

**PRESENT LAW AND BACKGROUND INFORMATION  
RELATED TO THE TAXATION  
OF CAPITAL GAINS**

Scheduled for a Public Hearing  
Before the  
SENATE COMMITTEE ON FINANCE  
AND THE  
HOUSE COMMITTEE ON WAYS AND MEANS  
on September 20, 2012

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



September 14, 2012  
JCX-72-12

**CONTENTS**

	<u>Page</u>
INTRODUCTION .....	1
I. INDIVIDUAL CAPITAL GAINS.....	2
II. SELECTED DATA AND DISCUSSION OF ISSUES.....	24

## INTRODUCTION

The Senate Committee on Finance and the House Committee on Ways and Means have scheduled a public hearing on “Tax Reform and the Tax Treatment of Capital Gains” for September 20, 2012. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, summarizes the Federal tax rules relating to the taxation of capital gains, and provides selected background data relating to capital gain realizations.

---

<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Information Related to the Taxation of Capital Gains* (JCX-72-12), September 14, 2012. This document can also be found on our website at [www.jct.gov](http://www.jct.gov).

## I. INDIVIDUAL CAPITAL GAINS

### 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. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income.<sup>2</sup> Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year.<sup>3</sup> Gain or loss is treated as long-term if the asset is held for more than one year.<sup>4</sup>

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct up to \$3,000 of capital losses against ordinary income in each year.<sup>5</sup> Any remaining unused capital losses may be carried forward indefinitely to another taxable year.<sup>6</sup>

A capital asset generally means any property except (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, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies.<sup>7</sup> In addition, the net gain from the sale, exchange, or involuntary conversion of certain property used in the taxpayer's trade or business is treated as long-term capital gain.<sup>8</sup>

Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances.<sup>9</sup> Gain from the disposition of depreciable real

---

<sup>2</sup> Sec. 1(h).

<sup>3</sup> Sec. 1222(11).

<sup>4</sup> Sec. 1222(3).

<sup>5</sup> The limitation on the deduction of capital losses in excess of capital gains was enacted by the Revenue Act of 1934. Pub. L. No. 73-216.

<sup>6</sup> Secs. 1211(b) and 1212(b).

<sup>7</sup> Sec. 1221.

<sup>8</sup> Sec. 1231. However, net gain from such property is treated as ordinary income to the extent that losses from such property in the previous five years were treated as ordinary losses.

<sup>9</sup> Sec. 1245.

property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.<sup>10</sup>

### **Tax rates before 2013**

Under present law, for taxable years beginning before January 1, 2013, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain that otherwise would be taxed at a 10- or 15-percent rate is taxed at a zero rate.<sup>11</sup> These rates apply for purposes of both the regular tax and the alternative minimum tax (“AMT”).

Under present law, the adjusted net capital gain of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term 28-percent rate gain means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles<sup>12</sup> and the amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

Unrecaptured section 1250 gain means any long-term capital gain from the sale or exchange of section 1250 property (*i.e.*, depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain.

An individual’s unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

---

<sup>10</sup> Sec. 1250.

<sup>11</sup> For married taxpayers filing jointly, this threshold includes taxpayers whose taxable income does not exceed \$70,700. For single taxpayers, this threshold includes taxpayers whose taxable income does not exceed \$35,350.

<sup>12</sup> The term collectible means any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property specified by the Secretary of the Treasury. Sec. 408(m)(2).

## **Tax rates after 2012**

For taxable years beginning after December 31, 2012, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain that otherwise would be taxed at the 15-percent rate is taxed at a 10-percent rate.<sup>13</sup>

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent capital gain rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, that would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured section 1250 gain are the same as for taxable years beginning before 2013.

Tables 1 and 2, below, detail the tax rates applicable to income from different investments yielding capital gains.

---

<sup>13</sup> The tax brackets are adjusted annually for inflation. For married taxpayers filing jointly, the staff of the Joint Committee on Taxation estimates that in 2013 this threshold will include taxpayers whose taxable income does not exceed \$60,350. For single taxpayers, the staff estimates that this threshold will include taxpayers whose taxable income does not exceed \$36,100.

**Table 1.—Tax Rates Applicable Under Present Law  
to Certain Categories of Income, 2012**

Category of income	Regular Tax Rate Bracket						Minimum Tax Rate Bracket	
	10%	15%	25%	28%	33%	35%	26%	28%
Short-term capital gain <sup>1</sup>	10	15	25	28	33	35	26	28
Long-term capital gain <sup>2</sup>	0	0	15	15	15	15	same as regular tax	
Section 1250 gain <sup>3</sup>	10	15	25	25	25	25	25	25
Collectibles gain	10	15	25	28	28	28	26	28
Small business stock <sup>4</sup>	0	0	12.5	14	14	14	13.91	14.98
Empowerment zone small business stock <sup>5</sup>	0	0	10	11.2	11.2	11.2	11.59	12.37
D.C. Zone assets/Renewal Community assets <sup>6</sup>	0	0	0	0	0	0	0	0

Notes:

<sup>1</sup> Gain from assets held not more than one year.

<sup>2</sup> Gain from assets held more than one year not included in another category.

<sup>3</sup> Capital gain attributable to depreciation on section 1250 property (*i.e.*, depreciable real estate).

<sup>4</sup> Effective rates after application of 50-percent exclusion for certain qualified small business stock held more than five years.

<sup>5</sup> Effective rates after application of 60-percent exclusion for certain qualified small business empowerment zone stock held more than five years.

<sup>6</sup> D.C. Zone assets acquired after December 31, 1997, and before January 1, 2012, and Renewal Community assets acquired after December 31, 2001, and before January 1, 2010. The assets must be held for more than five years. Gain attributable to periods after December 31, 2014 (December 31, 2016 in the case of D.C. Zone assets) does not qualify for lower rates.

**Table 2.—Tax Rates Applicable Under Present Law to  
Certain Categories of Income, 2013 and Thereafter**

Category of income	Regular Tax Rate Bracket					Minimum Tax Rate Bracket	
	15%	28%	31%	36%	39.6%	26%	28%
Short-term capital gain <sup>1</sup>	15	28	31	36	39.6	26	28
Long-term capital gain <sup>2</sup>	10	20	20	20	20	same as regular tax	
Section 1250 gain <sup>3</sup>	15	25	25	25	25	25	25
Collectibles gain	15	28	28	28	28	26	28
Small business stock issued before February 18, 2009 or after December 31, 2011. <sup>4</sup>	7.5	14	14	14	14	18.46 <sup>7</sup>	19.88 <sup>7</sup>
Empowerment zone small business stock issued before February 18, 2009, or after December 31, 2011	6	11.2	11.2	11.2	11.2	14.77	15.90
Small business stock issued after February 17, 2009, and before September 28, 2010.	3.75	7	7	7	7	11.76	12.88
Five-year gain acquired before 2001	8	20	20	20	20	same as regular tax	
Five-year gain acquired after 2000	8	18	18	18	18	same as regular tax	
Small business stock issued after September 27, 2010, and before January 1, 2012; D.C. Enterprise Zone stock/Renewal Community stock <sup>6</sup>	0	0	0	0	0	0	0

Notes:

See notes 1-6 on table 1.

<sup>7</sup> If the holding period for the stock begins after 2000, the rates are 16.64% and 17.92%, respectively.

## **Tax on net investment income**

For taxable years beginning after December 31, 2012, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount. The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case. For these purposes, net investment income includes capital gains.<sup>14</sup>

For purposes of this tax, modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.<sup>15</sup>

## **Certain nonrecognition events**

### Like-kind exchanges

In general.—An exchange of property, like a sale, generally is a taxable transaction. However, section 1031 provides that no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that is also held for productive use in a trade or business or for investment.<sup>16</sup> This provision does not apply to exchanges of stock in trade or other property held primarily for sale, stocks, bonds, partnership interests, choses in action, certificates of trust or beneficial interest, other securities or evidences of indebtedness or interest,<sup>17</sup> or to certain exchanges involving livestock<sup>18</sup> or involving foreign property.<sup>19</sup>

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of section 1031, but for the fact that the property received in the transaction

---

<sup>14</sup> Sec. 1411(c)(1)(A)(iii).

<sup>15</sup> The tax does not apply to a nonresident alien or to a trust all the unexpired interests in which are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

<sup>16</sup> Sec. 1031(a)(1).

<sup>17</sup> Sec. 1031(a)(2).

<sup>18</sup> Sec. 1031(e).

<sup>19</sup> Sec. 1031(h).

consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other property or money, then the gain to the recipient of the other property or money is to be recognized, but not in an amount exceeding the fair market value of such other property or money. Additionally, any gain realized on a section 1031 exchange must be recognized to the extent that the gain is subject to the recapture provisions of sections 1245 and 1250.<sup>20</sup> No losses may be recognized from a like-kind exchange.<sup>21</sup>

For example, if a taxpayer holding land A having a basis of \$40,000 and a fair market value of \$100,000 exchanges the property for land B worth \$90,000 plus \$10,000 in cash, the taxpayer would recognize \$10,000 of gain on the transaction, which would be includable in income. The remaining \$50,000 of gain would be deferred until the taxpayer disposes of land B in a taxable sale or exchange.

The basis of like-kind property received in the exchange is the same as the basis of the property that was exchanged. This basis is increased to the extent of any gain recognized due to the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer.<sup>22</sup> Thus, in the example above, the taxpayer's basis in B would be \$40,000 (the taxpayer's transferred basis of \$40,000, increased by \$10,000 in gain recognized, and decreased by \$10,000 in money received). The holding period of qualifying property received includes the holding period of the qualifying property transferred, but the nonqualifying property received is required to begin a new holding period.<sup>23</sup>

Deferred like-kind exchanges.—A like-kind exchange does not require that the properties be exchanged simultaneously. Rather, the Code requires that the property to be received in the exchange be received not more than 180 days after the date on which the taxpayer relinquishes the original property (but in no event later than the due date (including extensions) of the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs).<sup>24</sup> In addition, the taxpayer must identify the property to be received within 45 days after the date on which the taxpayer transfers the property relinquished in the exchange.<sup>25</sup>

The Treasury Department has issued regulations<sup>26</sup> providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges. These regulations allow a taxpayer who wishes to sell appreciated property and reinvest the proceeds in other like-kind property to

---

<sup>20</sup> Secs. 1245(b)(4), 1250(d)(4).

<sup>21</sup> Sec. 1031(c).

<sup>22</sup> Sec. 1031(d).

<sup>23</sup> Sec. 1223(1).

<sup>24</sup> Sec. 1031(a)(3).

<sup>25</sup> *Ibid.*

<sup>26</sup> Treas. Reg. sec. 1.1031(k)-1(a) through (o).

engage in “three-way” exchanges. For example, if taxpayer A wishes to sell his appreciated apartment building and acquire a commercial building, taxpayer A may transfer his apartment building to buyer B. Buyer B (directly or through an intermediary) agrees to purchase from owner C the commercial building that taxpayer A has designated. Buyer B then transfers title to the newly acquired commercial building to taxpayer A, completing the tax-free like-kind exchange. The economics of these transactions (taxes aside) are the same as if taxpayer A had sold the apartment building to buyer B and used the proceeds to purchase the commercial building from owner C. However, a transaction in which the taxpayer receives the proceeds of the sale and subsequently purchases like-kind property would be taxable to the taxpayer under general tax principles.

In order for a three-way exchange to qualify for tax-free treatment, the regulations prescribe detailed rules regarding identification of the replacement property, rules allowing the seller to receive security for performance by the buyer without the seller being technically in receipt of money or other property, and rules relating to whether a person is an agent of the taxpayer or is a qualified intermediary whose receipt of money or other property is not attributed to the taxpayer.

#### Involuntary conversions

In general.—Although gain or loss realized from the sale or other disposition of property must generally be recognized, section 1033 of the Code provides an exception to this rule in the case of certain involuntary conversions of property. Section 1033 applies if property is involuntarily or compulsorily converted into similar property or money. Such a conversion may occur as a result of the property’s destruction (in whole or in-part), theft, seizure, requisition or condemnation or a sale made under the threat of requisition or condemnation.<sup>27</sup>

For purposes of section 1033, “condemnation” refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation.<sup>28</sup> Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of anti-trust rules is not a condemnation (or a threat of imminence thereof), and the divestiture is not eligible for deferral under this provision.<sup>29</sup>

If property is involuntarily converted into property that is similar or related in service or use to the property so converted, no gain is recognized. This treatment is not elective. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. If the

---

<sup>27</sup> Sec. 1033(a).

<sup>28</sup> Rev. Rul. 58-11, 1958-1 C.B. 273.

<sup>29</sup> *Ibid.* If the replacement property is stock of a corporation and if the stock basis is decreased under this rule, the aggregate basis of the corporation’s assets is likewise decreased by the same amount (but not below that stock basis as so decreased). Sec. 1033(b)(3).

taxpayer receives money (for instance, insurance payments or condemnation awards), or other dissimilar property for the involuntarily converted property, and acquires qualified replacement property within the prescribed time period, nonrecognition of the gain is optional.<sup>30</sup> As a general matter, the prescribed time period begins on the date of the disposition of the converted property (or threat or imminence of a threat of condemnation begins) and ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.<sup>31</sup>

The taxpayer's basis in the replacement property is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.<sup>32</sup>

For example, if under the threat of condemnation, a taxpayer sells for \$35,000 a parcel of land C in which he has an adjusted basis of \$25,000, and the taxpayer did not acquire property that is similar or related in service or use to the condemned parcel, the taxpayer would recognize \$10,000 in gain. However, if within the prescribed time period described above, the taxpayer acquires a parcel of land D that is similar or related in service or use to C for \$35,000, the taxpayer may elect not to recognize the \$10,000 in gain from the sale of C. If the taxpayer so elects, his basis in D in would be \$25,000, and any gain would be deferred until the taxpayer disposed of D in a recognition transaction. If, on the other hand, the taxpayer had acquired D for only \$30,000, even if the taxpayer elected not to recognize gain on the transaction, the taxpayer would nevertheless recognize \$5,000 in gain (representing the \$5,000 in cash the taxpayer received from the \$35,000 sale price of C less the \$30,000 purchase price of D). The taxpayer's basis in D would remain \$25,000 (having been adjusted upwards by \$5,000 to reflect the amount of gain recognized on the conversion, and then having been adjusted downwards by \$5,000 to reflect cash received in the conversion). If the taxpayer subsequently sells D for at least \$30,000, this would trigger the remaining \$5,000 in deferred gain.

Treatment of losses.—Section 1033 does not, by its terms, apply to losses realized from the involuntary conversion of property.

#### Sales of qualified small business stock

Nonrecognition in the event of rollover.—Section 1045 provides for elective nonrecognition of capital gain on the sale of certain qualified small business stock held by a taxpayer other than a corporation for more than six months if the taxpayer rolls that gain over into new qualified small business stock within a 60-day period beginning on the date of sale. Qualified small business stock is any stock in a C corporation (originally issued after August 10, 1993), if, as of the date of issuance, the corporation is a qualified small business, and the stock is acquired by the taxpayer at original issue in exchange for money or property, or as compensation

---

<sup>30</sup> Sec. 1033(a)(2)(A).

<sup>31</sup> Sec. 1033(a)(2)(B).

<sup>32</sup> Sec. 1033(b).

for services provided to the corporation.<sup>33</sup> The term qualified small business refers to any domestic C corporation that has aggregate gross assets that, at all times on or after August 10, 1993, through and immediately following the issuance of the qualified small business stock, do not exceed \$50 million, and such corporation agrees to submit reports to the Treasury Department and its shareholders as may be required by the Secretary of the Treasury.<sup>34</sup>

Stock in a corporation may not be treated as qualified small business stock unless, during the first six months of the taxpayer's holding period,<sup>35</sup> it satisfies the active business requirement. To meet this test, at least 80 percent of the corporation's assets must be used in the "active conduct" of one or more trades or businesses other than specifically enumerated trades or businesses.<sup>36</sup> Additionally, such corporation must be an eligible corporation, meaning that it may not be a domestic international sales corporation ("DISC"), a corporation with respect to which an election under section 936 is in effect, a regulated investment corporation ("RIC"), real estate investment trust ("REIT"), real estate mortgage investment conduit ("REMIC"), or a cooperative.

If the above conditions are satisfied, and the taxpayer so elects, the taxpayer recognizes gain from the sale of the qualified small business stock only to the extent that the amount realized on the sale of the qualified small business stock exceeds the cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of the sale (reduced by any portion of that cost already used to shelter the amount realized with respect to the sale of other qualified small business stock).<sup>37</sup> To the extent that gain is not recognized, the taxpayer reduces his basis in the newly purchased qualified small business stock.

For example, if a taxpayer acquires qualified small business stock for \$50,000, and one year later, having met all of the requisites described above, sells the qualified small business stock for \$60,000, the taxpayer would not need to recognize the \$10,000 gain if within the 60-day period following the sale of the qualified small business stock the taxpayer purchased

---

<sup>33</sup> Sec. 1202(c)(1).

<sup>34</sup> Sec. 1202(d).

<sup>35</sup> The six-month holding period requirement varies from the active business requirement under section 1202, discussed below, which requires that the stock meet the active business requirement for "substantially all" the taxpayer's holding period.

<sup>36</sup> Sec. 1202(e)(3). Trades or businesses listed as nonqualifying are: (1) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees; (2) banking insurance financing, leasing, investing, or similar business; (3) any farming business (including the business of raising or harvesting trees); (4) any business involving the production or extraction of products with respect to which a deduction is allowable under sections 613 or 613A (*i.e.*, natural resource extraction); and (5) any business of operating a hotel, motel, restaurant, or similar business.

<sup>37</sup> The effect of this rule is to disallow multiple nonrecognition rollovers of QSBS on the same economic gain.

\$60,000 of qualified small business stock of another issuer. The taxpayer's basis in the new qualified small business stock would be \$50,000 (*i.e.*, the purchase price of the new qualified small business stock reduced by the \$10,000 of unrecognized gain). If the taxpayer instead had purchased only \$50,000 of qualified small business stock of another issuer, however, the taxpayer would be required to recognize the \$10,000 of gain on the sale of his initial qualified small business stock.

### **Treatment of certain capital assets**

#### Sale of qualified small business stock

**Partial gain exclusion.**—A taxpayer other than a corporation may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of qualified small business stock acquired at original issue and held for more than five years.<sup>38</sup> The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax.<sup>39</sup> A percentage of the excluded gain is an alternative minimum tax preference;<sup>40</sup> the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax (“AMT”).<sup>41</sup>

The amount of gain eligible for the exclusion by an individual with respect to any corporation for a taxable year is the greater of (1) ten times the taxpayer's basis in the stock or (2) \$10 million (reduced by the amount of gain eligible for exclusion in prior years). To qualify as a small business, the corporation must meet the same requirements as described above, however under section 1202 the active trade or business requirement must be met for substantially all the taxpayer's holding period.

For stock issued after February 17, 2009, and before September 28, 2010, the percentage exclusion for qualified small business stock sold by an individual is increased to 75 percent.

As a result of the increased exclusion, gain from the sale of qualified small business stock to which the provision applies is taxed at maximum effective rates of seven percent under the regular tax<sup>42</sup> and 12.88 percent under the AMT.<sup>43</sup>

---

<sup>38</sup> Sec. 1202.

<sup>39</sup> Sec. 1(h).

<sup>40</sup> Sec. 57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (1) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (2) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2012; and (3) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2012.

<sup>41</sup> The regular tax rates that apply to qualified small business stock are listed in Table 1.

<sup>42</sup> The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

For stock issued after September 27, 2010, and before January 1, 2012, the percentage exclusion for qualified small business stock sold by an individual is increased to 100 percent and the minimum tax preference does not apply.

Ordinary loss treatment.—Taxpayers who are individuals or partnerships are entitled to ordinary loss treatment on the disposition of certain small business stock (“section 1244 stock”) in amounts up to \$50,000 (\$100,000 in the case of a joint return).<sup>44</sup> The section 1244 stock must have been originally issued to the taxpayer in exchange for money or property by a small domestic business corporation.<sup>45</sup>

Stock must meet five requirements to qualify as section 1244 stock: (1) the stock must be stock in a domestic corporation; (2) the stock can be either common or preferred stock (however, the stock must be common stock if it was issued on or before July 18, 1984); (3) the issuer must be a small business corporation (described below); (4) the stock must be issued for money or other property (other than stock or securities); and (5) such corporation, during the period of its five most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.<sup>46</sup>

A corporation is considered a small business corporation if, at the time it issues its stock, the aggregate amount of money and other property received by the corporation in exchange for any of its stock, as a contribution to capital, and as paid-in-surplus, does not exceed \$1,000,000 (the “capital receipts limitation”).<sup>47</sup> During the first taxable year in which the capital receipts of the corporation exceed the capital receipts limitation, the corporation must designate which shares issued during that year qualify as section 1244 stock.<sup>48</sup> Regulations provide default rules in the event that the corporation fails to make this designation.<sup>49</sup>

### Section 1256 contracts

Section 1256 provides special timing and character rules for a contract identified as a section 1256 contract. Any gain or loss with respect to a section 1256 contract is subject to a mark-to-market timing rule. The character of gain or loss (if not otherwise ordinary) is

---

<sup>43</sup> The 46 percent of gain included in alternative minimum taxable income (“AMTI”) is taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

<sup>44</sup> Sec. 1244(a).

<sup>45</sup> Sec. 1244(c).

<sup>46</sup> *Ibid.*

<sup>47</sup> Sec. 1244(c)(3).

<sup>48</sup> Treas. Reg. sec. 1.1244(c)-2(b)(2).

<sup>49</sup> Treas. Reg. sec. 1.1244(c)-2(b)(3).

determined under the 60/40 rule. That is, it is treated as long-term capital gain or loss, to the extent of 60 percent of the gain or loss, and short-term capital gain or loss, to the extent of the remaining 40 percent of the gain or loss regardless of the taxpayer's holding period.<sup>50</sup> Gain or loss is recognized upon the termination (or transfer) of a section 1256 contract, by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise, and is also generally treated as 60 percent long-term capital and 40 percent short-term gain or loss.<sup>51</sup> A taxpayer other than a corporation may elect to carry back its net section 1256 contract losses for three taxable years.<sup>52</sup>

A section 1256 contract is defined as any (1) regulated futures contract; (2) foreign currency contract; (3) nonequity option, (4) dealer equity option, and (5) dealer securities futures contract.<sup>53</sup> The term section 1256 contract does not, however, include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (2) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.<sup>54</sup>

#### Property used in a taxpayer's trade or business

A special rule (section 1231) applies to gains and losses on the sale, exchange, or involuntary conversion of certain assets used in the taxpayer's trade or business. These assets are not capital assets, as that term is generally defined in the Code.<sup>55</sup> However, net gains from such assets (in excess of depreciation recapture) are treated as long-term capital gains, while net losses from such assets are treated as ordinary losses. However, net section 1231 gain from such property is converted into 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 or held primarily for sale to customers in the ordinary course of business). Also included are certain special assets important in particular industries, such as interests in timber, coal, domestic iron ore, certain livestock, and certain unharvested crops.

---

<sup>50</sup> Sec. 1256(a)(3). This general rule does not apply to 1256 contracts that are part of certain hedging transactions or section 1256 contracts that but for the rule in section 1256(a)(3) would be ordinary income property.

<sup>51</sup> Sec. 1256(c)(1).

<sup>52</sup> Sec. 1212(c).

<sup>53</sup> Sec. 1256(b).

<sup>54</sup> Sec. 1256(b)(2).

<sup>55</sup> Sec. 1221(a)(2).

### Exclusion of gain from sale of a principal residence

An individual taxpayer may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence.<sup>56</sup> To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the years of the five year period ending on the date of the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

### **Basis in property received from a decedent**

Property passing from a decedent's estate generally takes a stepped-up basis.<sup>57</sup> Stepped-up basis for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and eliminates the tax benefit from any unrealized loss.

### **Legislative Background**

#### **Reduced tax rate for capital gains**

Individual capital gains were taxable at reduced rates from 1921 through 1987. The Revenue Act of 1921<sup>58</sup> 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 ("1986 Act")<sup>59</sup> dated largely from the Revenue Act of 1942 ("1942 Act").<sup>60</sup> The 1942 Act provided for a 50-percent exclusion for individual 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 individual and corporate taxpayers. The basic structure of the 1942 Act was retained under the

---

<sup>56</sup> Sec. 121.

<sup>57</sup> Sec. 1014.

<sup>58</sup> Pub. L. No. 67-98.

<sup>59</sup> Pub. L. No. 99-514.

<sup>60</sup> Pub. L. No. 77-753.

Internal Revenue Code of 1954.<sup>61</sup> For much of the period from 1942 through 1969, the maximum rate was 25 percent.

The Revenue Act of 1978<sup>62</sup> increased the exclusion for individual long-term capital gains from 50 to 60 percent and repealed the alternative maximum rate. The increased exclusion reduced the maximum rate on capital gains from 35 percent<sup>63</sup> to 28 percent. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Tax Act of 1981<sup>64</sup> reduced the maximum effective capital gains rate from 28 percent to 20 percent.

The 1986 Act repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988.<sup>65</sup> 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<sup>66</sup> raised the maximum individual rate to 31 percent, and the Revenue Reconciliation Act of 1993<sup>67</sup> raised the top tax rate to 39.6 percent. Neither Act raised the maximum individual capital gains rate.

The individual capital gains tax rate structure in effect before 2003 and scheduled to go into effect after 2012, was enacted by the Taxpayer Relief Act of 1997 (“the 1997 Act”),<sup>68</sup> as modified by the Internal Revenue Restructuring and Reform Act of 1998.<sup>69</sup>

The individual capital gains tax rate structure in effect after 2002 and before 2013, was enacted by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (“the 2003 Act”).<sup>70</sup>

---

<sup>61</sup> Pub. L. No. 83-591.

<sup>62</sup> Pub. L. No. 95-600.

<sup>63</sup> The effective rate on individuals subject to the individual “add-on” minimum and the maximum tax “earned income” limitation was above 35 percent.

<sup>64</sup> Pub. L. No. 97-34.

<sup>65</sup> The legislative history to the 1986 Act expressed the Senate Finance Committee’s belief that “as a result of the bill’s reduction of individual tax rates... the need to provide a reduced rate for net capital gain is eliminated. This will result in a tremendous amount of simplification for many taxpayers since their tax will no longer depend on the characterization of their income as ordinary or capital gain.” S. Rep. No. 99-313, p. 169 (May 29, 1986).

<sup>66</sup> Pub. L. No. 101-508.

<sup>67</sup> Pub. L. No. 103-66.

<sup>68</sup> Pub. L. No. 105-34.

<sup>69</sup> Pub. L. No. 105-206.

<sup>70</sup> Pub. L. No. 108-27.

The capital gain exclusion for small business stock was adopted in the Revenue Reconciliation Act of 1993, and the increased exclusion for enterprise zone business was adopted in the Community Renewal Tax Relief Act of 2000.<sup>71</sup> The exclusion for D.C. Zone assets was adopted in the Tax Relief Act of 1997 and the exclusion for Renewal Community assets was adopted in the Community Renewal Tax Relief Act of 2000. Further temporary increases in the capital gain exclusion were adopted in the American Recovery and Reinvestment Act of 2009 and the Small Business Jobs Act of 2010.<sup>72</sup>

### **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<sup>73</sup> 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 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<sup>74</sup> 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

---

<sup>71</sup> Pub. L. No. 106-554.

<sup>72</sup> Pub. L. No. 111-240.

<sup>73</sup> Pub. L. No. 73-216.

<sup>74</sup> Pub. L. No. 94-455.

1988. Since 1988, the holding period for long-term capital gain has been one year. The 1997 Act provided lower rates for certain property held more than five years beginning in 2001 and 2006, depending on the tax bracket of the taxpayer. The 1997 Act also provided a higher rate for assets held less than 18 months. That provision was repealed by the Internal Revenue Service Restructuring and Reform Act of 1998. The 2003 Act repealed the five-year holding periods, subject to the sunset provisions of that Act.

### **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. The 1997 Act provided a maximum 25-rate for section 1250 recapture amounts that would be ordinary income if the property was section 1245 property.

**Table 3.—Tax Treatment of Long-Term Capital Gains of Individuals, 1913-2012**

<b>Year</b>	<b>Holding Period</b>	<b>Percentage of long-term capital gains includible in income</b>	<b>Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains</b>
1913-21	n/a	n/a	n/a (highest rate on ordinary income ranged from 7% to 77%)
1922-33	2 years or less	n/a	n/a (highest rate on ordinary income ranged from 24% to 73%)
	Over 2 years	50	12.5%
1934-37	1 year or less	n/a	n/a (highest rate on ordinary income ranged from 63% to 79%)
	Over 1 year to 2 years	80	50.4% in 1934-35; 63.2% in 1936-37
	Over 2 years to 5 years	60	50.4% in 1934-35; 63.2% in 1936-37
	Over 5 years to 10 years	40	25.2% in 1934-35; 31.6% in 1936-37
	Over 10 years	30	25.2% in 1934-35; 31.6% in 1936-37
1938-41	18 months or less	n/a	n/a (highest rate on ordinary income ranged from 79% to 81.1%)
	Over 18 months to 2 years	66.87	30% of included gain, which was equivalent to a 20% rate
	Over 2 years	50	30% of included gain, which was equivalent to a 15% rate

<b>Year</b>	<b>Holding Period</b>	<b>Percentage of long-term capital gains includible in income</b>	<b>Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains</b>
1942-69	6 months or less	n/a	n/a (highest rate on ordinary income ranged from 70% to 94%)
	Over 6 months	50	25% (26% in 1952-53)
1970-71	6 months or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 6 months	50	29.5% in 1970; 32.5% in 1971
1972-76	6 months or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 6 months	50	35%
1977	9 months or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 9 months	50	35%
1978	1 year or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 1 year	50 for gains realized before 11/1/78; 40 after 10/31/78	35% for gains realized before 11/1/78; 28% after 10/31/78
1979-80	1 year or less	n/a	n/a (highest rate on ordinary income: 70%)
	Over 1 year	40	28%

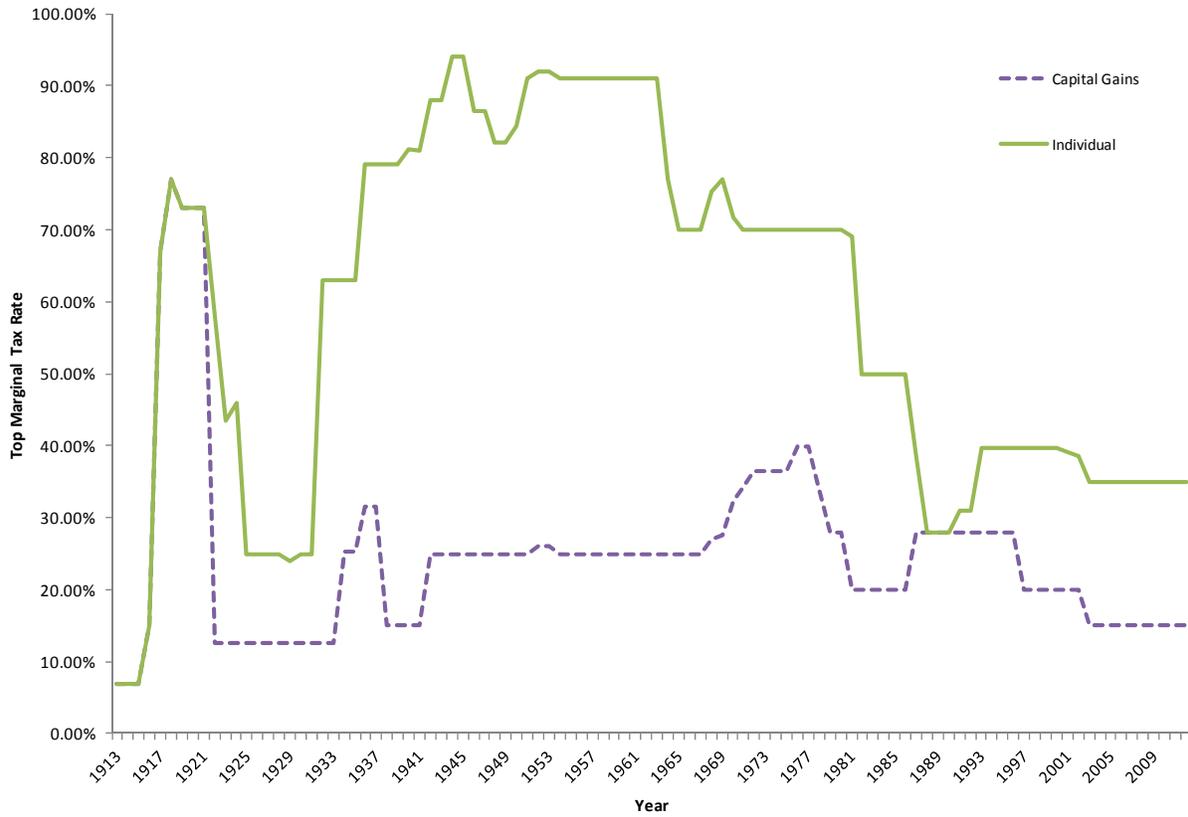
<b>Year</b>	<b>Holding Period</b>	<b>Percentage of long-term capital gains includible in income</b>	<b>Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains</b>
1981	1 year or less	n/a	n/a (highest rate on ordinary income: 69.125%)
	Over 1 year	40	28% for gains realized before 6/10/81; 20% after 6/9/81
1982-86	1 year or less (6 months or less for assets acquired after 6/22/84 and before 1/1/88)	n/a	n/a (highest rate on ordinary income: 50%)
	Over 1 year (over 6 months for assets acquired after 6/22/84 and before 1/1/88)	40	20%
1987-90	1 year or less (6 months or less for assets acquired after 6/22/84 and before 1/1/88)	n/a	n/a (highest rate on ordinary income: 38.5% in 1987; 33% thereafter (28% for individuals in the highest income group))
	Over 1 year (over 6 months for assets acquired after 6/22/84 and before 1/1/88)	100	28% in 1987; 33% thereafter (28% for individuals in the highest income group)
1991-92	1 year or less	100	n/a (highest rate on ordinary income: 31%)
	Over 1 year	n/a	28%
1993-97	1 year or less	100	n/a (highest rate on ordinary income: 39/6%)
	Over 1 year	n/a	28%

<b>Year</b>	<b>Holding Period</b>	<b>Percentage of long-term capital gains includible in income</b>	<b>Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains</b>
1997-1998	1 year or less	100	n/a (highest rate on ordinary income: 39.6%)
	Over 1 year	n/a	20% for gains realized after 5/7/97, 10% for gain income that would otherwise be taxed in the 15%-bracket. Maximum rate remains 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. A 50% exclusion for gains on sale of certain small business stock realized after 8/13/98 yields a maximum rate on qualifying stock at 14%.
1999-2000	1 year or less	100	n/a (highest rate on ordinary income: 39.6%)
	Over 1 year	n/a	20% (10% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.
2001	1 year or less	100	n/a (highest rate on ordinary income: 39.1%)
	Over 1 year	n/a	20% (10% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.
	Over 5 years	n/a	8% for gain on assets held for 5 or more years which otherwise would be taxed at 10% rate.

<b>Year</b>	<b>Holding Period</b>	<b>Percentage of long-term capital gains includible in income</b>	<b>Alternative tax rate on long-term capital gains, if any, or maximum marginal regular tax rate on long-term capital gains</b>
2002	1 year or less	100	n/a (highest rate on ordinary income: 38.6%)
	Over 1 year	n/a	20% (10% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.
	Over 5 years	n/a	8% for gain on assets held for 5 or more years which otherwise would be taxed at 10 percent rate.
2003-2007	1 year or less	100	n/a (highest rate on ordinary income: 35%)
	Over 1 year	n/a	15% (5% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.
2008-2012	1 year or less	100	n/a (highest rate on ordinary income: 35%)
	Over 1 year	n/a	15% (0% for gain income that would otherwise be taxed in the 15%-bracket). Maximum rate at 28% for collectibles. Recapture on sec. 1250 depreciation at 25%. Maximum rate on certain small business stock at 14%.

As shown below, for most of the history of Federal income taxation, the top individual income tax rate has exceeded the top capital gains tax rate. This has been the case except for the period from 1913 through 1921 and 1988 through 1990 when the rates were equal.

**Figure 1.—Top Marginal Tax Rates, 1913-2012**



Source: Statistics of Income Bulletin, Historical Table 23 and JCT staff calculations.

## II. SELECTED DATA AND DISCUSSION OF ISSUES

### Capital gain realizations

Figure 2 below shows total net capital gains, both short- and long-term, from 1979 to 2008.<sup>75</sup> The figure also shows the relative path of the Standard and Poor's 500 stock index, as well as the maximum statutory rate on long-term capital gains over this period. Together, the figure indicates the large impact of the growth in the stock market on the magnitude of realized gains, as well as the influence of tax rate changes at inducing gains realizations.

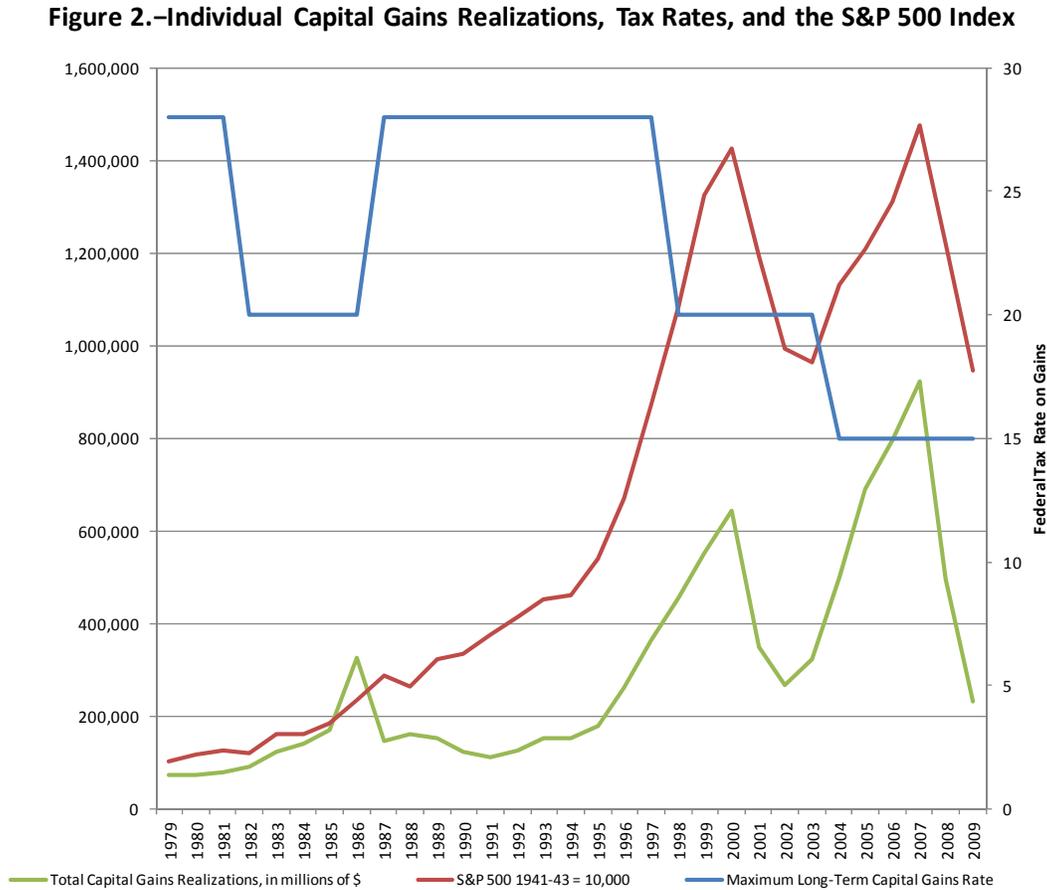


Table 4, below, shows capital gains by asset type for 2007 in greater detail. Pass-through gains constitute the largest category, at 40.1 percent of the total, followed by corporate stock at 24.9 percent of the total

<sup>75</sup> Data on gains from Department of the Treasury, Office of Tax Analysis, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/OTP-CG-Taxes-Paid-Pos-CG-1954-2008-12-2010.pdf>. Data on the S&P index from Economic Report of the President, February 2012.

**Table 4.—Tax Year 2007 Individual Sales of Capital Assets**

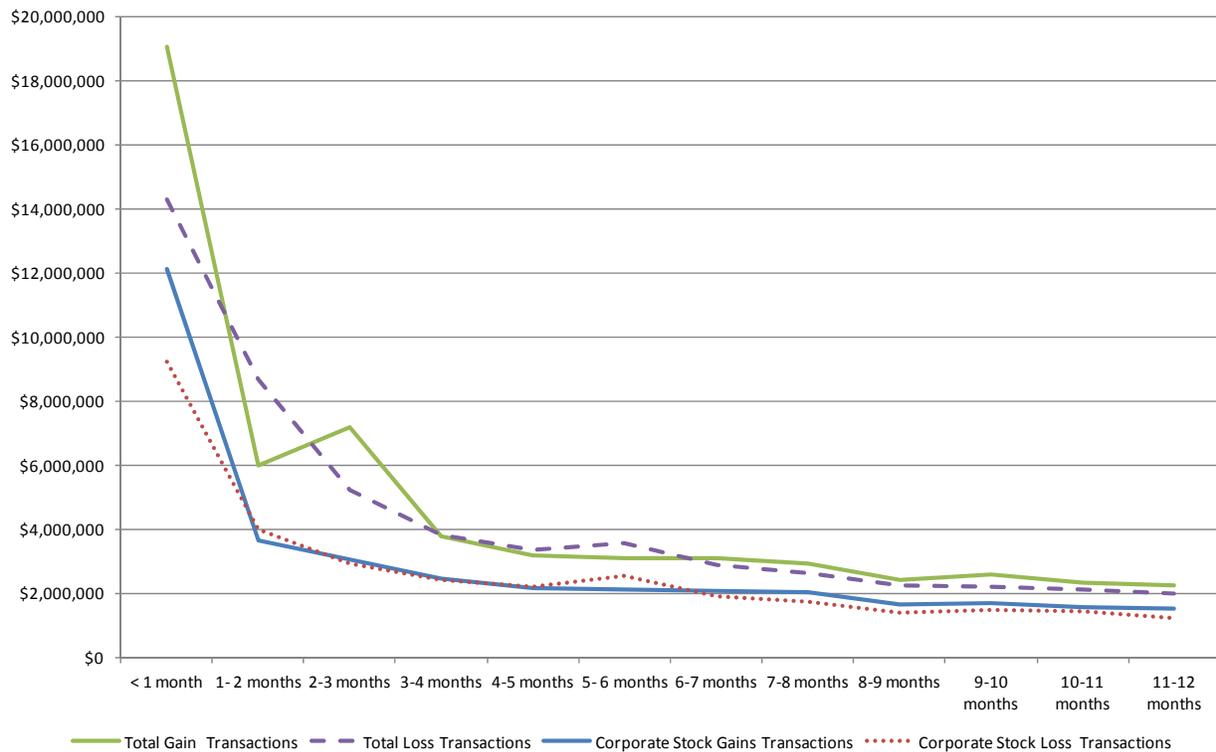
Asset Type	Short and Long Term Capital Gains				Long Term Capital Gains			
	All Transactions		Gain Transactions		All Transactions		Gain Transactions	
	Net Gain/Loss (1)	Percent of Total (2)	Gain (3)	Percent of Total (4)	Net Gain/Loss (5)	Percent of Total (6)	Gain (7)	Percent of Total (8)
<b>Total</b>	<b>914,042,040</b>		<b>1,106,865,343</b>		<b>872,954,607</b>		<b>970,360,118</b>	
Corporate stock	227,899,475	24.9%	320,121,692	28.9%	223,289,657	25.6%	271,314,848	28.0%
U.S. Government obligations	211,005	0.0%	695,864	0.1%	48,897	0.0%	301,382	0.0%
State and local government obligations	784,132	0.1%	2,230,513	0.2%	900,335	0.1%	2,027,500	0.2%
Other bonds, notes, and debentures	-238,117	0.0%	1,825,251	0.2%	120,725	0.0%	1,503,882	0.2%
Put and call options	2,674,767	0.3%	11,175,605	1.0%	1,050,906	0.1%	1,583,689	0.2%
Futures contracts	8,381,409	0.9%	19,276,305	1.7%	221,912	0.0%	452,510	0.0%
Mutual funds, except tax-exemp bond funds	28,129,389	3.1%	43,612,621	3.9%	28,333,592	3.2%	36,788,137	3.8%
Tax-exempt bond mutual funds	-691,750	-0.1%	755,948	0.1%	-346,380	0.0%	678,035	0.1%
Partnership, S corporation, and estate or trust interests	49,145,134	5.4%	58,928,225	5.3%	48,952,209	5.6%	56,299,450	5.8%
Livestock	2,411,515	0.3%	2,748,594	0.2%	2,230,920	0.3%	2,435,480	0.3%
Timber	1,366,931	0.1%	1,425,844	0.1%	1,360,156	0.2%	1,403,844	0.1%
Involuntary conversions	256,902	0.0%	562,436	0.1%	487,267	0.1%	533,212	0.1%
Residential rental property	37,311,783	4.1%	42,569,377	3.8%	36,248,279	4.2%	40,437,234	4.2%
Depreciable business personal property	2,297,692	0.3%	3,536,167	0.3%	2,207,324	0.3%	3,070,205	0.3%
Depreciable business real property	26,357,298	2.9%	27,843,783	2.5%	25,788,332	3.0%	27,077,263	2.8%
Farmland	4,584,038	0.5%	4,649,821	0.4%	4,560,809	0.5%	4,608,429	0.5%
Other land	25,682,168	2.8%	26,813,625	2.4%	25,024,681	2.9%	26,001,027	2.7%
Residences	12,832,996	1.4%	14,861,287	1.3%	12,549,713	1.4%	14,503,330	1.5%
Other assets	25,724,929	2.8%	44,093,416	4.0%	29,148,237	3.3%	37,117,308	3.8%
Unidentifiable	5,981,865	0.7%	8,340,659	0.8%	5,902,814	0.7%	7,173,447	0.7%
Passthrough gains or losses	366,909,407	40.1%	384,769,237	34.8%	338,845,149	38.8%	349,020,830	36.0%
Capital gain distributions	86,029,074	9.4%	86,029,074	7.8%	86,029,074	9.9%	86,029,074	8.9%

**NOTE:** Source: Statistics of Income Sales of Capital Assets by Asset Type, 2007. Figures in thousands of dollars.

## Holding periods

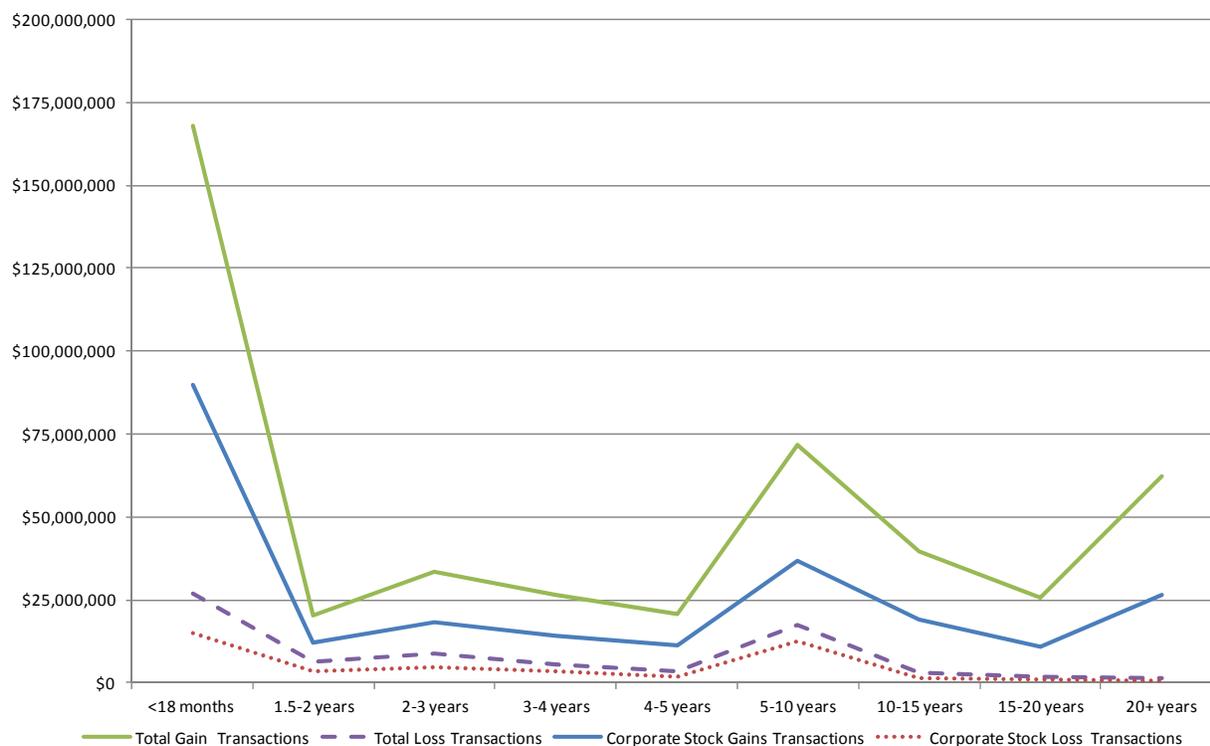
Figure 3 and 4, below, show holding period information for short term (one year or less) and long-term (more than one year) gains realizations, respectively.<sup>76</sup> While in many cases the holding period was not determinable, Figure 3 shows that most short-term gains are held for a few months or less. Figure 4 shows that a significant number of long-term gains are held just beyond the minimum holding period or so. This is consistent with the relative paucity of short-term gains held for more than a few months, and indicates the response to the incentive to hold short-term gains until they qualify for long-term capital gains treatment. Long-term gains gradually decline over succeeding holding periods. The data underlying the figure show \$101 billion in long-term gain held between 18 months and five years, \$72 billion held five to ten years, \$40 billion held 10 to 15 years, and \$25 billion held 15 to 20 years.

**Figure 3.—Individual Short-Term Gains and Loss Transactions,  
by Holding Period, 2007  
(Amounts in Thousands of Dollars)**



<sup>76</sup> Data from Internal Revenue Service, Statistics of Income Tax Stats - Sales of Capital Assets Reported on Individual Tax Returns, 2007, Tables 4a and 4b, available at <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96649,00.html>.

**Figure 4.—Individual Long-Term Gains and Loss Transactions,  
by Holding Period, 2007**  
(Amounts in Thousands of Dollars)



### **Issues related to differential rates for capital gains**

Present law has long maintained tax treatment for capital gain income that is more favorable than the tax rate applicable to a taxpayer's income from labor income (wages and salary) and from other types of capital income (for example, interest and rental income). The differential in tax rates between income from realized capital gains and other sources of income raises several policy issues.

- Does a differential rate promote improved efficiency of the capital markets?
- Does a differential rate promote the socially optimal level of risk taking?
- Does a differential rate promote long-run economic growth?
- Is income from capital gains properly measured?
- Is a differential in rates consistent with policy makers' equity goals?
- Does a differential rate create tax administration issues?

Does a differential rate promote improved efficiency of the capital markets?

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. 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 20-percent tax rate, if the taxpayer sells the stock one year or more from now (when it is worth \$1,100), he or she will net \$980 after payment of \$120 tax on the gain of \$600. With a tax rate on gain of 20 percent, if the taxpayer sold this stock today, he or she would have, after tax of \$100 on the gain of \$500, \$900 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 11.1 percent. If the tax rate on gain were 28 percent, the alternative investment would need to earn a total pre-tax return in excess of 11.6 percent to justify a switch, while the required rate of return with a 15-percent tax rate is only 10.8 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 both lowers the tax imposed when removing monies from old investments and increases the after-tax return when redirecting those monies to new investments. When the tax imposed on removing monies from old investments is reduced, taxpayers may not necessarily redirect their funds to new investments when their monies in older investments are unlocked. Taxpayers might instead choose to consume the proceeds. 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 could reduce lock-in, while requiring assets to be marked to market would eliminate lock-in.

The preference afforded capital gains favors investment in assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. Preferential rates may encourage investments in stock, and more specifically stock that offers its return in the form of capital gains rather than dividends.<sup>77</sup> Opponents of the preference have argued that non-neutral treatment generally is not consistent with capital market efficiency. 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.

#### Does a differential rate promote the socially optimal level of risk taking?

Some maintain that a preferential capital gains tax rate encourages investors to buy corporate stock, and especially to provide venture capital for new companies, stimulating investment in productive business activities. In theory, when a tax system with proportional taxation accords a full offset for capital 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 returns, both good and bad. A reduction in rates proportionately increases the private share of losses (i.e. private risk) and the yield on

---

<sup>77</sup> If dividends continue to be taxed in the same manner as capital gains, as the law for 2012 provides, then there is no Federal tax rate incentive to seek returns in the form of capital gains rather than dividends, though long-term gains benefit from deferral.

investments, so risk-taking has not become more attractive. The investor can thus maintain the same after-tax income he experienced prior to the rate reduction and reduce his holdings of risky assets.<sup>78</sup> 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 rates under these circumstances increases the after-tax yield on investments without commensurately increasing the after-tax cost of losses to the investor. 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 note that a broad capital gains preference affords capital gains treatment to non-equity investments such as gains on bonds and certain other financial instruments. They observe that present-law section 1202 (that provides individual holders of 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. However, the eligibility rules for these provisions add complexity and make it difficult for both taxpayers and the IRS to determine whether a particular stock sale meet the qualifications for the special provisions.

Proponents of special preferences for small businesses aver that it is important to provide a preference to equity investments in small businesses because they create the industries of the future. Others point out that a tax preference for small businesses 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, in 2009, tax-exempt entities (including public pension funds, endowments, foundations, sovereign wealth funds, and union pension funds) contributed nearly 37.7 percent of new venture capital funds.<sup>79</sup> On the other hand, proponents argue that preferential capital gains treatment for the venture capitalists who are taxable is important. They argue that initial investors in new ventures are frequently friends and family of the entrepreneur, all of whom are taxable, while the organized venture capitalists are more prevalent at later stages of financing.

Some may argue that a capital gains preference is desirable to encourage optimal risk taking, because it may help to offset the risk-d discouraging higher cost of capital that small businesses face relative to larger, established businesses. However, a higher cost of capital does not necessarily indicate a market failure for which a tax subsidy might be justified. Small

---

<sup>78</sup> Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk Taking," *Quarterly Journal of Economics*, 58, May 1944.

<sup>79</sup> Dow Jones Private Equity Analyst, *Sources of Capital*, April 2010, p. 4.

businesses are inherently risky, and many small businesses do not survive their first year.<sup>80</sup> A higher cost of capital may only reflect market realities in assuming risk by investors, and not a flaw in the capital markets.

### Does a differential rate promote long-run economic growth?

The United States has a low rate of household saving, averaging less than four percent of disposable income for more than the past decade.<sup>81</sup> 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 future consumption. 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.<sup>82</sup>

In addition, reduction in only the tax applicable to capital gains may prove to be an inefficient saving incentive. 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 form of interest, dividends, or royalties), may cause taxpayers to reallocate their holdings of assets to obtain higher after-tax returns without saving new funds. Such portfolio reallocations may also represent reduced efficiency of capital markets because 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.

---

<sup>80</sup> The one-year exit rate for business establishments started in 2010 was 25.3 percent. U.S. Census Bureau, Business Dynamics Statistics Data Tables: Establishment Characteristics, by Establishment Age, available at [http://www.census.gov/ces/dataproducts/bds/data\\_estab.html](http://www.census.gov/ces/dataproducts/bds/data_estab.html).

<sup>81</sup> Council of Economic Advisers, *Economic Report of the President*, (Washington, D.C.: U.S. Government Printing Office), February 2012, p. 354.

<sup>82</sup> See Douglas W. Elmendorf, "The Effect of Interest-Rate Changes on Household Saving and Consumption: a Survey," *Finance and Economics Discussion Series*, 96-27, (Washington D.C.: Board of Governors of the Federal Reserve System), 1996.

## Is income from capital gains properly measured?

Some proponents of lower tax rates on income from capital gain observe that the preference may provide taxpayers some rough compensation for the fact that part of the taxpayer's measured capital gain represents the effects of inflation and does not constitute real income. Others note that a preferential tax rate is a very crude adjustment for inflation. For example, an asset purchased in 1987 for \$1,000 and sold today for \$2,000 would have a purely inflationary gain. Even with a preferential rate, this gain would still be taxed. Alternatively, for an individual who purchased an asset in 2008 for \$1,000 and sold it today for \$2,000, today's preferential rates on gains 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.

As a counterweight to the taxation of purely inflationary gains, a taxpayer realizing income from a capital gain enjoys a tax benefit from the deferral of tax on accrued appreciation until the asset is sold. The following example illustrates the benefit of deferral alone, by abstracting from any preferential rate on capital gains. Assume a taxpayer in the 15-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 \$1,920.<sup>83</sup> After selling the stock and paying tax on the realized gain, the taxpayer would have \$1,972.<sup>84</sup> 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 11.4 percent, rather than the statutory tax rate of 15 percent.<sup>85</sup>

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. In the above example, the benefit of deferral was \$52 in additional after-tax value. If inflation were five percent annually over this period, the taxpayer's \$1,144<sup>86</sup> of gain would have included \$477 of purely

---

<sup>83</sup> 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 (15 percent in this example), and  $n$  is the number of years the asset is held (eight in this example).

<sup>84</sup> 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 (15 percent), and  $n$  is the number of years the asset is held (eight).

<sup>85</sup> 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.

<sup>86</sup> \$1,000 increasing at a 10 percent rate yields \$2,144 after eight years.

inflationary gain. At a 15 percent tax rate, the taxpayer paid about \$72 in tax on inflationary gains, substantially more than the benefit of deferral. In this particular example, the real gain of \$667 (\$1,144 - \$477) constitutes 58 percent of the total gain. Thus, a preferential capital gains rate that was 58 percent of ordinary income tax rates would be necessary to offset the impact of inflation in this example.

Is a differential in rates consistent with policy makers' equity goals?

A lower rate of tax for income from capital gains compared to the tax rate applicable to other income directly benefits those taxpayers who hold assets with accrued but unrealized capital gains. Information is somewhat scant regarding the distribution of assets with accrued capital gains among different taxpayers. However, 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 is by taxpayers who frequently realize capital gains. While many taxpayers may benefit from preferential treatment of capital gains, the bulk of the dollar value of any tax reduction goes to those taxpayers who realize the bulk of the dollar value of gains. Table 5, below, reports the incidence of the dollar value of multiple capital gain realizations accruing to each income class (as measured by AGI) over a panel data set of taxpayers from 1999 to 2008.<sup>87</sup> During the ten year period, individual taxpayers realized approximately \$5.8 trillion in long-term capital gains. Only 16.6<sup>88</sup> percent of the dollar value of gains was realized by taxpayers who realized gains in three or fewer years of the ten in the panel. By contrast, 46.4<sup>89</sup> percent of the dollar value of gain was realized by taxpayers who realized gains in at least eight of the ten years in the panel. Taxpayers whose adjusted gross income ("AGI") averaged in excess of one million dollars annually and realized gains in at least eight of the ten years of the panel realized 28 percent of all gains. Taxpayers whose AGI averaged less than \$100,000 and realized gains in three or fewer years of the panel realized less than seven percent of all gains.

---

<sup>87</sup> A panel of data tracks the same taxpayers over a number of time periods. For a description of the panel, see Michael E. Weber and Victoria L. Bryant, Internal Revenue Service, "The 1999 Individual Income Tax Return Edited Panel," available at: <http://www.irs.gov/pub/irs-soi/05weber.pdf>.

<sup>88</sup> 4.6 percent plus 12.0 percent from the first two categories of Table 5.

<sup>89</sup> 30.1 percent plus 16.3 percent from the last two categories of Table 5.

**Table 5.—Incidence of Capital Gain Realizations by 10 year average AGI, 1999-2008 Panel--Dollar Value of Gains  
[Millions of Dollars]**

Average AGI in 2011 Dollars	Taxpayers reporting gains in only 1 of 10 years		Taxpayers reporting gains in 2 or 3 of 10 years		Taxpayers reporting gains in 4 or 5 of 10 years		Taxpayers reporting gains in 6 or 7 of 10 years		Taxpayers reporting gains in 8 or 9 of 10 years		Taxpayers reporting gains in each of 10 years		Row Total	
	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent
LESS THAN ZERO	2,306	0.0%	13,369	0.2%	25,176	0.4%	23,074	0.4%	21,859	0.4%	19,335	0.3%	105,119	1.8%
\$1 TO \$10,000	4,545	0.1%	7,397	0.1%	6,174	0.1%	3,620	0.1%	928	0.0%	275	0.0%	22,939	0.4%
\$10,000 TO \$20,000	8,924	0.2%	16,425	0.3%	8,781	0.2%	6,137	0.1%	4,150	0.1%	1,167	0.0%	45,584	0.8%
\$20,000 TO \$30,000	14,436	0.3%	20,088	0.3%	15,191	0.3%	9,473	0.2%	5,217	0.1%	1,509	0.0%	65,914	1.1%
\$30,000 TO \$40,000	16,918	0.3%	30,634	0.5%	21,772	0.4%	14,645	0.3%	10,433	0.2%	3,428	0.1%	97,830	1.7%
\$40,000 TO \$50,000	18,529	0.3%	26,814	0.5%	17,026	0.3%	13,813	0.2%	10,338	0.2%	2,874	0.0%	89,394	1.6%
\$50,000 TO \$75,000	48,722	0.8%	63,016	1.1%	51,508	0.9%	42,309	0.7%	29,185	0.5%	8,687	0.2%	243,428	4.2%
\$75,000 TO \$100,000	29,081	0.5%	66,594	1.2%	59,182	1.0%	53,702	0.9%	43,032	0.7%	9,973	0.2%	261,564	4.5%
\$100,000 TO \$200,000	59,172	1.0%	142,505	2.5%	169,533	2.9%	149,355	2.6%	142,867	2.5%	69,120	1.2%	732,552	12.7%
\$200,000 TO \$500,000	29,131	0.5%	145,258	2.5%	187,212	3.2%	238,191	4.1%	254,266	4.4%	115,946	2.0%	970,003	16.8%
\$500,000 TO \$1,000,000	26,498	0.5%	69,055	1.2%	112,424	2.0%	146,441	2.5%	208,564	3.6%	94,224	1.6%	657,205	11.4%
\$1,000,000 AND OVER	8,745	0.2%	93,047	1.6%	230,577	4.0%	523,203	9.1%	1,003,748	17.4%	613,300	10.6%	2,472,620	42.9%
<b>TOTAL ALL RETURNS</b>	<b>267,006</b>	<b>4.6%</b>	<b>694,203</b>	<b>12.0%</b>	<b>904,555</b>	<b>15.7%</b>	<b>1,223,963</b>	<b>21.2%</b>	<b>1,734,588</b>	<b>30.1%</b>	<b>939,838</b>	<b>16.3%</b>	<b>5,764,153</b>	<b>100.0%</b>

**Table 6.—Incidence of Capital Gain Realizations by 10 year average AGI, 1999-2008 Panel--Number of Returns**

Average AGI in 2011 Dollars	Taxpayers reporting gains in only 1 of 10 years		Taxpayers reporting gains in 2 or 3 of 10 years		Taxpayers reporting gains in 4 or 5 of 10 years		Taxpayers reporting gains in 6 or 7 of 10 years		Taxpayers reporting gains in 8 or 9 of 10 years		Taxpayers reporting gains in each of 10 years		Row Total	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
LESS THAN ZERO	108,726	0.3%	109,823	0.3%	41,360	0.1%	20,589	0.1%	4,834	0.0%	7,323	0.0%	292,655	0.8%
\$1 TO \$10,000	800,883	2.1%	652,803	1.7%	271,126	0.7%	108,284	0.3%	29,995	0.1%	577	0.0%	1,863,668	4.9%
\$10,000 TO \$20,000	1,344,034	3.5%	968,632	2.5%	312,274	0.8%	157,975	0.4%	42,020	0.1%	12,110	0.0%	2,837,045	7.4%
\$20,000 TO \$30,000	1,412,038	3.7%	981,208	2.6%	390,339	1.0%	198,309	0.5%	77,354	0.2%	16,298	0.0%	3,075,546	8.0%
\$30,000 TO \$40,000	1,366,308	3.6%	1,006,165	2.6%	390,993	1.0%	213,499	0.6%	88,938	0.2%	29,227	0.1%	3,095,130	8.1%
\$40,000 TO \$50,000	1,254,779	3.3%	982,643	2.6%	382,055	1.0%	180,044	0.5%	105,213	0.3%	21,288	0.1%	2,926,022	7.6%
\$50,000 TO \$75,000	2,814,919	7.3%	2,182,407	5.7%	948,702	2.5%	509,681	1.3%	228,694	0.6%	55,439	0.1%	6,739,842	17.5%
\$75,000 TO \$100,000	2,112,175	5.5%	1,712,347	4.5%	846,806	2.2%	480,824	1.3%	220,485	0.6%	52,342	0.1%	5,424,979	14.1%
\$100,000 TO \$200,000	2,454,584	6.4%	2,863,739	7.5%	1,512,722	3.9%	869,475	2.3%	539,261	1.4%	144,365	0.4%	8,384,146	21.8%
\$200,000 TO \$500,000	425,833	1.1%	866,490	2.3%	689,621	1.8%	531,412	1.4%	330,906	0.9%	85,955	0.2%	2,930,217	7.6%
\$500,000 TO \$1,000,000	54,830	0.1%	126,314	0.3%	144,725	0.4%	124,847	0.3%	104,060	0.3%	30,033	0.1%	584,809	1.5%
\$1,000,000 AND OVER	10,844	0.0%	40,891	0.1%	53,526	0.1%	73,347	0.2%	67,342	0.2%	24,157	0.1%	270,107	0.7%
<b>TOTAL ALL RETURNS</b>	<b>14,159,951</b>	<b>36.9%</b>	<b>12,493,462</b>	<b>32.5%</b>	<b>5,984,249</b>	<b>15.6%</b>	<b>3,468,283</b>	<b>9.0%</b>	<b>1,839,103</b>	<b>4.8%</b>	<b>479,114</b>	<b>1.2%</b>	<b>38,424,162</b>	<b>100.0%</b>

Source: Staff of the Joint Committee on Taxation calculations from the 1999 Individual Income Tax Return Edited Panel.

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. For example, Table 5 shows that taxpayers whose AGI averaged over one million dollars realized 42.9 percent of all capital gains, while Table 6 shows those same taxpayers accounted for less than one percent of taxpayers realizing gains in the 10 year period. 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.

To investigate the issue of whether capital gain realizations make a taxpayer appear wealthier than he would on a recurring basis, the Joint Committee staff has constructed a “transition matrix” that shows the probability that a taxpayer in a given income class in a given year is in the same or another income class in the succeeding year. Table 7, below, is a transition matrix for 1999 to 2000, for those taxpayers who realized capital gains in 1999. The rows are classified by the taxpayer’s 1999 AGI, including realized gains. The columns are classified by the taxpayer’s 2000 AGI, including realized gains, if any. All entries are a percentage of the number of taxpayers in the given income class who realized capital gains in 1999. Thus, the entry 15.9 in the fifth column of the third row means that 15.9 percent of the taxpayers who had a 1999 AGI between \$10,000 and \$20,000, and reported income from capital gains in 1999, had a 2000 AGI between \$20,000 and \$30,000, regardless of whether they recognized any capital gain or loss in 2000.

**Table 7.—Transition Matrix of 2000 AGI by 1999 AGI, Taxpayers with Capital Gains in 1999**  
**[Percentage Distributions of Returns]**

AGI (1999 Income Class)	Missing	2000 Income Class											
		LESS THAN OR EQUAL ZERO	\$1 to \$10,000	\$10,000 to \$20,000	\$20,000 to \$30,000	\$30,000 to \$40,000	\$40,000 to \$50,000	\$50,000 to \$75,000	\$75,000 to \$100,000	\$100,000 to \$200,000	\$200,000 to \$500,000	\$500,000 to \$1,000,000	\$1,000,000 AND OVER
LESS THAN OR EQUAL ZERO	10.1	48.4	11.9	10.2	5.0	3.8	1.8	4.2	0.4	2.5	0.7	0.5	0.4
\$1 TO \$10,000	12.3	4.5	61.9	15.2	3.0	0.6	0.2	1.2	0.3	0.5	0.2	0.0	0.0
\$10,000 TO \$20,000	5.5	1.6	17.0	45.6	15.9	7.7	3.0	2.0	0.9	0.9	0.0	0.0	0.0
\$20,000 TO \$30,000	2.9	1.7	5.3	19.5	37.9	17.8	5.1	6.7	1.5	1.2	0.4	0.0	0.0
\$30,000 TO \$40,000	2.2	0.5	2.8	6.1	19.3	31.3	18.1	14.1	3.0	1.9	0.5	0.2	0.0
\$40,000 TO \$50,000	0.7	0.9	1.8	5.5	9.3	18.3	29.2	24.8	5.3	3.9	0.3	0.0	0.0
\$50,000 TO \$75,000	1.3	0.3	0.7	1.9	3.3	5.1	10.4	51.5	18.2	6.4	1.0	0.0	0.1
\$75,000 TO \$100,000	0.8	0.2	0.7	1.3	2.2	2.1	3.4	21.0	43.6	22.5	2.1	0.1	0.0
\$100,000 TO \$200,000	0.5	0.2	0.2	1.0	0.8	0.9	1.5	5.3	11.4	67.3	9.8	0.6	0.3
\$200,000 TO \$500,000	0.4	0.6	0.3	0.2	0.5	0.6	0.8	1.6	3.1	19.6	64.0	6.8	1.5
\$500,000 TO \$1,000,000	0.4	0.8	0.0	0.3	0.4	0.4	0.6	0.5	1.1	6.7	26.1	49.7	13.0
\$1,000,000 AND OVER	0.5	1.2	0.1	0.1	0.2	0.2	0.4	0.8	1.1	3.9	11.9	17.9	61.6

Source: Staff of the Joint Committee on Taxation calculations from the 1999 Individual Income Tax Return Edited Panel.

The transition matrix indicates that generally taxpayers who realize gains remain approximately at the same income class in the subsequent year regardless of whether they recognize gains in the subsequent year.<sup>90</sup> Reading down the diagonal (from top left to bottom right) indicates that this is generally the case for each income class. For example, of those who had AGI between \$100,000 and \$200,000 in 1999, approximately 10 percent had income less than \$75,000 (that is, fell by more than one income class from the year in which they realized a capital gain), while more than 75 percent had a 2000 income in excess of \$100,000 (that is, remained in at least the same income class as the year in which they realized a capital gain). These data, together with the data on multiple gains realizations, generally indicate that “bunching” of capital gains is not itself a compelling argument in favor of a reduced rate on capital gains. That is, most taxpayers do not appear to realize capital gains in a lumpy manner that causes their income to be significantly higher in the year of the gains realization, which, with progressive tax rates, would cause their gain income to be taxed at rates significantly greater than their generally applicable marginal rate. Nonetheless, while the phenomenon of bunched gains may not be common, they are still economically significant to those who do have bunched gains due to the sale of a business, for example. In the absence of a preferential rate of tax for capital gains, some form of income-averaging from gains could be considered to handle situations like these, such that large temporary gains do not result in taxes at marginal rates in excess of a taxpayer’s more typical marginal rate of tax.

#### Does a differential rate create tax administration issues?

Beyond any difficulties the various rates may create for a taxpayer’s calculation of his or her tax liability, 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 or loss as derived from the preferred source. Taxpayer time and efforts to characterize income in the preferred way represent an economically inefficient use of resources. 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 IRS 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.

Even if there were no preferential rate on capital gains, it is argued that so long as a limitation on deductions of capital losses 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). Disadvantageous treatment of capital losses may encourage

---

<sup>90</sup> On average, 83.0 percent of taxpayers that realized gains in 1999 remain within one adjusted gross income class of their 1999 AGI in 2000. The comparable figure for taxpayers that did not realize gains in either 1999 or 2000 is 84.2 percent. This suggests that while capital gains realizations introduce some volatility into income, it is not much more than exists for income generally.

taxpayers to mischaracterize losses as ordinary rather than capital. Because 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 from eliminating a preferential rate on gains may be limited.