation and the definitions of "capital assets" were altered. Prior to the 1986 tax reform, the capital gains provision exempted sixty percent of a taxpayer's gain from his taxable income. Since the maximum individual tax rate at this time was fifty percent, the maximum tax on capital gains was twenty percent.

B. The Tax Reform Act of 1986

The Tax Reform Act of 1986 represented a radical change in philosophy toward the treatment of capital gains. Rather than continuing the trend of increasingly preferential treatment of capital gains, Congress abruptly reversed the policy of the previous sixty-five years by making capi-
tal gains taxable at the same rate as ordinary income. The sweeping reforms of 1986 were motivated by widespread frustration with the incredible complexity of the Internal Revenue Code (the Code), resentment of abusive tax shelters, and dauntingly high marginal tax rates of up to fifty percent. Congress was therefore trying to make the Code simpler and more fair while simultaneously lowering marginal rates and maintaining adequate revenues. This balancing act required many political compromises and trade-offs. The central trade-off, however, was that a reduction in the marginal tax rates could be achieved only in return for broadening the tax base. Collecting the same revenues while lowering tax rates requires an increase in the amount of economic activity which was fully taxable. For example, if a family has 100,000 dollars of income but is allowed 50,000 dollars in deductions, the remaining income has to be taxed at a rate of 50 percent to generate 25,000 dollars in revenues. If no deductions were allowed, the same revenue could be collected with a tax rate of only twenty-five percent. Before 1986 the availability of a wide range of deductions allowed many taxpayers to shelter a large portion of their incomes. In order to bring down rates, many of these tax preferences had to be eliminated or drastically reduced. These preferences, often referred to as loopholes, included deductibility of personal interest expense, educational travel expenses, and the deduction of excess losses from passive investments. The preferential treatment of capital gains was also eliminated as part of this overall package. As a result of the elimination of these deductions, as well as many others, the tax rate was dropped from a maximum of fifty percent to only twenty-eight percent, while the amount of tax paid by the average taxpayer remained essentially unchanged.

Although Congress increased the rate of taxation on capital gains to

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41. Id. at 7.
42. Id. at 7, 178.
43. Id. at 7.
44. I.R.C. § 163(h) (1986). Prior to 1987 all interest including consumer loans was tax deductible. This deduction was phased out over four years. Id. § 163(b)6.
45. Id. § 162. Prior to 1987 travel expenses were liberally allowed as business expenses; this provision was widely abused.
46. Id. § 469 (1988). Under previous law, "paper" losses such as depreciation could be deducted against ordinary income in amounts which greatly exceeded the actual investment. The 1986 bill requires that these losses can generally be deducted only against other "passive" income.
47. Id. § 301. Under previous law, only 40% of capital gains were taxed as income. After 1987 they were fully taxable as ordinary income.
50. General Explanation of TRA 1986, supra note 9, at 7.
match the tax on other forms of income, they also made clear their intent that, as a matter of policy, such gains should be taxed at a comparatively low rate:

The Congress believed that the top rate on individual capital gains should not exceed the maximum rates set forth in the Act, and therefore the Act provides that the maximum tax rate on capital gains will not exceed the top individual rate that the Act provides in the event that the top individual rate is increased by a subsequent public law (unless that law specifically increases the capital gains).\(^1\)

With an eye to the future, Congress thus retained the mechanism in the Code by which capital gains are distinguished from other forms of income.\(^5\) Congress also set a permanent ceiling of twenty-eight percent on capital gains.\(^5\) These actions foreshadowed the 1990 legislation, in which the top individual rate was in fact raised to thirty-one percent and the tax on capital gains was maintained at a constant rate of twenty-eight percent.\(^54\)

C. President Bush's Proposals and Current Debate in Congress

During the presidential race of 1988, George Bush campaigned on a platform that included a reduction in the capital gains tax as a major plank.\(^55\) Once elected, Bush's attempts to turn his campaign promise into legislation met with the criticism that it was an unnecessary tax break for the rich.

When an actual bill was introduced in the fall of 1989, it called for a reduction in the tax rate on capital gains from 28 percent to 19.6 percent for a period of 2 years, after which it would return to 28 percent.\(^56\) At the end of the two years, however, the tax rate would return to the same level as ordinary income but the value of the asset would be indexed to inflation.\(^57\) The bill passed in the House of Representatives by a large margin\(^58\) but was prevented from reaching a vote in the Senate by a filibuster organized by Democratic leaders.

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51. *Id.* at 178.
57. *Id.* at 2856. Indexing to inflation allows the amount of profit from the sale of property which resulted solely from inflation to be excluded from income.
58. *Id.* at 1.
In 1990 the issue returned, this time overshadowed by an impending record level federal deficit. President Bush once again pushed for a capital gains cut. But as budget talks proceeded, Democratic leaders once again forced him to abandon his insistence on a substantial capital gains tax cut as part of a compromise on deficit reduction. The resulting legislation included only a watered down version of a capital gains preference: the rate for capital gains remains twenty-eight percent while the maximum marginal rate for ordinary income was increased from twenty-eight to thirty-one percent.

In practice, this level of preference for capital gain will not have a significant effect for many taxpayers. For example, if a married couple has 90,000 dollars of taxable income, including 30,000 dollars in capital gains, they would owe a tax of 20,981.50 dollars under the new law. The reduced rate of tax on their capital gains results in a savings of only 348 dollars. This savings is relatively small because the 3 percent difference between the 31 percent rate on ordinary income and the 28 percent rate on capital gains only applies when total income is greater than 78,400 dollars. The 348 dollar tax savings equals 3 percent of 11,600 dollars (90,000 dollars - 78,400 dollars). This degree of preference is generally not considered sufficient to affect many investment decisions. Additionally, this provision has the perverse effect of actually raising the tax on capital gains for those few taxpayers who have capital gains and are in the lowest bracket of fifteen percent.

Proponents of a capital gains cut remain committed, however, and a more extensive cut will undoubtedly be reintroduced in the near future. Such a preference, when and if enacted, could take a variety of forms. Several different proposals have been advanced, including a return to some kind of sliding scale as existed in the 1930s, and the introduction of various plans for indexing to inflation. In the end, however, these new

61. This is computed by applying the current statutory rates under Section 1. Thus, the married couple would owe $12,581.50 on their $60,000 in ordinary income (which is taxed at 28%) and another $8,400.00 on their $30,000 of capital gain (also now taxed at 28%). M. Macmillan, A Complete Guide to the Omnibus Budget Reconciliation Act of 1990, at 14-15 (1990).
62. Id. at 15.
63. Id.
64. Id.
65. Id.
66. Id.
67. See, e.g., N.Y. Times, supra note 59.
ideas are simply variations on the conventional formula which allows a reduced rate of tax on sales made after an arbitrary holding period. Given the long history of controversy over this issue, there is little reason to expect that any of these plans will lead to lasting legislation.

D. Non-Recognition Provisions

While the political debate has always centered on the desirability of reducing the tax rates imposed on capital gains, other less well known provisions of the Code have allowed capital gains to be earned without incurring immediate tax liability. Two of these provisions, Internal Revenue Code sections 1031 and 1034, allow a taxpayer to dispose of investment property (section 1031) or a personal residence (section 1034) at a profit and yet pay no tax. These sections may seem to resemble some of the unfair loopholes which were largely eliminated during the 1986 tax reform. Yet, these provisions are two of the most popular and least controversial in the Code.69

Section 1031 authorizes what are commonly known as like-kind exchanges.70 If an investor exchanges property for sufficiently similar property, no tax is assessed, even if the new property is worth substantially more than the original purchase price of the old property.71 For example, if an investor bought an apartment building for 200,000 dollars and it is now worth 300,000 dollars, selling it would result in 100,000 dollars of taxable income, ignoring the effects of depreciation and other adjustments to basis.72 But, if instead of selling it outright, the investor was to trade it for like-kind property worth 300,000 dollars, the investor would pay nothing in taxes.73 The term "like-kind" has been liberally construed; not only a new apartment building but raw land, or any other form of investment real estate, would qualify.74 Section 1031, however,

71. Id.
72. "Basis" is an accounting term used to measure the value of an asset for the purpose of determining gain or loss upon its sale. BLACK'S LAW DICTIONARY 79 (5th ed. 1979). The purchase price, or cost, will initially constitute the tax basis of a property. However, any depreciation deduction allowed against the property will reduce the basis, while any capital improvements to the property will increase the basis. See, e.g., id. Capital gain is computed by subtracting a property's adjusted basis from the amount realized on its sale. I.R.C. § 1001 (1988).
73. See, e.g., Commissioner v. Chrichton, 122 F.2d 181 (5th Cir. 1941).
74. Id.
does not apply to stocks and other securities.\footnote{76}{Id. § 1031(a)(2).}

Section 1034,\footnote{77}{Id. § 1034.} the provision dealing with the sale of one's principal residence, is even more favorable to the taxpayer. This section functions just as 1031 does, except it is not necessary to specifically exchange one property in return for another.\footnote{78}{Id. § 1034(a).} Instead, a homeowner may sell a principal residence and, as long as the homeowner buys another residence within two years for an equal or greater purchase price, no tax is paid on the gain from the sale.\footnote{79}{Id.}

It is important to realize that these provisions do not waive tax liability; they merely defer its collection. This deferral is accomplished through the mechanism of the transferred basis.\footnote{80}{Id. §§ 1031(d), 1034(e).} Thus, in the apartment building example, the investor's new building would assume the same basis that the investor had in the old building—200,000 dollars.\footnote{81}{See id. § 1031(d).} Were the investor to subsequently sell the new building for cash at its fair market value of 300,000 dollars, the investor would have to recognize and pay taxes on the 100,000 dollars gain. The same result would occur if the original building had been sold for cash. The investor has merely postponed paying taxes on the gain from the first property until the gain from selling the second building is recognized. The investor may further postpone tax liability by exchanging for a third building rather than selling the second. Similarly, under section 1034 a new principal residence takes a transferred basis from the old residence.\footnote{82}{Id. § 1034(a)-(e).}

This principle also applies to a partial recognition in cash. If the apartment owner had taken a 250,000 dollar building along with 50,000 dollars cash in trade for his old building, the entire 50,000 dollars payment is currently taxable because it has not been used to purchase the replacement building.\footnote{83}{Id. § 1031(d).} Furthermore, if the homeowner bought a new home for less than the sale price of the old one, gain on the sale of the first house would be recognized to the extent of the difference in home prices.\footnote{84}{Id. § 1034(a)-(e).} Thus, under these non-recognition provisions, the tax liability on capital gain is deferred only to the extent that it is reinvested in a new property. Any portion of the gain which is realized in cash is fully taxable.

\footnotesize{76. Id. § 1031(a)(2).} \\
\footnotesize{77. Id. § 1034.} \\
\footnotesize{78. Id. § 1034(a).} \\
\footnotesize{79. Id.} \\
\footnotesize{80. Id. §§ 1031(d), 1034(e).} \\
\footnotesize{81. See id. § 1031(d).} \\
\footnotesize{82. Id. § 1034(e).} \\
\footnotesize{83. Id. § 1031(d).} \\
\footnotesize{84. Id. § 1034(a)-(e).}
The philosophy behind these provisions is based on the realization that if one purchases property that is the same as the property sold, one's economic position is unchanged and it would be unfair to impose a tax on the transaction. The potential for abuse is low because tax is only postponed to the extent that gains are continually reinvested. Thus, these provisions are an extremely effective way of dealing with capital gains because they encourage reinvestment of gain without granting an unfair or expensive tax preference.

III. JAPANESE TREATMENT OF CAPITAL GAINS

A. History

Japan did not experience constitutional difficulty with the taxation of capital gains comparable to the controversy in the United States regarding the scope of the sixteenth amendment. Yet, as a system which grew out of a feudal tradition, Japan historically tended to concentrate on property and excise taxes which are easier to collect and administrate than taxes on capital gains or income.

The basic framework of the current Japanese tax system, like many of Japan's institutions, is largely a product of the American occupation following World War II. As such, it reflected the thinking of American planners at that time and incorporated reduced rates of taxation on capital gains. Despite this strong American influence, the Japanese were faced with their own unique concerns, which included the prospect of rebuilding their economy from the ground up after its virtual destruction during the war. Thus, in contrast to American preoccupation with achieving tax equity, Japan's primary policy objective in the postwar era has been to achieve a high level of economic growth. Achieving this growth required accumulating enormous amounts of domestic capital. Consequently, economic policy in general, and tax policy in particular,

85. This is true because the transferred basis represents the historical cost of the original property. Thus, when the investor eventually sells, his total accumulated gain for all his successive investments is represented by the difference between the ultimate sales price and the transferred basis. See id. § 1031(d).
86. General Explanation of TRA 1986, supra note 9, at 7.
88. Sheppard, supra note 8, at 224.
89. Id.
90. Id.
91. McCauley, supra note 2, at 15.
were heavily skewed toward generating this capital.\textsuperscript{92}

As a result, Japan has favored capital accumulation heavily through a variety of economic incentives. For example, individuals are allowed to accumulate up to 82,500 dollars in a special tax free savings account.\textsuperscript{93} Furthermore, double taxation\textsuperscript{94} on corporate earnings is avoided through the use of a shareholder tax credit.\textsuperscript{95} This allows Japanese investors to retain a larger portion of the return from their investment than Americans.\textsuperscript{96} In addition, capital gains have been accorded highly favorable treatment.\textsuperscript{97} In fact, until 1988 capital gains from the sale of securities were totally tax exempt.\textsuperscript{98} Finally, another strength of the Japanese system is its stability, which allows investors to plan effectively without the uncertainty of an unpredictable tax burden.\textsuperscript{99} The Internal Revenue Code of the United States is altered significantly each year with little regard for the resulting uncertainty to taxpayers. By contrast, it is a major Japanese policy goal to provide a stable business environment in order to encourage investment and economic growth.\textsuperscript{100} Japan's level of capital accumulation has also been aided by an extremely low level of public debt\textsuperscript{101} and the lowest overall tax burden of any industrialized nation.\textsuperscript{102}

While other factors are involved, these policies have contributed significantly to what can only be described as an economic miracle. Savings and investment, as a percentage of GNP, rose to the highest levels in the world\textsuperscript{103}—averaging around twenty percent for much of the postwar period\textsuperscript{104}—and economic growth followed suit.\textsuperscript{105} The years between 1950 and 1973 saw average annual growth of over ten percent, again the highest in the world.\textsuperscript{106} The growth rate has leveled off in recent years as the

\begin{itemize}
\item\textsuperscript{92} Id.
\item\textsuperscript{93} Sheppard, supra note 8, at 224.
\item\textsuperscript{94} Double taxation occurs when corporate earnings are first subjected to a corporate income tax when they are earned by the corporation, and are then subjected to a personal income tax when they are distributed to shareholders in the form of dividends.
\item\textsuperscript{95} Sheppard, supra note 8, at 224.
\item\textsuperscript{96} Id.
\item\textsuperscript{97} Id.
\item\textsuperscript{98} Y. Gomi, supra note 87, at 12.
\item\textsuperscript{99} Sheppard, supra note 8, at 224-25.
\item\textsuperscript{100} Note, Intercompany Pricing of Intangibles Under Section 482: A Comparison with Japanese Tax Policy, 13 Hastings Int'l & Comp. L. Rev. 179, 180 (1990).
\item\textsuperscript{101} Komiya, Japan, in Foreign Tax Policies, supra note 87, at 47-49.
\item\textsuperscript{102} World Tax Reform: A Progress Report 1-2, table 1 (J. Pachman ed. 1988) [hereinafter World Tax Reform].
\item\textsuperscript{103} N.Y. Times, supra note 55.
\item\textsuperscript{104} L.A. Times, supra note 7.
\item\textsuperscript{105} P. Kennedy, supra note 3, at 417.
\item\textsuperscript{106} Id. at 417-18.
\end{itemize}
economy has matured, yet is still the highest in the industrialized world, and is typically twice that of the American economy.\textsuperscript{107}

Of course, imposing such light tax burdens on capital means that revenue must be raised in some other way. Because of the heavy tax preferences accorded investment, Japan has traditionally relied upon relatively high taxes on consumption and, to a lesser extent, steeply progressive tax rates on noninvestment income.\textsuperscript{108} A striking feature of Japan's consumption tax system is its selectivity.\textsuperscript{109} Most countries have some form of general consumption or value added tax which taxes all purchases at a uniform national rate.\textsuperscript{110} By contrast, the Japanese system relies heavily on a variety of specialized excise taxes. These taxes include everything from special taxes on tobacco\textsuperscript{111} and aircraft fuel\textsuperscript{112} to an automobile tonnage tax,\textsuperscript{113} and even a special golf course tax.\textsuperscript{114} It has proven politically difficult to expand this system of excise taxation to new products, however.\textsuperscript{115} Consequently, those items which are already taxable must bear a disproportionately heavy burden.\textsuperscript{116} This widely varying treatment leads to economic distortions and the misallocation of resources. Furthermore, these consumption taxes are generally regressive; that is, they account for a larger percentage of the incomes of low-income taxpayers than of higher income taxpayers.\textsuperscript{117}

B. Tax Reform of 1988

As successful as Japanese tax policy seems to have been in furthering postwar economic objectives, it has not been perfect. Dissatisfaction with certain aspects of the Japanese tax code led to a reform movement which culminated in major tax reform legislation in 1988.\textsuperscript{118} In the years

\begin{itemize}
  \item \textsuperscript{107} N.Y. Times, \textit{supra} note 4.
  \item \textsuperscript{108} Nagano, \textit{Japan}, in \textit{WORLD TAX REFORM}, \textit{supra} note 102, at 163. During the seventies, national and local taxes combined rose to a staggering 93\% top marginal rate. \textit{Id.} The seeming paradox of a nation having the lowest overall tax burden of any industrialized country, see \textit{supra} note 102, and yet simultaneously having among the highest marginal tax rates in the world demonstrates the extent to which the tax base had been narrowed by special preferences.
  \item \textsuperscript{109} \textit{Id.} at 156.
  \item \textsuperscript{110} \textit{Id.}
  \item \textsuperscript{111} Y. Gomi, \textit{supra} note 87, \textsection 2-640.
  \item \textsuperscript{112} \textit{Id.} \textsection 2-585.
  \item \textsuperscript{113} \textit{Id.} \textsection 2-350.
  \item \textsuperscript{114} \textit{Id.} \textsection 2-650.
  \item \textsuperscript{115} Nagano, \textit{supra} note 108, at 156.
  \item \textsuperscript{116} \textit{Id.} at 157.
  \item \textsuperscript{117} Komiya, \textit{supra} note 108, at 54.
  \item \textsuperscript{118} Tax reform was actually composed of six individual bills. Y. Gomi, \textit{supra} note 87, \textsection 1-200.
\end{itemize}
since World War II, the Japanese economy had not only succeeded in rebuilding but had become a global economic superpower with a diversified economy and one of the world’s highest per capita incomes. Yet, the tax system had remained essentially unchanged. Many Japanese resented the fact that their salaries were being heavily taxed while investments were so heavily subsidized.\(^1\) This perception was intensified by the incredible increase in land and stock prices which resulted from the postwar economic boom.\(^2\) As investors reaped huge profits from the sale of these assets, the dissatisfaction with the tax system centered on the capital gains provisions which allowed these investors to pay little or no tax on their windfalls.\(^3\)

The Japanese tax reform movement was also encouraged by the success of tax reform in the United States,\(^4\) and the results of tax reform in Japan were not dissimilar to those in the United States. The tax base was broadened by scaling back tax preferences for savings and investment income, and the tax schedule was flattened and simplified by replacing 12 different brackets ranging from 10.5 percent to 60 percent, with 5 new brackets ranging from 10 percent to 50 percent.\(^5\)

C. Current Capital Gains Provisions

The Japanese Tax Code imposes separate capital gains taxes for securities and real property.\(^6\) Since 1953 capital gains on the sale of securities had, as a rule, been totally free from taxation.\(^7\) Since 1989 however, gains from securities have been subject to the still highly favorable tax rate of twenty percent.\(^8\) It appears that the motivation for this change was largely based on equity considerations rather than economic policy.\(^9\) The tremendous multidecade boom in the Japanese stock market, which was certainly encouraged by this tax treatment, left many investors holding portfolios which had appreciated by several

\(^{119}\) Nagano, supra note 108, at 156; Kaizuka, Comment, in WORLD TAX REFORM, supra note 102, at 163-64.
\(^{120}\) Y. GOMI, supra note 87, ¶ 1-200.
\(^{121}\) Id.
\(^{122}\) WORLD TAX REFORM, supra note 102, at vii.
\(^{123}\) Y. GOMI, supra note 87, ¶ 1-200. The current brackets and rates are: 0-3,000,000 yen-10%; 3,000,000-6,000,000 yen-20%; 6,000,000-10,000,000 yen-30%; 10,000,000-20,000,000 yen-40%; over 20,000,000 yen-50%. COOPERS & LYBRAND INTERNATIONAL TAX NETWORK, INTERNATIONAL TAX SUMMARIES 1990, at 5-12 (1990) [hereinafter INT'L TAX SUMMARIES].
\(^{124}\) Y. GOMI, supra note 87, ¶ 5-250.
\(^{125}\) Id. ¶ 5-260.
\(^{126}\) INT'L TAX SUMMARIES, supra note 124, at J-13.
\(^{127}\) Nagano, supra note 108, at 156; Kaizuka, supra note 119, at 163-64.
thousand percent; yet, they paid no taxes whatsoever on this windfall.\textsuperscript{128} Not surprisingly, this created resentment among wage earners who were paying marginal rates, including national and local taxes, of up to eighty-eight percent.\textsuperscript{129} These equity concerns, with obvious political consequences, prompted the elimination of this tax free status, despite the favorable effect on investment.\textsuperscript{130}

In contrast with the treatment of securities, capital gains on land and buildings are computed separately, and are further broken down into long and short-term capital gain.\textsuperscript{131} To qualify as long-term gain, land and buildings must have been held for more than five and ten years, respectively.\textsuperscript{132} Short-term capital gains are anything held for less than this period.\textsuperscript{133} The distinction is significant because long-term capital gains are subject to substantially preferable treatment. Long-term gains are subject to a flat tax of twenty percent on the first forty million yen of gains and twenty-five percent for gains above that amount.\textsuperscript{134} Short-term gains are taxed at a minimum of forty percent.\textsuperscript{135} Furthermore, depending on the purpose for which the land or building has been used, substantial special deductions are available.\textsuperscript{136} For example, a deduction of up to thirty million yen is available if the property was used for housing or was expropriated by the government.\textsuperscript{137} If land is used for a qualified development project, twenty million yen are deductible.\textsuperscript{138} If it is farmland which is being developed, only five million yen are deductible.\textsuperscript{139} Instead of providing for a reduced rate for real estate gains generally, the Japanese use the concept of a potentially large deductible for which it is difficult to qualify. Property must be held up to ten years, and the tax treatment of gains are highly discriminatory in regard to the kind of land use involved. The Japanese policy of subsidizing housing development and agriculture tends to skew investment decisions at the expense of other land uses.

These rigorous qualifications, however, are mitigated by the liberal
non-recognition provisions of the Japanese code. The Code section entitled “Replacement of Business Property” provides that “[c]apital gains are deemed not to have accrued, where the proceeds of a sale of land or buildings used for business purposes are used by the taxpayer to acquire land or buildings replacing the former . . . .”

This is far more beneficial to the investor than the comparable American “like-kind” provision, because instead of requiring a bilateral exchange of property, the taxpayer need only use the proceeds from any such sale to buy new investment property. Business property in Japan is accorded treatment which in the United States is reserved for residential property: the investor may roll over any gain into a new property without a tax penalty. The Japanese, as part of the general policy of subsidizing housing, extend this same treatment, subject to certain holding periods, to personal residences as well, with the added incentive that gains are tax exempt up to three million yen. The first forty million yen over that amount are taxable at ten percent. Any subsequent gains are taxable at only fifteen percent.

IV. COMPARISON OF JAPANESE AND AMERICAN TREATMENT OF CAPITAL GAINS

It is often difficult to balance the competing claims made by the special interest groups who square off in the debates over economic policy. In the field of taxation, however, Congress has developed specific criteria for evaluating the merit of a given proposal. Congress has identified the goals of simplicity, fairness, and efficiency as the paramount considerations in drafting tax legislation. Congress is also vitally interested in the effect any change will have on government revenues. These criteria, therefore, provide a useful framework with which to compare the Japanese and American systems.

A. Efficiency

Tax incentives have a powerful effect on the economic decisions made by investors, wage earners, and consumers. The goal of efficiency, or tax neutrality as it is sometimes termed, is furthered when these deci-

141. Id. ¶ 5-200(3).
143. Id. § 1034.
144. INT'L TAX SUMMARIES, supra note 123, at J-14.
145. Id.
146. General Explanation of TRA 1986, supra note 9, at 6.
147. Id. at 136.
sions are made because of their economic merit rather than their tax consequences. The incentives provided by returns on investments encourage investors to allocate their resources in ways that are most highly valued by consumers. Investors who seek out the highest returns for their capital are therefore guided by the market to those investments which are most demanded by consumers. Under classical economic theory, investors will therefore tend to achieve an efficient allocation of resources by maximizing their own profits. However, investors are concerned with profits after tax, whereas benefits to the economy and consumer welfare are measured by the economic return before taxes. Thus, to the extent that investors are motivated by tax considerations, they will tend to make economically inefficient investment decisions. When they are forced to allocate their capital into lower yielding investments for tax purposes, everyone loses. The investors often earn lower returns than they could have earned without the interference of the Tax Code. The government loses revenues, and the economy in general ends up with too many avocado farms, or whatever activity is artificially encouraged, instead of what market forces determine that consumers really want. By 1986 it was widely felt that the Code was seriously distorting business decisions and had led to an inefficient over-investment in industries such as real estate and agriculture. Congress voiced its desire to address this problem when it adopted the 1986 reform: "Congress desired to make the tax treatment of diverse economic activities more even. Neutral taxation promotes the efficient allocation of investment and yields productivity gains without requiring additional saving."

The 1986 legislation did in fact make the Code more neutral. For the most part, no form of income or activity is substantially favored over another form. However, to the extent that increasing our national rate of investment is a legitimate and beneficial economic goal, the current law is too neutral. Although the current law does not discriminate in favor of one investment over another, it also does not discriminate in favor of the decision to invest over the decision to consume, and this inhibits economic growth by reducing the level of investment.

In any event, the current law still creates certain economic distortions because of the so-called "lock-in effect." This effect describes the

148. Id. at 9-10.
149. E. BROWNING & J. BROWNING, supra note 27, at 16.
150. Id.
151. Id.
152. General Explanation of TRA 1986, supra note 9, at 6.
153. Id. at 10.
tendency of owners to hold properties until death because their sale would trigger a large tax liability. A large contingent tax liability inhibits the free alienability of assets. This effect was cited as a major rationale for the very first capital gains preference enacted in 1921. More recently, it was explained by a U.S. Treasury Commission report on the possibility of reforms in the inheritance tax:

When tax liability is allowed to depend on whether an appreciated asset is sold or kept . . . the tax law operates to produce undesirable economic effects . . . . Assets become "locked in" by the prospect of avoiding income tax . . . . This freezing of investment positions deprives the economy of the fruits of an unencumbered flow of capital toward areas of enterprise promising larger rewards.

To illustrate the lock-in principle, suppose an investor founded a start-up company and its stock eventually increases from a few pennies per share to one hundred dollars a share. Suppose also that the company is now past its growth stage and has leveled off at a constant ten percent rate of return on its stock. The investor may feel that he could sell his stock and use the capital to start a more profitable company which would yield eighteen percent. Yet, the tax consequences may prevent him from doing so. If he owned ten million dollars in stock in the first company, a ten percent return would yield one million dollars a year. If the tax on capital gain is fifty percent, however, he would have to pay almost five million dollars in taxes on the sale of his original stock (assuming that the basis of the stock is practically zero). Reinvested at eighteen percent, his remaining five million dollars would earn only nine hundred thousand dollars per year. Thus, it would be in his interest not to sell his stock even if he could earn almost twice the return elsewhere, and the economy thus loses the benefits of a new and profitable venture.

In contrast, the Japanese system strongly encourages the decision to invest by taxing gains lightly. This allows investors to keep a larger portion of the income from their investments and thus makes these investments more attractive than consumption. The reduced tax rate on gains from securities also encourages liquidity in securities transactions by lowering the penalty for selling appreciated stocks. However, the strict ten year holding period for real estate transactions has a strong distorting effect on economic decisions. A Japanese investor's incentive

156. See generally R. POSNER, supra note 1.
to hold property for the full ten years inhibits the alienability of the property and prevents other more profitable investments. The widely varying treatment given to different land uses\textsuperscript{158} skews investment choices still further by favoring certain land uses at the expense of others.

The most economically efficient provisions in the Japanese and American tax systems are the non-recognition provisions. By allowing property to be traded without being taxed, the lock-in effect is eliminated. Furthermore, by allowing taxpayers to shift their profits into new investments without taxation, investment is maximized.

The problem with these provisions is the limitation of their scope. In both the United States and Japan, gain from securities may not be rolled over,\textsuperscript{159} and in the United States, investment property must be exchanged directly for like-kind property.\textsuperscript{160} These limitations inhibit the utility of what would otherwise be an ideal way to favor capital gains without distorting the economy. Permitting gain to be freely rolled over into new investments encourages investment, while allowing capital to flow to its most efficient use. To the extent that Japan is more liberal in allowing this to occur, their system is more efficient in its treatment of capital gains.

B. Simplicity

By 1986 many people in the United States felt that the ever-expanding complexity of the Internal Revenue Code was reaching crisis proportions which threatened the American system of voluntary compliance.\textsuperscript{161} Filing a return often required a detailed knowledge of arcane and often poorly written statutes, as well as meticulous record keeping and paperwork. The assistance of an accountant or tax attorney was considered necessary in order to fully take advantage of the tax laws. Congress estimated in 1986 that the amount of time and money expended by taxpayers in order to comply with the tax laws was equal to five to ten percent of the revenues actually collected.\textsuperscript{162} Thus, Congress made simplification one of the primary objectives of tax reform, noting that “simplification of the tax code itself is a form of tax reduction.”\textsuperscript{163}

Elimination of the capital gains preference was largely justified on

\textsuperscript{158} Y. Gomi, \textit{supra} note 87, ¶ 5-200.
\textsuperscript{159} \textit{Id.} at 126; I.R.C. § 1031 (1988).
\textsuperscript{160} I.R.C. § 1031 (1988).
\textsuperscript{161} General Explanation of TRA 1986, \textit{supra} note 9, at 7.
\textsuperscript{162} \textit{Id.} at 11.
\textsuperscript{163} \textit{Id.}
the grounds of simplification. Yet, four years after tax reform was enacted, elimination of the preferential tax rate for capital gains had failed to eliminate any complexity from the Tax Code. There is no doubt that a special capital gains taxing regime requires statutory complexity: assets must be characterized as capital and noncapital, a special holding period must be established, and the concept of sale or exchange must be defined.

Tax reform failed to simplify the law of capital gains, however, because even when all income is taxed at the same rate, it is still necessary to differentiate between capital gains, capital losses, and ordinary income. The distinction between capital gains and losses, and ordinary income has to be maintained because taxpayers are only allowed to deduct capital losses against capital gains and not against ordinary income. If taxpayers could deduct capital losses against ordinary income then investors with a diversified portfolio would sell only their losing investments, deducting these losses from ordinary income, while at the same time keeping their winning investments and paying no tax on the appreciation. In other words, they could selectively minimize their taxes by deducting all their losses while never realizing their gains. Thus, the 1986 Act by necessity requires separate accounts for capital gains, which are taxed as regular income, and capital losses, which can only be deducted against capital gains and not against ordinary income. This complex set of statutory definitions and procedures is therefore inherent in any system which allows investment losses to be deducted against income. This observation led Professor Martin D. Ginsburg of Georgetown University Law Center to remark:

Over the decades reams were written on the capital gain/loss taxing scheme and the enormous increase in simplicity that surely would accrue if only we could eliminate the special taxing regime. But none of us, I suspect, conceived that Congress would eliminate the long-term

165. Id.
166. Id. at 10-4.
167. Id.
168. Id. The problem arises because certain financial transactions can significantly change the nature of a property right. It must therefore be determined whether such an alteration is significant enough to trigger a potential tax liability. For example, retirement of a debt instrument may constitute a "sale or exchange." I.R.C. § 1271(a)(1) (1988).
169. M. Ginsburg, supra note 164, at 10-6. Under current law a taxpayer must first deduct all capital losses against capital gains; capital losses in excess of gains can be deducted from ordinary income only at the rate of 3,000 dollars per year. I.R.C. § 1211 (1988).
capital gain rate preference but retain the whole horrible technical structure—capital asset, section 1231(b) property, capital gain, capital loss, long-term, short-term, and all those nefarious sale/exchange/cancellation distinctions. In other words, Congress in 1986 found a way to eliminate the rate preference while preserving virtually all the complicating features of the special capital gain/loss taxing scheme.171

For this reason, the restoration of a small capital gains preference in 1990 could be inserted into the preexisting statutory framework with no real increase in complexity.172

The Japanese system not only recognizes a distinction between capital gain and ordinary income,173 but further distinguishes gains from the sale of securities and gains from the sale of real estate.174 Gains from real estate are further divided into long and short-term gains.175 These gains are then accorded various degrees of special treatment based on the type of land use involved.176 Yet, the American system, even when it recognized no preferential treatment of capital gains whatsoever, was almost as complex in practice as the Japanese system.

C. Fairness

Maintaining a fair system is another vital congressional goal. The essential objective is to ensure that individuals with similar incomes pay similar amounts of tax. If some are able to exploit the system and greatly reduce their taxes, it increases the burden on other taxpayers and requires higher tax rates. People who are unable or unwilling to utilize tax shelters may lose confidence in the fairness of the system. They may respond by evading their own tax liabilities.177

Opponents of a reduction in the capital gains tax rate concede that it will stimulate investment, but they invariably claim that it unfairly gives a windfall to the wealthy.178 It is inevitable that any preference for capital gains will accrue disproportionately to upper income taxpayers, because sixty percent of all capital gains, excluding gains on personal residences, are earned by the two-tenths of one percent of taxpayers with incomes over two hundred thousand dollars a year. Eighty percent of gains are earned by the one percent with incomes over one hundred thou-

171. Id.
172. Id.
173. Y. Gomi, supra note 87, ¶ 5-250.
174. Id. ¶¶ 5-250, 5-260.
175. INT'L TAX SUMMARIES, supra note 123, at J-13.
176. Y. Gomi, supra note 87, ¶ 5-200(5).
177. General Explanation of TRA 1986, supra note 9, at 7.
sand dollars.\textsuperscript{179} Despite these figures, there is widespread support for the goal of increasing investment.\textsuperscript{180} If legislation is to endure, however, it must be perceived as a fair incentive for making economically beneficial investments, rather than as a windfall for the rich. For example, the backlash against the capital gains preference for securities which resulted in the Japanese tax reform of 1988 was largely based on equitable concerns.\textsuperscript{181} The long and unstable history of the law on capital gains in the United States indicates that any cut in the rate of capital gains tax is vulnerable to shifting public perceptions. Thus, any preference enacted now may be repealed once political alignments have shifted or a new administration takes office.

The temporary cut which was passed in the House of Representatives in 1989 was unfair to the extent that it would have offered a tax break to those who had already invested in the past without rewarding those who would invest in the future.\textsuperscript{182} This kind of temporary cut is the most inequitable. It gives a windfall to those who are liquidating their investments, which hurts the economy by encouraging taxpayers to reduce the level of their investments. At the same time the cut provides no incentive for the creation of new investment because the rate will rise back to the level of ordinary income in the near future. Equity and effectiveness considerations, therefore, dictate that such temporary cuts should be rejected.

The Japanese and American non-recognition provisions represent perhaps the most equitable way of dealing with capital gains. When taxpayers roll gain from one investment into another, their financial position is essentially unchanged in the sense that they don't have any more money to spend on personal consumption than they had before. It is arguable that such gain cannot legitimately be called income in the common sense of the word. These non-recognition provisions encourage taxpayers to continually reinvest their capital.\textsuperscript{183} Only when the gain is made available for personal consumption rather than invested, is it subject to taxation. Thus, it is difficult to argue that the investor receives an undeserved windfall because the money the investor chooses to spend,

\begin{itemize}
\item \textsuperscript{179} N.Y. Times, \textit{supra} note 55, at C4, col. 3.
\item \textsuperscript{180} Id.
\item \textsuperscript{181} Y. GOMI, \textit{supra} note 87, ¶ 1-200.
\item \textsuperscript{182} The rate would have returned to its previous level after two years. Consequently, anyone choosing to invest currently, and expecting to hold their assets for more than two years, would not benefit from the law. \textit{See} N.Y. Times, \textit{supra} note 55.
\item \textsuperscript{183} By increasing the amount which taxpayers may reinvest after a sale (\textit{i.e.} by not taking taxes out first) reinvestment is made more attractive relative to the alternative of using the gain for consumption purposes.
\end{itemize}
rather than reinvest, is subject to the same tax as any other form of income. This concept can be thought of in terms of a trust; as long as the funds are left in the trust for the benefit of the economy, any tax liability is deferred. Once withdrawn however, the tax bill becomes due. This is precisely why the non-recognition sections concerning principal residences and like-kind exchanges have rarely been criticized as unfair and remain extremely popular.184

D. Revenue Effects

The effect on government revenues is another important and controversial factor to consider when evaluating any tax cut. A cut in the tax rate will generally produce less revenue. A cut in the capital gains tax rate would increase the incentive to invest and encourage people to sell their appreciated assets. Consequently, proponents of a reduction in the capital gains tax rate claim that the tax revenue which would result from both increased economic growth due to new investment and a surge in taxable sales of property would more than offset the revenue lost from the tax cut itself.185 While this revenue raising aspect certainly exists, it is extremely difficult to discern the extent to which increased investment and sales of properties will compensate for lost revenue from the decline in the rate itself.186 For this reason, it is virtually impossible to quantify the exact revenue effect of the various Japanese provisions dealing with capital gains. Similarly, the revenue effects of the small cut enacted in 1990 are uncertain, although the effect is undoubtedly slight, since both the economic stimulus and the loss of direct tax revenues are so limited. Most economists who studied the American proposal of 1989 concluded that it would generate a small rise in revenues in the short term as investors sold properties to take advantage of the reduced rate, but would cost billions of dollars in future years as transactions which would have occurred anyway are subjected to lower taxes.187

The revenue effects of the non-recognition provisions employed by both Japan and the United States are more predictable because they only allow a taxpayer to defer taxes rather than to avoid them. If an investor continues to reinvest taxable gain, the revenues which the government will eventually collect are merely that much greater. For example, suppose that a taxpayer could earn a ten percent return by continually selling and reinvesting a ten thousand dollar investment so that the entire

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184. D. Smith, supra note 69, at 151.
185. N.Y. Times, supra note 55.
186. Id.; see also General Explanation of TRA 1986, supra note 9, at 1362, esp. table A-2.
187. N.Y. Times, supra note 55.
amount of his gain was taxable at the end of each year. If the taxpayer were to do this for ten years, the IRS would dutifully collect its share of 2,800 dollars per year (28 percent of 10,000 dollars) for a 10 year total of 28,000 dollars. If that same taxpayer invests 100,000 dollars of capital at a rate of 10 percent annually and is allowed to continually reinvest his gains at that same rate, at the end of 10 years the taxpayer will have almost 260,000 dollars.\textsuperscript{188} If the taxpayer were then to sell, the IRS would net (at the current 28 percent rate of tax) almost 45,000 dollars. Thus, while the government has to postpone collection, the future revenues which it can expect will grow at the same rate of return that the investor is earning on the reinvestment. For this reason, merely deferring the tax liability will theoretically cost the government nothing in the long-term and, to the extent that the taxpayer invests well, will actually make a profit for the government.

\textbf{V. PROPOSAL}

The experience of the United States and Japan demonstrates that stimulating capital accumulation through tax incentives requires a balancing of many different political and economic factors. These competing considerations are most successfully balanced when taxes are deferred on reinvested capital. Allowing investors to defer the recognition of income by reinvesting their profits\textsuperscript{189} stimulates investment and allows capital to move where it is most needed; it also sidesteps the accusation of unfairness by merely deferring tax on profits which are put to a socially beneficial use. While Japan has generally been more liberal than the United States in allowing gain to be freely reinvested, it also incorporates many restrictions such as a ten year holding period for long term real estate gains and discriminatory tax rates based on the land use involved.\textsuperscript{190} These kinds of restrictions lead to unnecessary complexity and distorting economic effects.\textsuperscript{191} As American policymakers prepare to embark on a new round of capital gains legislation, they must consider the lessons which are offered through a careful analysis of measures already adopted, in this country and abroad. This analysis indicates that

\textsuperscript{188} $260,000 equals $100,000 invested at 10\% interest compounded for 10 years; or $(100,000)((1.10)^{10})$.

\textsuperscript{189} In general, all gains which are realized, \textit{i.e.} reduced to spendable funds, are also simultaneously \textquotedblleft recognized,	extquotedblright\ that is, treated as taxable income. I.R.C. § 1001(e) (1988). Non-recognition provisions such as I.R.C. sections 1031 and 1034 allow taxpayers to avoid recognizing realized funds by reinvesting or \textquotedblleft rolling\textquotedblright\ them into a new qualified property. \textit{Id.} §§ 1031, 1034.

\textsuperscript{190} See Y. Gomi, \textit{supra} note 87, ¶¶ 5-200(1)(a), 5-200(5).

\textsuperscript{191} See \textit{General Explanation of TRA 1986}, \textit{supra} note 9, at 9, 178.
whatever legislation is ultimately adopted should be founded on the nonrecognition concept of allowing a taxpayer to postpone taxes by continually reinvesting profits. I propose the following legislation as a model which, although representing a radical departure from current practice, merely extends this policy of allowing tax deferred investment:

Sec. — — Qualified Investment Deduction
a) A deduction from taxable income will be allowed for the full amount expended to acquire property to be held for investment purposes.
b) The basis of all property acquired under subsection (a) shall be zero.
c) Any excess deduction under subsection (a) may be carried back one year and forward indefinitely.
d) Any gain from the sale of property acquired under subsection (a) will be fully taxable upon the death of the holder.
e) Any amounts borrowed for the purpose of acquiring property under subsection (a), or secured by such property, shall be included in taxable income.
f) Any repayment of indebtedness under subsection (e) shall be deductible against taxable income.

The consequences of such legislation are not immediately obvious. Allowing the total amount of any investment to be immediately deductible seems excessive. This deduction is balanced out, however, by setting the basis of all such property at zero rather than at the purchase price. Although the taxpayer may initially deduct the full amount of his investment, tax must be paid on the entire amount realized upon liquidating this same investment. Under current law, only the difference between the basis and the sales price is taxable gain. The net effect of the proposal is that capital is totally exempted from tax, both when it is initially created and when it is subsequently reinvested. Tax liability is only incurred when funds are earned and then used for personal consumption rather than reinvested.

As an illustration, suppose an individual earned 200,000 dollars in salary. If the investor immediately invested 80,000 dollars of this income in the stock market, this entire sum would be deductible. The investor would have to pay tax only on the 120,000 dollars of salary which had not been invested, but had been spent. If the stock rose in value, say to 120,000 dollars, and was then sold, the investor would have income of 120,000 dollars: the basis of the stock would be zero and the entire amount would therefore be taxable gain. The investor would have the option, however, of reinvesting the 120,000 dollars, thereby creating a
deduction which would exactly equal the income from the sale. Were the investor to spend the money on a yacht or some other form of personal consumption, there would be no offsetting deduction and the IRS would take its share, exactly as if the money had been earned in the form of salary compensation and then spent. Finally, if the taxpayer had not been so lucky, and the stock had dropped in value to only 80,000 dollars before being sold, the taxpayer would still have 80,000 dollars in taxable gain because the basis of the stock is still zero. But again, if the taxpayer wanted to defer all or part of that tax liability the proceeds could be reinvested for a new investment deduction.

Subsections (e) and (f) address leveraged investments, investments which are made using borrowed money. Subsection (e) includes borrowed money in income. This is necessary in order to prevent an investor from earning a deduction far in excess of his actual investment. For example, if an investor purchases an apartment building for a million dollars subject to a 900,000 dollar mortgage, the investor would not be able to deduct a million dollars from income. Rather, the investor would have a deduction under subsection (a) of 1,000,000 dollars, but would have to declare the 900,000 dollar loan as income under subsection (f); thus, the net deduction would be 100,000 dollars, or the amount of the true investment in the building.

Subsection (f) allows a deduction for any increase in equity due to repayment of borrowed funds which have been used for investment. For example, if the above investor decided to put more of personal capital into the investment by refinancing with a smaller loan of, for example, 500,000 dollars, the investor would be able to deduct 900,000 under subsection (f) for retiring the previous loan, but would have to declare the new 500,000 dollar loan as income under subsection (e). The net result is a 400,000 deduction, which is the amount of new capital that has been invested.

Under current law, an investor who owns an appreciated asset can take cash out of the investment without paying taxes by refinancing. For example, if the investor described above had seen the value of the building increase from 1,000,000 to 2,000,000 dollars, the investor could have taken out a new mortgage on the property of, say, 1,700,000 dollars. Using the proceeds of the new loan to pay off the previous 900,000 dollar mortgage, the investor would then be able to pocket the difference of

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192. Because borrowed funds are received concurrently with an offsetting liability they are held not to constitute a net "ascension in wealth" and are not taxable income. See I.R.C. § 61 (1988).
800,000 dollars. The investor's wealth has increased, the investor has cash to spend on personal choices, and yet the investor has incurred no tax liability. Subsection (e) prevents this "indirect realization" of profit by including borrowed money which is secured by investment property as income. Under subsection (e) the new loan of 1,700,000 is included in income, under subsection (f) the repayment of the 800,000 loan is deductible, and the net result of this refinancing is therefore a taxable gain of 800,000 dollars, which is the true nature of the transaction. (Of course, the investor could always invest this money in another venture which would generate another offsetting deduction.)

Under all circumstances, the deduction applies only to the net capital investment. Any income which the investment produces, for example, all net rental revenue from the above mentioned apartment building, would be fully taxable when it is earned, regardless of the financing arrangement. Although, of course, this income itself could always be reinvested.

This proposed reform would encourage investment without creating an undeserved windfall. In order to realize income for private consumption, an investor has to pay taxes exactly as any other wage earner who realizes the same income. Significantly, while this proposal would have the effect of taxing only income used for consumption, it completely avoids the problem of regressiveness normally associated with consumption taxes. Consumption taxes, such as the elaborate Japanese system of excise taxes, are regressive because they impose a disproportionate burden on lower income taxpayers for whom consumption is a larger percentage of income. Unlike sales or value added taxes, which impose a flat rate on consumption goods, the proposed reform would exempt capital first and then tax any remaining income at ordinary rates. However, this remaining income, although used for consumption, is fully subject to the progressive tax rates which now exist; the burden therefore will not fall disproportionately on lower income taxpayers. This proposal is actually a progressive consumption tax. Thus, it combines the benefits of a flat consumption tax which creates no disincentive to invest with the advantage of the progressive income tax which makes one's tax burden proportionate to one's ability to pay.

Economic efficiency is enhanced because there are no restrictions on reinvestment. There is no holding period or other penalty for selling assets and there is no discrimination between different forms of investment. A taxpayer is free to sell stocks or bonds and invest in real estate or oil wells, or vice-versa. Capital is free to flow wherever the investor feels that he can earn the greatest return. Furthermore, there is no rate differ-
ential between investment income and wages. The decision whether to finance consumption from salary or investment is therefore unaffected. The only decision which is favored over another is the choice to invest instead of consume, and this is the whole point of favoring capital gains in the first place—to provide capital for economic growth.

Perhaps the most striking aspect of this reform is the extent to which it completely cuts through the complexity of the present Code. Because basis is automatically set at zero there is no need to differentiate between capital gains and losses—all costs of investment assets are treated as deductible losses and all proceeds from their sale are treated as taxable gains. Thus, the whole technical structure erected to restrict the utility of capital losses is obviated. There is no need to wrestle with the distinction between expenses and capital improvements because both would now be fully deductible.193 Furthermore, since basis is set at zero, the need to depreciate is dispensed with, along with all the attendant difficulties of computing accelerated depreciation and recapturing excess depreciation.194 Clearly, this proposed reform would further the cause of tax simplification.

For all that it accomplishes, this reform should create no long-term loss in revenues. Deferring tax on an appreciating asset merely causes the government’s unrealized revenues to increase at the same rate of return as the taxpayer’s investment. Subsection (d) of the proposed statute makes all property taxable upon the death of the taxpayer. Thus, the eventual tax liability is inescapable.195 There is no guarantee that there

193. Under current law this is a crucial distinction. Expenses are immediately and totally deductible while capital improvements add to the value of a given property and must be depreciated along with the rest of that property, which in some cases may take over 30 years. Capital improvements are generally defined as those which increase the value of a property for substantially more than one year. This definition becomes highly problematic in application, and the distinction is inevitably debatable. See id. §§ 212, 263.

194. Depreciation is the annual deduction allowed for the loss of value in a property due to aging and wear. Currently, the Code allows property to be depreciated over periods ranging from three to fifty years depending on the specific type of property involved. Under certain circumstances, the Code also allows the depreciation allowance to be “accelerated” — that is, a majority of the total depreciation which will eventually be allowed may be taken in the early years of ownership. Id. § 168. However, if an asset has not been sufficiently depreciated at the time of its sale, some of the gain from the sale may be “recaptured” as ordinary income rather than capital gain. Id. §§ 1245, 1250.

195. Under current law, when property is received by inheritance, its basis is increased or “stepped up” from the historical cost to the decedent, minus depreciation, to a figure equal to the property’s fair value at the time of the owner’s death. Thus, if a taxpayer can retain a property until his death, he can pass it on to his heirs without an accompanying tax liability, and the property’s gain is never taxed. Id. § 1012. The proposed reform would therefore eliminate this “loophole.” Id.
might not be a temporary revenue loss in the short-term before accumulated gains begin to be recognized. This shortfall, however, would merely represent a delay in the collection of revenues. As such, it would not be unreasonable for the government to borrow against these future revenues by selling bonds.

There may be a concern that under this statute a taxpayer has total control over when income is recognized. For example, a taxpayer might try to take an investment deduction in the current year with the anticipation that he may be able to later recognize the gain in a year in which he is in a lower tax bracket. If Congress found this possibility abusive, however, they could simply require that all investment proceeds be automatically subject to the maximum rate.

VI. CONCLUSION

The experiences of Japan and the United States demonstrate that the best way to stimulate capital formation is by allowing gains to be freely reinvested. Rather than adopt a measure which merely cuts the applicable rate on capital gains, Congress should enact legislation which is based on this non-recognition principle. The legislation proposed by this Note, which calls for the full deductibility of all investments and the full recognition of all proceeds from their sale, provides such a model. In terms of simplicity, fairness, and efficiency, this proposed legislation is vastly superior to both the current law and foreseeable congressional changes.