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TAX TREATMENT OF CAPITAL GAINS AND LOSSES

SCHEDULED FOR A PUBLIC HEARING

BY THE

SENATE COMMITTEE ON FINANCE

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PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 13, 1997, on the tax treatment of capital gains and losses. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law, the legislative background, current Senate legislative proposals, and an analysis of issues.

Part I of the pamphlet is a description of present-law treatment of capital gains and losses. Part II is an overview of the legislative background of the tax treatment of capital gains and losses. Part III is a description of current Senate legislative proposals, and Part IV is an analysis of issues. The Appendix provides the data underlying the figures shown in the text.

[1] This pamphlet may be cited as follows: *Tax Treatment of Capital Gains and Losses* (JCS–4–97), March 12, 1997.

I. PRESENT LAW

In general

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 (sec. 1001).[2] On the sale or exchange of capital assets, the net capital gain is taxed as ordinary income, except that the net capital gain of noncorporate taxpayers is subject to a maximum marginal rate of 28 percent.

Net capital gain; holding period

Net capital gain is the excess of net long-term capital gain for the taxable year over the net short-term capital loss for the year (sec. 1222). Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year.

Capital losses

Capital losses are generally deductible in full against capital gains (sec. 1211).[3] In addition, in the case of noncorporate taxpayers, such losses may be deducted against ordinary income, up to a maximum of $3,000 in each year. Noncorporate taxpayers can carry forward capital losses in excess of these limitations to future years indefinitely, but may not carry back the losses to prior years. Corporate taxpayers generally may carry back capital losses three years and forward five years (sec. 1212).

Capital assets

A "capital asset" generally means any property held by the taxpayer except for the following specified classes: (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 (sec. 1221).

Certain depreciable property, nondepreciable business property, and special assets

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 five 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

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[2] 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.

[3] 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).

in the ordinary course of business), as well as certain special assets including timber, coal, domestic iron ore, certain livestock and certain unharvested crops.

Patents

Under certain circumstances, the holder 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 treated as short-term gain or loss and 60 percent of the gain or loss is treated as long-term gain or loss. Individuals who have a net loss from such contracts may elect to carry the loss back three years against prior net gain from such contracts.

Gains on certain small business stock

The Revenue Reconciliation Act of 1993 provided a 50-percent exclusion for gain from the sale of stock in certain corporations that was acquired at original issuance when the corporation had aggregate gross assets of not more than $50 million and was held for more than five years. One-half of the excluded gain is a minimum tax preference. The amount of gain eligible for the 50-percent exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million gain from stock in that corporation (sec. 1202).

Losses on small business stock

An individual may treat 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 originally issued to the individual (or to a partnership having the individual as a partner) (sec. 1244). 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, in order to compensate for the deferral of U.S. tax on corporate earnings and profits accumulated abroad (secs. 1246, 1248).

Collapsible property

The distinction between capital gains and ordinary income has led to numerous 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) are known respectively as the "collapsible" corporation and "collapsible" partnership provisions.

Similarly, certain partnership rules relating to basis allocations (secs. 732 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.

Conversion transactions

The Revenue Reconciliation Act of 1993 provided that capital gain from the disposition of property that was part of a "conversion transaction" would be recharacterized as ordinary income, with certain specified limitations (sec. 1258).

In general, a "conversion transaction" is a transaction, generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction. To be classified as a "conversion transaction," a transaction must also satisfy one of the following four criteria: (1) the transaction consists of the acquisition of property by the taxpayer and a substantially contemporaneous agreement to sell the same or substantially identical property in the future; (2) the transaction is a straddle, within the meaning of the straddle rules (sec. 1092); (3) the transaction is one that was marketed or sold to the taxpayer on the basis that it would have the economic characteristic of a loan but the interest-like return would be taxed as capital gain; or (4) the transaction is described as a conversion transaction in regulations promulgated the Treasury. (No such regulations have been issued.)

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 the modified accelerated cost recovery system ("MACRS"), for personal property, previously allowed depreciation (up to the amount of realized gain) is generally recaptured as ordinary income (sec. 1245). 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 MACRS), there is no depreciation recapture upon disposition if the asset is held for more than one year (sec. 1250). For real property to which the MACRS 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 de-

ducted intangible drilling and development costs, mining expenses, and depletion (sec. 1254).

Nonrecognition transactions

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 of property, and involuntary conversions followed by an acquisition of replacement property (secs. 361, 1031, and 1033). 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.

In addition, the Revenue Reconciliation Act of 1993 permitted any corporation or individual to elect to roll over without payment of tax any capital gain realized upon the sale of publicly-traded securities where the corporation or individual uses the proceeds from the sale to purchase common stock or a partnership interest in a specialized small business investment company within 60 days of the sale of the securities (sec. 1044).

Capital gains on sale of principal residence

Rollover of gain

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule.

One-time exclusion

In general, an individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale (sec. 121). (A loss on the sale or exchange of a principal residence is treated as a nondeductible personal loss.)

Investment interest limitations

The amount of investment interest that an individual may deduct in a taxable year is limited to the amount of net investment income for that year (sec. 163). Excess amounts of investment interest are carried forward. To the extent an individual elects to treat long-term capital gain as investment income for purposes of computing the investment interest limitation, that amount of net capital gain does not qualify for the maximum 28-percent rate (sec. 1(h)).

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 (sec. 1014).[4]

[4] Such appreciation might give rise to Federal estate and gift 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 cumulative taxable transfers. The Federal estate and gift tax rates begin at 18 percent on the first $10,000 of cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million. A unified credit in effect generally exempts the first $600,000 in cumulative taxable transfers from estate and gift tax. The graduated rates and unified credit are phased out by a five-percent surtax imposed on cumulative taxable transfers in excess of $10 million and not exceeding $21,040,000.

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 two 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 ("1942 Act"). The 1942 Act provided for a 50-percent exclusion for noncorporate capital gains or losses on property held for more than six months. The 1942 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 and repealed the alternative maximum rate. 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[5] to 28 percent. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Tax Act of 1981 reduced the maximum effective capital gains rate from 28 percent to 20 percent.

The Tax Reform Act of 1986 ("1986 Act") repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988. The 1986 Act provided that the maximum rate on capital gains (i.e., 28 percent) would not be increased in the event the top individual rate was increased by a subsequent public law (unless that law specifically increased the capital gains tax). The Revenue Reconciliation Act of 1990 raised the maximum individual rate to 31 percent, and the Revenue Reconciliation Act of 1993 raised the top tax rate to 39.6 percent. Neither Act raised the maximum individual capital gains rate.

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 alternative rate to 28 percent. The 1986 Act 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 two 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

[5] 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.

gains was excludible if an asset was held for one to two years, 40 percent if an asset was held for two to five years, and 60 percent if the asset was held for between five 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 two years, a 33-percent exclusion was allowed. Where assets were held for more than two 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 1942 Act, 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 six months (long-term capital assets), for which a 50-percent exclusion was allowed; and assets held for six 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 six-month holding period.

A six-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 nine months for 1977 and to one year for 1978 and all subsequent years. The Deficit Reduction Act of 1984 reduced the holding period to six months for property acquired after June 22, 1984 and before 1988. After 1988, the holding period is one year.

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.

Capital losses

Noncorporate taxpayers

In the early years of the Federal 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, that 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, the net long-term loss that could be carried

forward was reduced by $2 for every dollar of loss that offset ordinary income.

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

Corporate taxpayers

The Revenue Act of 1942 provided a five-year carryforward of unused corporate capital losses. In 1969, a three-year carryback was added.

III. CURRENT LEGISLATIVE PROPOSALS

A. "American Family Tax Relief Act" (Title II of S. 2) (Senator Roth and others)

1. 50-percent capital gains deduction for individuals

Description of Provision

S. 2 would allow individuals a deduction equal to 50 percent of net capital gain for the taxable year. The bill would repeal the present-law maximum 28-percent rate. Thus, under the bill, the effective rate under the regular tax on the net capital gain of an individual in the highest (i.e., 39.6 percent) marginal rate bracket would be 19.8 percent.

Collectibles would not be allowed the capital gains deduction; instead a maximum rate of 28 percent would apply to the gain of an individual from the sale or exchange of collectibles held for more than one year if the individual did not index the basis of the collectible (as described below).

The bill would reinstate the rule in effect prior to the 1986 Tax Reform Act that required two dollars of the long-term capital loss of an individual to offset one dollar of ordinary income. The $3,000 limitation on the deduction of capital losses against ordinary income would continue to apply.

Effective Date

The provision would generally apply to sales and exchanges of capital assets after December 31, 1996.

2. Indexing of basis of certain assets for purposes of determining gain

Description of Provision

In general

The bill generally would provide for an inflation adjustment to (i.e., indexing of) the adjusted basis of certain assets (called "indexed assets") for purposes of determining gain (but not loss) upon a sale or other disposition of such assets by a taxpayer other than a C corporation. Assets held by trusts, estates, S corporations, regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and partnerships are eligible for indexing, to the extent gain on such assets is taken into account by taxpayers other than C corporations.

Indexed assets

Assets eligible for the inflation adjustment generally would include common (but not preferred) stock of C corporations and tangible property that are capital assets or property used in a trade or business. To be eligible for indexing, an asset must be held by the taxpayer for more than three years.

Computation of inflation adjustment

The inflation adjustment under the provision would be computed by multiplying the taxpayer's adjusted basis in the indexed asset by an inflation adjustment percentage. The inflation adjustment percentage would be the percentage by which the gross domestic product deflator for the last calendar quarter ending before the disposition exceeds the gross domestic product deflator for the last calendar quarter ending before the asset was acquired by the taxpayer. The inflation adjustment percentage would be rounded to the nearest one-tenth of a percent. No adjustment would be made if the inflation adjustment is one or less.

Special entities

RICs and REITs

In the case of a RIC or a REIT, the indexing adjustments generally would apply in computing the taxable income and the earnings and profits of the RIC or REIT. The indexing adjustments, however, would not be applicable in determining whether a corporation qualifies as a RIC or REIT.

In the case of shares held in a RIC or REIT, partial indexing generally would be provided by the provision based on the ratio of the value of indexed assets held by the entity to the value of all its assets. The ratio of indexed assets to total assets would be determined quarterly (for RICs, the quarterly ratio would be based on a three-month average). If the ratio of indexed assets to total assets exceeds 80 percent in any quarter, full indexing of the shares would be allowed for that quarter. If less than 20 percent of the assets are indexed assets in any quarter, no indexing would be allowed for that quarter for the shares. Partnership interests held by a RIC or REIT would be subject to a look-through test for purposes of determining whether, and to what degree, the shares in the RIC or REIT are indexed.

A return of capital distribution by a RIC or REIT generally would be treated by a shareholder as allocable to stock acquired by the shareholder in the order in which the stock was acquired.

Partnership and S corporations, etc.

Under the bill, stock in an S corporation or an interest in a partnership or common trust fund would not be an indexed asset. Under the provision, the individual owner would receive the benefit of the indexing adjustment when the S corporation, partnership, or common trust fund disposes of indexed assets. Under the provision, any inflation adjustments at the entity level would flow through to the holders and result in a corresponding increase in the basis of the holder's interest in the entity. Where a partnership has a section 754 election in effect, a partner transferring his interest in the partnership would be entitled to any indexing adjustment that has accrued at the partnership level with respect to the partner and the transferee partner is entitled to the benefits of indexing for inflation occurring after the transfer.

The indexing adjustment would be disregarded in determining any loss on the sale of an interest in a partnership, S corporation or common trust fund.

Foreign corporations

Common stock of a foreign corporation generally would be an indexed asset if the stock is regularly traded on an established securities market. Indexed assets, however, would not include stock in a foreign investment company, a passive foreign investment company (including a qualified electing fund), a foreign personal holding company, or, in the hands of a shareholder who meets the requirements of section 1248(a)(2) (generally pertaining to 10-percent shareholders of controlled foreign corporations), any other foreign corporation. An American Depository Receipt (ADR) for common stock in a foreign corporation would be treated as common stock in the foreign corporation and, therefore, the basis in an ADR for common stock generally would be indexed.

Other rules

Improvements and contributions to capital

No indexing would be provided for improvements or contributions to capital if the aggregate amount of the improvements or contributions to capital during the taxable year with respect to the property or stock is less than $1,000. If the aggregate amount of such improvements or contributions to capital is $1,000 or more, each addition would be treated as a separate asset acquired at the close of the taxable year.

Suspension of holding period

No indexing adjustment would be allowed during any period during which there is a substantial diminution of the taxpayer's risk of loss from holding the indexed asset by reason of any transaction entered into by that the taxpayer, or a related party.

Short sales

In the case of a short sale of an indexed asset with a short sale period in excess of three years, the bill would require that the amount realized be indexed for inflation for the short sale period.

Related parties

The bill would not index the basis of property for sales or dispositions between related persons, except to the extent the adjusted basis of property in the hands of the transferee is a substituted basis (e.g., gifts).

Collapsible corporations

Under the bill, indexing would not reduce the amount of ordinary gain that would be recognized in cases where a corporation is treated as a collapsible corporation (under sec. 341) with respect to a distribution or sale of stock.

Effective Date

The provision would apply to dispositions of property the holding period of which begins after December 31, 1996. The provision also would apply to a principal residence held by the taxpayer on January 1, 1997 (as if the holding period began on that date). An individual holding any indexed asset (other than a personal residence)

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on January 1, 1997, may elect to treat the indexed asset as having been sold and reacquired for its fair market value. If the election is made, any gain is recognized (and any loss is disallowed).

3. Gain from sale of small business stock

Description of Provision

Under the bill, the maximum rate of regular tax on the qualifying gain from the sale of small business stock by a taxpayer other than a corporation would remain at 14 percent. The minimum tax preference would be repealed.

The bill would increase the size of an eligible corporation from gross assets of $50 million to gross assets of $100 million. The bill would also repeal the limitation on the amount of gain an individual can exclude with respect to the stock of any corporation.

The bill would provide that certain working capital must be expended within five years (rather than two years) in order to be treated as used in the active conduct of a trade or business. No limit on the percent of the corporation's assets that are working capital would be imposed.

The bill would provide that if the corporation establishes a business purpose for a redemption of its stock, that redemption is disregarded in determining whether other newly issued stock could qualify as eligible stock.

Effective Date

The increase in the size of corporations whose stock is eligible for the exclusion would apply to stock issued after the date of the enactment of the bill. The remaining provisions would apply to stock issued after August 10, 1993 (the original effective date of the small business stock provision).

4. 28-percent corporate alternative tax for capital gains

Description of Provision

The bill would provide an alternative tax of 28 percent on the net capital gain of a corporation if that rate is less than the corporation's regular tax rate.

The bill would also provide an alternative rate of 21 percent on the gain from the sale or exchange of qualified small business stock (other than stock of a subsidiary corporation) held more than five years.

Effective Date

The provision would generally apply to sales and exchanges of capital assets after December 31, 1996.

The small business stock provision would apply to stock issued after the date of enactment.

5. Capital loss deduction on the sale or exchange of a principal residence

Description of Provision

The bill would provide that a loss from the sale or exchange of a principal residence would be treated as a deductible capital loss.

Effective Date

The provision would apply to sales and exchanges after December 31, 1996.

B. The "Targeted Investment Incentive and Economic Growth Act of 1997" (S. 20) (Senator Daschle and others)

1. Rollover of capital gains

Description of Provision

S. 20 would allow a taxpayer to roll over gain on the sale of an eligible small business investment where the proceeds are used to purchase another eligible small business investment within six months of the sale of the original investment. An eligible small business investment would mean stock in a corporation or a partnership interest held six months or more in a qualified small business entity acquired by the taxpayer at original issue in exchange for money or property. The entity must be engaged in an active business. A qualified small business entity means a domestic corporation or partnership with aggregate gross assets of less than $25 million at all times before, and immediately after, the issuance of the stock or partnership interest.

Effective Date

The provision would apply to investments made after December 31, 1996.

2. Losses on small business investments

Description of Provision

The bill would allow individuals to treat as an ordinary loss up to $150,000 ($300,000 in the case of a joint return) from the loss on the sale or exchange of an eligible small business investment.

Effective Date

The provision would apply to investments made after December 31, 1996.

3. Gain from sale of small business stock

Description of Provision

The bill would amend the current rules relating to the 50-percent exclusion on gain on certain small business stock by (1) making corporations eligible for the exclusion, (2) repealing the minimum tax preference, (3) increasing the maximum size of an eligible corporation from $50 million of gross assets to $100 million, (4) in-

creasing the per issuer limitation on eligible gain from $10 million to $20 million, and (5) amending the working capital rules and the redemption rules.

Effective Date

The provisions relating to the size of the corporations and the eligibility of corporate shareholders would apply to stock issued after date of enactment. The other provisions would apply to stock issued after August 10, 1993.

4. Gain from sale of a principal residence

Description of Provision

An individual generally would be able to exclude up to $250,000 ($500,000 if married filing a joint return) of capital gain realized on the sale or exchange of a principal residence. The exclusion would be allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years. Under the provision, gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after December 31, 1996.

To be eligible for the exclusion, a taxpayer must have owned a residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange of the residence. A taxpayer who is forced to sell without meeting these requirements (e.g., because of a change of place of employment or medical reasons) would be able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 would be available on a qualifying sale or exchange of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the provision would allow the newly married taxpayer a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude $500,000 of gain on their joint return.

Effective Date

The provision would be available for all sales or exchanges of a principal residence occurring on or after January 1, 1997, and would replace the present-law rollover and one-time exclusion provisions applicable to principal residences. In the case of sales or exchanges occurring between January 1, 1997 and the date of enactment, taxpayers could elect whether to apply the new exclusion or prior law. For a taxpayer who acquired his or her current principal residence in a rollover transaction within the five years prior to the date of enactment, the residency requirement of the provision would be applied by taking into account the period of the taxpayer's residence in the previous principal residence.

5. Gain from sale of farm assets

Description of Provision

An individual materially participating in, and owning a 50-percent or greater interest in, a farming business for five years or more could rollover capital gain from the sale of assets used in the active conduct of the farming business into an individual retirement account. The maximum rollover in any year would be $10,000 ($20,000 for a joint return) multiplied by the number of years the individual (and spouse) was an eligible farmer. The maximum rollover could not exceed $400,000 reduced by the value of all regular individual retirement accounts of the taxpayer (and spouse) in excess of $100,000.

Effective Date

The provision would apply to sales and exchanges after date of enactment.

C. The "Capital Formation Act of 1997" (S. 66) (Senators Hatch, Lieberman, Grassley, and Breaux)

1. Capital gains reduction

Description of Provision

S. 66 would provide individuals a 50-percent capital gains deduction, and corporations a maximum capital gains rate of 25 percent.

Effective Date

The provision would be effective on January 1, 1997.

2. Gain from sale of small business stock

Description of Provision

The bill would amend the rules relating to gain on certain small business stock by (1) increasing the exclusion to 75 percent, (2) reducing the holding period from five to three years, (3) making corporations eligible for the exclusion, (4) repealing the minimum tax preference, (5) increasing the maximum size of the corporation from $50 million of gross assets to $100 million, adjusted for inflation, (6) repealing the $10 million per-issuer limitation, (7) amending the working capital rules and the redemption rules, (8) allowing hotels, motels, and restaurants to be a qualified business, and (9) allowing taxpayers to rollover gain from the sale or exchange of small business stock to purchase other qualifying small business stock within 60 days of the original sale.

Effective Date

The provision would apply to stock issued after date of enactment, except that items (1), (3), (5), and (6) would apply to stock issued after August 10, 1993.

D. The "Capital Gains Reform Act of 1997" (S. 72) (Senator Kyl)

Description of Provision

S. 72 would provide a 70-percent capital gains deduction for individuals, and would provide a maximum capital gains rate of 22 percent for corporations.

Effective Date

The provision would be effective on January 1, 1997.

E. The "Family Retirement Equity Act of 1997" (S. 80) (Senator Kohl)

Description of Provision

S. 80 would provide that an individual materially participating in, and owning a 50-percent or greater interest in, a farming business for five years or more could roll over capital gain from the sale of assets used in the active conduct of the farming business into an individual retirement account. The maximum rollover in any year would be $10,000 ($20,000 for a joint return) multiplied by the number of years the individual (and spouse) was an eligible farmer. The maximum rollover could not exceed $500,000 reduced by the value of all regular individual retirement accounts of the taxpayer (and spouse) in excess of $100,000.

Effective Date

The provision would apply to sales and exchanges after date of enactment.

F. "Long-Term Investment Act of 1997" (S. 252) (Senator Gregg)

Description of Provision

S. 252 would provide individuals a capital gain deduction of 5, 10, and 20 percent for assets held more than two, three, and four years, respectively. The present-law maximum rate of 28 percent of net capital gain would be retained. In addition, a surcharge of 5.6 percent would apply to assets held six months or less, and a surcharge of 2.8 percent would apply to assets held between six and 12 months.

Effective Date

The provision would apply to sales and exchanges after January 31, 1997.

G. S. 306 (Senator Ford)

Description of Provision

S. 306 would reduce the present-law 28-percent individual maximum capital gains rate for assets held more than two years on a sliding scale down to a 14-percent maximum rate for assets held

more than eight years. The capital gains tax rate schedule would be as follows:

Asset holding period	Tax rate (percent)
More than 1 year to 2 years	28
More than 2 years to 3 years	26
More than 3 years to 4 years	24
More than 4 years to 5 years	22
More than 5 years to 6 years	20
More than 6 years to 7 years	18
More than 7 years to 8 years	16
More than 8 years	14

Effective Date

The provision would be effective on January 1, 1997.

IV. ANALYSIS OF ISSUES

A. Scope of Capital Gains Taxation

In 1994, among individual taxpayers who filed Form 1040, Schedule D,[6] 11 million taxpayers recognized $168 billion in long-term capital gains and 3.5 million taxpayers recognized $23.2 billion in short-term capital gains. In addition, 5.8 million taxpayers reported $8.5 billion of capital gain distributions, generally received from mutual funds. Taxpayers also reported $78.2 billion of long-term capital losses on 6.5 million returns and $47.5 billion in short-term losses on 3.6 million returns.[7]

While these data represent a substantial number of transactions and a substantial amount of economic activity, not all transactions are taxable transactions. Many capital gains (and losses) are recognized annually by tax-exempt persons such as pension funds, private foundations, and charities. In addition, foreign persons generally are exempt from tax on capital gains recognized in the United States.

Because gain recognition by taxpayers is elective, many analysts believe that capital gains recognized by taxable persons represent a fraction of the gains accrued by taxable persons annually. Estimates of the percentage of gains recognized by taxable persons to the total accrued gains earned by taxable persons range from 15 to 50 percent.[8] If the gains recognized annually fall short of accrued gains, the stock of accrued, but unrecognized capital gains, is growing through time and recognized capital gains in any one year would represent a small percentage of the total stock of accrued, and hence potentially recognizable, gains.[9]

The majority of the dollar value of gains recognized represented gains from the sale of corporate stock or mutual funds, interests in partnerships, S corporations or other fiduciaries, and the sale of real estate. Figures 1a and 1b, below, reports the distribution of long-term capital gains by number of transactions and by the dollar value of the gains recognized by a sample of individual taxpayers in 1994. These data report only recognitions reported on Schedule D and thus may not be fully representative of the distribution of

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[6] Capital gains may also be reported on Form 2119, Form 4684, Form 4797, Form 6252, Form 6781, and Form 8824. Therefore, the following figures understate the total amount of gains and losses recognized in 1994.

[7] The staff of the Joint Committee on Taxation derived these figures from tabulations of Statistics of Income ("SOI") data on 1994 individual income tax returns.

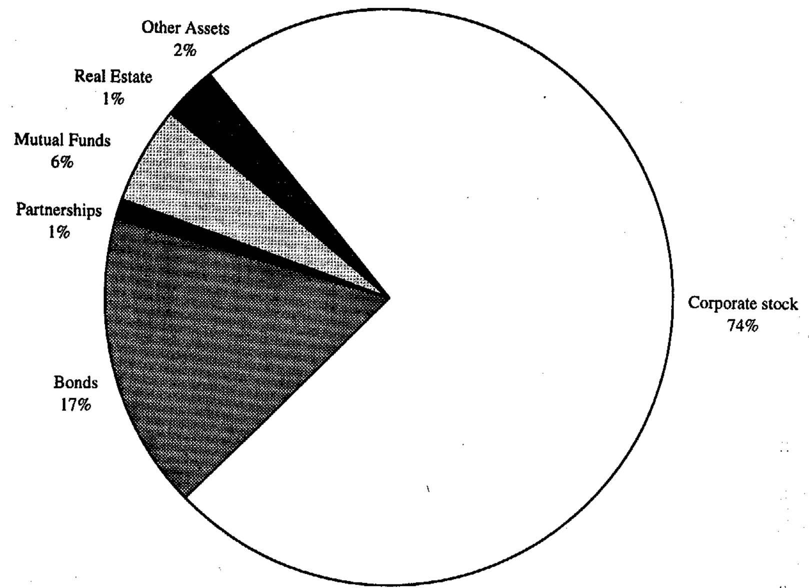
[8] See Robert Gillingham and John S. Greenlees, "The Effect of Marginal Tax Rates on Capital Gains Revenue: Another Look at the Evidence," *National Tax Journal*, 45, June 1992, pp. 167-177. Such estimates vary widely from year to year. Gillingham and Greenlees estimate that 1989 taxable realizations were 16 percent of 1989 accruals, but that taxable realizations averaged 25 percent of accruals between 1987 and 1989. However, their estimate of accruals is based upon the Federal Reserve Board's "Flow of Funds Account" and may overstate the percentage as accrued taxable gains may be understated because the Flow of Funds Accounts do not adjust for depreciation claimed against the tax basis of taxable assets. Jane Gravelle, "Limits to Capital Gains Feedback Effects," CRS Report for Congress, 91-250, March 15, 1991, estimates average taxable realizations to be approximately 50 percent of potentially taxable annual average accrued gains. Jane Gravelle and Lawrence B. Lindsay, "Capital Gains," *Tax Notes*, 38, January 25, 1988, estimate that taxable recognized gains average one third of annual accrued gains.

[9] Gillingham and Greenlees, "The Effect of Marginal Tax Rates on Capital Gains Revenue." Gillingham and Greenlees estimated that 1989 realizations represented less than 2.5 percent of the stock of accrued since acquisition, but unrealized, capital gains held by taxpayers.

all gain recognitions.[10] Nevertheless, Figures 1a and 1b should represent a substantial portion of 1994 recognitions.

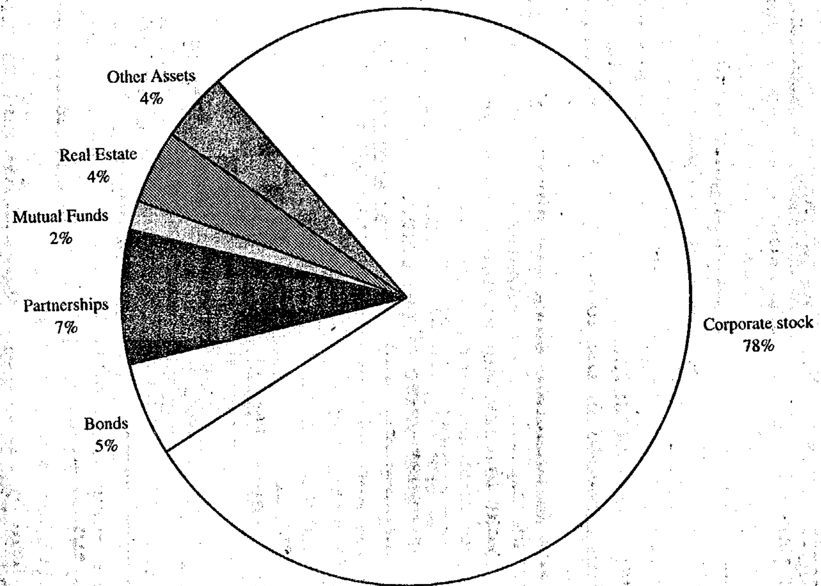
[10] The staff of the Joint Committee on Taxation drew these data from a sample of 1994 tax returns. The sample may not statistically reflect the recognition patterns of all taxpayers. See Appendix Table A.1 for underlying data. The categories in Figures 1a and 1b are defined as follows. "Corporate Stock" consists of sales of corporate stock, but not sales of mutual fund shares. However, "corporate stock" includes certain indirect capital gains recognized by a partnership and passed through to the individual partners. "Bonds" consists of sales of U.S. Government obligations, State and local government obligations, other bonds, notes, and debts, and sales of shares in tax-exempt municipal bond funds or trusts. "Partnerships" consists of sales of interests in partnerships, S corporations, or other fiduciaries. "Mutual Funds" consists of sales of shares in mutual funds other than tax-exempt municipal bond funds. "Real Estate" consists of sales of residential rental property, personal residences, and land other than farm or ranch land. "Other" encompasses sales of options, commodities, futures contracts, livestock, timber, farm and ranch land, depreciable business personal property, depreciable business real property, involuntary conversions other than from casualties and thefts, interests in passthrough entities not classified elsewhere, unidentified assets, and other assets.

Figure 1a.--Distribution of Transactions with Long-Term Gain Reported on Schedule D By Asset Type, 1994



NOTE: Sample from Schedule D may not be representative of all gain recognitions.

Figure 1b.--Distribution of Dollar Value of Long-Term Gains Reported on Schedule D By Asset Type, 1994



NOTE: Sample from Schedule D may not be representative of all gain recognitions.

The data in Figures 1a and 1b show the dominance of corporate stock in capital gain realizations in 1994. In addition, sales of interests in partnerships, S corporations, and other fiduciaries accounted for 7.4 percent of the value of long-term gains realized and 1.0 percent of transactions. Long-term gains from the sale of real estate other than farmland comprised 2.4 percent of the total value of gains and 1.1 percent of the transactions. Long-term gains from the sale of bonds (U.S. government, State and local government, including tax-exempt bond funds, and other bonds, notes, and debts) comprised 5.3 percent of the total value of gains and 16.7 percent of transactions.

While sales of corporate stock are always an important component of annual capital gain realizations, the degree of importance varies from year to year. For example, 1989 return data show that 38.4 percent of 1989 long-term gain recognitions involved corporate stock (excluding capital gain distributions) and accounted for 22.6 percent of the dollar value of net gains; sales of interests in partnerships, S corporations, and fiduciaries accounted for 11.5 percent of transactions and 28.3 percent of the dollar value; and sales of real estate [11] accounted for 9.0 percent of transactions and 24.6 percent of the dollar value.[12]

The holding period of recognized gains varies from a matter of moments to decades. Figures 2a and 2b below report the percentage distribution of long-term gain recognitions by length of holding period for a sample of long-term gains recognized in 1994 and reported on Schedule D.[13] Figure 2a reports the distribution by number of transactions and Figure 2b reports the distribution by dollar value of gains recognized. In terms of number of transactions (Figure 2a), the median long-term gain was held between two and three years. When measured by the dollar value of long-term gains recognized (Figure 2b), the median long-term gain was recognized after being held by the taxpayer between five and six years.

Figures 3a and 3b report the percentage distribution of long-term loss recognitions by length of holding period.[14] As Figure 3a indicates, more than 50 percent of long-term losses are recognized after a holding period of less than two years. When measured by the dollar value of loss, the median occurs between years two and three (Figure 3b). These findings are consistent with advice given to taxpayers by financial planners to recognize losses, because they can offset gain recognitions and perhaps other income, and defer gain recognition. These data only represent the holding period of realized gains and losses. Also, they do not report the quantity or dollar magnitude of short-term (less than one year) gain and loss realizations. As such, these figures understate the holding period of realized capital gains and losses. On the other hand, as reported above, the stock of accrued, but unrealized, gains may be substan-

[11] Real estate includes taxable sales of personal residences, residential rental property, and land other than farmland.

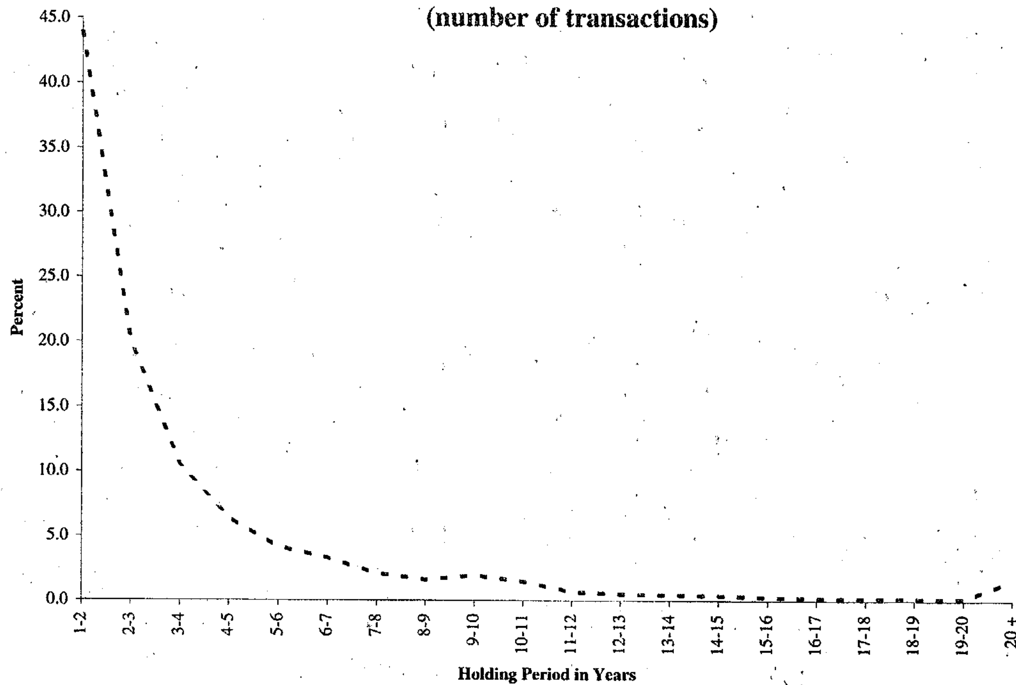
[12] 1989 data from tabulations of the 1989 Sale of Capital Assets file from the Statistics of Income Division of the Internal Revenue Service. This encompasses reporting of transactions beyond those reported on Schedule D.

[13] These figures draw on the same sample of individual taxpayer transactions reported on Schedule D in 1994 as were Figures 1a and 1b. Appendix Table A.2 contains the data underlying Figures 2a and 2b. As Figures 1a and 1b demonstrated, in 1994, these sales of corporate stock dominate these data.

[14] The data underlying Figures 3a and 3b is in Appendix Table A.3.

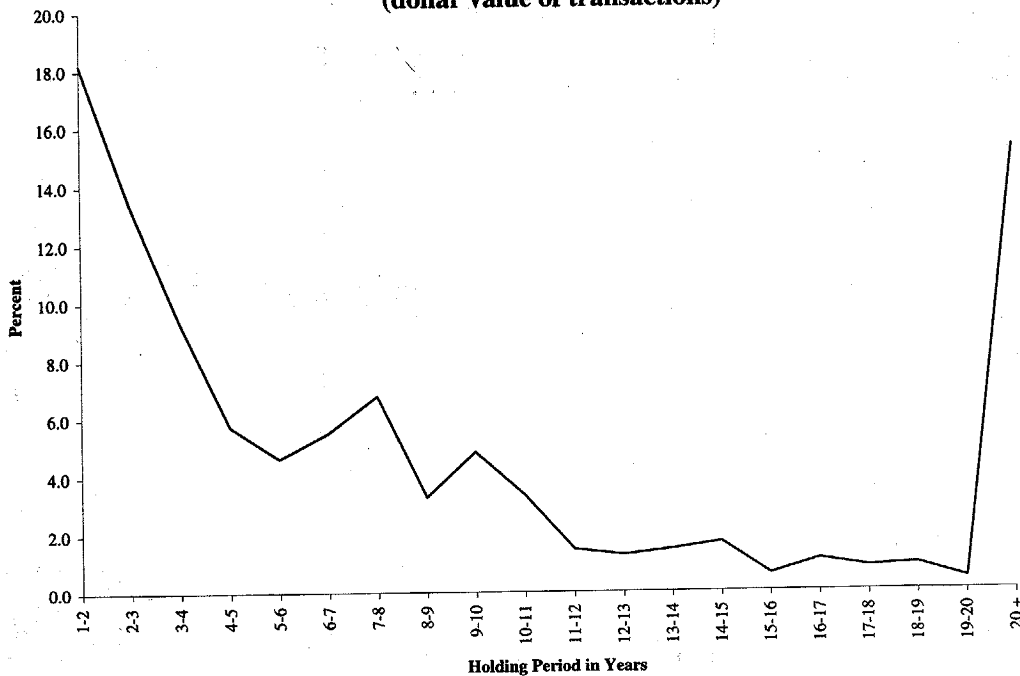
tial in comparison to annual asset dispositions. This does not make it possible to assess the median holding period of all capital assets.

Figure 2a.--Percentage Distribution of Holding Period of Long-Term Gains, 1994 (number of transactions)



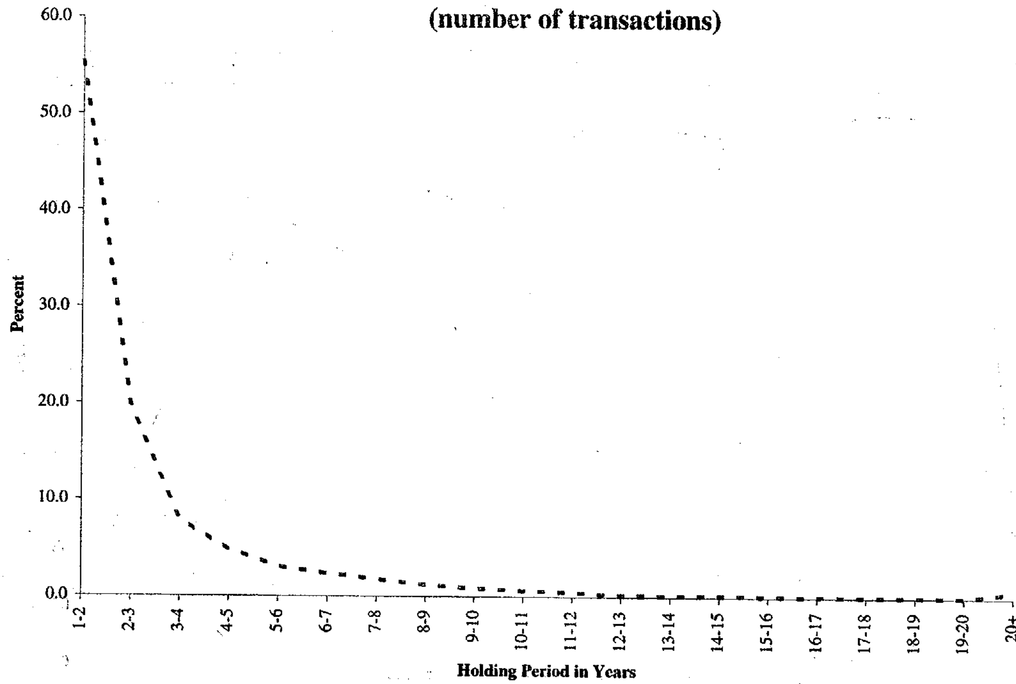
NOTE: Sample from Schedule D may not be representative of all gain recognitions.

Figure 2b.--Percentage Distribution of Holding Period of Long-Term Gains, 1994 (dollar value of transactions)



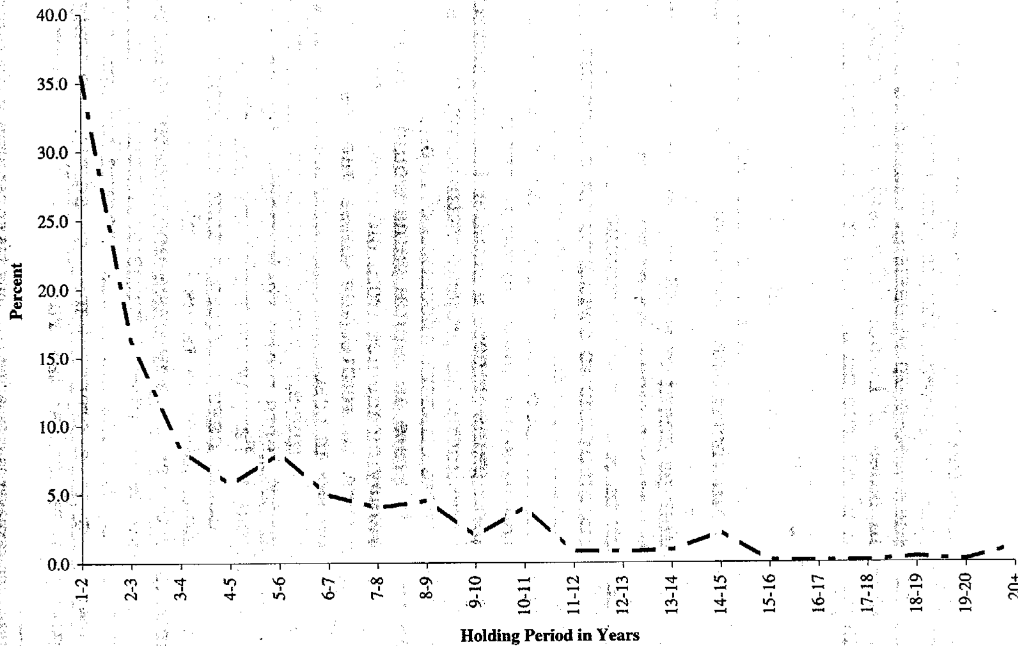
NOTE: Sample from Schedule D may not be representative of all gain recognitions.

Figure 3a.--Percentage Distribution of Holding Period of Long-Term Losses, 1994 (number of transactions)



NOTE: Sample from Schedule D may not be representative of all loss recognitions.

Figure 3b.--Percentage Distribution of Holding Period of Long-Term Losses, 1994 (dollar value of transactions)



NOTE: Sample from Schedule D may not be representative of all loss recognitions.

B. Issues Relating to a Reduced Tax on Capital Gains

Arguments for reduced tax on capital gains

Lock-in

Many argue that higher income tax rates discourage sales of assets. For individual taxpayers, this lock-in effect is exacerbated by the rules that 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 that 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 net $932 after payment of $168 tax on the gain of $600. 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.[15] Thus, the taxpayer is said to be "locked in" to the existing, lower-earning investment. Preferential tax rates on capital gains impose a smaller tax on redirecting monies from older investments to projects with better prospects, which contributes 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. When the tax imposed on removing monies from old investments is reduced, taxpayers would not necessarily redirect their funds to new investments when their monies in the older investments are unlocked. Taxpayers might instead choose to consume the proceeds.[16] 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. Lock in could be eliminated while still taxing gains upon their realization by varying the tax to the size and holding period of the gain. However, such a proposal may be administratively complex. Alternatively, preferential tax rates only for gains on newly ac-

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[15] Intuitively, the taxpayer is comparing retaining his or her funds in the current investment as opposed to switching those funds to an alternative investment. If the taxpayer switches investments, by recognizing gain and paying tax, the taxpayer has a smaller principal amount to invest in the alternative investment than if he or she were to retain the funds in the current investment. Because the taxpayer will have a smaller invested principal in the alternative investment, the alternative investment may have to earn substantially higher returns than would the current investment, for the taxpayer's wealth to be greater by making the switch.

[16] One study argues that second mortgages (or home equity loans or lines of credit) permit taxpayers to "realize" accrued capital gains on their personal residences without paying tax. The study presents data that 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. Another study observes that because capital gains realizations are positively correlated to a taxpayer's "permanent," or long-run average, income and negatively correlated to "transitory" income (short run deviations about permanent income) many realization decisions might be motivated by a consumption motive. See Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Review*, 84, September 1994, pp. 794-809.

quired assets would increase the after-tax return to new investments, thereby making reallocation of investment funds more attractive than currently is the case.

Proponents of a preferential tax rate on corporate capital gains observe that corporations have the same ability to defer realization and, consequently corporations can be subject to substantial lock-in effects. However, opponents have argued that the lock-in effect should not be as strong for capital gains accrued on assets held by corporations as on assets held by individual taxpayers because corporate assets do not receive the benefit of a step up in basis at death. Also, many 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 the timing of realization of corporate assets.

Incentives for equity investments and risk taking

A second argument for preferential capital gains tax rates is that they encourage investors to buy corporate stock, and especially encourage investors to provide venture capital for new companies, thereby stimulating investment in productive business activities. This argument was important in the 1978 debate over capital gains taxes, and a large growth in the availability of venture capital occurred after 1978. In theory, when a tax system accords full offset for capital losses (see below for further discussion of losses), a reduction in tax rates applicable to capital gains and losses would reduce risk taking. This is because with full loss offset the government acts like a partner in the investment, bearing an equal share of the risk, both good and bad.[17] However, the present-law limitation on taxpayers' ability to offset capital losses against other income creates a bias against risk taking by implicitly reducing the value of any loss by deferring its inclusion in income. A reduction in the tax rate on realized gain, proponents argue, therefore should increase risk taking. Proponents argue that the preference provides an incentive for investment and capital formation, with particular importance for 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, broadly applied, is not targeted toward any particular type of equity investment. They observe that present-law section 1202 (that provides certain small businesses with a reduced tax on realized capital gains) and present-law section 1244 (that provides expanded loss offset for investments in certain small business stock) more specifically target risk-taking activities. Replacing those provisions with a broadly applicable capital gains preference may place such investments at a relative disadvantage as compared to present law. 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.

Moreover, opponents of a capital gains preference point out that a tax preference could have only a small incentive effect on invest-

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[17] Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk Taking," *Quarterly Journal of Economics*, 58, May 1944.

ment because a large source of venture capital and other equity investment is tax-exempt or partially tax-exempt entities (for example, pension funds and certain insurance companies and foreign investors). For example, 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 preferential capital gains treatment for venture capitalists who are taxable is important. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital. They further observe that initial investors in new ventures are frequently friends and family of the entrepreneur, all of whom are taxable. The organized venture capitalists are more prevalent at later stages of financing.

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.

Savings incentive

The United States has a relatively low rate of household saving, currently less than 5 percent of disposable income. This rate is low both in comparison to other industrialized countries and in comparison to prior United States experience. At the aggregate level, a low saving rate is a concern because saving provides the wherewithal for investment in productivity-enhancing equipment and technology. At the household level, a low saving rate may imply households are accumulating insufficient assets for retirement, emergencies, or other uses.[19] By reducing the tax on realized capital gains, the after-tax return to household saving is increased.

Theoretically, the effect on saving of a reduction of taxes on capital income is ambiguous. There are two effects. First, the increased return to saving should encourage people to save more. Second, the increased return people receive on assets they have already accumulated and on saving they had already planned increases their income. This increased income may encourage them to increase their consumption and may reduce their saving. Empirical economic evidence also is ambiguous on whether, and in what magnitude, household saving responds to changes in the after-tax rate of return.[20]

In addition, reduction in only the tax applicable to capital gains may prove to be an inefficient saving incentive. By favoring certain types of assets (those that generate returns in the form of accrued gains) over other types of assets (those that generate returns in the

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

[19] For a discussion of the importance of saving in the economy and a review of U.S. savings rates over the past three decades and in comparison to that of other countries, see Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving and IRAs* (JCS-2-97), March 3, 1997.

[20] For a brief review of the economic literature on taxpayer response to savings incentives, see Joint Committee on Taxation, *Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution* (JCS-18-91), December 12, 1991, pp. 48-49.

form of interest, dividends, or royalties), taxpayers may reallocate their holdings of assets to obtain higher after-tax returns without saving new funds. Such portfolio reallocations also represent reduced efficiency of capital markets as choices have been distorted. As noted above, the application of a reduced tax on capital gains to those who currently hold assets with accrued gains could lead to reduced saving as households sell those assets and increase consumption from the proceeds.

Competitiveness

Related to the argument that preferential capital gains tax rates encourage saving and 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 capital 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, the highest tax rate on capital gains in Canada is less than 25 percent. Japan imposes a tax at the taxpayer's discretion of either one percent of the gross proceeds or 20 percent of the gain, a rate below the maximum United States rate. In Germany, generally all long-term gains are exempt from income 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, estate taxes, net wealth taxes,[21] as well as taxes on capital gains, all may affect the cost of capital. Proponents of a capital gains tax reduction contend that any reduction in a tax on capital should contribute to a reduction in 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. Tax rates on corporate income, interest, and dividends are often lower in the United States than in other countries. Moreover, because of the ability to defer gains, the opportunity to receive a step-up in basis at death, and the 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 study calculated that prior to 1987 the effective marginal tax rate on capital gains, including State taxes, was less than 6 percent.[22] On the other hand, while other industrialized countries have lowered their tax rates since 1987, the United States has increased individual and corporate income tax rates.

Bunching

Because capital gain is generally not taxed until a disposition of an asset, taxpayers can face large jumps in taxable income when

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

[22] 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.

a 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.

On the other hand, the maximum tax rate of 28 percent applicable to capital gains under present law diminishes the amount of bunching and so, presumably, reduces the need for a further reduction in the tax rate as a remedy for it. Some 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.

Inflation

While issues relating to indexing the basis of capital assets are discussed in more detail below, 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 an important factor in the 1978 capital gains rate reduction. Proponents observe that a preferential capital gains tax rate may provide to taxpayers some rough compensation for inflation.

Others note that a preferential tax rate is a very crude adjustment for inflation. For example, since 1980 the price level approximately has doubled. Thus, an asset purchased in 1980 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 1990 for $1,000 and sold it today for $2,000, a reduction in the tax rate from 28 percent to 19.8 percent would more than offset the effects of inflation over the past seven years.[23] 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

Preferential 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 that have increased in value (presumably by retained earnings) are sold. However, preferential capital gains treatment is a very inexact means of reducing any double taxation. 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 still would be generally subject to double taxation.

Arguments against a reduced tax on capital gains

Measurement of income

Opponents of a reduced tax on capital gains argue that appreciating assets already enjoy a tax benefit from the deferral of tax

[23] Cumulative inflation since 1990 has totaled slightly over 21 percent.

on accrued appreciation until the asset is sold, which benefit reduces in whole or in part any bunching or inflationary effects.[24] As a result, the effective rate of taxation on realized capital gains is less than the rate of taxation applicable to assets that pay current income. The following example illustrates the benefit of deferral. Assume a taxpayer in the 28-percent tax bracket has $1,000 to invest and may choose between two investment alternatives, each of which generates a return of 10 percent annually. Assume the one investment is a certificate of deposit that pays the 10-percent return out annually as interest on which the taxpayer must pay tax. After paying tax, the taxpayer reinvests the principal and net proceeds in a new certificate of deposit. The other investment, stock in a company that pays no dividends, accrues the 10-percent return untaxed until a capital gain is realized. After eight years the after-tax value of the taxpayer's certificate of deposit would be $1,744.[25] After selling the stock and paying tax on the realized gain, the taxpayer would have $1,823.[26] In this particular example, the effective rate of taxation on the realized capital gain is 22 percent, rather than the statutory tax rate of 28 percent.[27]

In addition, if capital assets are debt-financed, inflation will reduce the real cost of borrowing to the extent interest is deductible and interest rates on that debt do not rise to compensate for the reduced value of principal repayments. 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.[28]

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 form of asset appreciation rather than current income such as dividends or interest. On the other hand, it is argued that asset 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.

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

[25] This is calculated as $1,000(1 + r(1 - t))^n$, where r is the interest rate (10 percent in this example), t is the marginal tax rate (28 percent in this example), and n is the number of years the asset is held (eight in this example).

[26] This is calculated as the $1,000 principal plus the net, after-tax gain of $(1,000(1 + r)^n - 1,000)(1 - t)$, where r is the interest rate (10 percent), t is the marginal tax rate (28 percent), and n is the number of years the asset is held (eight).

[27] The effective rate of taxation on a realized gain is calculated by asking what rate of tax on an asset that paid current income would yield an equivalent amount of net proceeds to the taxpayer if that asset were held until the taxpayer realized the capital gain.

[28] More detailed discussion of issues relating to indexation of capital gains is below (IV. C. "Issues Relating to Indexing").

Reduction of "conversion" opportunities

Opponents of the preferential capital gains rate contend that it also encourages taxpayers to enter transactions designed to convert 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[29] 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, the passive loss limitations of present law and "anti-conversion provisions" such as present-law section 1258 limit taxpayers' benefit or ability to "convert" ordinary income to capital gains.

Simplification and consistent treatment of taxpayers

Opponents of a 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 some 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.

On the other hand, it is argued that so long as a limitation on deductions of capital loss is retained, some areas of uncertainty and dispute will continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business). Because (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 potential for simplification and consistency may be limited.

C. Issues Relating to Indexing

In general

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

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

Opponents contend that indexing is complex and that it would not be necessary if efforts to control inflation are successful.

Inflation and effective real tax rates

Under present law, even modest annual inflation can significantly increase the effective real tax rate on income from realized capital gains. For example, assume an investor purchases stock for $100 and the stock appreciates in value at 10 percent per year. After five years the stock will be worth $161. If sold, and the investor is in the 28-percent tax bracket, the investor will incur a tax liability of $17. If over that five-year period inflation had averaged 3 percent per year, the investor would have needed to realize $116 from the sale of the asset to maintain his or her real purchasing power. Consequently, the investor's real gain is $45. A $17 tax on a $45 real gain implies an effective tax rate of 37.8 percent on real gains as compared to the statutory rate of 28 percent.

Table 1 reports transactions by a sample of individuals who realized nominal long-term capital gains on corporate stock in 1994.[30] For holding periods between one year and 19 years, the staff of the Joint Committee on Taxation has calculated a real (inflation-adjusted) capital gain.[31] The third column reports the aggregate dollar value of nominal gains by length of holding period. It is nominal gain on which tax is assessed under present law. The fourth column calculates the aggregate real (inflation-adjusted) dollar value of those nominal gains. The fifth column calculates the inflationary component of the nominal gain (nominal gain less real gain) as a percentage of the nominal gain. Hence, of assets acquired in 1992 and sold at a nominal gain in 1994, 20.6 percent of the gain was the inflation component on average. This implies the effective tax rate on real capital gains was increased, on average, by 25 percent by inflation. A similar study of taxable sales of corporate stock in 1973 calculated that of the $1,138 million in tax paid on nominal gains, only $661 million represented taxes attributable to the real component of that year's nominal gains.[32]

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[30] The data in Table 1 are drawn from the same sample of individual taxpayer transactions reported on Schedule D in 1994 as were Figures 1a and 1b. The transactions are limited to those with net gain on corporate stock and holding period between one and 19 years.

[31] The staff of the Joint Committee on Taxation calculated the inflation component by taking the taxpayer's reported basis and increasing it by the cumulative inflation, as measured by the change in the CPI, that occurred between the taxpayer's year of acquisition and 1994 (the year of sale). This assumes, for example, that all assets acquired in 1990 and disposed of in 1994 were held for four years. In reality the holding period of some assets acquired in 1990 and disposed of in 1994 will include some assets held for three years and one month and some held for four years and eleven months.

The real component was calculated as the difference between the nominal gain and the inflationary component. For the purposes of this calculation nominal gains were permitted to become real losses. This particular calculation is not intended to correspond to the manner in which any legislative proposal would index for the purpose of calculating gain.

[32] Martin Feldstein and Joel Slemrod, "Inflation and the Excess Taxation of Capital Gains on Corporate Stock," *National Tax Journal*, 31, June 1978, pp. 107-118.

Table 1.—Inflationary Component of Nominal Long-Term Gains Realized on Corporate Stock, 1994

Holding period in years	Number of transactions	Dollar value of nominal gains ($ millions)	Dollar value of real gains ($ millions)	Inflation component as a percentage of nominal gain
1	64,428	486.4	407.6	16.2
2	29,945	359.2	285.3	20.6
3	15,421	249.9	170.6	31.7
4	9,345	153.4	75.0	51.1
5	6,089	123.9	60.0	51.5
6	4,818	147.5	80.3	45.6
7	3,084	181.3	122.8	32.3
8	2,357	88.1	44.1	49.9
9	2,844	129.5	59.5	54.1
10	2,154	89.9	41.4	54.0
11	1,021	39.4	21.6	45.2
12	740	33.9	19.1	43.7
13	623	39.2	25.0	36.2
14	595	45.5	30.5	33.1
15	291	15.7	4.8	69.2
16	270	29.1	−3.6	112.2
17	251	22.0	11.2	48.9
18	261	34.0	20.9	38.5
19	239	10.8	2.5	77.3

Note.—Sample from Schedule D may not be representative of all gain recognition.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service SOI data.

While, as discussed in Part IV.B., above, the benefit of deferral can reduce the effective tax rate, proponents of indexing observe that because inflation is not predictable, non-indexed taxation implies an uncertain effective rate of taxation. This added uncertainty may discourage saving generally and, in particular, saving in assets that produce their returns in the form of accruing capital gains.

Non-indexed taxation of gain and saving and investment

In most respects, indexing the basis of capital assets for the purpose of determining gain may be thought of as providing an exclusion for gain that varies with the holding period of the asset. As such, the arguments discussed in Part IV.B., above, regarding the lock-in effect, household saving, the cost of capital, and risk taking generally would apply to the indexation of basis for the purpose of determining gain.

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 aris-

ing from inflation. Some critics question the value of indexing as a policy to promote risk taking. They observe that much of the basis of entrepreneurial effort, so-called "sweat equity," has a nominal basis of zero, and that indexing a zero basis provides no benefit.

To the extent the indexed basis is not used to compute a loss, it would create a notch at an index gain-value of zero. Such a notch produces inefficiencies in the taxation of real gains in much the same manner as present-law restrictions on using capital losses to offset other income. Such a notch is arguably inequitable as taxpayers with different nominal gains would be treated as having no real gain despite experiencing different losses in consumer purchasing power. On the other hand, to permit indexation for the determination of loss may create opportunities to create paper losses and expand the possibilities for tax arbitrage.

Issues related to partial indexing

Indexing income, but not expense

Indexation of income without indexation of cost may increase the possibility for tax arbitrage. 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 debt-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 -- i.e., 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, the taxpayer has $10 of gain and $10 of offsetting deductible interest, again producing no after-tax net cash flow.[33] 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.[34] Thus, because

[33] Full indexing and no indexing generally will only achieve the same results where the asset is full debt-financed (i.e., the basis of the asset and the liability are the same).

[34] 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 both a pre-tax and after-tax positive net cash flow of $5. Of course, under present law receipts of nominal interest payments represents income to the lender. In real, inflation-adjusted, terms the lender's income is overstated. This increases the effective tax rate on real interest income earned by lenders.

equity assets are indexed while debt is not, taxpayers will have an incentive to engage in transactions to take advantage of this tax arbitrage. This may increase the need for anti-arbitrage rules, which would increase the administrative cost and complexity of the tax system.

Defining indexed assets

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 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-indexed 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.

Complexity

Indexing would involve a significant amount of recordkeeping. Records of the cost of property and improvements are generally maintained under present law. However, records of the dates the cost are incurred are not relevant to the determination of tax liability once the asset has been held for one year.

Indexing would substantially increase the number of calculations necessary to calculate taxable gain for many common transactions. For example, consider an individual who sells stock in a regular corporation or in a mutual fund that was purchased 10 years before the sale and who reinvested the quarterly dividends in additional stock during the entire period. Under present law, 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. Assuming qualified assets must be held for three years before the benefits of indexing can be claimed, each of the first 29 of the 41 components of basis (the original purchase plus the 40 dividend payments) would be multiplied separately by indexing factors based on the period elapsed between the calendar quarter the stock was purchased and it was sold, in order to determine the indexed basis of the stock for purposes of determining

long-term indexed gain. The nominal basis of each of the next eight purchases would be added together, as under present law, to determine the basis of non-indexed long-term gain. As under present law, the nominal basis of each of the last four purchases would be added together to determine the basis of non-indexed short-term gain. Further, if the corporation or mutual fund had ever paid a return of capital distribution, adjustments would be needed to the basis of each separate block of stock. Similarly, if capital improvements were made to qualified property, records of the dates of improvements would have to be maintained in order to compute the basis of the property.

The basis adjustments to indexed assets held by passthrough entities such as partnerships, S corporations, common trust funds, regulated investment companies (RICs) and real estate investment companies (REITs) need to be reflected in the investor's basis in those entities. For example, the basis of a partnership 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 those interests. Even where the adjustments are passed through to the shareholders or investors, discrepancies and complexities may arise where there is a change in interest in the pass-through entity.

Property may be acquired or disposed of pursuant to options, forward contracts, regulated future contracts, installment sales and contracts requiring contingent payments. A system of full indexing would need to consider the treatment of each of these instruments. Under a partial indexing system that does not take into account debt, the timing of the amounts paid or received under these instruments are ignored on the grounds that there are two parties to the transaction, and if both parties to the transaction are denied indexing, the amount of indexing adjustments in the entire system is maintained. However, where parties are in different tax brackets, the tax system may not be made whole and tax planning is possible.[35]

In 1982, in response to high levels of inflation, the United Kingdom adopted a partial indexing system for inflation after 1982. The administrative burden in the United Kingdom is eased by providing all taxpayers with a 100-percent exclusion for the first 5,800 pounds sterling (approximately $9,000) of gains realized. Consequently, capital gains taxation applies to less than 1 percent of individual taxpayers in the United Kingdom. This means many taxpayers never have to make the computations required by indexing. While it may be the case that the less than 1 percent of British taxpayers who index their realized capital gains are those with the more complex transactions, according to British tax professionals, taxpayers generally cannot compute their gains without professional advice. The calculations are not particularly difficult for professionals and have increased the demand for professional tax preparers. Nevertheless, the tax administrators have found indexing

[35] To the extent that lenders are in lower tax brackets than borrowers (the so-called "clientele effect"), the value of the tax deductions for interest claimed will exceed the value of taxes collected from interest income.

difficult to administer, and reportedly compliance has suffered.[36] The United Kingdom has frequently adopted new legislation and regulations to combat the problem of arbitrage.

Further, with preferential capital gains treatment for some types of assets, depending upon the rate of inflation, taxpayers will have an incentive to engage in transactions designed to convert ordinary income to capital gains income. Thus, the complex provisions of present law dealing with situations in which capital gains treatment is available (for example, the collapsible partnership rules) will continue to be necessary.

Choice of price index

The rationale for indexing capital gains, and for the present-law indexing of various provisions of the Code, is to better measure the real income available to taxpayers. One price index that could be used to adjust basis for the purpose of computing gain is the Department of Commerce's Bureau of Economic Analysis's GDP deflator.[37] Another alternative index would be the Labor Department's Bureau of Labor Statistics's Consumer Price Index (CPI). The Code generally uses the CPI to index provisions related to individual taxpayers. Use of the CPI would provide consistency in the measurement of real income.

Recently, some economists have criticized the CPI as an accurate measure of consumer cost of living. The CPI is a fixed-basket price index. Given an identified basket of "consumer" goods, the CPI is estimated by comparing estimated prices for the "same" goods in one year compared to another year. Generally speaking, the CPI requires estimates of prices only. The purpose of measuring consumer purchases is to approximate consumer well-being. The primary drawback of a fixed-basket price index is that, through time, the basket may fail to represent consumer purchases. For example, if gas prices move higher, consumers may substitute public transportation for consumption of gasoline. An additional problem is identifying the "same" goods in different years, that is adjusting for quality changes. For example, one should not compare the average personal computer of 1997 with the average personal computer of 1990 as the average 1990 computer was much less powerful than the average 1997 computer.

The GDP deflator is not a fixed-basket price index. The GDP deflator is determined by estimating quantities of output of different goods in one year and identifying prices for those goods. Quantities of goods are then estimated for a subsequent year and prices are identified for those goods. The GDP deflator requires estimates of both quantities and prices. The GDP deflator will vary with the composition of GDP. As a measure tied to GDP, the GDP deflator also picks up certain international transactions, such as the value of U.S. goods sold abroad. One may not see such transactions as indicative of U.S. prices, but rather pricing conditions abroad. Similarly, the GDP deflator measures an economy average, including intermediate goods, and may not reflect inflation relevant

[36] As reported in Andrew Hoerner, "Indexing Capital Gains: The British Experience", *Tax Notes Today*, February 23, 1990.

[37] The U.S. Department of Commerce, Bureau of Economic Analysis, now more often refers to this measure as "the implicit price deflator for gross domestic purchases."

to individual taxpayer purchases of consumer products. An alternative that uses the same methodology as the GDP deflator would be the Bureau of Economic Analysis's Implicit Price Deflator for Personal Consumption Expenditures.

An additional consideration may be the need to maintain some constancy to the index, as taxpayers may hold assets for 20 years or more before selling the asset. The CPI is never revised, save for identification of new base year baskets. National income and product account data go through multiple revisions. The Bureau of Economic Analysis makes monthly revisions to its price deflators, an annual revision, and every five years makes further revisions when it changes its benchmark year.

D. Capital Gains and Losses on Owner-Occupied Housing

Present law imposes tax on the gain from a sale of personal residence in limited circumstances. Critics of present law note that the disparate taxation of gain depending upon the disposition of proceeds or age of the taxpayer may distort taxpayer choice leading to inefficient outcomes. Assuming the principal residence is sold at a gain, because the taxpayer pays tax when he or she moves to a less expensive home, but not to a more expensive home, there is no incentive for the taxpayer to reduce the size of the housing they consume. This may cause taxpayers to invest more of their saving in owner-occupied housing and make less available for alternative investments such as plant and equipment. Similarly, present law may discourage the taxpayer from redeploying his or her assets from home ownership to other uses by becoming a renter. As discussed in Part IV.B., above, the taxpayer may be "locked-in" to more homeownership than would be efficient for the economy. Critics of present law observe that because the tax can be avoided through deferral (sec. 1034) and the one-time exclusion (sec. 121), little revenue is collected on the sale of principal residences, so the efficiency losses to the economy are made in exchange for relatively little revenue gain. In addition, they note that there may be substantial noncompliance with present law. For example, in 1993 the National Association of Realtors reported 3.8 million home sales which is more than twice the amount of sales reported by taxpayers filing Form 2119.[38] Proposals that excluded all, or a substantial portion of, gain on the sale of a principal residence would mitigate these concerns.

Opponents of such changes counter that owner-occupied housing already is tax-favored. Some opponents believe that the favorable treatment accorded owner-occupied housing under present law has distorted aggregate investment towards housing and away from plant and equipment. They argue that an expansion of preferential treatment of gain on owner-occupied housing would increase inefficiency in investment decisions.

[38] Most observers believe that it is unlikely that half of that year's home sales occurred at a loss. Even if sold at a loss, taxpayers deferring recognition of gain under section 1034 should file Form 2119. For a discussion of inefficiencies created by present law, see Leonard E. Burman, Sally Wallace, and David Weiner, "How Capital Gains Taxes Distort Homeowners' Decisions," photocopy, November 1996. Burman, Wallace, and Weiner estimate the extent to which present homeowners are discouraged from "downsizing."

Proponents of permitting taxpayers to claim as capital loss any loss realized on the sale of their principal residence argue that because capital gains on a sale or exchange of a principal residence are taxable, losses on similar sales or exchanges should be treated as capital losses. As such losses represent a reduction in the taxpayer's wealth, it is also argued that the losses should be taken into account by the tax system to provide a better measure of economic income.

In response, it is argued that in practice many capital gains on the sale or exchange of principal residences are not taxed (e.g., through the operation of the sec. 1034 rollover provision and the sec. 121 one-time $125,000 exclusion for taxpayers aged 55 or over); therefore, capital losses on similar sales or exchanges should not be allowed. To permit recognition of losses would favor purchases of principal residences over other forms of investments that do not receive preferential taxation upon the payment of dividends or interest or recognition of gain. Another counter-argument is that not all economic losses are recognized for tax purposes. Taxpayers purchase homes, cars, and other consumer durable goods primarily for consumption purposes. Many losses arise from use and physical depreciation of such goods. For example, it is argued that if a taxpayer purchases a new car for $20,000 (for personal use) and sells it five years later for less than $20,000, he or she should not be allowed a capital loss.

E. Capital Loss Deduction Limit

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 supports retention of a limitation on the deduction of capital or investment losses, even if capital or investment gains are 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 mark-to-market system (parallel to the 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 the 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 deduc-

tion 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

Prior law required that long-term losses be reduced by 50 percent when deducted against ordinary income (up to the $3,000 limit). That rule 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 less than the full value 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.

F. Distributional Effects of a Reduction in Capital Gains

Either an exclusion from income or indexing the basis of capital assets will benefit directly those taxpayers who hold assets with accrued capital gains. Information is somewhat scant regarding the distribution of assets with accrued capital gains among different taxpayers. Tax return data contain information on which taxpayers have realized capital gains in the past. These data reveal that many taxpayers realize a capital gain from time to time, but the majority of the dollar value of gains realized are by taxpayers who frequently realize capital gains. For example, the staff of the Joint Committee on Taxation studied a panel representative of the more than 15 million taxpayers who realized capital gains between 1979 and 1983. Approximately 44 percent of those taxpayers realized capital gains in only one year of that five-year period, and the gains realized by that 44 percent of taxpayers accounted for approximately 10 percent of the dollar value of gains realized. Taxpayers who realized gains in each of the five years comprised approximately 16 percent of the sample, but accounted for approximately 60 percent of the dollar value of gains realized.[39] Results

[39] Joint Committee on Taxation, *Explanation of Methodology Used to Estimate Proposals Affecting the Taxation of Income from Capital Gains* (JCS-12-90), March 27, 1990, pp. 48-49.

of similar magnitude are found for at data for any one year. The staff of the Joint Committee on Taxation found that in 1985, 44 percent of all taxpayers who reported gains reported only one transaction and those transactions accounted for 21 percent of the dollar value of all gains realized in 1985. Consequently, nearly 80 percent of all gains realized in 1985 were realized by those taxpayers who realized more than one gain in that year.[40] Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, the bulk of the dollar value of any tax reduction will go to those taxpayers who realize the bulk of the dollar value of gains.

The data also suggest that taxpayers who infrequently realized capital gains generally have lower incomes than those taxpayers who frequently realized capital gains. These findings have been criticized because income is sometimes measured including the realized gain. However, attempts to account for this problem by measuring income less realized gains or by using a measure of income averaged over a period of years generally reveal that a large portion of the dollar value of gains are realized by higher-income taxpayers while a large portion of the transactions in which gains are realized are undertaken by the remaining taxpayers. Such findings are consistent with information on the ownership of assets in the United States. Higher-income taxpayers generally hold a larger proportion of corporate stock and other capital assets than do other taxpayers. Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, a larger proportion of the dollar value of any tax reduction will go to those higher-income taxpayers who realize the bulk of the dollar value of gains.

Although an exclusion and indexation of basis have similar economic effects, the distribution of expected benefits of the two proposals might be expected to differ somewhat. This is because an exclusion applies to the total gain, excluding from income both a portion of the inflationary gain and the real gain, while indexation only excludes the inflationary gain. If different taxpayers hold different assets and the assets experience different real returns, the benefits of an exclusion as compared to indexing will differ across different taxpayers. For example, older taxpayers may be more concerned with preservation of their principal and seek to hold less risky assets. Similarly, higher-income taxpayers generally are more willing to accept riskier investments. To compensate for risk, more risky assets generate, on average, higher returns than less risky assets. Such returns to risk are not inflationary returns but real returns. Indexing provides no tax benefit to such risk premiums earned by investors. All else being equal, an exclusion might be expected to offer greater tax benefits to higher-income taxpayers (who invest in more risky assets) than would indexing.

[40] Joint Committee on Taxation, *Explanation of Methodology*, p. 49.

APPENDIX

Table A.1.—Distribution of Transactions and Gains By Asset Type For Transactions With Net Long-Term Gain, 1994, As Reported on Schedule D

Asset type	Number of transactions with net gain	Dollar value of net gains	Percentage of all transactions	Percentage of total value of all gains
Corporate Stock	108,198	2,329,742,349	73.6	78.2
U.S. Government Obligations	4,239	30,681,504	2.9	1.0
State & Local Government Obligations	15,138	89,322,884	10.3	3.0
Other Bonds, Notes, & Debts	2,410	32,424,537	1.6	1.1
Put and Call Options	874	5,757,473	0.6	0.2
Commodities and Futures	(1)	(1)	(1)	(1)
Tax-Exempt Municipal Bond Funds	2,864	6,276,992	1.9	0.2
Interests in Partnerships/S Corporations	1,488	221,587,471	1.0	7.4
Mutual Funds	8,255	49,741,609	5.6	1.7
Livestock	(1)	(1)	(1)	(1)
Timber	105	5,724,489	0.1	0.2
Involuntary Conversions, Other Than Casualties/Thefts	(1)	(1)	(1)	(1)
Residential Rental Property	510	35,058,048	0.3	1.2
Depreciable Business Personal Property	(1)	(1)	(1)	(1)
Depreciable Business Real Property	(1)	(1)	(1)	(1)
Land Other Than Farmland	1,164	82,227,427	0.8	2.8
Farmland and Ranches	(1)	(1)	(1)	(1)
Residences	(1)	(1)	(1)	(1)

Footnote at end of table.

Other Assets	1,145	69,652,381	0.8	2.3
Unidentifiable Assets	522	19,643,541	0.4	0.7
Pass Through, Not Elsewhere Classified	(1)	(1)	(1)	(1)
Totals	146,912	2,977,840,705	100	100

[1] Fewer than 100 transactions; dollar amounts not disclosed.

Note.—Sample from Schedule D may not be representative of all gain recognitions.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service SOI data.

Table A.2.—Transactions With Long-Term Gains, By Holding Period, 1994, As Reported on Schedule D

Holding period in years	Number of transactions	Dollar value of gains	Percentage of total transactions	Percentage of total value of gains
1–2	64,428	486,388,482	44.0	18.2
2–3	29,345	359,160,421	20.0	13.4
3–4	15,421	249,850,605	10.5	9.3
4–5	9,345	153,370,504	6.4	5.7
5–6	6,089	123,891,319	4.2	4.6
6–7	4,818	147,468,480	3.3	5.5
7–8	3,084	181,272,115	2.1	6.8
8–9	2,357	88,066,537	1.6	3.3
9–10	2,844	129,482,931	1.9	4.8
10–11	2,154	89,853,595	1.5	3.4
11–12	1,021	39,410,985	0.7	1.5
12–13	740	33,913,789	0.5	1.3
13–14	623	39,223,290	0.4	1.5
14–15	595	45,527,637	0.4	1.7
15–16	391	15,674,162	0.3	0.6
16–17	270	29,080,531	0.2	1.1
17–18	251	21,981,705	0.2	0.8
18–19	261	23,990,520	0.2	0.9
19–20	239	10,790,886	0.2	0.4
20+	2,274	406,686,449	1.6	15.2
Totals	146,550	2,675,083,943	100.0	100

Note.—Sample from Schedule D may not be representative of all gain recognitions.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service SOI data.

Table A.3.—Transactions With Capital Losses By Holding Period, 1994, As Reported on Schedule D

Holding period in years	Number of loss transactions	Dollar value of losses	Number of transactions percentage	Dollar value of transactions percentage
1–2	56,828	449,941,281	55.5	35.6
2–3	20,259	206,118,499	19.8	16.3
3–4	8,065	104,203,849	7.9	8.2
4–5	4,944	73,006,333	4.8	5.8
5–6	3,133	100,663,605	3.1	8.0
6–7	2,398	62,209,894	2.3	4.9
7–8	1,817	50,750,354	1.8	4.0
8–9	1,245	57,061,087	1.2	4.5
9–10	886	24,980,927	0.9	2.0
10–11	638	50,418,466	0.6	4.0
11–12	492	10,259,088	0.5	0.8
12–13	205	10,266,616	0.2	0.8
13–14	186	11,458,411	0.2	0.9
14–15	196	27,161,379	0.2	2.1
15–16	127	1,754,878	0.1	0.1
16–17	102	1,329,719	0.1	0.1
17–18	62	1,454,582	0.1	0.1
18–19	64	4,596,337	0.1	0.4
19–20	64	2,215,849	0.1	0.2
20+	646	14,188,061	0.6	1.1
Totals	102,357	1,264,039,215	100	100

Note.—Sample from Schedule D may not be representative of all loss recognitions.

Source: Joint Committee on Taxation staff calculations from Internal Revenue Service SOI data.

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