Joint Committee on Taxation
February 23, 1989
JCX-2-89

ESTIMATE OF PRESIDENT'S BUDGET PROPOSAL FOR A REDUCTION IN TAXES ON CAPITAL GAINS

We have now had the opportunity to study the President's proposal on capital gains in some detail. Although we still have some questions about some of the specifics of the proposal which I outline below, this memorandum provides you with our current estimate of the proposal.

The President's Proposal

The President's budget proposal would allow individuals an exclusion of 45 percent of the gain realized upon the disposition of qualified capital assets. Further, the maximum tax rate applicable to any gains on qualified assets would be 15 percent. The exclusion would not be a preference for purposes of the alternative minimum tax. Taxpayers with gain on qualified assets would be able to exclude 100 percent of the gain, if the taxpayer's adjusted gross income (calculated including 55 percent of the gain) is less than $20,000 ($10,000 for single taxpayers or married taxpayers filing separately). Taxpayers with an adjusted gross income less than $20,000 but who are subject to the alternative minimum tax would not be eligible for the 100 percent exclusion.

Qualified capital assets generally would be capital assets as defined under present law other than depreciable, depletable, and amortizable property used in the taxpayer's trade or business. Collectibles would not be treated as qualified assets. The special section 1231 assets, i.e., certain interests in timber, coal, iron ore, livestock, and unharvested crops, would not be treated as qualified assets.

In addition, to be a qualified asset, the taxpayer must satisfy a holding period requirement. The asset must have been held for more than 12 months if the asset is sold in 1989, 1990, 1991, or 1992; for more than 24 months if the asset is sold in 1993 or 1994; and for more than 36 months if the asset is sold in any year after 1994.

The proposal would be effective for assets sold on or after July 1, 1989.

Estimated Revenue Effect

The table below provides our current revenue estimate of the President's proposal, subject to some qualifications which I discuss below.

The first line presents the revenue effect which would result from a 45 percent exclusion, with a maximum 15 percent rate, for capital gains regardless of asset type, and assuming a one-year holding period and an effective date of sales on or after January 1, 1989. This calculation is based on baseline realizations from CBO's January economic forecast[1] and includes our estimate of the revenue effect which would result from a tax-induced increase in realizations. Consistent with recent economic analysis of capital gain realization behavior, our estimate reflects a larger short-run than long-run behavioral response.

The second line presents the estimated revenue effect which would result from moving the effective date of this proposal from January 1, 1989, to July 1, 1989. The third line presents the estimated revenue effect which results from excluding collectibles and depreciable property from the proposal. The fourth line presents the revenue effect of the lengthening, on a phased-in basis, of the holding period. The fifth line estimates the effect of providing the additional 100 percent exclusion to those eligible taxpayers with adjusted gross income less than $20,000.

Projected Revenue Effect
(Billions of Dollars)

Item	Fiscal Years						
	1989	1990	1991	1992	1993	1994	1989-94
1. 45% Exclusion	0.3	0.6	-6.2	-8.9	-9.8	-11.6	
2. Effective Date	0.3	1.8	0.0	0.0	0.0	0.0	
3. Exclusion of Certain Asset Types	0.2	1.3	2.7	2.9	3.1	3.2	
4. 3-Year Holding Period	0.0	0.0	0.0	0.1	0.3	-1.9	
5. Exclusion for Certain Taxpayers	-0.1	-0.4	-0.4	-0.5	-0.5	-0.5	
Total Revenue Effect	0.7	3.3	-4.0	-6.4	-6.9	-10.9	-24.2

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1 The CBO baseline forecast differs from that made by OMB which forms the baseline for the Treasury estimate.

We have not estimated the revenue effect for years beyond 1994 because the CBO baseline does not extend beyond that date. If the baseline realizations were to continue to grow at the same rate as between 1989 and 1994, we would estimate that the proposal loses revenue in the years beyond 1994. However, the magnitude of the losses would not increase smoothly, as the table above might suggest, because of the effect of the phase-in of the lengthened holding period.

Qualifications to the Estimate

The President's proposal lacks details which could materially affect our estimated revenue effects. For example, our estimate of the President's proposal assumes the enactment of very strong rules to prevent gains on collectibles and depreciable property from qualifying for the exclusion. Such rules have not yet been fully specified by Treasury. We are concerned that both C and S corporate structures could be used in some circumstances to qualify collectibles and depreciable property for the exclusion. In the absence of effective rules preventing this behavior, we would estimate a greater revenue loss.

The President's proposal does not detail how it will interact with the kiddie tax (dependents age 13 or under) or how it will affect the taxation of income of other dependents. It may be possible for high income taxpayers to shift assets with accrued capital gains to their dependents whose adjusted gross income is less than $10,000. Although our current estimate assumes very limited income shifting, substantial income shifting would increase the revenue loss.

The President's proposal does not specify certain aspects of the treatment that capital losses would receive. It is not clear whether a taxpayer will be permitted to deduct 50 or 100 percent of net long-term losses and whether the losses on collectibles will be unlimited or allowed to offset gains on qualified capital assets. For the purpose of this estimate we have assumed that the taxpayer is permitted to deduct 50 percent of net long-term losses and that losses on qualified assets must be netted against gains on qualified assets, while losses on non-qualified assets must be netted separately against gains on non-qualified assets.

The preceding discussion should not be construed as an exhaustive list of those areas which are unclear in the President's proposal. I included the above examples to suggest that our estimate of the revenue effects may change as the details are developed.