

Capital gains taxation

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Treatment of the changes in value of capital assets such as corporate stock, real estate, or a business interest.

Under a pure net accretion (Haig-Simons) approach to income taxes, real capital gains would be taxed each year as they accrued and real capital losses would be deducted. Capital gains are generally taxed only when “realized” by sale or exchange, however, because it would be difficult to estimate the value of many assets, it would be viewed as unfair to tax income that had not been realized, and it could force the liquidation of assets to pay the tax on accruals. Taxation upon realization, however, leads to other problems, which require policy compromises.

Current law

Since 1987, realized capital gains have been fully included in adjusted gross income. Beginning with assets sold on or after May 7, 1997, long-term capital gains on assets held at least 18 months will be taxed under a separate rate schedule. Long-term gains in the 15 percent tax bracket will be taxed at a 10 percent rate, and those in higher tax brackets will be taxed at 20 percent. Gains on assets held from 12 to 18 months will be taxed at ordinary tax rates but will be eligible for an alternative rate of 28 percent (as under prior law). Beginning in 2001, capital gains in the 15 percent bracket on assets held at least five years will be taxed at 8 percent. Capital gains in the 28 percent and higher brackets on assets purchased in 2001 or later and held for at least five years will be taxed at 18 percent. Depreciation on real estate is “recaptured” subject to a maximum rate of 25 percent.

Capital losses can be used to offset capital gains, and a maximum \$3,000 of capital losses can be used to offset other taxable income. Unused capital losses can be carried forward to future years. The limit on the capital loss deduction is necessary to prevent taxpayers from recognizing capital losses but not capital gains.

The Taxpayer Relief Act of 1997 also substantially changed the taxation of capital gains on principal residences. The one-time exclusion of up to \$125,000 of capital gains on residences for taxpayers age 55 and over, and the rollover of capital gains from one residence to another, were replaced with an exclusion of up to \$500,000 (\$250,000 for non-

joint returns). The new exclusion can be claimed whenever the taxpayer meets the eligibility requirement of owning and occupying the residence for at least two of the previous five years and using the exclusion only once in a two-year period. Prior law had been criticized as being complex, distorting certain housing decisions, and generating little tax revenue.

When appreciated assets are transferred by bequest, the basis is stepped up to the value of the assets on the date of death. Thus, the accrued gains on assets held at death are not taxed under the income tax, although they may be subject to the estate tax.

A 50 percent exclusion for capital gains from the sale of certain small business stocks purchased at the time of issue and held for at least five years was introduced in 1993. Eligible businesses must have less than \$50 million in assets (including the proceeds of the stock issue) and meet certain other requirements. The 1997 act allowed a rollover provision for such gains and provided for a maximum rate of 14 percent.

History of capital gains taxation in the United States

From 1913 to 1921, capital gains were taxed at ordinary rates, initially up to a top rate of 7 percent. Because of concern that the higher income tax rates introduced during World War I reduced capital gains tax revenues, from 1922 to 1934 taxpayers were allowed an alternative tax rate of 12.5 percent on capital gains on assets held at least two years. From 1934 to 1941, taxpayers could exclude percentages of gains that varied with the holding period. For example, in 1934 and 1935, 20, 40, 60, and 70 percent of gains were excluded on assets held 1, 2, 5, and 10 years, respectively. Beginning in 1942, taxpayers could exclude 50 percent of capital gains on assets held at least six months or elect a 25 percent alternative tax rate if their ordinary tax rate exceeded 50 percent. Capital gains tax rates were increased significantly in the 1969 and 1976 Tax Reform Acts. The 1969 act imposed a 10 percent minimum tax, excluded gains, and limited the alternative tax to \$50,000 of gains. The 1976 act further increased capital gains tax rates by increasing the minimum tax rate to 15 percent. In 1977 and 1978, the maximum tax rate on capital gains reached 39.875 percent with the minimum tax and 49.875 percent including an interaction with the maximum tax. In 1978, Congress reduced capital gains tax rates by eliminating the minimum tax on excluded gains and increasing the exclusion to 60 percent, thereby reducing the maximum rate to 28 percent. The 1981 tax rate reductions further reduced capital gains rates to a maximum of 20 percent.

The Tax Reform Act of 1986 repealed the exclusion of long-term gains, raising the maximum rate to 28 percent (33 percent for taxpayers subject to certain phaseouts). When the top ordinary tax rates were increased by the 1990 and 1993 budget acts, an alternative tax rate of 28 percent was provided. Effective tax rates exceeded 28 percent for many high-income taxpayers, however, because of interactions with other tax provisions. The new lower rates for 18-month and five-year assets were adopted in 1997. Nominal and effective tax rates for the period 1984–1995 are shown in table 1.

Economic issues in capital gains taxation

Inflation

Taxing nominal gains raises the effective tax rate on real capital gains and can lead to imposition of a tax in cases of real economic losses. Several studies have shown that a large percentage of reported capital gains reflect the effects of inflation, with the capital gains of lower- and middle-income taxpayers commonly representing nominal gains but real economic losses. The indexing of the cost or basis of an asset has frequently been proposed to correct for inflation.

Deferral

From the standpoint of economic accretion, the deferral of capital gains taxes until realization reduces the present value of the tax, thereby reducing the effective tax rate below the statutory tax rate. (The combination of deferral and inflation can produce

effective tax rates much higher or lower than the statutory tax rates.)

Lock-in effects

Because capital gains are taxed only when realized, high capital gains tax rates discourage the realization of capital gains and encourage the realization of capital losses. Investors induced to hold appreciated assets because of capital gains tax when they would otherwise sell are said to be “locked in.” Lock-in effects impose efficiency losses when investors are induced to hold suboptimal portfolios with inappropriate risk or diversification, or forgo investment opportunities that may offer higher expected pretax returns. Investors with appreciated property may also incur unnecessary transaction costs to avoid capital gains taxes if they obtain cash from their investment by using it as security for a loan, or reduce their risk by selling short an equivalent asset (short against the box). The financial incentive to be locked in is greater for long-held, highly appreciated assets and is increased by the step-up in basis at death.

Behavioral responses and revenues

Behavioral responses associated with capital gains tax rates are complex. In the absence of tax law changes, transitory fluctuations in income and tax rates may induce taxpayers to accelerate or defer realizations of gains. Similarly, taxpayers time realizations to take advantage of differential tax rates on short- and long-term gains. Statutory changes in tax

TABLE 1

Realized Capital Gains and Taxes Paid on Capital Gains, 1984–95

<i>Year</i>	<i>Total Positive Realized Capital Gains (\$ billion)</i>	<i>Taxes Paid on Capital Gains (\$ billion)</i>	<i>Effective Tax Rate on Capital Gains (%)</i>	<i>Gains as Percent of Gross Domestic Product (%)</i>	<i>Maximum Tax Rate on Long-Term Gains (%)</i>
1984	140.5	21.5	15.3	3.7	20.0
1985	172.0	26.5	15.4	4.3	20.0
1986	327.7	52.9	16.1	7.7	20.0
1987	148.4	33.7	22.7	3.3	28.0
1988	162.6	38.9	23.9	3.3	28.0
1989	154.0	35.3	22.9	2.9	28.0
1990	123.8	27.8	22.5	2.2	28.0
1991	111.6	24.9	22.3	2.0	28.9
1992	126.7	29.0	22.9	2.1	28.9
1993	152.3	36.1	23.7	2.4	29.2
1994	152.7	36.2	23.7	2.2	29.2
1995	180.1	44.3	24.6	2.5	29.2

Notes: Realized gains include positive amounts of both short- and long-term capital gains. The maximum rate includes the effects of the 3 percent phaseout of itemized deductions for high-income taxpayers (computed for 1994 as $29.188 = 28 + 0.03 \cdot 39.6$). Taxpayers in the income range over which personal exemptions are phased out or subject to certain other phaseout provisions could pay higher effective tax rates. In 1988 through 1990, taxpayers in the so-called “bubble” tax bracket paid a 33 percent tax rate on capital gains.

Source: U.S. Treasury Department, Office of Tax Analysis.

rates are likely to result in short-run and long-run responses. Taxpayers may initially react to a cut in the capital gains tax rate by unlocking significant amounts of accumulated capital gains (such as the 49% increase in long-term gains after the 1978 capital gains tax reduction). The long-run response, which is generally thought to be smaller, would include higher realizations from more rapid turnover, from sales of more long-held assets, and from sales of assets that would otherwise be held for life or given to charity. Responses to increased tax rates are not necessarily symmetric as there is little inducement for a large short-run response, and taxpayers may gradually reduce realizations as they adjust portfolios and learn avoidance methods in response to the higher tax rates (such as seemed to occur after rate increases in the 1970s and after the 1986 Tax Reform Act).

Empirical studies have provided widely ranging estimates of the responsiveness of capital gains because of the apparent sensitivity to the implicit assumptions inherent in the data and methodologies used. Using a cross-section sample of 1973 tax returns in a study that may have influenced the 1978 capital gains tax cut, Feldstein et al. (1980) estimated an elasticity of realizations of corporate stock gains for wealthy taxpayers with respect to tax rates of about -3.8 and concluded that reducing rates from 1970s levels would increase tax revenues. Auten and Clotfelter (1982) used panel data to separate the response into short-run and long-run components; they estimated short-run elasticities generally larger than -1.0 and long-run elasticities generally averaging about -0.5 (0.8 at a 20% tax rate), implying that rate reductions might lead to increased revenues in the short run but lower revenues in the long run. A recent micro-data study by Burman and Randolph (1994) found a large transitory response (-6.4) and a small permanent response (-0.2) based on the variation in state capital gains tax rates. Time series studies generally find elasticities between -0.5 and -0.9 , implying that the realizations responses offset a large part but not all of the effects of tax rate changes.

The question of whether the short- and long-run responses to lower capital gains rates are large enough to offset the lower rate has been debated for over 70 years and is likely to remain controversial.

Savings and investment effects

Capital gains tax rates may affect the savings rate through the after-tax rate of return, but this effect is generally believed to be small. Capital gains tax rates may affect the quantity of investment through the cost of capital, and the allocation of investment through effects on the relative returns to risk-taking.

Preferential tax rates for capital gains may increase the proportion of higher-risk investment such as in startup or venture capital businesses.

By reducing the expected variance of after-tax returns, a flat-rate income tax with full deduction of losses would increase risky investment. However, the current income tax system may discourage risky investment because of progressive tax rates and limits on the deduction of losses.

Income conversion

Preferential tax rates for capital gains induce taxpayers to attempt to convert ordinary income into capital gains taxed at a lower rate. Executive compensation may be shifted from salaries to stock options. Many tax shelters before the 1986 act were based on investments that permitted operating losses created by the deduction of expenses at ordinary tax rates and the deferred taxation of capital gains at a preferential rate.

Distribution of tax burden

The income distribution effects of lowering or raising capital gains tax rates has been an important issue affecting debates about capital gains rate changes. Capital gains are more highly concentrated among high-income households than other forms of income, and therefore it is argued that capital gains rate cuts would be regressive.

Equity and efficiency

Tax equity implies that capital gains income should be taxed at the same rates as other income. However, if the responsiveness to tax rates is greater for capital gains than for other forms of income, the excess burden of the income tax would be reduced by providing a lower rate for capital gains than for other income.

Additional readings

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Cross references: [elasticity](#), [demand and supply](#); [income tax, corporate, federal](#); [income tax, federal](#); [portfolio choice](#).