[COMMITTEE PRINT]

DESCRIPTION OF S. 2428, S. 2608, AND S. 3065

RELATING TO

CAPITAL GAINS AND LOSSES

LISTED FOR A HEARING

BY THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON JUNE 28 AND 29, 1978

PREPARED FOR THE USE OF THE

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BY THE STAFF OF THE

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I. INTRODUCTION

The bills discussed in this pamphlet, S. 2428, S. 2608, and S. 3065, have been scheduled for a hearing on June 28 and 29, 1978 by the Subcommittee on Taxation and Debt Management of the Committee on Finance. The bills relate to the tax treatment of capital gains and losses.

In connection with this hearing, the staff of the Joint Committee on Taxation has prepared a description of the bills. The description indicates the present law treatment and its background, an explanation of what changes each bill would make, its effective data, and its possible revenue effect.

II. SUMMARY

A. Nonrecognition of Gain on Sales of Certain Small Business Investments (S. 2428)

The bill would provide for the elective nonrecognition of an individual's long-term capital gain from the sale or exchange of certain small business investments if at least 80 percent of the proceeds are reinvested in another small business within 12 months of the sale. Under the election provided in the bill, gain would be recognized, and the recapture rules would apply, to the extent that the amount realized on the sale exceeds the total of the individual's qualified small business investments made during the 12 months following the sale. Where a taxpayer makes the nonrecognition election under the bill, the basis of the acquired small business investment would be required to be reduced by an amount equal to the unrecognized gain realized on the sale.

To be eligible for the nonrecognition election, the bill would require that both the interest sold and the interest subsequently acquired constitute "qualified small business investments."

The provisions of the bill would apply to sales made after December 31, 1977.

B. Graduated Exclusion of Capital Gains and Losses (S. 2608)

The bill would provide noncorporate taxpayers with a graduated exclusion from gross income for a percentage of long-term capital gains. The exclusion would start at 50 percent of the gain on the sale or exchange of a capital asset held for more than one year, and would increase by 2 percentage points for each additional 12-month period, up to a maximum exclusion of 80 percent of gain on a capital asset held for more than 192 months (16 years). Similarly, the bill would provide a graduated nonrecognition of long-term capital losses for noncorporate taxpayers—starting with 50 percent of the loss on the sale or exchange of a capital asset held for more than one year, and increasing by 2 percentage points for each 12-month period in excess of one year, up to a maximum of 80 percent after 16 years.

In addition, the bill would repeal the present 25-percent alternative capital gains tax (applicable to the first $50,000 of net long-term capital gain) for individuals.

The provisions of the bill would apply to taxable years beginning after December 31, 1979.

C. Reduction in Maximum Capital Gains Tax Rate (S. 3605)

The bill would remove capital gains as an item of tax preference subject to the minimum tax for both corporate and noncorporate taxpayers. The bill also would provide that the present 25-percent alternative capital gains tax on the first $50,000 of net long-term capital gains for individuals would be applicable to all such capital gains, and it would reduce the alternative capital gains rate for corporations from 30 percent to 25 percent.

The provisions of the bill would apply to taxable years beginning after December 31, 1979.

III. DESCRIPTION OF BILLS

A. Nonrecognition of Gain on Sales of Certain Small Business Investments (S. 2428)

Present law

Present law generally requires recognition of the entire amount of gain or loss realized on the sale or exchange of property (sec. 1001(c)). However, in a number of instances, the Code also provides for the nonrecognition of gain or loss, *e.g.*, sec. 351 (relating to transfers to corporations controlled by the transferor), sec. 354 (relating to exchanges in certain reorganizations), sec. 721 (relating to certain partnership contributions), sec. 1031 (relating to certain exchanges of business or investment property), sec. 1033 (relating to certain involuntary conversions), sec. 1034 (relating to certain residential sales or exchanges), and sec. 1039 (relating to certain sales of low-income housing projects). Generally, none of these nonrecognition provisions would apply to gain realized on the sale of a small business investment.[1]

Description of S. 2428

The bill would provide for the elective nonrecognition of an individual's long-term capital gain from the sale or exchange of certain small business investments if at least 80 percent of the proceeds are reinvested in another small business within 12 months of the sale. Under the election provided in the bill, gain would be recognized, and the recapture rates would apply, to the extent that the amount realized on the sale exceeds the total of the individual's qualified small business investments made during the 12 months following the sale. Where a taxpayer makes the nonrecognition election under the bill, S. 2428 would require the reduction of the basis of the acquired small business investment by an amount equal to the unrecognized gain realized on the sale.

To be eligible for the nonrecognition election, the bill would require that both the interest sold and the interest subsequently acquired constitute "qualified small business investments." Under the bill, a "qualified small business investment" is defined as any equity or unsecured investment in any small business concern, within the meaning of section 3 of the Small Business Act (15 U.S.C. sec. 632).[2] In addition, the investment would have to be a capital asset with respect to the taxpayer.

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[1] Nonrecognition treatment would be available, of course, if the sale and acquisition of the small business investments met the requirements of section 1039, relating to certain sales of low-income housing projects.

[2] A small business concern is one which is independently owned and operated, and which is not dominant in its field of operation. The Small Business Act charges the Administrator of the Small Business Administration with the formulation of a definition of small business concerns. While the definition will vary from industry to industry to reflect differing characteristics and other relevant factors, the Administrator may take the number of employees and the dollar volume of business into account, among other items (15 U.S.C. sec. 632). A list of small business concerns is contained in 15 C.F.R. sec. 121.3.

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S. 2428 also would establish a special procedure under which the statutory period for the assessment of any deficiency would not expire until 3 years from the time that the taxpayer notifies the Secretary of the Treasury of the qualified small business investments acquired or of the failure to make such investments timely.

Effective date

The amendments made by S. 2428 would apply to sales made after December 31, 1977.

Revenue effect

It is estimated that the provisions of S. 2428 would result in a revenue reduction of $600 million annually. This estimate assumes no changes in economic behavior in response to the tax change.

B. Graduated Exclusion of Capital Gains and Losses (S. 2608)

Present law

Under present law, a noncorporate taxpayer generally deducts from gross income 50 percent of the amount of any net capital gain for the taxaple year (the excess of net long-term capital gains for the year over net short-term capital losses for the same period). The remaining 50 percent of the net capital gain is includible in gross income and taxed at the regular tax rates. However, for noncorporate taxpayers, an alternative 25-percent capital gains tax rate is available for the first $50,000 of the taxpayer's net capital gain (sec. 1201(b)). (This is beneficial where the taxpayer's marginal tax rate exceeds 50 percent.) Regardless of the manner in which the tax on capital gains is computed, present law treats one-half of a noncorporate taxpayer's net capital gain as an item of tax preference subject to the 15-percent minimum tax (sec. 57(a)(9)). As an item of tax preference, one-half of an individual's net capital gain reduces the amount of personal service income eligible for the 50-percent maximum tax (sec. 1348(b)(2)).

Under present law, the capital losses of noncorporate taxpayers generally are deductible in full against capital gains. For taxable years beginning after 1977, capital losses in excess of capital gains may be deducted only against up to $3,000 of ordinary income each year. However, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income. As a result, for example, $2,000 of net long-term capital losses is required to offset $1,000 of ordinary income. Capital losses in excess of the applicable limitations may be carried forward to future years indefinitely.

Present law does not require a graduated nonrecognition of capital losses.

Background

While present law contains no provision which allows a graduated exclusion of long-term capital gains, or which requires a graduated nonrecognition of long-term capital losses, based on the length of the taxpayer's holding period, such a provision was enacted by Congress as part of the Revenue Act of 1934.[1] Under this provision, which replaced the 12½ percent alternative rate capital gains tax which Congress had enacted in 1921, progressively smaller percentages of capital gains were included in a taxpayer's income, depending upon the length of time that the asset had been held. Where gain was recognized on the disposition of an asset which had been held for more than 10 years, taxpayers were permitted to exclude 70 percent of the gain.

Congress modified this "sliding scale" exclusion provision in the Revenue Act of 1938, citing as reasons for change complexity and the

[1] Revenue Act of 1934, sec. 117(a), 48 Stat. 680, 714 (1934).

reluctance of some taxpayers to dispose of assets until the percentage of gain includible in income was low enough. The 1938 Act provided a 15-percent alternative tax rate, and divided long-term capital gains into two classes, with the percentage excludible from income depending upon the length of the holding period. One-third of the gain from assets held for more than 18 months but less than 2 years was excludible from income, and 50 percent of gain from assets held for more than 2 years was excludible. These two classes of gain were eliminated in 1942 when Congress adopted the 50-percent deduction now contained in section 1202 of the Code, and the predecessor of the present alternative tax.

Prior to the Tax Reform Act of 1969, the 25-percent alternative tax applied to all of a noncorporate taxpayer's net long-term capital gains. Thus, where a noncorporate taxpayer's marginal tax rate was over 50 percent, the alternative capital gains rate was more beneficial, and such gains were subject to a 25-percent tax rate. In the 1969 Act, Congress limited the availability of the alternative tax to the first $50,000 of a noncorporate taxpayer's net capital gain. Also, that Act made capital gains eligible for income averaging, but only if the taxpayer does not elect the alternative tax.

In addition, in 1969 Congress classified one-half of a noncorporate taxpayer's net capital gain as an item of tax preference subject to the minimum tax, and as an item which was to reduce the amount of personal service income eligible for the 50-percent maximum tax.[2] These changes were implemented because Congress felt that previously applicable rules, which allowed taxpayers to avoid tax on certain portions of their economic income, resulted both in an unfair distribution of the tax burden, and in large variations in the tax burdens placed on taxpayers who receive different kinds of income.[3]

Prior to the Tax Reform Act of 1969, if a noncorporate taxpayer's capital losses exceeded its capital gains, the taxpayer could deduct on a dollar-for-dollar basis up to $1,000 of the excess losses against ordinary income. Any remaining excess loss could be carried forward indefinitely and deducted against either capital gains or ordinary income, subject to the applicable $1,000 annual limitation on deductibility of capital losses against ordinary income. In the 1969 Act, Congress provided that only 50 percent of net long-term capital losses in excess of net short-term capital gains could be deducted from ordinary income. This change was intended to provide parallel tax treatment for net long-term capital losses and net long-term capital gains, only 50 percent of which are included in a noncorporate taxpayer's income.

For taxable years beginning after 1977, the Tax Reform Act of 1976 increased to $3,000 the amount of ordinary income which could be offset by excess capital losses.

The Finance Committee, in its consideration of the Tax Reform Act of 1976, approved and reported a provision which was similar

[2] Both the minimum and maximum tax provisions were amended by the Tax Reform Act of 1976. The minimum tax rate was increased from 10 percent to 15 percent, and the $30,000 exemption and deduction for regular taxes of prior law were replaced with an exemption equal to the greater of $10,000 or one-half of regular tax liability. The Act also repealed the carryover of regular taxes paid. With respect to the maximum tax, the 1976 Act eliminated both the $30,000 exemption to the preference offset and the 5-year averaging provision.

[3] Senate Report No. 91-552, 91st Cong., 1st Sess. 122 (1969).

to S. 2608.[4] The Finance Committee amendment would have provided a deduction, in addition to the existing 50-percent deduction, equal to 1 percent of an individual's capital gain on an asset multiplied by the number of years in excess of 5 years that the asset was held. The additional deduction would have been limited to 20 percent of the gain recognized on the disposition of a qualifying asset. Thus, the maximum allowable deduction would have been 70 percent of the capital gain recognized on the disposition of a property which had been held by the taxpayer for more than 25 years. The 1976 provision also would have limited a taxpayer's total capital gain deduction to 75 percent of the net capital gain (the excess of net long-term capital gains over net short-term capital losses) for the taxable year. In addition, the committee's 1976 amendment would have repealed the alternative tax rate of 25 percent on the initial $50,000 of a noncorporate taxpayer's net long-term capital gain.

This committee amendment was not adopted by the Senate.

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[4] Senate Report No. 94–938, Part II (H.R. 10612), 94th Cong., 2d Sess. 70 (1976).

Description of S. 2608

The bill would provide noncorporate taxpayers with a graduated exclusion from gross income for long-term capital gains, and a graduated nonrecognition of long-term capital losses. In addition, it would repeal the alternative tax for individuals.

S. 2608 would provide noncorporate taxpayers with a graduated exclusion from gross income for a percentage of their long-term capital gain, *i. e.*, recognized gain from the sale or exchange of a capital asset held for more than 12 months. The excluded amount would equal 50 percent of the gain from the sale or exchange of a capital asset which has been held for more than 12 months. The excluded amount of gain would increase by 2 percentage points for each 12-month period in excess of 1 year for which the taxpayer held the property from which the gain was derived.[5] However, no more than 80 percent of the gain from the sale or exchange of a capital asset would be excludible under the bill. For example, 52 percent of the gain from the sale of a capital asset held for more than 2 years would be excluded under S. 2608, and 80 percent of the gain derived from the sale of a capital asset held for more than 16 years would be excluded. (See table 1.) The balance of any gain not excluded from gross income, or offset by capital losses, would be taxed at ordinary income rates.

TABLE 1.—APPLICABLE PERCENTAGE OF CAPITAL GAIN EXCLUDED OR LOSS UNRECOGNIZED UNDER S. 2608

Holding period in excess of the following number of yeasr:	*Percentage of gain excluded or loss unrecognized*
1	50
2	52
3	54
4	56
5	58
6	60
7	62
8	64
9	66
10	68
11	70
12	72
13	74
14	76
15	78
16	80

The bill would provide a graduated nonrecognition of a noncorporate taxpayer's long-term capital losses. The amount of loss realized which would not be recognized would be equal to 50 percent of the loss for the taxable year from the sale or exchange of a capital asset which has been held for more than one year. The amount of the unrecognized loss would increase by 2 percentage points for each year in excess of 1 year for which the taxpayer held the property on which the loss was realized.[6]

[5] In the case of an estate or trust, S. 2608 would apply by excluding the applicable percentage from the beneficiary's gross income where capital gains are includible in the beneficiary's income pursuant to sections 652 or 662.

[6] In the case of an estate or trust, S. 2608 would apply the same graduated nonrecognition rule, subject, however, to the general provisions of subchapter J which pertain to capital losses.

Under S. 2608, the maximum amount of any unrecognized loss would be equal to 80 percent of the loss realized on the sale or exchange of any capital asset. This point would be reached with respect to a loss realized on the sale or exchange of a capital asset which had been held for more than 192 months (16 years). (See table 1).

Recognized losses and included gains generally would remain subject to all other Code provisions presently applicable to capital gains and losses.

S. 2608 also would repeal the alternative tax rate of 25 percent on the initial $50,000 of a noncorporate taxpayer's net long-term capital gain.

Effective date

The amendments made by S. 2608 would apply with respect to taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that the provisions of S. 2608 would result in an annual revenue reduction of $1 billion. This estimate assumes no change in economic activity as a result of the bill.

C. Reduction in Maximum Capital Gains Tax Rate (S. 3605)

Present law

Noncorporate taxpayers

Under present law, a noncorporate taxpayer generally deducts from gross income 50 percent of the amount of any net capital gain for the taxable year (the excess of net long-term capital gains for the year over net short-term capital losses in the same period). The remaining 50 percent of the net capital gain is included in gross income and taxed at the regular tax rates. This can lead to a capital gains tax rate of up to 35 percent, *i.e.*, one-half the maximum individual tax rate of 70 percent.

In lieu of taxing 50 percent of long-term capital gains at the regular tax rates, an alternative tax applies if it results in a lower tax rate than that produced by the normal method (sec. 1201(b)). The alternative tax consists of a 25 percent tax on the first $50,000 of net long-term capital gain. Therefore, the alternative tax is applicable and beneficial only to those noncorporate taxpayers whose income is subject to marginal tax rates exceeding 50 percent. Taxpayers who elect the alternative tax are not eligible for income averaging.

Regardless of the manner in which the tax on capital gains is computed, present law treats one-half of a noncorporate taxpayer's net capital gain as an item of tax preference subject to the 15-percent minimum tax (sec. 57(a)(9)(A)). The minimum tax for individuals equals 15 percent of a taxpayer's tax preferences, reduced by either $10,000 or one-half of regular tax liability, whichever is greater. As an item of tax preference, the excluded half of the capital gain reduces the amount of personal service income eligible for the 50-percent maximum tax (sec. 1348(b)(2)).

Generally, the effect of classifying one-half of a noncorporate taxpayer's capital gains as an item of tax preference is to increase the maximum rate of tax on capital gains to 39.875 percent. This is the sum of the highest applicable rate of regular tax (35 percent), and a 4.875 percent minimum tax (the effective rate of the minimum tax after giving effect to the deduction for regular taxes).[1] In some isolated cases in which the taxpayer uses the $10,000 exemption instead of the deduction for one-half of regular taxes, the combined minimum and regular tax rates may equal 42.5 percent. If the impact of the 50-percent maximum tax on earned income, under which the capital gain preference reduces the amount of the income eligible for maximum tax, is taken into account, the highest potential tax rate on capital gains generally is 49.125 percent. This is the sum of a 35 percent regualr tax, a tax increase in earned income equal to 10 percent of the capital gain (a tax increase from 50 percent to 70 percent on an amount of earned income equal to one-half the gain), and a 4.125 percent minimum

[1] On a $1 gain, the minimum tax is 15 percent of half the gain (50 cents), reduced by one-half the regular tax on the gain (17½ cents), or 4.875 cents.

tax.[2] In certain very unusual circumstances, the rate of tax on a capital gain can be as high as 52.5 percent, *i.e.*, where due to various tax credits the minimum tax exemption is not increased by the regular income tax on the capital gains because the taxpayer elects the $10,000 exemption instead of the deduction for one-half of regular taxes.

Corporate taxpayers

Under present law, the alternative tax on corporate capital gains (the excess of net long-term capital gain over net short-term capital loss) is 30 percent (sec. 1201(a)). No special deduction for 50 percent of a long-term capital gain is available for corporations as is the case with noncorporate taxpayers. Use of the corporate alternative tax will not be advantageous to a corporation if its gain is subject only to the normal corporate rate (which is less than 30 percent), rather than the combined normal and surtax rate of 48 percent.

Under present law, 18/48ths of a corporation's net long-term capital gain is treated as an item of tax preference subject to the 15-percent minimum tax (sec. 57(a)(9)(B)). For corporations, the minimum tax exemption equals the greater of $10,000 or all of regular tax liability (instead of half as with noncorporate taxpayers). Also, a series of special rules apply to capital gains from timber and reduce the minimum tax on that item of tax preference.

Background

Noncorporate taxpayers

Prior to the Tax Reform Act of 1969, the 25-percent alternative tax was not limited to the initial $50,000 of a noncorporate taxpayer's net long-term capital gains. Thus, where a noncorporate taxpayer's marginal tax rate was over 50 percent, the alternative capital gains rate was applicable, and the entire amount of gain was subject to a 25-percent tax rate. In the 1969 Act, Congress limited the availability of the alternative tax to the first $50,000 of a noncorporate taxpayer's net capital gain, and made capital gains eligible for income averaging.

In addition, Congress classified one-half of a noncorporate taxpayer's net capital gain as an item of tax preference subject to the minimum tax, and as an item which reduces the amount of personal service income eligible for the 50-percent maximum tax. These changes were implemented because Congress felt that previously applicable rules, which allowed taxpayers to avoid tax on certain portions of their economic income, resulted both in an unfair distribution of the tax burden, and in large variations in the tax burdens placed on taxpayers who receive different kinds of income.[3] These changes generally were effective for taxable years beginning after December 31, 1969.

Both the minimum and maximum tax provisions were amended by the Tax Reform Act of 1976. The minimum tax rate was increased from 10 percent to 15 percent, and the $30,000 exemption and deduction for regular taxes of prior law were replaced with an exemption equal to the greater of $10,000 or one-half of regular tax liability. The Act also repealed the carryover of regular taxes paid. With respect to the

[2] On a $1 gain, the minimum tax is 15 percent of half the gain (50 cents) reduced by one-half the regular tax liability (one-half of 45 cents, or 22½ cents), or 4.125.

[3] Senate Report No. 95-552, 91st Cong., 1st Sess. 122 (1969).

maximum tax, the 1976 Act eliminated both the $30,000 exemption to the preference offset and the 5-year averaging provision.

Noncorporate taxpayers

Prior to the Tax Reform Act of 1969, the corporate alternative tax on net long-term capital gains was 25 percent.

In the 1969 Act, Congress classified 18/48ths of corporate capital gains as an item of tax preference. The denominator of this ratio is the regular corporate tax rate (48 percent), and the numerator is the regular corporate tax rate less the rate generally applicable to corporate capital gains (48 percent minus 30 percent). The Tax Reform Act of 1976 increased the minimum tax rate from 10 percent to 15 percent, and replaced the $30,000 exemption and deduction for regular taxes, which were enacted in 1969, with an exemption equal to the greater of $10,000 or regular taxes. The 1976 Act also eliminated the carryover of regular taxes paid.

Description of S. 3065

The bill would eliminate both corporate and noncorporate capital gains as an item of tax preference subject to the 15-percent minimum tax and, for individuals, the preference offset to the maximum tax.

The bill also would amend the alternative tax for capital gains to provide that the maximum tax rate applicable to any taxpayer's net capital gain would be 25 percent.

Effective date

The amendments made by S. 3065 would apply with respect to taxable years beginning after December 31, 1979.

Revenue effect

The Treasury estimates that S. 3065 would reduce receipts by $2.2 billion at 1979 income levels and by $2.4 billion in 1980. Of the projected 1979 revenue loss, $1.3 billion would result from removing capital gains from the minimum and maximum taxes for individuals, $0.4 billion from repealing the $50,000 ceiling on the alternative tax rate for individuals, $0.1 billion from removing capital gains from the minimum tax for corporations, and $0.3 billion from reducing the corporate alternative capital gains rate from 30 percent to 25 percent. These estimates assume no change in economic activity as a result of the tax act.

Several private studies have critized these revenue estimates. These include studies by Chase Econometrics Associations, Inc. (sponsored by the American Council for Capital Formation), the Securities Industry Association (using the Data Resources, Inc., econometric model), Merrill Lynch Economics, Inc., and Norman Ture (in conjunction with the National Association of Manufacturers). Each of these studies attempts to quantify the effects of the tax cut on the economy and the "feedback" effect on Federal revenues. The estimated effects of S. 3065 on the Federal revenues in the second year after the effective date derived by these studies are as follows:

	Billions
Chase	$3.9
Merrill Lynch	2.3
SIA	7.3
Ture	1.0

The Chase, Merrill Lynch and SIA studies are similar in many respects. They each assume an increase in the extent to which taxpayers realize their accrued capital gains in response to the tax cut. The SIA study assumes a 10-percent increase in realizations, which would cause the revenue gain from additional realizations by individuals to offset slightly more than half of the initial revenue loss. The Chase and Merrill Lynch studies each assume sufficient additional realizations to lead to no revenue loss (for individuals, about 18 percent more realizations).

Also, each study assumes a significant increase in stock prices as a result of the bill—40 percent in the Chase study, 10 percent in the SIA study and 4 to 6 percent in the Merrill Lynch study. An increase in stock prices would reduce the cost of raising equity capital, thereby stimulating investment, and would raise each household's wealth, thereby encouraging consumer spending. Each of these effects would increase national income and, therefore, increase Federal revenues.

The Ture study is somewhat different. It assumes no change in realizations, not because it does not believe that there will be some increase, but rather because it believes there is insufficient evidence to quantify this effect. Also, the Ture study assumes no increase in stock prices on the grounds that sales of assets because of "unlocking" in response to the reduction in capital gains rates will reduce stock prices, while additional purchases of stock in response to the greater attractiveness of common stocks will increase them, so that the net effect on stock prices will be indeterminate. Rather in the Ture study, the main economic effect of lower capital gains taxes is to increase savings, which is assumed to increase investment and gross national product, thereby generating additional revenue.

The Treasury has disputed the conclusions of these studies, asserting that they are based on unwarranted assumptions.

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