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TAX TREATMENT OF CAPITAL GAINS AND LOSSES

SCHEDULED FOR PUBLIC HEARINGS

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PREPARED BY THE STAFF

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INTRODUCTION

The Senate Committee on Finance has scheduled public hearings on February 15 and 16, 1995, 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, 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 legislative proposals. Part IV is a description of President Bush's fiscal year 1991 legislative proposal. Part V is an analysis of issues.

[1] This pamphlet may be cited as follows: *Tax Treatment of Capital Gains and Losses* (JCS–4–95), February 13, 1995.

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 or-

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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).

dinary losses. However, net gain from such property is recharacterized as ordinary income to the extent net losses from such property in the previous 5 years were treated as ordinary losses. The assets eligible for this treatment include depreciable property or land held for more than one year and used in a trade or business (if not includible in inventory and not held primarily for sale to customers in the ordinary course of business), 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 stock). 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 taxpayer attempts to realize the value of an anticipated future ordinary income stream through the sale of a "capital" asset, such as stock in a corporation, or an interest in a partnership, that holds the income-producing asset.

Present law contains statutory rules intended to prevent such use of partnerships and corporations to convert what otherwise would be ordinary income into capital gains from the disposition of stock or a partnership interest. These provisions (secs. 341 and 751) 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 deducted 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, involuntary conversions followed by an acquisition of replacement property, and the sale of a principal residence within two years of the acquisition of a new principal residence (secs. 361, 1031, 1033, and 1077). 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).

Certain exemptions

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

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]

Sale of principal residence.—$125,000 of gain on the sale of a principal residence by a taxpayer age 55 or over is exempt from tax if, during the 5-year period ending with the date of the sale, the property was owned and used as the taxpayer's principal residence for at least an aggregate of 3 years (sec. 121). (A loss on the sale or exchange of a principal residence is treated as a nondeductible personal loss.)

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

The extent to which such inclusion gives rise to Federal estate and gift tax depends on the value of the decedent's 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.

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 is not subject to the maximum 28-percent rate (sec. 1(h)).

II. LEGISLATIVE BACKGROUND

Reduced tax rate for capital gains

Noncorporate capital gains were taxable at reduced rates from 1921 through 1987. The Revenue Act of 1921 provided for a maximum 12.5 percent tax on gain on property held for profit or investment for more than 2 years (excluding inventory or property held for personal use). Because of the relatively low tax rates on ordinary income during the 1920's and 1930's, this provision benefited only higher bracket taxpayers.

The system of capital gains taxation in effect prior to the Tax Reform Act of 1986 dated largely from the Revenue Act of 1942 ("1942 Act"). The 1942 Act provided for a 50-percent exclusion for noncorporate capital gains or losses on property held for more than 6 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.

[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.

Holding period

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

The Revenue Act of 1934 provided for exclusion of varying percentages of capital gains and losses depending upon the period for which an asset was held. Under that Act, 20 percent of capital gains was excludible if an asset was held for 1 to 2 years, 40 percent if an asset was held for 2 to 5 years, and 60 percent if the asset was held for between 5 and 10 years. Where an asset had been held for more than 10 years, 70 percent of capital gains was excluded.

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

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

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

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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. The Job Creation and Wage Enhancement Act of 1995 (H.R. 9)[6]

1. 50-percent capital gains deduction

Description of Provision

H.R. 9 would allow all taxpayers (both individual and corporate) 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, the effective rate on the net capital gain of an individual in the highest (i.e., 39.6 percent) rate bracket would be 19.8 percent, and the effective rate for a corporation in the 35-percent bracket would be 17.5 percent.

The bill would repeal the provisions in the Revenue Reconciliation Act of 1993 providing a capital gain exclusion for sales of certain small business stock.

The bill would reinstate the rule in effect prior to the Tax Reform Act of 1986 that required two dollars of long-term capital loss of an individual to offset one dollar of ordinary income. The $3,000 limitation for noncorporate taxpayers on the deduction of capital losses against ordinary income would continue to apply. The capital gains deduction would not be treated as a tax preference item for purposes of the alternative minimum tax.

Effective Date

The provision generally would apply to sales and exchanges of capital assets after December 31, 1994.

2. Indexing of basis

Description of Provision

In general

H.R. 9 also would provide for an inflation adjustment to (i.e., indexing of) the basis of certain assets (called "indexed assets") for purposes of determining gain or loss upon a sale or other disposition of such assets. Assets eligible for the inflation adjustment generally would include corporate stock and tangible property that are capital assets or property used in a trade or business and are held by the taxpayer for more than one year. The inflation adjustment would be measured by increases in the gross domestic product

[6] Title I of H.R. 9 provides the changes in the taxation of capital gains and losses described herein. H.R. 9 was introduced by Representative Archer and others on January 4, 1995 (as part of the House Republican proposed "Contract With America"). See also, Joint Committee on Taxation, *Description of Tax Proposals in the Contract With America* (JCS–1–95), January 9, 1995.

("GDP") deflator occurring after December 31, 1994, regardless of whether the asset was acquired by the taxpayer prior to that date.

Indexed assets

The bill generally would provide for the indexing of corporate stock. For this purpose, options, warrants, or other contract rights with respect to stock would not be considered stock. The inflation adjustment would not apply to stock in an S corporation, or generally to stock in a foreign corporation.[7] In addition, no inflation adjustment would be provided for preferred stock that is fixed and preferred as to dividends and does not participate in corporate growth to any significant extent.

The bill would provide for the indexing of the basis of tangible property (or any interest therein) that is a capital asset or property used in a trade or business. An indexed asset would not, however, include any mortgage or other creditor's interest in property. In addition, a lessor's interest in property subject to a net lease would not be an indexed asset. No property using "neutral cost recovery" (as proposed in Title II of the bill) would be an indexed asset.

The basis of debt would not be indexed. For example, in the case of a loan, a precise inflation adjustment would require the lender to deduct a loss from inflation and the borrower to report a gain. Similarly, the bill would exclude from indexing intangible assets, such as options, where there is an option writer and option buyer who have offsetting inflation adjustments.

Computation of inflation adjustment

The inflation adjustment under the bill would be computed by multiplying the taxpayer's adjusted basis in the indexed asset by the ratio that the GDP deflator for the calendar quarter in which the disposition takes place bears to the GDP deflator for the calendar quarter in which the asset was acquired by the taxpayer (or, if later, the calendar quarter ending on December 31, 1994). The inflation ratio would be rounded to the nearest one-thousandth. No adjustment would be made if the inflation ratio is one or less.

Indexing with respect to any asset would end at the time the asset is treated as disposed of for tax purposes. Thus, with respect to installment sales, the inflation adjustment to the seller would not take into account any periods after the sale is made. The purchaser would be entitled to inflation adjustments beginning with the date of purchase, even though the purchase price is not paid until a later date.

In computing the inflation ratio, periods of time for which an asset is not an indexed asset would not be taken into account. For example, if convertible debt is converted into common stock, the period prior to conversion would be disregarded in determining the inflation ratio applicable to the disposition of the common stock.

Special entities

RICs and REITs

In the case of a regulated investment company (RIC) or a real estate investment trust (REIT), the indexing adjustments provided

[7] See further discussion below relating to these entities.

generally would apply in computing the taxable income and the earnings and profits of the RIC or REIT. The indexing adjustments, however, would not apply 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 bill based on the ratio of the value of indexed assets held by the entity to its total assets. If the ratio of indexed assets to total assets exceeds 90 percent in any month, full indexing of the shares would be allowed for that month. If less than 10 percent of the assets are indexed assets in any month, no indexing of the shares would be allowed for that month. The ratio of indexed assets to total assets would be determined every month. However, in the case of a REIT, an actual valuation would be required only once every three years because of the cost and difficulty of more frequent valuations.

Partnerships and S corporations, etc.

Under the bill, stock in an S corporation or an interest in a partnership would not be an indexed asset.[8] This rule avoids the complexity that would result in determining the proper measure of the basis adjustment if indexing were to take into account the fluctuating basis of the S corporation stock or partnership interest attributable to earnings and distributions or to the frequently changing mix of assets (i.e., indexed assets and other assets) of the entity. Under the bill, the shareholder or partner would receive the benefit of the indexing adjustment to his or her stock or partnership interest to the extent the corporation or partnership disposes of indexed assets.[9] Under the bill, 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.

Foreign corporations

Stock of a foreign corporation generally would not be an indexed asset. Thus, investors would not be permitted to place nonindexed assets in a foreign corporation (which generally is not subject to United States tax) and, in effect, receive an inflation adjustment for those assets by selling their stock in the foreign corporation at a later date. However, an exception would be made in the case of stock of a foreign corporation traded on an established domestic securities market, on the grounds that there would be little potential for the shareholders to transfer nonindexed assets to such a foreign corporation to obtain the adjustment. This exception would not apply to certain foreign corporations that are controlled by U.S. investors, or that hold substantial amounts of passive assets, or earn substantial amounts of passive income. An American depository receipt (ADR) for stock in a foreign corporation would be treated as stock in the foreign corporation and, therefore, the basis in such an ADR generally would be indexed.

[8] An interest in a real estate mortgage investment conduit ("REMIC") also would not be an indexed asset, since a REMIC is not treated as a corporation for income tax purposes.

[9] Similar rules would apply to common trust funds.

Other rules

Short sales

In the case of a short sale of an indexed asset with a short sale period in excess of one year, the bill would provide that the amount realized would be indexed for inflation in the same manner that the basis would be indexed to the holder of the property. If the taxpayer (or taxpayer's spouse) sells short substantially identical property to an asset held by the taxpayer (i.e., sells short "against the box") no indexing adjustments would be allowed during the short sale period.

Limitation on ordinary losses

The bill generally would not apply to assets that give rise to ordinary income or loss because they are not capital assets or trade or business property to the taxpayer. In addition, in the case of capital assets or trade or business property the sale of which could result in an ordinary loss (under sec. 1231), the provision would not be applied to create or increase the amount of ordinary loss. Instead, the amount of ordinary loss determined under that provision would be limited to the loss that would arise without regard to any inflation adjustment. Any additional loss created by the inflation adjustment would be treated as a long-term capital loss notwithstanding any other provision of the Code.

Related parties

The bill would not index the basis of property for sales or dispositions between related persons, except to the extent the 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 indexing provisions would apply to dispositions of property after December 31, 1994, in taxable years ending after that date.

3. Capital loss deduction for sale of principal residence

Description of Provision

H.R. 9 also would provide that losses from the sale or exchange of a principal residence would be treated as a deductible capital loss rather than a nondeductible personal loss.

Effective Date

The provision would be effective for sales and exchanges after December 31, 1994.

B. The Small Investors Tax Relief Act of 1995 (S. 181) (Senator Hatch)

Description of Provisions

The bill has two provisions that would affect the treatment of capital gains and losses. First, section 3 of the bill would index the basis of capital assets in a manner similar to the indexing provision contained in H.R. 9. The primary difference is that the bill would use changes in the consumer price index, rather than the gross domestic product, as the applicable measure of inflation. Other differences include the treatment of short sales, common trust funds, personal holding companies, passive foreign investment companies, and American depository receipts for stock in a foreign corporation.

Second, section 4 of the bill would allow an individual to take a deduction for any taxable year equal to the lesser of the individual's net capital gain for the year or $10,000 ($20,000 in the case of a married couple that files a joint return).[10] The deduction would not be available to dependents, estates or trusts, or with respect to gains from sales to related persons. For purposes of determining the deduction, net capital gain would not include gain from the sale of qualified small business stock held for more than five years.

Effective Date

The capital gain provisions of the bill would apply to dispositions after December 31, 1994.

C. The Capital Formation and Job Creation Act of 1995 (S. 182) (Senator Hatch)

Description of Provisions

The bill would provide a 50-percent deduction for capital gains, the indexation of capital assets, and for a capital loss deduction on the sale or exchange of a principal residence. These provisions are identical to the provisions of H.R. 9, as described above.

[10] These amounts would be indexed for inflation beginning after 1995.

IV. PRESIDENT BUSH'S FISCAL YEAR 1991 CAPITAL GAINS PROPOSAL

Description of Provision

President Bush's fiscal year 1991 budget proposal would have allowed individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets.[11] Assets held 3 years or more would qualify for a 30-percent exclusion; assets held at least 2 years but less than 3 years would qualify for a 20-percent exclusion; and assets held at least one year but less than 2 years would qualify for a 10-percent exclusion. For a taxpayer in the 28-percent tax bracket,[12] this would result in an effective regular tax rate of 19.6 percent for assets held 3 years or more, 22.4 percent for assets held between 2 and 3 years and 25.2 percent for assets held between 1 and 2 years.

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

The capital gains exclusion would be a preference for purposes of the alternative minimum tax.[13] The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

Effective Date

The provision would have applied to dispositions (and installment payments received) after the date of enactment, subject to a phase-in of the multiple holding periods.

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[11] A similar budget proposal was submitted by President Bush for fiscal year 1992; for fiscal year 1993, President Bush's budget proposal was similar except the deductions would be increased up to 45 percent.

[12] At the time the fiscal year 1991 budget proposal was submitted, the maximum tax rate on ordinary income was 28 percent.

[13] At the time the fiscal year 1991 budget proposal was submitted, the alternative minimum tax rate for individuals was 21 percent.

V. ANALYSIS OF ISSUES

A. Issues Relating to a Reduced Tax on Capital Gains

Arguments for reduced tax on capital gains

Lock-in

Many argue that higher tax rates discourage sales of assets. For individual taxpayers, this lock-in effect is exacerbated by the rules 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. With a tax rate on gain of 28 percent, if the taxpayer sold this stock today, he or she would have, after tax of $140 on the gain of $500, $860 available to reinvest. The taxpayer would not find it profitable to switch to an alternative investment unless that alternative investment would earn a total pre-tax return in excess of 11.6 percent. Preferential tax rates on capital gains impose a smaller tax on redirecting monies from older investments to projects with better prospects, in that way contributing to a more efficient allocation of capital.

A preferential tax rate on capital gains would both lower the tax imposed when removing monies from old investments and increase the after-tax return to redirecting those monies to new investments. 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 older investments are unlocked. Taxpayers might instead choose to consume the proceeds.[14] 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. A recent study has suggested that lock-in could be eliminated while still taxing gains upon their realization by varying the tax to the

[14] 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.

size and holding period of the gain.[15] Alternatively, preferential tax rates only for gains on newly acquired assets would increase the after-tax return to new investments, thereby making reallocation of investment funds more attractive than currently is the case.

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

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 to provide venture capital for new companies, stimulating investment in productive business activities. This argument was important in the 1978 debate over capital gains taxes, and 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 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.[16] 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

[15] Alan J. Auerbach, "Retrospective Capital Gains Taxation," *American Economic Review*, 81, March 1991.

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

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 investment 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.[17] 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 low rate of household saving, currently less than five 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. 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, or if at all, household saving responds to changes in the after-tax rate of return.[18]

In addition, reduction in only the tax applicable to capital gains may prove to be an inefficient saving incentive. By favoring certain

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

[18] 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 and 49.

types of assets (those that generate returns in the form of accrued gains) over other types of assets (those that generate returns in the 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 20 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, 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,[19] 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.[20]

Bunching

Because capital gain is generally not taxed until a disposition of an asset, taxpayers can face large jumps in taxable income when a gain is realized. With graduated tax rates, such bunching could

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

[20] 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.

lead to a higher tax burden than if the gain were taxed as it accrued. If the benefit of deferral is not enough to compensate for the extra tax in some of those cases, then the additional benefit of a preferential tax rate helps to achieve parity (although its availability is not limited to such cases).

Some analysts have argued that the flattened marginal tax rate schedule and 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. These analysts have stated that the most significant bunching problems under present law would now befall those taxpayers in the 15-percent marginal tax bracket whose gains could push them into the 28-percent bracket. However, they point out that relatively few taxpayers who realize gains are in these circumstances.

Inflation

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 the preference 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 four years. A preferential rate also does not account for the impact of inflation on debt-financed assets, where inflation reduces the cost of repaying the debt.

H.R. 9 provides for both the indexing of basis and a 50-percent exclusion of gain from taxable income. If the taxation of inflationary gain is viewed as the primary defect of present-law taxation of income from capital gains, H.R. 9 would provide tax reduction in excess of that required to eliminate the taxation of inflationary gain.

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 on accrued appreciation until the asset is sold, which benefit reduces in whole or in part any bunching or inflationary effects.[21] 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.[22] After selling the stock and paying tax on the realized gain, the taxpayer would have $1,823.[23] Another way to characterize the benefit of deferral is that the effective rate of taxation on realized capital gains is less than the rate of taxation applicable to assets that pay current income. 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.[24]

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.[25]

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

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

[22] 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).

[23] 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).

[24] 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.

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

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.

Reduction of "conversion" opportunities

Opponents of the preferential capital gains rate contend that it not only provides a reduced tax rate on gains from the preferred assets but also encourages taxpayers to enter transactions designed to convert 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[26] 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 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

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

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.

B. 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. Opponents contend that indexing is complex, that it would not be necessary if efforts to control inflation are successful, and that it would erode revenues if inflation control efforts are not 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 three 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. While, as discussed in Part V. A 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 V.A. 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 arising 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.

H.R. 9 would index basis both for the purpose of computing gain and loss. In this regard indexing differs from a variable exclusion because an exclusion never creates a loss. Past proposals have restricted indexing to only real gains (e.g., the 1989 House-passed reconciliation bill, H.R. 3299). Such proposals 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

H.R. 9 would provide indexing of basis but would not generally index costs of financing property.[27] 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—the taxpayer receives $15 of income taxable at 28 percent and pays $15 of offsetting, deductible interest, producing no after-tax net cash flow. If both the basis of the asset and the interest on the financing are indexed (assuming an accurate indexing factor has been identified and applied), the taxpayer has $10 of gain and $10 of offsetting deductible interest, again producing no after-tax net cash flow.[28] 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

[27] H.R. 9 also would index only for increases in the price level. If the price level were to decline, as in the 1930s, taxpayers could be in the situation of reporting losses on what in fact could be real gains.

[28] 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).

to offset other income in the 28-percent bracket.[29] Thus, because 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. These rules 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.

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.

Complexity

Indexing would involve a significant amount of record-keeping. 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

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

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. Under indexing, each of the 41 components of basis (the original purchase plus the 40 dividend payments) would be multiplied separately by indexing factors based on the period elapsed between the calendar quarter the stock was purchased and it was sold, in order to determine the indexed basis of the stock. 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 improvements were made to a residence or other property, records of the dates of improvements would have to be maintained in order to compute the basis of the property. Under H.R. 9, if an improvement to property were not substantial, the cost of that improvement would be indexed from the original date of acquisition; if substantial, it would be indexed from the date of the improvement.

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. H.R. 9 would pass through the adjustments of the partnership to the partners. Although this is a relatively simple passthrough system, where there is a change in the interests in the partnership before the partnership disposes of an indexed asset, the former partners will not receive the proper indexing adjustment and the newer partners will receive too large an adjustment.[30] Where the partners are in different tax brackets, this may lead to arrangements or transactions to reduce overall taxes. In the case of RICs and REITs, H.R. 9 would provide for indexing of "outside" basis by multiplying the otherwise applicable basis adjustment by a fraction based on the percentage of the entities' total assets that are indexed assets. This may lead to additional complication in computing gain.

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

[30] The negotiated price for the transferred partnership interest might be adjusted to account for this adjustment.

possible.[31] In the case of short sales of indexed assets, H.R. 9 would index the amount realized by the seller, in order to maintain a symmetry between buyer and seller.

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 one 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 one 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 difficult to administer and compliance has suffered.[32] The United Kingdom has frequently adopted new legislation and regulations to combat the problem of arbitrage.

C. Capital Losses on Owner-Occupied Housing

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 section 1034 rollover provision and the section 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, or should be, recognized for tax purposes. Taxpayers purchase homes, cars, and many expensive consumer durable goods primarily for consumption purposes. Many losses arise from use and depreciation of such goods. For example, 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.

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[31] 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.

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

D. 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 deduction may discourage taxpayers from undertaking risky investments. However, the ability of the taxpayer to defer realization of his gains at his discretion creates incentives to undertake such investments.

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

Reduction of long-term capital loss carryovers

Prior law required that long-term losses be reduced by 50 percent when deducted against ordinary income (up to the $3,000 limit). H.R. 9 would reinstate this prior-law rule. 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.

E. 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.[33] One finds results of similar magnitude if one looks 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.[34] 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

[33] 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.
[34] Joint Committee on Taxation, *Explanation of Methodology*, p. 49.