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PROPOSALS AND ISSUES RELATING TO TAXATION OF CAPITAL GAINS AND LOSSES

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON MARCH 28, 1990

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a hearing on March 28, 1990, on the tax treatment of capital gains and losses and the President's fiscal year 1991 budget proposal to reduce the tax rate on certain capital gains.

This pamphlet,[1] prepared in connection with the hearing, provides a description of the present-law tax treatment of capital gains and losses (Part I), legislative background (Part II), the President's budget proposal (Part III), other capital gains proposals (Part IV), as well as a brief analysis of issues related to the taxation of capital gains and losses generally and specific issues related to the President's proposal (Part V). A 1989 staff pamphlet provided a description and analysis of the President's fiscal year 1990 budget proposal to reduce the capital gains tax rate.[2]

Prior Joint Committee on Taxation staff pamphlets [3] also provide a discussion of prior law tax treatment of capital gains and losses and related issues.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Proposals and Issues Relating to the Taxation of Capital Gains and Losses* (JCS-10-90), March 23, 1990.

[2] Joint Committee on Taxation, *Tax Treatment of Capital Gains and Losses* (JCS-7-89), March 11, 1989.

[3] *See* Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Capital Income* (JCS-35-85), August 8, 1985, pp. 24-44; and Joint Committee on Taxation, *Taxation of Capital Gains and Losses* (JCS-52-83), November 1, 1983.

I. PRESENT LAW

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On disposition of a capital asset, long-term capital gain is currently taxed at the same rate as ordinary income. Long-term capital loss is deductible against capital gain, but not against ordinary income except to a limited extent. For depreciable property used in a trade or business and not held for sale to customers, and for certain other noncapital assets, net gain can be treated as capital gain, while net loss is an ordinary loss.

A complex set of statutory provisions attempts to limit the ability of taxpayers to recharacterize ordinary income assets as assets eligible for capital gain treatment, and also requires recharacterization of capital gain as ordinary income to the extent of certain prior deductions from ordinary income. In addition, certain judicial interpretations of the statutory provisions require gain or loss to be characterized as ordinary, rather than capital, in certain circumstances.

As a result of the changes made by the Tax Reform Act of 1986, taxing capital gains at the same rate as ordinary income, many of these rules now affect only the determination of the deductibility of capital losses.

The Tax Reform Act of 1986 provided that the maximum rate for capital gains would not exceed the maximum ordinary income rates specified in the Act. (See Code sections 1(j) and 1201.) The various rules relating to the recharacterization of gains as capital rather than ordinary were retained in the Code to facilitate the reinstatement of a capital gains rate differential if there is a future tax rate increase.[4]

A. Statutory Provisions

Capital gains

Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year. Net long-term capital gain is the excess of long-term capital gains over long-term capital losses.

Capital losses

Capital losses of noncorporate taxpayers are generally deductible in full against capital gains.[5] In addition, such losses may be de-

[4] H. Rept. 99-841, p. II-106, Conference Report on H.R. 3838.

[5] However, section 165 generally denies individuals a deduction for losses not incurred in a trade or business unless such losses are incurred in a transaction entered into for profit or qualify as deductible casualty losses. *See also* section 267 (disallowance of deduction for certain losses from sale or exchange of property between related persons) and section 1092 (limitation on current deductibility of losses in the case of straddles).

ducted against a maximum of $3,000 of ordinary income in each year. Capital losses in excess of these limitations may be carried over to future years indefinitely, but may not be carried back to prior years.

Capital assets

A "capital asset" generally means any property held by the taxpayer except certain specified classes. Capital assets generally do not include (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications.

Certain depreciable property, nondepreciable business property, and special assets (sec. 1231)

A special rule (sec. 1231) applies to gains and losses on the sale, exchange, or involuntary conversion of certain noncapital assets. Net gains from such assets (in excess of depreciation recapture) are treated as long-term capital gains but net losses are treated as ordinary losses. However, net gain from such property is recharacterized as ordinary income to the extent net losses from such property in the previous 5 years were treated as ordinary losses. The assets eligible for this treatment include depreciable property or land held for more than one year and used in a trade or business (if not includible in inventory and not held primarily for sale to customers in the ordinary course of business). Also included are certain special assets including interests in timber, coal, domestic iron ore, certain livestock and certain unharvested crops.

Patents

Under certain circumstances, the creator of a patented invention may transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset, whether or not the proceeds are contingent on the use or productivity of the patent (sec. 1235).

Regulated futures contracts

Under present law, unlike most assets (with respect to which no gain or loss is realized until a disposition), regulated futures contracts, foreign currency contracts, nonequity options and dealer equity options are "marked-to-market" as gain or loss accrues (sec. 1256). Forty percent of the gain or loss is short-term gain or loss and 60 percent of the gain or loss is long-term gain or loss. Prior to the Tax Reform Act of 1986, this resulted in a maximum tax rate of 32 percent. Individuals who have a net loss regarding such contracts may elect to carry it back three years against prior net gain regarding such contracts.

Losses on small business stock

An individual may deduct as an ordinary loss up to $50,000 ($100,000 in the case of a joint return) on the loss from the disposition of small business corporation stock (section 1244 stock) originally issued to the individual (or to a partnership having the individual as a partner), without regard to the $3,000 limit generally applicable to losses. A small business corporation is a corporation engaged in the active conduct of a trade or business whose equity capital does not exceed $1,000,000.

Certain foreign corporate stock

Special rules recharacterize as ordinary income a portion of gain on the sale or exchange of certain foreign corporate stock, to compensate for the deferral of U.S. tax on corporate earnings and profits accumulated abroad (sec. 1248).

Collapsible property

The distinction between capital gains and ordinary income has led to numerous taxpayer attempts to realize the value of an anticipated future ordinary income stream through the sale of a "capital" asset, such as stock in a corporation, or an interest in a partnership, that holds the income-producing asset.

Present law contains statutory rules intended to prevent such use of partnerships and corporations to convert what otherwise would be ordinary income into capital gains from the disposition of stock or a partnership interest. These provisions (secs. 341 and 751) known as the "collapsible" corporation and "collapsible" partnership provisions, are among the most complex provisions of the Internal Revenue Code and have been criticized by some for apparent inconsistencies in application and for limited effectiveness in some circumstances.

Similarly, certain partnership rules relating to basis allocations (secs. 732(c) and 755) attempt to prevent conversion of ordinary income to capital gain by preventing allocations of basis from capital assets to ordinary income assets in certain partnership transactions. These rules have also been criticized by some as having limited effectiveness in certain situations.

Recapture provisions

Depreciation recapture rules recharacterize as ordinary income a portion of gain upon dispositions of depreciable property. These rules vary with respect to the type of depreciable property. Under ACRS, for personal property, previously allowed depreciation (up to the amount of realized gain) is generally recaptured as ordinary income. In the case of real property using the straight-line method of depreciation (the only method generally permitted for real property placed in service under present-law ACRS), there is no depreciation recapture upon disposition if the asset is held more than one year. For real property to which the present-law ACRS does not apply, generally, the excess of depreciation deductions over the straight-line method is recaptured as ordinary income. Special rules apply to certain non-residential property and to certain low-income housing.

Similar recapture rules apply to dispositions of oil, gas, geothermal or other mineral property. These rules require ordinary income recapture (up to the amount of realized gain) of previously deducted intangible drilling and development costs, mining expenses, and depletion.

The recapture rules require the recognition of ordinary income in some situations that are otherwise tax-free or tax-deferred. For example, although recognition of gain on an installment sale is otherwise deferred, recaptured ordinary income with respect to depreciated real or personal property is recognized in the year of the sale.

Recapture is imputed to a partner who sells a partnership interest if recapture would have been imposed upon the disposition by the partnership of the recapture property. Except in the case of certain previously deducted depletion, intangible drilling and development and mining exploration costs, there is no comparable imputation to a shareholder of an S corporation who sells his or her stock.

Realization events

In general, property appreciation is not taxed until the property is disposed of in a taxable transaction. There are certain exceptions to this rule. For example, regulated futures contracts and certain other items must be "marked to market" as gain or loss accrues even though there has been no disposition of the asset.

Nonrecognition events

Under various nonrecognition provisions, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain corporate reorganizations, certain like-kind exchanges or property, involuntary conversions followed by an acquisition of replacement property, and the sale of a principal residence within two years of the acquisition of a new principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing a carryover basis from the old holder to the new holder or a substitution of basis from the old property to the new property.

Certain exemptions

Present law effectively forgives income tax on accrued appreciation on the occurrence of certain events. For example:

Basis step-up at death.—At death, income tax on unrealized capital gains on an individual taxpayer's assets is forgiven, due to the step-up in basis such assets receive.[6]

Sale of principal residence.—$125,000 of gain on the sale of a principal residence by a taxpayer age 55 or over is exempt from tax if, during the 5-year period ending with the date of the sale, the property was owned and used as the taxpayer's principal residence for at least an aggregate of 3 years.

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[6] Such appreciation might give rise to Federal estate and gift tax. In many instances, however, opportunities for deferral and the rate structure under the Federal estate and gift tax may result in significantly less tax than would be imposed under the income tax. The value of stock or other assets held at death would be included in the decedent's gross estate and, if not passing to a surviving spouse or to charity, the decedent's taxable estate as well.

The extent to which such inclusion gives rise to Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent (50 percent for descendents dying after 1992) on taxable transfers over $3 million. A unified credit in effect exempts the first $600,000 from estate and gift tax. The graduated rates and unified credit are phased out for estates in excess of $10 million.

B. Statutory Interpretations

The statutory provisions described above have led to numerous disputes about the characterization of gain or loss as capital or ordinary. Literally hundreds of cases have been litigated involving capital gains issues; and the varying results of the cases can encourage taxpayers to take aggressive positions on tax returns. The issues that have been litigated and the principles asserted in particular cases include the following.

Property held primarily for sale to customers

Inventory and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business are excluded from the definition of a capital asset. The object of this exclusion is to preclude capital gains treatment for receipts obtained in the routine conduct of the taxpayer's enterprises.

A host of cases have been litigated over whether gain realized by a taxpayer was attributable to the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The majority of these cases has involved real estate sales, and the sale of equipment held for rental (or for rental and then sale). In both instances, the litigation generally revolves around the question of the "primary" purpose for which the property was held. *Cf. Malat v. Riddell*, 383 U.S. 569 (1966). The resolution of this question, in turn, has generated an intricate web of subordinate rules and exceptions relating to (1) the existence of business (ordinary income) and investment (capital gain) purposes and (2) the acquisition of property for one purpose and its disposition for another purpose. Factual issues include the extent to which the taxpayer advertised the property, the frequency of sales, and whether unusual circumstances led to the sale. *See, e.g., The Municipal Bond Corporation v. Commissioner,* 341 F.2d 683 (8th Cir. 1965), *on remand*, 46 T.C. 219 (1966). In many situations, the taxpayer may have a considerable degree of flexibility in adopting those advertising or sales practices that are the most likely to support the desired result.

Sale or exchange treatment

Many cases have involved the issue whether a transfer is a sale or exchange, thus qualifying for capital gains treatment, or a transfer more properly characterized as a lease or other transfer producing ordinary income. This issue arises, for example, where the transferor has the right to receive contingent payments based on future sales or profits, or retains certain elements of control over the property. *See, e.g., Nassau Suffolk Lumber & Supply Corp. v. Commissioner*, 53 T.C. 280 (1969) (Acq. 1970-2 C.B. xx). Statutory provisions have been enacted to deal with certain types of transfers (*e.g.*, sec. 1235, providing capital gain treatment for certain transfers of patents for future periodic or contingent payments; sec.1253, providing ordinary income treatment when certain rights to control the use of specified intangibles are retained). However, where these provisions do not apply, the issue remains.

Another issue that arises is whether there is a difference in sale or exchange characterization between the termination or expiration of certain instruments or contract rights and the assignment of such rights to a third party prior to expiration.[7] There is some authority that in certain situations if an instrument or right is held to maturity or expiration, the expiration is not a sale or exchange and the resulting gain or loss is ordinary; but if the instrument or right is sold prior to expiration, gain or loss on the sale is capital. *See, e.g., International Flavors and Fragrances v. Commissioner*, T.C. Memo 1977-58, 36 T.C.M. 260 (1977). Various statutory provisions attempt to specify the outcome in the case of particular instruments or rights (*e.g.*, sec. 988, generally requiring ordinary rather than capital treatment for certain foreign currency related transactions; sec. 1271 and related provisions, dealing with certain debt instruments).

Holding period

Numerous cases have involved the issue whether the taxpayer satisfied the required holding period for capital gains treatment. Taxpayers may utilize various arrangements in attempts to shift ownership of assets prior to the expiration of the required holding period while still appearing to meet the holding period requirement. For example, taxpayers may attempt to transfer short-term assets in a tax-free transaction to another entity controlled by the taxpayer that has been held for the required period of time, and then dispose of that entity under circumstances where the various collapsibility or recapture rules may be vulnerable or inadequate.

Taxpayers may also attempt to enter transactions that effectively shift the risk of gain or loss to another taxpayer prior to expiration of the holding period, but that do not in form provide for a sale until after the holding period expires.

Allocation of gain to capital assets

Numerous cases have involved the proper allocation of purchase price among assets. When a taxpayer sells a combination of assets some of which are eligible for capital gains treatment and some of which are not, it is necessary to allocate the purchase price and the taxpayer's resulting gain among the assets. *Williams V. McGowan*, 152 F. 2d 570 (2d Cir. 1945). Under the prior law differential between capital gains and ordinary income, the seller of property had an incentive to allocate more of his gain to capital assets. As one example, under the prior law differential for capital gains, on the sale of a building and land under circumstances where there would be recapture of accelerated depreciation on the building, the seller had an incentive to allocate more of the gain to the land, thus reducing the potential recapture. Because the building is depreciable and the land is not, the buyer has an incentive on the contrary to allocate more of the price to the building. In some cases, this tension between the parties might limit the degree to which the government would be whipsawed by parties taking inconsistent positions. In general, if the parties did specify an allocation in their contract with appropriate regard to value, they are bound by it for tax purposes; and if they have adverse tax interests the courts and

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[7] *See also* discussion of "Other capital asset definitional issues," *infra*.

the Internal Revenue Service will generally accept the allocation. *See, e.g., Ullman v. Commissioner*, 264 F. 2d 305 (2d Cir. 1959); *Commissioner v. Danielson*, 378 F. 2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967). However, it is not clear whether taxpayers will always specify an allocation in a contract or take consistent positions.

Another example of the same issue arises on the sale of a business, where the seller would have an incentive to allocate more of the price to goodwill or other assets eligible for capital gains treatment, while the buyer would prefer to allocate more of the price to depreciable assets. Under prior law, many intangible assets depreciable by the buyer were eligible for capital gains treatment by the seller, thus eliminating any tension between the parties.

The Tax Reform Act of 1986 added section 1060 to the Code. This section generally applies to sales of trade or business assets. It specifies a residual method of allocating price to nondepreciable goodwill and going concern value, generally adopting the method specified in Treasury Regulations dealing with certain sales of corporate stock that are treated as sales of the underlying assets (Prop. and Temp. Reg. sec. 1.338(b)–2T). It also authorizes the Internal Revenue Service to require the parties to report their respective allocations of purchase price, thus assisting the Internal Revenue Service in identifying inconsistent positions for audit. Some commentators have observed that the section does not strictly require consistent allocations and it is unclear to what extent the government would still be exposed to whipsaw due to inconsistent positions taken by the parties during periods of a capital gains rate differential.

Corn Products doctrine

In *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), the Supreme Court addressed a taxpayer claim that gain on the disposition of corn futures was capital gain. The taxpayer was a manufacturer of products made from grain corn and had acquired the corn futures to assure the needed supply of corn at a fixed price. The Supreme Court held that the disposition of the futures produced ordinary income, even though the futures were not literally inventory or other property specifically excluded by statute from the definition of a capital asset. The Court held that gain on this type of hedging transaction was ordinary income, and stated that Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss. Numerous subsequent lower court decisions interpreted the *Corn Products* decision to mean that property otherwise within the definition of a capital asset may have such an important and integral relationship to the ordinary conduct of the taxpayer's business that it loses its identity as a capital asset. In 1975, the Internal Revenue Service stated that if a taxpayer acquired and held property with a "predominant" business (as opposed to investment) purpose, gain or loss on disposition would be ordinary; conversely, a "predominant" investment purpose would cause gain or loss to be capital. (Rev. Rul. 75–13, 1975-1 C.B. 67.) Later, following several

Tax Court decisions,[8] the Internal Revenue Service took the position that even a "predominant" business motive cannot preclude capital gain or loss treatment, as long as there was a "substantial" investment motive for acquiring or holding the property. (Rev. Rul. 78-94, 1978-1 C.B. 58). Of course, it is to the taxpayer's advantage to have gains characterized as capital, and losses as ordinary.

In *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), the Supreme Court rejected a taxpayer claim for ordinary loss treatment on the sale of stock of a bank that had been 65 percent owned by the taxpayer's holding company. The Supreme Court stated that *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of the Code. There is considerable uncertainty about the scope of the *Arkansas Best* decision and its impact on lower court decisions and Internal Revenue Service positions interpreting *Corn Products*.

Arrowsmith doctrine

In *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), the Supreme Court held that amounts paid by former corporate shareholders (as the transferees of corporate assets received in a prior year corporate liquidation) to satisfy liabilities of the liquidated corporation were capital, rather than ordinary losses. The Court related the payments to the earlier receipt (at capital gains rates) of corporate assets in the liquidation. Pursuant to *Arrowsmith*, the characterization of a transaction in one year may depend upon its relationship to another transaction in a prior year.

Other capital asset definitional issues

A number of cases have addressed the question of the extent to which a taxpayer may obtain capital rather than ordinary treatment by assigning various contract rights that, if held to maturity, would have produced ordinary income. In certain circumstances, this ability has been limited by a court's conclusion that the asset assigned is not a capital asset but rather a substitute for ordinary income. *See, e.g., Commissioner v. Ferrer*, 304 F. 2d 125 (2d Cir. 1962); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). On the other hand, in many situations the assignment of all rights to a lease or to a business interest that would produce ordinary income in the future can be treated as capital gain.

Tax benefit rule

The Internal Revenue Service has occasionally asserted the "tax benefit rule" in attempts to recharacterize as ordinary income a portion of the gain from the disposition of property otherwise entitled to capital gain treatment. The amount to be recharacterized reflects the extent to which the basis of such property was reduced by deductions taken from ordinary income, to which no specific

[8] *W. W. Windle Co. v. Commissioner*, 65 T.C. 694 (1976), *aff'd on other grounds*, 550 F.2d 43 (1st Cir. 1977), *cert. denied*, 431 U.S. 966 (1977); *Bell Fibre Products Corp. v. Commissioner*, 36 T.C.M. (CCH) 182 (1977). *Compare Union Pacific Railroad Co., Inc. v. United States*, 524 F.2d 1343 (Ct.Cl. 1975), *cert. denied*, 429 U.S. 827 (1976).

statutory recapture provision applies on disposition of the property. For example, in *First National Bank of Lawrence County v. Commissioner,* 16 T.C. 147 (1951), the Internal Revenue Service successfully asserted that net proceeds received on the retirement of certain bonds that had previously been written off by a bank against ordinary income as worthless were taxable as ordinary income rather than as capital gain.

The scope of the tax benefit rule is uncertain [9] and the Internal Revenue Service does not contend that all items deducted from ordinary income are automatically subject to recapture on the sale of property otherwise eligible for capital gains treatment. For example, the Internal Revenue Service has ruled under section 174 that deductions previously taken for research and experimental expenditures under that section are not recaptured on disposition of the developed property.[10]

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[9] *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370 (1983), for Supreme Court discussion of the rule.

[10] Rev. Rul. 85-186, 1985-2 C.B. 84. Prior to the issuance of this ruling, the Internal Revenue Service had taken a different position and indicated in a revenue ruling and in a technical advice memorandum that it might assert tax benefit rule recapture of research and experimental deductions taken under section 174 of the Code on the disposition of patents or technology otherwise eligible for capital gains treatment under the special rules applicable to patents or under other provisions (Rev. Rul. 72-528, 1972-2 C.B. 481; TAM 8409009 (1983)).

II. LEGISLATIVE BACKGROUND

Reduced tax rate for capital gains

Noncorporate capital gains were taxable at reduced rates from 1921 through 1987.

The Revenue Act of 1921 provided for a maximum 12.5 percent tax on gain on property held for profit or investment for more than 2 years (excluding inventory or property held for personal use). Because of the relatively low tax rates on ordinary income during the 1920's and 1930's, this provision benefited only higher bracket taxpayers.

The system of capital gains taxation in effect prior to the Tax Reform Act of 1986 dated largely from the Revenue Act of 1942. The 1942 Act provided for a 50-percent exclusion for noncorporate capital gains or losses on property held for more than 6 months. The Act also included alternative maximum rates on capital gains taxes for noncorporate and corporate taxpayers. The basic structure of the 1942 Act was retained under the Internal Revenue Code of 1954.

The Revenue Act of 1978 increased the exclusion for noncorporate long-term capital gains from 50 to 60 percent. Together with concurrent changes in the noncorporate minimum tax, this had the effect of reducing the highest effective rate on noncorporate capital gains from approximately 49 percent [11] to 28 percent. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Act of 1981 (ERTA) reduced the maximum effective capital gains rate from 28 percent to 20 percent.

The Tax Reform Act of 1986 repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988.

The Internal Revenue Code of 1954 as originally enacted provided for an alternative tax rate of 25 percent on corporate capital gains. The Tax Reform Act of 1969 raised this rate to 30 percent. The Revenue Act of 1978 reduced the rate to 28 percent. Finally, the Tax Reform Act of 1986 repealed the alternative rate.

Holding period

Under the Revenue Act of 1921, the alternative maximum rate for capital gains applied to property held for more than 2 years. Since that time, Congress has, on several occasions, adjusted the holding period required for reduced capital gains taxation.

The Revenue Act of 1934 provided for exclusion of varying percentages of capital gains and losses depending upon the period for which an asset was held. Under that Act, 20 percent of capital gains was excludible if an asset was held for 1 to 2 years, 40 per-

[11] The 49-percent rate resulted in certain cases where the taxpayer was subject to the individual "add-on" minimum tax and the maximum tax "earned income" limitation.

cent if an asset was held for 2 to 5 years, and 60 percent if the asset was held for between 5 and 10 years. Where an asset had been held for more than 10 years, 70 percent of capital gains was excluded.

The Revenue Act of 1938 provided for two classes of long-term capital gains. For assets held for 18 months to 2 years, a 33-percent exclusion was allowed. Where assets were held for more than 2 years, a 50-percent exclusion was provided. No exclusion was allowed for assets held for 18 months or less. The 1938 Act also provided alternative ceiling rates applicable to the same holding periods as the capital gains exclusions.

In the Revenue Act of 1942, Congress eliminated the intermediate holding period for capital gains purposes. The 1942 Act provided for two categories of capital assets: assets held for more than 6 months (long-term capital assets), for which a 50-percent exclusion was allowed; and assets held for 6 months or less (short-term capital assets) for which no exclusion was provided. The alternative tax rates on individual and corporate net capital gains (i.e., the excess of net long-term capital gains over short-term capital losses) were based upon the same 6-month holding period.

A 6-month holding period for long-term capital gains treatment remained in effect from 1942 through 1976. The Tax Reform Act of 1976 increased the holding period to 9 months for 1977 and one year for 1978 and all subsequent years. The Deficit Reduction Act of 1984 reduced the holding period to 6 months for property acquired after June 22, 1984 and before 1988.

Treatment of gain and loss on depreciable assets and land used in trade or business

Depreciable property used in a trade or business was excluded from the definition of a capital asset by the Revenue Act of 1938, principally because of the limitation on deductibility of losses imposed by the Revenue Act of 1934. This step was motivated in part by the desire to remove possible tax deterrents to the replacement of antiquated or obsolete assets such as equipment, where depreciation would be fully deductible against ordinary income if the asset were retained, but loss would be subject to the capital loss limitations if the asset were sold.

The availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, in the Revenue Act of 1942, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets since it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions.

The Revenue Act of 1938 did not exclude land used in a trade or business from the capital asset definition. Since basis would have to be allocated between land and other property for purposes of depreciation in any event, the differing treatment of land used in a trade or business and depreciable property used in a trade or business was not viewed as creating serious allocation difficulties.

However, in the Revenue Act of 1942, Congress excluded land used in a trade or business from the definition of a capital asset and extended to such property the same special capital gain/ordinary loss treatment afforded to depreciable trade or business property.

In 1962, Congress required that depreciation on section 1245 property (generally, personal property) be recaptured as ordinary income on the disposition of the property. In 1964, Congress required that a portion of the accelerated depreciation on section 1250 property (generally, real property) be recaptured as ordinary income. Subsequent amendments have required that the entire amount of accelerated depreciation on section 1250 property be recaptured as ordinary income. However, any depreciation taken to the extent allowable under the straight-line method is generally not recaptured as ordinary income, but rather creates capital gain.

Noncorporate capital losses

In the early years of the income tax, losses from investments not connected with a trade or business were not deductible even against gains from similar transactions. This rule was changed in 1916 to allow deductions for transactions entered into for profit (but only to the extent of gains from similar transactions). The rule was further adjusted by the Revenue Act of 1918.

The Revenue Act of 1921 provided that net capital losses were deductible in full against capital gains or ordinary income. Because capital gains at this time were taxable at a maximum 12.5-percent rate, but capital losses could be used to offset income taxable at higher rates, this rule resulted in substantial revenue loss. Accordingly, the rule was amended by the Revenue Act of 1924 to limit the tax benefit from capital losses to 12.5 percent of the amount of such losses. The 1924 Act also repealed the previously existing carryforward for excess capital losses.

Under the Revenue Act of 1934, the percentage exclusion for net capital gains was made dependent upon the length of time for which the property was held. In conjunction with this change, the Act allowed equivalent percentages of capital losses to be deducted against capital gains and, in the event of any excess, against $2,000 of ordinary income. The $2,000 limit on the amount of ordinary income against which capital losses could be deducted was motivated by the fact that some very wealthy investors had been able to eliminate all their income tax liability by deducting losses incurred in the stock market crash against ordinary income.

Under the Revenue Act of 1942, capital losses could offset up to $1,000 of ordinary income with a carryforward of unused losses. The Tax Reform Act of 1976 increased this amount to $3,000. Between 1970 and 1986, only one-half of the net long-term loss could be carried forward.

business corporation as an ordinary loss. These limitations were doubled in 1978.

In 1958, individuals were allowed to deduct up to $25,000 ($50,000 on a joint return) of loss from the disposition of stock in a small

III. PRESIDENT'S BUDGET PROPOSAL

Description of Proposal

The President's fiscal year 1991 budget proposal [12] would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 3 years or more would qualify for a 30-percent exclusion; assets held at least 2 years but less than 3 years would qualify for a 20-percent exclusion; and assets held at least one year but less than 2 years would qualify for a 10-percent exclusion. For a taxpayer in the 28-percent tax bracket, this would result in a regular tax rate of 19.6 percent for assets held 3 years or more, 22.4 percent for assets held between 2 and 3 years and 25.2 percent for assets held between one and 2 years.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

The capital gains exclusion would be a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

The provision would apply to dispositions (and installment payments received) after the date of enactment. For the portion of 1990 to which the proposal applies, a 30-percent exclusion would apply for all assets held one year or more. For 1991, the exclusion would be 20 percent for assets held between one and 2 years and 30 percent for assets held at least 2 years. After 1991, the staggered exclusion described above would apply.

Revenue Effects

Table 1 provides the Joint Committee on Taxation staff's estimate of the net budgetary effects of the Administration's capital gains proposal for fiscal years 1990 through 1995.[13]

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[12] The proposal was introduced by Senators Packwood, Dole and Roth as S. 2071. A companion bill, H. R. 3772, was introduced in the House of Representatives by Mr. Archer. The effective date of these bills is March 15, 1990.

[13] The Treasury Department's estimate of the revenue effects for the same period is a revenue gain of $0.5 billion in fiscal 1990, a revenue gain of $4.9 billion in fiscal 1991, a revenue gain of $2.8 billion in fiscal 1992, a revenue gain of $1.2 billion in fiscal 1993, a revenue gain of $1.7 billion in fiscal 1994, and a revenue gain of $1.4 billion in fiscal 1995, for a six-year total gain of $12.5 billion.

Table 1.—Revenue Estimates of the Administration's Capital Gains Proposal, Fiscal Years 1990–1995

[Fiscal year; billions of dollars]

	1990	1991	1992	1993	1994	1995	1990–95
Revenue Effect.........	0.7	3.2	−4.3	−3.6	−4.3	−3.1	−11.4

Source: Joint Committee on Taxation.

IV. OTHER LEGISLATIVE PROPOSALS

1. S. 1771 (Senator Packwood and others)

S. 1771, introduced by Senator Packwood and others on October 19, 1989, would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 7 years or more would qualify for a 35-percent exclusion; assets held more than one year but less than 7 years would be allowed an exclusion equal to 5 percent for each full year the asset was held. This gain would not be taken into account under the phase-out of the 15-percent rate and personal exemptions.

In addition, corporations would pay tax at a lower rate on the gain realized upon the disposition of qualified capital assets. Assets held more than 15 years would be taxed at a 29-percent rate. Assets held more than 3 years but less than 15 years would be taxed at a rate equal to one percentage point below the regular tax rate of 34 percent for each three full years the asset was held.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

The capital gains exclusion would be a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

An individual could elect to index the basis of certain assets held more than two years for inflation occurring after 1990 for purposes of determining gain upon a taxable sale, rather than to exclude a portion of the capital gains for that year. Under the bill, the assets generally eligible for indexing would be common stock, tangible personal property and real property, provided such assets are either capital assets or assets used in a trade or business and were held for more than two years.

The bill contains numerous exceptions and other provisions dealing with an array of issues. These issues include the denial of indexing for debt instruments,[14] the differentiation of common stock eligible for indexing from preferred stock (considered more like non-indexable debt); possible abuses such as incorporation of non-indexed assets to obtain indexing with respect to stock; depreciation recapture, problems regarding the appropriate treatment of in-

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[14] The legislative history of prior Congressional proposals to index for inflation have disallowed indexing for debt instruments. Indexing debt was viewed as producing complex adjustments that would not produce additional revenues where both the borrower and the lender have the same marginal tax rate. The legislative history (apparently still addressing the situation in which a borrower and a lender have the same marginal rate) suggested that to the extent inflation is anticipated correctly and interest rates are free to rise, interest rates would tend to rise to a rate that would compensate for inflation on an after-tax basis.

terests in different types of flow-through entities (such as regulated investment companies, real estate investment trusts, partnerships and subchapter S corporations); and concerns related to application of the short sale provisions of existing law.[15]

The bill would apply to sales and exchanges after October 1, 1989.

2. S. 1938 (Senator Graham and others)

S. 1938, introduced by Senator Graham and others on November 20, 1989, would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 10 years or more would qualify for a 50-percent exclusion; assets held more than one year but less than 10 years would be allowed an exclusion equal to 5 percent for each full year the asset was held. For assets held before October 14, 1989, the exclusion would be one-half of these amounts (but, for this purpose, in no event shall an asset be treated as acquired before October 19, 1983). Qualified venture capital stock would be allowed an exclusion of 40 percent for stock held between 4 and 6 years and 50 percent for stock held more than 6 years.

In addition, corporations would pay tax at a lower rate on the gain realized upon the disposition of qualified capital assets. Assets held more than 10 years would be taxed at a 25.5-percent rate. Assets held more than 2 years but less than 10 years would be taxed at a rate equal to .85 percent below the regular tax rate of 34 percent for each full year the asset was held. Qualified venture capital stock would be taxed at a rate of 20.4 percent if held between 4 and 6 years and 17 percent if held more than 6 years.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

Qualified venture capital stock means stock in a qualified venture capital corporation issued after October 18, 1989, originally issued to the taxpayer. A qualified venture capital corporation means a corporation with a paid-in capital of less than $20 million (on the date of issuance) engaged in the active conduct of a trade or business. Personal service corporations are excluded.

The capital gains deduction is not allowed for purposes of the minimum tax to the extent it exceeds one-half of the deduction allowed with respect to qualified venture capital stock net capital gain. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

The bill would apply to sales and exchanges after October 18, 1989.

3. S. 348 (Senator Bumpers and others)

S. 348, introduced by Senator Bumpers and others on February 7, 1989, would provide a capital gains exclusion for certain small busi-

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[15] A similar proposal for indexing passed the Senate in 1982 (as a floor amendment to the Tax Equity and Fiscal Responsibility Act of 1982), but was not enacted. Likewise, a similar proposal passed the House of Representatives in 1978 but was not enacted.

ness stock. Specifically, taxpayers other than corporations would be able to deduct from gross income 25 percent of net capital gain from the disposition of "qualified small business stock" that was held for at least 4 years at the time of the disposition. A maximum tax rate of 21 percent would apply. In addition, the deduction would be treated as a preference for purposes of the alternative minimum tax.

"Qualified small business stock" means stock which is (1) issued by a "qualified small business" more than 6 months after the date of enactment, (2) first acquired by the taxpayer (directly or through an underwriter), and (3) not issued in redemption of (or otherwise exchanged for) stock that was issued prior to the effective date.

A "qualified small business" means a corporation that: (1) has paid-up capital of $100 million or less immediately after the issuance; (2) was engaged in an active trade or business for at least 5 years prior to the issuance (or, if shorter, its period of existence); (3) is engaged in an active trade or business immediately after the issuance; and (4) is not a personal service corporation.

4. Other bills introduced in the Senate

Other bills introduced in the Senate relating to capital gains include S. 171, introduced by Senator Kasten and others, to provide a variable capital gains tax differential for certain capital gains and to index the basis of capital assets; S. 182, introduced by Senator Heinz, to provide for indexing of certain assets; S. 411, introduced by Senator Boschwitz and others, to restore a capital gains tax differential; S. 551, introduced by Senator Cranston and Senator Boschwitz, to restore a capital gains differential; S. 645, introduced by Senator Boschwitz, to provide for the indexing of certain assets and to increase the holding period for capital assets from one year to three years; S. 664, introduced by Senator Armstrong and others, to provide for the indexing of certain assets; S. 869, introduced by Senator DeConcini, to restore the deduction for capital gains of individuals and to ensure that the tax-rate on long-term capital gains of individuals does not exceed 21 percent; S. 1238, introduced by Senator Fowler, to restore the capital gains treatment for timber; S. 1286, introduced by Senator Kasten, to provide a maximum long-term capital gains rate of 15 percent and indexing of certain capital assets; S. 1311, introduced by Senator Armstrong and others, to provide a maximum rate of 15 percent on capital gains before 1991, to provide indexing of the bases of certain capital assets after 1990, and to provide a 20-percent maximum rate on capital gains from qualified small business stock held for 4 years or more; and S. 1541, introduced by Senator Kerry, to restore a capital gains tax differential for small and high-risk business stock held for 5 years or more (with lower rates on gains from such stock held for 10 years or more).

5. H. R. 3299 and H.R. 3628 as passed by the House

The Omnibus Budget Reconciliation Act of 1989 (H.R. 3299)[16] as passed by the House of Representatives on October 5, 1989, would

[16] For a description of the provisions, see H. Rept. 101-247, September 20, 1989, pp. 1474-1480.

have allowed individuals a temporary exclusion of 30 percent of the gain realized upon the disposition of qualified capital assets held more than one year. The capital gains provision in H.R. 3299 were deleted in conference. The identical provisions also passed the House as H.R. 3628 on November 9, 1989.

Qualified capital assets generally would have been capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would have been recaptured in full as ordinary income.

The capital gains exclusion would have been a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would have been reduced by the capital gains exclusion attributable to investment assets.

The exclusion would have applied to sales and exchanges on or after September 14, 1989 and before January 1, 1992.

In addition, the bill provided that gains from the sale or exchange of qualified capital assets on or after September 14, 1989, were not taken into account in computing the additional 5-percent tax imposed by reason of the phaseout of the 15-percent bracket and personal exemptions.

Finally, the bill provided for indexing the basis of certain assets acquired after 1991 for inflation.

V. ANALYSIS OF ISSUES

A. Issues Relating to a Reduced Tax on Capital Gains

1. Arguments for reduced tax on capital gains

Lock-in.—Many argue that higher tax rates discourage sales of assets. For individual taxpayers, this lock-in effect is exacerbated by the rules which allow a step-up in basis at death and defer or exempt certain gains on sales of homes. The legislative history suggests that this lock-in effect was an important consideration in Congress' decision to lower capital gains taxes in 1978. As an example of what is meant by the lock-in effect, suppose a taxpayer paid $500 for a stock which now is worth $1,000, and that the stock's value will grow by an additional 10 percent over the next year with no prospect of further gain thereafter. Assuming a 28-percent tax rate, if the taxpayer sells the stock one year or more from now, he or she will receive $932 after payment of $168 tax on the gain of $600. With a tax rate on gain of 28 percent, if the taxpayer sold this stock today, he or she would have, after tax of $140 on the gain of $500, $860 available to reinvest. The taxpayer would not find it profitable to switch to an alternative investment unless that alternative investment would earn a total pre-tax return in excess of 11.6 percent. Preferential tax rates impose a smaller tax on redirecting monies from older investments to projects with better prospects, in that way contributing to a more efficient allocation of capital.

A preferential tax rate on capital gains would both lower the tax imposed when removing monies from old investments and increase the after-tax return to redirecting those monies to new investments. Some have suggested that the lock-in effect could be reduced without lowering taxes on old investments. For example, eliminating the step-up in basis upon death would reduce lock-in. Alternatively, preferential tax rates only for gains on newly acquired assets would increase the after-tax return to new investments, thereby making reallocation of investment funds more attractive than currently is the case. On the other hand, taxpayers would not necessarily redirect their funds to new investments when their monies in older investments are unlocked. Taxpayers might instead choose to consume the proceeds.[17]

Some have argued that the lock-in effect should not be as strong for capital gains accurred on assets held by corporations as on assets held by individual taxpayers, because corporations do not re-

[17] One recent study argues that second mortgages permit taxpayers to "realize" accrued capital gains on their personal residences without paying tax. The study presents data which indicate that taxpayers use their accrued gains to finance increased consumption more often than re-investment. Such behavior would reduce personal saving and investment. *See* Joyce M. Manchester and James M. Poterba, "Second Mortgages and Household Saving," *Regional Science and Urban Economics*, vol. 19, May 1989.

ceive the benefit of step-up in basis. They also observe that most corporate assets do not represent portfolio investments, but rather are held in furtherance of the corporation's business activity. Therefore, there is likely to be less discretion in timing of realization of corporate assets. Proponents of a preferential tax rate on corporate capital gains counter that lock-in occurs because of the ability to defer realization and that consequently corporations can be subject to substantial lock-in effects.

Incentives for equity investments.—A second argument for preferential capital gains tax rates is that they encourage investors to buy corporate stock, and especially to provide venture capital for new companies, stimulating investment in productive business activities. This argument was important in the 1978 debate over capital gains taxes, and there has been a large growth in the availability of venture capital since 1978. Proponents argue that the preference provides an incentive for investment and capital formation, with particular mention of venture capital and high technology projects.

Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate is not targeted toward any particular type of equity investment although promotion of high technology venture capital is apparently a goal. Furthermore, a broad capital gains preference affords capital gains treatment to non-equity investments such as gains on municipal bonds and certain other financial instruments.

To the extent that potential sources of venture capital or other equity investment, or secondary purchasers of corporate stock, are tax-exempt or partially tax-exempt (for example, pension funds and certain insurance companies and foreign investors), a tax preference could have a small incentive effect on investment. Since 1978, tax-exempt entities (pension funds and non-profit institutions) have constituted the fastest growing source of new venture capital funds.[18] On the other hand, proponents argue that capital gains treatment for venture capitalists who are taxable has importance. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital.

Opponents of a capital gains preference argue that creating a preference for capital gains could encourage the growth of debt and the reduction of equity throughout the economy. When debt is used in a share repurchase program or leveraged buyout transaction the taxpayers who hold the original equity securities must realize any gain that they might have. A lower tax rate on gains could make holders of equity more likely to tender their shares in a leveraged buyout transaction or share repurchase program.[19]

Competitiveness.—Related to the argument that preferential capital gains tax rates encourage investment is the argument that a lower capital gains tax rate will improve the international competitive position of the United States. Proponents of a reduction in cap-

[18] *See* James M. Poterba, "Venture Capital and Capital Gains Taxation," in Lawrence H. Summers (ed.), *Tax Policy and the Economy,* (Cambridge: MIT Press), 1989.

[19] Jane Gravelle, "Tax Aspects of Leveraged Buyouts," CRS Report to Congress, 89-142 RCO, March 2, 1989.

ital gain tax rates observe that many of our major trading partners have lower marginal tax rates on the realization of capital gains than does the United States. For example, prior to this year, all gains on stocks, bonds, and unit trusts were exempt from tax in Japan. The recent Japanese tax reform imposes a tax at the taxpayer's discretion of either one percent of the gross proceeds or 20 percent of the gain, a rate still below the maximum U.S. rate. In West Germany, all long-term gains are exempt from tax.

Others point out that the issue of the effect of capital gains taxes on international competitiveness is really one of the cost of capital of domestic firms compared to that of their competitors. Corporate income taxes, individual income taxes on interest and dividends, net wealth taxes,[20] as well as taxes on capital gains, all may affect the cost of capital. Opponents of a capital gains preference argue that the fact that marginal tax rates on capital gains are higher in the United States than in other countries does not imply automatically that American firms are at a competitive disadvantage. Moreover, because of the ability to defer gains, to receive step-up at death, and because of substantial holding of corporate equity by tax-exempt institutions, the effective tax rate on gains, which helps determine the cost of capital, may be substantially below the statutory rate. For example, one recent study calculated that prior to 1987 the effective marginal tax rate on capital gains, including State taxes, was less than 6 percent.[21]

On the other hand, proponents of a capital gains tax reduction contend that any reduction in a tax on capital may reduce the cost of capital.

Bunching.—Because capital gain is generally not taxed until a disposition, taxpayers can face large jumps in taxable income when the gain is realized. With graduated tax rates, such bunching could lead to a higher tax burden than if the gain were taxed as it accrued. If the benefit of deferral is not enough to compensate for the extra tax in some of those cases, then the additional benefit of a preferential tax rate helps to achieve parity (although its availability is not limited to such cases).

Some analysts have argued that the flattened marginal tax rate schedule of present law diminishes the amount of bunching and so, presumably, reduces the need for a preferential tax rate as a remedy for it. These analysts have stated that the most significant bunching problems under present law would now befall those taxpayers in the 15-percent marginal tax bracket whose gains could push them into the 28-percent bracket. However, they point out that relatively few taxpayers who realize gains are in these circumstances.

Inflation.—Another argument for preferential tax treatment of capital gain is that part of the gain represents the effects of inflation and does not constitute real income. This argument was also

[20] While the United States does not impose on annual tax on an individual's net wealth, several of our trading partners do, for example, West Germany, the Netherlands, Spain, and Switzerland. *See* OECD, *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals*, Paris, 1988.

[21] Don Fullerton, "The Indexation of Interest, Depreciation, and Capital Gains and Tax Reform in the United States," *Journal of Public Economics*, 32, February 1987, pp. 25–51.

important in 1978. Proponents observe that the preference may provide to taxpayers some rough compensation for inflation.

Others claim that a preferential tax rate is a very crude adjustment for inflation. For example, since 1978 the price level approximately has doubled. Thus, an asset purchased in 1978 for $1,000 and sold today for $2,000 would have a purely inflationary gain. Even with a preferential rate, this gain would be taxed. On the other hand, for an individual who purchased an asset in 1986 for $1,000 and sold it today for $2,000, a reduction in the tax rate from 28 percent to 19.6 percent would more than offset the effects of inflation over the past three years. A preferential rate also does not account for the impact of inflation on debt-financed assets, where inflation reduces the cost of repaying the debt.

Double taxation of corporate earnings.—Theorists have suggested that capital gains treatment on a disposition of corporate stock might be viewed as ameliorating the double taxation of corporate earnings. The first step of double taxation occurs at the corporate level; the second step occurs at the shareholder level as dividends are paid or as shares which have presumably increased in value by retained earnings are sold. However, other theorists have argued that preferential capital gains treatment is a very inexact means of accomplishing any such benefit. Among other things, the capital gains holding period requirement is unrelated to earnings. Also, any relief that a capital gains preference provides from the burden of double taxation applies only to retained corporate earnings. Distributed earnings would be still generally subject to double taxation.

2. Arguments against reduced tax on capital gains

Measurement of income.—Opponents of reduced tax on capital gains argue that appreciating assets already enjoy a tax benefit from the deferral of tax on accrued appreciation until the asset is sold, which benefit reduces in whole or in part any bunching or inflationary effects.[22] In addition, if capital assets are debt-financed, inflation will reduce the real cost of borrowing to the extent interest rates do not rise to compensate for the reduced value of principal repayments and interest is deductible. Thus, debt financing may further tend to offset any adverse impact of inflation. Some opponents of the preference have contended that a direct basis adjustment by indexing for inflation would be more accurate and would reduce uncertainty regarding the eventual effective rate of tax on investments that might impair capital formation.[23]

On the other hand, proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation. Moreover, they argue that indexing may be viewed as too complex to implement.

Neutrality.—To the extent that preferential rates may encourage investments in stock, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the

[22] *See* Roger Brinner, "Inflation, Deferral and the Neutral Taxation of Capital Gains," *National Tax Journal*, vol. 46, December 1973.

[23] A more detailed discussion of issues relating to indexation of capital gains is below (D. "Indexing").

form of asset appreciation rather than current income such as dividends or interest. Furthermore, because the individual capital gains preference is accomplished by a deduction (or exclusion) from income, it provides a greater benefit to high-income than to middle- or low-income taxpayers. On the other hand, it is argued that neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Reduction of "conversion" opportunities.—Opponents of the preferential capital gains rate contend that it not only provides a reduced tax rate on gains from the preferred assets but also encourages taxpayers to enter transactions designed to convert other, ordinary, income to capital gains.

Conversion can also occur through debt-financing the cost of assets eligible for capital gains rates. For example, if a taxpayer borrows $100 at 10 percent annual interest to acquire a capital asset that is sold for $110 a year later, and repays the borrowing with sales proceeds, the taxpayer has an interest deduction of $10 that can reduce ordinary income [24] and a capital gain of $10 subject to preferential rates. The taxpayer thus has a net after-tax positive cash flow even though on a pre-tax basis the transaction was not profitable.

On the other hand, it is argued that such "conversion" opportunities are simply an additional tax incentive for types of investments the capital gains preference is intended to encourage. In addition, it is argued that the passive loss limitations of present law limit taxpayers' ability to "convert" ordinary income to capital gains.

Simplification and consistent treatment of taxpayers.—Opponents of the preferential capital gains rate point out that the application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. Litigation involving holding period, sale or exchange treatment, asset allocation, and many other issues has been extensive in the past. A significant body of law, based both in the tax code and in judicial rules, has developed in response to conflicting taxpayer and Internal Revenue Service positions in particular cases. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case and leaving opportunities for taxpayers to take aggressive tax return positions. It has been argued that the results derived in particular cases lack even rough consistency, notwithstanding the substantial resources consumed in this process by taxpayers and the Internal Revenue Service. Elimination of the preferential rates on capital gains has obviated the incentive for many such disputes. It has also obviated the need for such complex provisions as the collapsible corporation and collapsible partnership rules, which have been criticized for apparent inconsistencies in ap-

[24] Even if an interest deduction is subject to present law investment interest limitations, it can be offset against investment income that is ordinary income.

plication, and certain aspects of the varying recapture provisions for different types of assets.

On the other hand, it is argued that so long as a limitation on deductions of capital or investment loss is retained, some areas of uncertainty and dispute continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business, and the application of the *Corn Products* and related doctrines). Since (as discussed further below) limitations on the deductibility of capital or investment losses may be desirable to limit the selective realization of losses without realization of gains, the amount of simplification and consistency that has occurred as a result of eliminating the preference for long term capital gains has been limited somewhat.

B. Issues Specific to the Administration's Proposal

1. Holding period

Some argue that taxpayers do not plan their investments with sufficiently long time horizons. They argue that because some taxpayers realize their gains after holding the investment for short periods, managers of enterprises plan their enterprise's investment with a view to the short run, forsaking profitable long-term investments. Others argue that there is no evidence that managers ignore potentially profitable long-term investments at the expense of short-term investments and that there is no evidence of a causal link between stockholder holding period and management behavior.

Establishing a holding period requirement of 36 months to qualify for preferential capital gain treatment would create incentives for some of those taxpayers who would otherwise realize their gains in less than 36 months to defer some of those gains until they had been held for at least 36 months.[25] The holding period requirement would not be expected to have any effect on the timing of the realization of gains which taxpayers would have realized after 36 months in the absence of the holding period requirement.

Two studies, which specifically examined the effect of the holding period requirement of prior law, concluded that the holding period requirement did affect individual taxpayers' decisions as to when to realize gains.[26] If the tax rate varies by holding period, the taxpayer's decision to realize a gain now or later involves a comparison of the current after-tax yield from realization to the expected future after-tax yield from realization. While a tax rate which is lower the longer an asset has been held would increase

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[25] Under the proposal, it may be necessary to develop rules to prevent a taxpayer from first contributing assets with a short holding period to an entity, such as a partnership or S corporation, in which the taxpayer's equity interest has a longer holding period, and then selling the equity interest, in order to obtain the benefits of the longer holding period.

[26] *See* J. Eric Fredland, John A. Gray, and Emil M. Sunley, Jr., "The Six Month Holding Period for Capital Gains: An Empirical Analysis of Its Effect on the Timing of Gains," *National Tax Journal*, vol. 21, December 1968, and Steven Kaplan, "The Holding Period Distinction of the Capital Gains Tax," National Bureau of Economic Research Working Paper Number 762, September 1981.

An earlier study, *see* Lawrence H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (National Bureau of Economic Research) 1951, had concluded that the five graduated holding periods which were part of the Code from 1934 to 1937 reduced the turnover of capital assets.

the after-tax yield to waiting, the taxpayer is uncertain as to whether his pre-tax gain will be larger or smaller if he waits. The taxpayer must decide whether the gain in tax reduction offsets the uncertainty about the size of the gain. Under prior law, the reward to waiting was more substantial than that offered by the Administration's current proposal. For example, if a taxpayer had accrued $100 in gain, under prior law if it was classified as short term, the net would be $50 (assuming the 50-percent marginal tax rate). If the gain was classified as long-term, the net would be $80 (assuming the 60-percent exclusion of prior law). Under the Administration's proposal, the net return on a $100 gain to a taxpayer in the 28-percent tax bracket would be $72 if the asset had been held less than one year, $74.80 if the asset had been held between 12 and 24 months, $77.60 if the asset had been held between 24 and 36 months, and $80.40 if the asset had been held 36 months or longer.

Lengthening the holding period should, by itself, increase taxpayers' average holding periods for all assets in their portfolios. However, taxpayers' average holding periods probably are affected by more than the holding period requirement. If a reduction in the tax rate on capital gains induces taxpayers to realize gains in their portfolios more frequently and to realize gains which they otherwise would have held, unrealized, until death, then taxpayers' average holding periods for all assets in their portfolios may decline. Consequently, while the Administration's proposal may cause fewer taxpayers to realize gains within 36 months, it may also cause the average holding period to fall.

2. Capital losses

Deductibility against ordinary income.—The present limits on the deductibility of capital losses against ordinary income are intended to address problems that arise from the high degree of taxpayer discretion over when to sell certain types of assets. If capital losses were fully deductible against ordinary income, as was the case between 1921 and 1934, a taxpayer owning many assets could selectively sell only those assets with losses and thereby wipe out the tax on ordinary income even if those losses were offset by unrealized capital gains in the taxpayer's portfolio. This concern would support retention of a limitation on the deduction of capital or investment losses, even if capital or investment gains were not subject to preferential tax treatment and even though tax distinctions between investment and non-investment assets tend to generate disputes over the proper characterization of particular assets. Some have suggested a marked-to-market system (parallel to present-law treatment of regulated futures contracts) for both gains and losses, at least in the case of publicly traded stock and securities or other readily valued assets. Others contend that limitation of such a system to these types of assets would retain possibilities for taxpayer manipulation.

Limits on the deductibility of capital losses may be unfair to taxpayers who have losses in excess of unrealized gains, since they may never get to deduct legitimate losses. Or, even if, over a period of years, the taxpayer can deduct his full loss, the present value of the deduction is reduced by deferral of the loss deduction. The reduction in the value of the loss deduction creates an asymmetric treatment of gains and losses. This relative penalty on loss deduction may discourage taxpayers from undertaking risky investments. However, the ability of the taxpayer to defer realization of his gains at his discretion creates incentives to undertake such investments.

The present system—allowing the deduction of losses against up to $3,000 of ordinary income—is a compromise between the desire to be fair to taxpayers with net losses and the need to protect the tax base from selective realization of losses. In effect, small investors, who are presumed not to have large portfolios with unrealized gains, are allowed to deduct capital losses against ordinary income, and large investors, for whom $3,000 is not significant, are not. Arguably, however, large investors may have larger portfolios and lower transactional costs, making it easier selectively to realize accrued gains to offset losses and reduce the adverse impact of the $3,000 limit.

Reduction of long-term capital loss carryovers.—The prior law rule requiring that long-term losses be reduced by 50 percent when deducted against ordinary income (up to the $3,000 limit) was also a compromise between the need to protect the tax base and equity to investors with net capital losses. If long-term losses were fully deductible against ordinary income, as was the case before 1969, taxpayers with both long-term gains and losses could realize the gains and losses in alternate years, paying tax on only 40 percent of the gains and fully deducting the losses. Under prior law, a taxpayer who took care to realize losses before they became long-term could, of course, achieve this result despite the 50-percent reduction. To compensate for the loss limitation, Congress retained a 50-percent cutback, instead of increasing it to 60 percent, when the capital gains exclusion percentage was increased from 50 to 60 percent in 1978.

The Administration's proposal does not reduce long-term losses deducted against ordinary income. The proposal treats all long-term loss carryovers as losses from the sale or exchange of property held between one and two years.

3. Treatment of taxpayer with both gains and losses from the sale of capital assets

In general.—Under the law prior to the Tax Reform Act of 1986, the amount of gain that was entitled to the 60-percent capital gains exclusion was the excess of net long-term capital gain over net short-term capital loss for the year. Thus, in determining the amount eligible for the exclusion, the amount of gain from the sale or exchange of capital assets held more than six months was reduced, first, by the amount of losses from the sale or exchange of capital assets held more than six months and then was further reduced by the excess of short-term capital losses for the year over short-term capital gains for the year.

If a capital gains structure is adopted with multiple holding periods providing a larger exclusion for longer-held gains, rules must be adopted to provide the manner in which a taxpayer's capital losses for any taxable year offset capital gains for that year. Rules also must be adopted to prescribe the treatment of the carryover of long-term capital losses.

Administration proposal.—The Administration proposal would, in effect, treat all long-term capital losses as losses arising from the sale of assets held between one and two years, notwithstanding the actual holding period of the asset sold. This would result in long-term capital losses first offsetting capital gains with a holding period of between one and two years, with any excess next offsetting capital gains with a holding period of between two and three years, and with any further excess then offsetting capital gains from assets held more than three years.

Assume, for example, a taxpayer has a $100 gain from the sale of a capital asset held between one and two years, a $50 gain from the sale of a capital asset held more than three years and a $100 loss from the sale of an asset held more than three years. Under the Administration proposal (when fully effective in 1992), the $100 loss from the asset held more than three years would offset the $100 gain from the asset held between one and two years. The taxpayer would then be entitled to exclude $15 of gain (30 percent of the $50 gain attributable to the asset held more than three years), resulting in $35 of net gain being subject to tax.

Principles set forth in S. 1771 and S. 1938.—Under these bills, gains and losses within each category of gains and losses are first netted against each other. Next, the net loss from any category is then netted against the net gain from other categories in a prescribed order. Under these bills, the carryover of any long-term capital loss is treated as loss from the sale or exchange of an asset with a holding period of between one and two years. This carryover rule is intended to simplify the calculation of the loss carryovers.

Assume the facts in the example set forth above under the discussion of the Administration proposal. Under the principles set forth in each of these bills (but using the holding periods and exclusion amounts set forth in the Administration proposal), $50 of the loss from the asset held more than three years would first offset the $50 of gain from the asset held more than three years. The remaining $50 loss would then offset the gain from the asset held between one and two years. The taxpayer would then be entitled to exclude $5 of gain (10 percent of the $50 gain attributable to the asset held between one and two years), resulting in $45 of net gain being subject to tax.

Principles used under prior law when multiple holding periods were in effect.—When multiple holding periods for long-term capital gains were in effect before World War II, netting of gains and losses between categories of gains and losses (either short-term and long-term) did not occur. The applicable portion of the net gain from each category of long-term gain was excluded from income and the allowable loss from any category of asset with a net long-term loss was reduced by the applicable portion of the loss. Under this system, any capital loss carryover (after proper reduction in the current year) would be carried over in full.

Again assume the facts in the prior example. Applying these principles to the holding periods and exclusion amounts set forth in the Administration proposal, 10 percent of the $100 gain (i.e., $10) from the asset held between one and two years would be excluded from income. In addition, the $50 gain and $100 loss from the sale of capital assets held more than three years would be netted, resulting in a net loss of $50. However, the taxpayer would be allowed to deduct only 70 percent of the $50 net loss (i.e., $35) from the assets held more than three years. The net amount of capital gain included in taxable income would thus be $55 ($90 gain reduced by $35 allowable loss).

4. Definition of qualified assets

The Administration proposal generally would apply to all assets which were eligible for the long-term capital gain exclusion of prior law. The proposal, however, would deny the proposed exclusions to collectibles. The proposal, however, Proponents of the proposal argue that denying the exclusion to collectibles targets the proposal towards those assets which are most directly responsible for future growth, such as investments in plant and equipment. On the other hand, economic neutrality argues for not artificially biasing taxpayer's choices of the form of their investments.

A preference which applies to corporate stock but not to collectibles, or some other class of assets, may make tax administration and compliance more difficult. Taxpayers may attempt to obtain the capital gains preference for sales of collectibles by contributing these assets to a C corporation and selling the stock of that entity. Certain disadvantages to holding such property in corporate form, such as the imposition of a corporate-level tax if the collectibles themselves are later sold or distributed by the corporation, would tend to discourage such activity.[27]

C. Distributional Effects of a Reduction in Capital Gains Taxes

Table 2 below presents the Joint Committee on Taxation staff's estimate of the distributional effect of the Administration's proposal. The second column in the table below estimates the number of returns in each income class which will benefit from the proposed capital gains rate reduction. The third column reports the aggregate tax reduction which accrues to each income class. The fourth column calculates the average dollar tax reduction per return. The last column calculates the percentage of the aggregate tax change which accrues to each income class.

[27] The Administration proposal, S. 1771, and S. 1938 each would deny long-term capital gains treatment to the sale of S corporation stock or a partnership interest to the extent the gain is attributable to the gain from collectibles held by the S corporation or partnership.

Table 2.—Distributional Effect of the Administration's Capital Gains Proposal

[1990 income levels]

Income class [1]	Number of returns with tax change (Thousands)	Aggregate tax change (Millions of dollars)	Average tax reduction [2] (Dollars)	Percent distribution of aggregate tax change
Less than $10,000	59	−$4	$68	(3)
$10,000 to $20,000	638	−56	88	0.4
$20,000 to $30,000	1,360	−136	100	.9
$30,000 to $40,000	1,811	−297	164	1.9
$40,000 to $50,000	1,502	−415	276	2.6
$50,000 to $75,000	2,423	−1,004	414	6.3
$75,000 to $100,000	984	−785	798	4.9
$100,000 to $200,000	1,299	−2,709	2,085	17.0
$200,000 and above	681	−10,522	15,454	66.1
Total	**10,756**	**−15,928**	**1,481**	**100.0**

[1] The income concept used to place tax returns into income classes equals adjusted gross income plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) inside buildup on life insurance, (4) worker's compensation, (5) nontaxable social security benefits, (6) deductible contributions to individual retirement accounts, (7) the minimum tax preferences, and (8) net losses in excess of minimum tax preferences from passive business activities.

[2] The tax reduction reported here assumes no change in taxpayer behavior. Thus, this measure understates the tax benefit received by certain taxpayers.

[3] Negligible.

NOTE.—Details may not add to totals due to rounding.

SOURCE: Committee on Taxation.

The table above calculates the benefit from the proposed rate reduction which taxpayers would receive if they realized the same amount of gains that they would have realized in the absence of a rate reduction. In other words, this calculation measures only the benefit the taxpayer receives if he or she does not alter behavior. This is a conservative estimate of the actual benefit, because it does not assume a behavioral response. If taxpayers respond by realizing additional gains they will obtain even more benefit from the change, since taxpayers change their behavior only if the change makes them even better off. Thus, this calculation understates the benefit received by higher income taxpayers.

In other words, Table 2 reports the distribution of the tax burden rather than the distribution of taxes paid. If a reduction in capital gains tax rates leads to greater realizations and tax revenue paid by high-income taxpayers, the distribution of taxes paid will have shifted more onto high-income taxpayers. However, an increase in the distribution of taxes paid does not imply that the tax burden on high-income taxpayers has increased, because, as noted above, any additional tax paid in response to a capital gains rate cut results only from changed behavior.[28]

D. Indexing

Proponents of indexing contend that indexing would accomplish the goals of capital gains taxation while producing a more accurate measurement of economic income with greater neutrality.

Opponents contend that indexing is complex, should not be significant if efforts to control inflation are successful, and would erode revenues if such efforts are not successful.

1. Issues related to partial indexing

The 1989 House-passed reconciliation bill (H.R. 3299) and S. 1771 would provide indexing of basis but would not generally index costs of financing property.

Where some but not all assets are indexed, several issues arise. To the extent that the basis of certain assets is indexed but debt-financing of those assets is not, the adjustment for inflation may be overstated. An overadjustment in favor of the taxpayer who finances assets can occur even if it is assumed that interest rates correctly anticipate inflation and rise in the marketplace to reflect the effect of inflation on borrower and lender. For example, suppose a taxpayer acquires an asset for $100 (fully financed) and sells it one year later for $115. Inflation over the year is 5 percent. The lender and the taxpayer are each in a 28-percent tax bracket. The lender, seeking a 10 percent pre-tax rate of interest and anticipating 5-percent inflation, charges 15 percent interest for the year. On a pre-tax basis, the taxpayer receives $115 in return of basis and gain on the sale, but pays the lender $115 in interest and principal, producing no net cash flow.

If there is no indexing and no capital gains preference, the after-tax result is the same as the pre-tax economic result—the taxpayer receives $15 of income taxable at 28 percent and pays $15 of offsetting, deductible interest, producing no after-tax net cash flow. If both the basis of the asset and the interest on the financing are indexed (assuming an accurate indexing factor has been identified and applied) the taxpayer again has $10 of gain and $10 of offsetting deductible interest, producing no after-tax net cash flow. However, if the basis of the asset is indexed for inflation but the financing is not indexed, then the taxpayer has $10 of gain (taxed at 28 percent) but a $15 deduction, producing an after-tax positive net cash flow of $1.40, assuming the deduction can be used in full to offset other income in the 28-percent bracket.[29]

If some but not all assets are indexed, additional consideration would have to be given to provisions designed to accomplish the desired results in certain special situations. For example, if stock but

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[28] For further discussion on the appropriate methodology for assessing distributional effects, *see* Jane G. Gravelle and Lawrence B. Lindsey, "Capital Gains," *Tax Notes*, 38, January 25, 1988, pp. 397–405.

[29] Indexing the basis of assets without indexing debt-financing of such assets also overcompensates the borrower if interest rates do not rise enough to compensate for inflation on an after-tax basis. Thus, if the stated interest payment in the example is only $10 (rather than $15), interest is not indexed, and there is no capital gains preference, the taxpayer will have a pre-tax positive net cash flow of $5 and an after-tax positive net cash flow of $3.60.

not debt is indexed, (or if debt is indexed in a different manner than stock—for example, by interest adjustments rather than basis adjustments) the question arises whether some types of assets, such as preferred stock or convertible debt, should be classified as stock or as debt for this purpose.

If some assets are not indexed or are only indexed at the option of the holder, it would be necessary to provide for the appropriate treatment of various types of flow-through entities that may hold indexed assets but whose stock or interests may or may not be indexed. Conversely, if an interest in an entity is eligible for indexing but the entity may hold substantial non-indexable assets, consideration could be given to provisions designed to prevent taxpayers from indirectly obtaining indexing for nonqualified assets.

The question also arises whether indexing of an otherwise capital asset is appropriate in situations such as the disposition of stock in a controlled foreign corporation or foreign investment company, where present law requires ordinary income treatment to account for prior income deferral.

In the case of depreciable assets, rules are necessary to prevent the churning of assets in order for the buyer to obtain a higher basis for depreciation than the seller's basis, where the seller's gain is not taxed as a result of indexing. H.R. 3299 provided that indexing did not apply to the extent of depreciation recapture.

Finally, if capital gains treatment is reinstated for some types of assets (as would the case under H.R. 3299) then, depending upon the rate of inflation, taxpayers may continue to have an incentive to engage in transactions designed to convert ordinary income to capital gains income. Because of this possibility, the complex provisions of present law dealing with situations in which capital gains treatment is available (for example, the collapsible partnership rules) presumably could not be eliminated.

2. Other indexing considerations

"Lock-in".—It is possible that indexing might not relieve "lock-in" problems, because a taxpayer whose after-tax economic gain is protected against future inflation may decide to continue to hold an asset to obtain the benefits of tax deferral, or the benefits of tax exemption if the asset is held until death. Others contend that indexing alleviates "lock-in" by removing the burden of taxing nominal gains arising from inflation.

Complexity.—Indexing would involve a significant amount of recordkeeping. Records of the cost of property and of improvements are generally maintained under present law. However, records of the dates such costs are incurred may not be retained under present law, since the acquisition date is generally not relevant to the determination of tax liability.

Indexing would substantially increase the volume of calculations necessary to calculate taxable gain for many common transactions. For example, consider an individual who sells stock which was purchased 10 years before the sale and who has reinvested the quarterly dividends in additional stock during this entire period. Under present law, if all the stock is sold at once, the individual can add the original cost and the dollar amounts of each of the 40 reinvested dividend payments in order to obtain the stock's basis, which is subtracted from the sales proceeds in order to determine taxable gain. Under indexing, each of the 41 components of basis (the original purchase plus the 40 dividend payments) would be multiplied separately by indexing factors based on the full number of years that had elapsed since the dividend was reinvested in order to compute the inflation-adjusted value of that component and determine the basis of stock.

The interaction of indexing rules with other Code provisions would raise further issues. For example, the basis of a partnership interest or S corporation stock in the hands of a partner or shareholder is affected by numerous transactions, including distributions, that could complicate accurate indexing of such interests. Another example is the appropriate interaction with the short sale provisions of the Code. Theoretically, it can be argued that any inflation adjustment for a short sale should require the short seller to report a capital gain to the extent of inflation. If such a requirement were not imposed, it may not be appropriate to allow a shareholder who sells short "against the box" (i.e., while he or she owns shares of stock for which the short sale is made) to receive an inflation adjustment for the stock owned during the period of the short sale.

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