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Capital Gains Taxes: An Overview of the Issues

May 24, 2022

Congressional Research Service
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R47113

CRS REPORT
Prepared for Members and
Committees of Congress

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SUMMARY

R47113

May 24, 2022

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Capital Gains Taxes: An Overview of the Issues

Capital gain is the difference between an asset's market value and its basis (generally the original purchase price). The tax code treats capital gains more favorably than it does other forms of income, with lower tax rates on long-term gains, taxation only when an asset is sold, and forgiveness of gain on assets passed on at death. Tax does not apply to most gains on housing or to gains on assets held in retirement accounts. Certain other types of gains are allowed special treatment, including gains during tax-free reorganizations, like-kind exchanges, installment sales, coal and iron ore royalties, carried interest (i.e., earnings of investment fund managers taxed as a gain), and charitable gifts of appreciated property. Capital gains, however, as in the case of other investment income, are not indexed for inflation, which increases effective tax rates.

Individual long-term gains are taxed at 0%, 15%, or 20%, depending on taxable income. For married couples with taxable income of less than $83,350, there is no tax on these gains, and the 15% tax rate applies until taxable income reaches $517,200, at which the rate is then 20%. (Lower income levels apply to singles.) This 20% rate is low compared with the top rate on ordinary income of 37%. Higher-income taxpayers may also be subject to an additional 3.8% tax that applies to a range of income types. Effective tax rates on realized gains are higher than statutory rates due to the lack of inflation indexing but lower because of deferral, with assets held for longer periods subject to lower effective rates. The overall effective capital gains tax rate on corporate profits, adjusted for deferral, inflation, stepped-up basis, tax-exempt assets in retirement accounts, and other features is small, around 3%.

About two-thirds of individual capital gains subject to tax appear to arise from corporate stock; the remainder is from the sale of property, largely buildings and land. Unrealized gains (i.e., gains on assets that are never sold but have appreciated) appear to be larger than realized gains and slightly over half of unrealized gains appear attributable to corporate stock. Corporate capital gains account for about 20% of all realized capital gains.

Capital gains revenues have fluctuated over time and realizations as a percentage of gross domestic product have largely reflected the business cycle. Individual realizations were $944 billion in 2018, the last year of historical data and the first year they exceeded the $924 billion in realizations in 2007. The Congressional Budget Office projected revenues at $170 billion in FY2018 and $239 billion in FY2023. Additional revenue from raising the capital gains tax rate is constrained by the realization response: individuals selling fewer of their assets as the tax rate increases. Over the past 30 years, research on this realization response has found a range of effects, and the magnitude of the effect is uncertain.

Capital gains are largely concentrated in higher incomes, and more concentrated than overall income. For example, the top 1% of tax units accounts for 16.7% of total income but 75.4% of capital gains. Unrealized capital gains appear distributed in a similar fashion, with close to 90% of taxable gains and unrealized gains falling into the top 10% of tax units.

Capital gains taxes can introduce efficiency costs, although the primary effect, the lock-in effect, applies not because of the tax per se but because gains are taxed on realization and not on accrual or at death. Since the 2017 tax changes, corporate tax rates have fallen relative to noncorporate tax rates, indicating that the argument that capital gains tax on corporate stock contributes to a distortion is no longer valid. The tax does favor debt over equity, but it likely has a minimal effect of uncertain direction on economic growth.

Proposals have been introduced to increase certain taxes on high-income individuals, owing to concentrated capital gains at high-income levels but taxed at lower rates and large amounts of unrealized gains that escape tax at death. The realizations response has led to interest in measures to supplement rate increases to reduce the lock-in effect. Proposals include increasing the tax rate, taxing gains on an accrual basis, taxing gains at death, and eliminating step-up in basis at death and substituting carryover basis (where heirs keep the original basis). Some proposals would correct for the effects of inflation. Other proposals include several changes in the tax treatment of more narrow items, such as eliminating carried interest, like-kind exchanges, and capital gains taxes on coal royalties.

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Capital gain subject to tax arises when an asset is sold. It is the difference between the basis (i.e., the acquisition price) and the sales price. If capital gains were effectively taxed at ordinary rates, real gains would be taxed in the year they accrue regardless of whether they were sold. Current practice departs from this approach. Gains are not taxed until realized, benefitting from the deferral of taxes. Gains on an asset held until death may be passed on to heirs with the tax forgiven; if the asset is then sold, the gain is sales price less market value at the time of death, a treatment referred to as a "step-up in basis." Some gains are excluded from tax, notably gains on homes up to a limit and gains from assets in retirement accounts. For individuals, capital gains on assets held for one year (long-term gains) are also, along with dividends, subject to lower rates than ordinary income, with a top rate of 20% compared with the ordinary rate of 37%. (The top rate is increased to 23.8% by the net investment income tax of 3.8%; this increased tax is also imposed on most ordinary income through the net investment income tax or the Medicare payroll tax.) This combination of provisions makes capital gains subject to low effective tax rates.

This report explains how gains are taxed; discusses the sources of capital gains; estimates effective tax rates; and addresses a number of issues, such as revenue yield, distributional effects, efficiency effects, and policy options.

Tax Treatment of Capital Gains

Capital gain is the difference between the basis of the asset and its sales price. For financial assets, such as corporate stock, the basis generally is the price originally paid for the stock. For physical assets, such as buildings, it is the difference between the sales price and the acquisition cost plus any improvements, minus depreciation. Capital gains occur in an economic sense regardless of whether they are realized. For example, if an individual were to buy a stock that appreciates in value there would be an *accrued* capital gain. However, the gain would not be subject to tax until the stock were sold, at which point the gain would be *realized*.

Aside from the realization of a capital gain, the tax treatment of a capital gain depends on three general factors: (1) the applicable tax rate, which depends on whether a gain is a short-term or long-term gain, and if the gain is included as part of an individual's "net investment income"; (2) the extent to which losses on certain assets may be used to offset gains on other assets; and (3) the existence of tax preferences for certain types of gains.

Tax Rates

Short-term gains on assets held for less than a year are taxed at ordinary rates that depend on the taxable income brackets and rates. Current, temporary rates, were adopted in 2017 by the Tax Cuts and Jobs Act (TCJA; P.L. 115-97). Under the new law, the original 10% and 15% brackets are replaced by a single 12% rate bracket that ends at the same point as the end of the 15% bracket. There is no 39.6% bracket (the top rate is 37% and begins at a higher level than the top bracket under previous law). For 2022, the 37% bracket begins at $647,850 for joint returns, half that amount for married filing separate, and $539,500 for head of household and single returns. Tax brackets are indexed for inflation. These lower tax rates and larger brackets are scheduled to expire after 2025, returning to the pre-2018 levels.[1]

[1] For the ordinary tax rate schedule for 2022, see IRS Rev. Proc. 2021-45, https://www.irs.gov/pub/irs-drop/rp-21-45.pdf.

Taxes on long-term gains (assets held a year or more) are imposed at rates corresponding to pre-2018 taxable income brackets: a 0% rate for those whose taxable income placed them in the regular 15% bracket or less (now in the 12% bracket) and 15% for taxpayers in higher brackets, except for those in the 39.6% bracket, who pay 20%. The thresholds depend on filing status, as shown in **Table 1**. The brackets are indexed for inflation.

Table 1. Capital Gains Tax Rates by Taxable Income Level and Filing Status, 2022

Tax Rate	Single	Married Filing Separate	Head of Household	Joint
0%	Up to $41,465	Up to $41,465	Up to $55,800	Up to $83,350
15%	$41,465 to $459,750	$41,465 to $258,000	$55,800 to $488,500	$83,350 to $517,200
20%	Over $459,750	Over $258,000	Over $488,500	Over $517,200

Source: IRS Rev. Proc. 2021-45, https://www.irs.gov/pub/irs-drop/rp-21-45.pdf.

The Health Care and Education Reconciliation Act of 2010 (HCERA; P.L. 111-152), enacted shortly after the Patient Protection and Affordable Care Act (P.L. 111-148), provided for a tax of 3.8% (the same level as the Medicare rate of 3.8% on labor income) on high-income taxpayers on various forms of passive income, including capital gains.[2] The tax applies to passive income for taxpayers with adjusted gross income in excess of $250,000 for joint returns and $200,000 for single returns, increasing the top long-term capital gains tax rate from 20% to 23.8% and increasing the 15% rate to 18.3% for some taxpayers in the 15% bracket. These floors are not indexed for inflation.

Higher tax rates are applied to long-term gains in certain circumstances. Gain arising from prior depreciation deductions for personal property (equipment) and gain from depreciation deductions arising from depreciation in excess of straight-line depreciation is "recaptured" or treated as ordinary income.[3] The gain arising from prior straight-line depreciation on real property (called unrecaptured section 1250 gain) is taxed at ordinary rates but at a maximum rate of 25%. Gain from collectibles is taxed at 28%. Carried interest (earnings from the management of funds, such as hedge funds) is taxed as a capital gain but must be held for three years.

Corporate capital gains are taxed at the ordinary rate of 21%.

Treatment of Losses

Taxpayers may have a gains or losses on a transaction. These are offset to determine net gain or loss, which is figured separately for each category: short-term and long-term. Then losses in one category can offset gains in the other. If the total of short-term and long-term transactions is a loss, the amount of losses that can be deducted against ordinary income is limited to $3,000 for individuals; if there are both short-term and long-term losses, short term losses are used first. Unused losses can be carried forward indefinitely to offset future capital gains or limited amounts of ordinary income. Losses on property used in the trade or business are ordinary losses and can

[2] For more information, see CRS In Focus IF11820, *The 3.8% Net Investment Income Tax: Overview, Data, and Policy Options*, by Mark P. Keightley.

[3] Because real property has been subject to straight-line depreciation since 1986, depreciation recapture on this property is largely moot, although some recapture can occur under provisions that allow bonus depreciation for certain improvements (recaptured under the rules applying to equipment) and for expensing under Section 179, limited to certain dollar amounts (treated as recapture rules applying to real property).

offset other income. Corporations cannot deduct net capital losses against ordinary income, but can carry them backward for three years and forward for five years to offset net capital gains.

Special Treatment of Certain Gains

Some types of realized gains are exempted or more favorably treated, including personal residences, retirement accounts, stock and assets exchanged in corporate reorganizations, like-kind exchanges, and a number of specialized investments. These special categories are discussed in a subsequent section.

Sources of Capital Gains

Capital gain can arise from financial assets (such as corporate stock and bonds), assets used in the trade or business (such as buildings), and capital assets held for investment (such as buildings, land, and collectibles).

Individual Capital Gains

Most capital gains are taxed under the individual income tax, including gains on assets held by pass-through business (such as partnerships, Subchapter S corporations that elect to be taxed under the individual tax, and limited liability companies).

Realized Gains Reported on Individual Tax Returns

The Internal Revenue Service (IRS) typically publishes detailed data on sales of capital assets, although the latest data are from 2015. Realized capital gains data reported on individual tax returns indicate that a large share of gain is from corporate stock, around two-thirds; this share can vary over the business cycle. Capital gains for 2015 still did not reach the peak before the 2008 recession, so **Table 2** reports the share by asset type for the latest pre-recession year (2007) and for the latest data year (2015). The types are listed in descending order of importance in 2007. As discussed below, a large share of pass-through gains is in corporate stock. The small share in residences does not indicate that these gains are not important, but rather that almost all gains on residences are excluded from tax.

Table 2. Net Long-Term and Short-Term Gains, by Asset Type, Percentage Share

Asset Type	2007	2015
Pass-through Gains (Corporate Stock and Other)	40.1%	50.9%
Corporate Stock	24.9	18.5
Capital Gains Distributions	9.4	11.5
Partnerships, Subchapter S, Estates and Trusts	5.4	5.4
Residential Rental Property	4.1	1.8
Mutual Funds	3.1	-0.0
Depreciable Real Business Property	2.9	0.2
Nonfarm Land	2.9	1.2
Homes	2.8	1.2

Source: For 2007, Janette Wilson and Pearson Liddell, "Sales of Capital Assets Data Reported on Individual Tax Returns, 2007-2012," Internal Revenue Service, *Statistics of Income Bulletin*, vol. 35, No. 3 (Winter 2016), pp. 63-155, https://www.irs.gov/pub/irs-soi/soi-a-inca-id1604.pdf. The underlying data tables for all years through 2012 are at https://www.irs.gov/statistics/soi-tax-stats-sales-of-capital-assets-reported-on-individual-tax-returns. For 2015, Janette Wilson and Christopher Williams, "Sales of Capital Assets Data Reported on Individual Tax Returns, Tax Years 2013–2015," Internal Revenue Service, *Statistics of Income Bulletin*, vol. 41, no. 3 (Winter 2022), pp. 134-207, https://www.irs.gov/pub/irs-pdf/p1136.pdf.

Notes: These data do not reflect gains or losses reported on tax returns, since returns with net losses can deduct only $3,000 against ordinary income. Any remainder is carried over to future years. Thus, current gains reported on tax returns reflect both increases from the limit on loss deductions and reductions from the carryover of prior-year losses.

Table 2 reflects the net of short-term and long-term gains and losses. In 2015, loss on loss transactions offset 33% of gains on gains transactions. Short-term gains are a small part of net gains, and they are more likely to have large losses relative to gains. In 2015, short-term sales had an overall loss that offset 2.3% of net gain on long-term transactions. In 2007, loss on loss transactions offset 17% of gains on gains transactions. Short-term net gains were 4.5% of overall net gains, with short-term losses offsetting 70% of short-term gains.

A large share of gain is from the sales of assets directly passed through to the partner and shareholder by pass-through businesses (such as partnerships and certain corporations electing to be taxed under the individual tax). A Congressional Budget Office (CBO) and Joint Committee on Taxation (JCT) study reported long-term gains on underlying assets for 2010 and indicated that corporate stocks (including the corporate stock gains for pass-throughs, plus the direct corporate stock and capital gains distributions) accounted for 67.9% of gains.[4] For that same year, IRS data showed net long-term gains as 48.8% for pass-throughs, 28.6% as corporate stock, and 2.2% as capital gains distributions. Based on the corporate stock totals in the CBO/JCT study, about three quarters of the gain from pass-throughs was from underlying gain on corporate stock.

The IRS reports more recent data on gains than is reported in **Table 2** but not in the same level of detail. **Table 3** reports the most recent data on distribution of net long-term gains in 2019 and compares it to 2010 to determine whether the share for corporate stock is still likely to be around 68%. The first line almost entirely reflects the gain from the sales of business assets, including those received through pass-throughs. Almost all of the remainder are from financial assets, primarily corporate stock. Because these amounts are similar for 2010 and 2019 (69.5% and 68.9%), it appears that a similar share of gain is due to corporate stock.

Table 3. Net Long-Term Gain by Asset Type, 2010 and 2019, Percentage Share

Type of Gain	2010	2019
Gains Largely from Sales of Business Property	30.5%	31.1%
Financial Gains from Pass-through	37.1	27.1
Capital Gains Distributions	2.7	8.6
Other	29.7	33.2

Source: Congressional Research Service (CRS) calculations from Internal Revenue Service, Statistics of Income, Individual Income Tax Returns Line Item Estimates, Schedule D, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-line-item-estimates-publication-4801 and Individual Income Taxes, All Returns: Sources of Income, Adjustments Deductions and Exemptions, and Tax Items, Table 1.4, capital gains distributions

[4] Congressional Budget Office (CBO) and Joint Committee on Taxation (JCT), *The Distribution of Asset Holdings and Capital Gains*, August 2016, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51831-capitalgains.pdf.

reported on the 1040, https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income.

Notes: In 2010, about 5% of the gain on line 1 of **Table 3** was due to certain financial contracts; in 2019 that share was 1%. Losses on the sale of business assets are deducted as ordinary losses so gains reported on Schedule D are not reduced by that loss. Net gains long-term gains were $288.6 billion in 2010 and $817.7 billion in 2019. *Gains largely from sales of business assets* are from line 11 of Schedule D minus losses from line 11 of Form 4797. *Financial gains from pass-throughs* are from line 12 of Schedule D. *Capital gains distributions* are from line 13 respectively of Schedule D plus *capital gains distributions* reported directly on Form 1040 from Table 1.4. *Other* is the remaining gain of Schedule D of the line item estimates (lines 8a through 10). All are divided by the total long-term gains reported on Schedule D and Form 1040.

The distribution, as well as the size, of gains is affected by the business cycle. For example, during the financial crisis, when total net gains fell from $914 billion in 2007 to $185 billion in 2008 and $37 billion in 2009, before beginning to recover in 2010, gains on corporate stock were negative. This shift occurs in part because realized gains reflect accumulated gains over time. Because corporate stock is held for a shorter time than physical assets, corporate stocks are more likely to reflect losses rather than reduction in gain. The data, however, indicate that over time corporate stock reflects around two-thirds of all realized gains.

Realized Gains Not Subject to Tax

Not all realized gains are subject to tax. An asset accounting for only a small share of gains subject to tax is a personal residence, which is a significant share of realized gains but is allowed large exemptions from tax if held for two years ($500,000 for joint returns and $250,000 for single returns). For 2019, the JCT estimated a revenue loss of $35 billion for the exclusion of gains on housing.[5] Assuming a 15% to 20% tax rate, this estimate implies excluded gains of around $175 billion to $230 billion, indicating net long-term gains would increase by 21% to 28% if these gains were not excluded.

A similar effect was found in a study of sales of homes for 2007, which indicated that only about 10% of gains on homes are subject to tax.[6] This estimate indicates that repealing this exclusion would increase gain by 25%, personal residences would be responsible for 22% of net gains, and the shares of other types would be 80% as large as a share of taxed gains. Gains from home sales subject to tax fell as a share during the financial crisis and although prices and sales volume had recovered by 2015, the share represented by homes declined between 2007 and 2015.[7]

Another major source of excluded gains is gains on assets held in retirement accounts. Although distributions from traditional retirement accounts are taxed as ordinary income (up to the amount of any nondeductible contributions), the effect of allowing an up-front deduction offsets the present value of future taxes paid on distributions, making the income from pension funds and traditional Individual Retirement Accounts (IRAs) largely effectively exempt from tax.[8] Roth accounts do not allow deductions up-front, but the distributions (including earnings) are not

[5] Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2019-2023*, JCX-55-19, December 18, 2019, https://www.jct.gov/publications/2019/jcx-55-19/.

[6] See Gerald Auten and Jane G. Gravelle, "The Exclusion of Capital Gains on the Sale of Principal Residences: Policy Options," National Tax Association Proceedings, *102 Annual Conference on Taxation*, 2009, https://ntanet.org/wp-content/uploads/proceedings/2009/012-auten-the-exclusion-capital-2009-nta-proceedings.pdf.

[7] For average house prices, see FRED Economic Data, Average Prices of Houses Sold for the United States, https://fred.stlouisfed.org/series/ASPUS. For number of homes sold, see Number of existing homes sold in the United States from 2005 to 2023, *Statista*, https://www.statista.com/statistics/226144/us-existing-home-sales/.

[8] A complete offset occurs when tax rates are the same on contributions and distributions and there are no early withdrawal penalties.

taxed. One estimate indicates that of total equity in U.S. corporations, 25% are in taxable accounts and 30% are in retirement assets.[9] (The remaining stock is held by foreigners and not subject to tax.) If two-thirds of gains reflect earnings from corporate stock, these ratios imply that gains would increase by around 80% if these gains were taxed when realized, and if the realization rates were similar.

Assuming that net gains would be increased by 25% by adding back home sales and 80% by adding back retirement account stock, corporate stock accounts for about 72% of realized gains.[10]

Gains can occur without being immediately subject to tax through like-kind exchanges (known as 1031 exchanges) and tax-free corporate reorganizations. In addition, some categories of assets, such as investments in certain small business stocks and qualified opportunity zones, are exempted from capital gains tax; these account for a small revenue loss.

Unrealized Gains

In contrast to realized gains, unrealized gains are less likely to reflect corporate stock. The Survey of Consumer Finances (SCF) data estimate that, in 2019, the accumulated unrealized gains were 27.8% of assets, with 41.7% from real property, 42.8% from business assets, and 15.5% from financial assets.[11] Based on the survey's distribution of assets data, about 80% of the gains from real property were from personal residences.[12] If these are excluded from the distribution, the gains are 64.4% from business assets, 23.3% from financial assets, and 12.3% from real property aside from homes. These data suggest that accumulated gains from corporate stock are a smaller share of assets than for realized gains. In **Table 3**, 47% of gains from business property plus financial gains of pass-throughs were financial gains, suggesting a share, if this ratio were the same, of 54% (0.47 times 66.4 plus 23). This result is not surprising given the shorter holding periods for corporate stock. The SCF, however, does not include data from the top wealth holders (the Forbes 400) who have benefited from a larger appreciation.[13]

Based on these data, unrealized gains appear to be larger than realized gains. After excluding residences, the average unrealized gains were $162,440. The SCF uses the primary economic unit in the household, which includes only members of the household who are financially interdependent. Multiplying by the number of households, which were 128.58 million in 2019,[14]

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[9] Steve Rosenthal and Theo Burke, "Who's Left to Tax? US Taxation of Corporations and Their Shareholders," Fall 2020, NYU Tax Policy Colloquium, October 27. 2020, https://www.law.nyu.edu/sites/default/files/Who%E2%80%99s%20Left%20to%20Tax%3F%20US%20Taxation%20of%20Corporations%20and%20Their%20Shareholders-%20Rosenthal%20and%20Burke.pdf.

[10] (0.68+0.80)/(1+0.25+0.80).

[11] Urban Brookings Tax Policy Center, Unrealized Capital Gains, https://www.taxpolicycenter.org/statistics/unrealized-capital-gains.

[12] Board of Governors of the Federal Reserve System (Federal Reserve System), Historical Tables, Survey of Consumer Finances, https://www.federalreserve.gov/econres/scfindex.htm.

[13] The Forbes 400 were estimated to hold $4.5 trillion in wealth in 2021 and their wealth was $92 billion in 1982, a 49 fold increase compared with a 36 fold increase in the overall stock market. See Chase Peterson-Withorn "Inside The Most Elite Club In America: How The Forbes 400 Has Gotten $4 Trillion Richer Since The 1980s," *Forbes*, October 9, 2021, https://www.forbes.com/sites/chasewithorn/2021/10/09/inside-the-most-elite-club-in-america-how-the-forbes-400-has-gotten-4-trillion-richer-since-the-1980s/?sh=20aa2f8014fe. Much of this wealth is in the form of corporate stock. The U.S. stock market at the end of 2021 was valued at $53 trillion for U.S. companies. See "Total Market Value of the U.S. Stock Market," Siblis Research, https://siblisresearch.com/data/us-stock-market-value/#:~:text=The%20total%20market%20capitalization%20of,about%20OTC%20markets%20from%20here.

[14] Census Bureau, "Historical Households Tables," https://www.census.gov/data/tables/time-series/demo/families/households.html.

results in $20.9 trillion in unrealized gains. The data on gains reported on tax returns, covering the period since 1954, totals to $16.0 trillion.[15] These data indicate that the unrealized gains are 57% of accruals. Adding amounts to unrealized gains to reflect the Forbes 400 would increase the share to 59%.[16] The share might be somewhat higher because of the excluded household members in the survey, but this addition is likely to have a minimal effect on the share of unrealized gains.[17]

This result is consistent with, although slightly larger than, other studies comparing accruals to gains: an early study for the 1954-1989 period found unrealized gains were 54% of accruals and a study of the years 1989-2013 found it to be 52%.[18] CBO uses 47%, but that measure is for corporate stock, which is more likely to be realized based on the shorter holding periods.[19] That estimate is consistent with the data presented here.[20]

Capital Gains' Sources Reported by Corporations

Corporate capital gains were 20% of total net gains (both individual and corporate) in 2018. According to IRS's Corporate Complete Report Publication, capital gains reported by corporations are last available for 2018.[21] Data are for gains reported on the tax return and not for net gains, which do not reflect limits in the deduction of losses.[22] Gains were $212.9 billion, or 23% of the size of gains reported on individual tax returns in 2018 ($943.9 billion).[23] As the data

[15] Data from 1954 to 2014 are from The Department of Treasury, Office of Tax Analysis, https://home.treasury.gov/policy-issues/tax-policy/office-of-tax-analysis. Data from 2015 to 2019 are from the Internal Revenue Service, "Statistics of Income, Number of Returns, Shares of AGI, Selected Income Items, Credits, Total Income Tax, AGI Floor on Percentiles, and Average Tax Rates," Table 1, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-rates-and-tax-shares#Early%20Release.

[16] This estimate increases unrealized gains by 10.6%. See discussion in footnote to **Table 9** for methodology.

[17] The Urban-Brookings Tax Policy Center estimates the number of tax units, at 174.690 million in 2019, which is too large because it includes multiple tax returns for primary economic units. See https://www.taxpolicycenter.org/model-estimates/distribution-individual-income-tax-long-term-capital-gains-and-qualified-44. Another study estimates that an additional 24 million should be added to the SCF numbers to account for financially independent members of the household, leading to 153 million. See Jesse Bricker, Sarena Goodman, Kevin B. Moore, and Alice Henriques Volz, "A Wealth of Information: Augmenting the Survey of Consumer Finances to Characterize the Full U.S. Wealth Distribution," Board of Governors of the Federal Reserve, August 2021, https://www.federalreserve.gov/econres/feds/augmenting-the-survey-of-consumer-finances-to-characterize-the-full-u-s-wealth-distribution.htm. This number would indicate a total of $27 trillion in unrealized gains ($162.440 times 158 million plus 2.1 trillion for the Forbes 400) and a share of 63%. While that number provides an upper limit, it is unrealistically high because (1) these financially independent units have a smaller average wealth, (2) multiple units are less common in the top 10% where 80% of wealth of primary economic units is held, and (3) they are more likely to have assets like bank accounts that do not generate capital gains.

[18] See CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle.

[19] Congressional Budget Office, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options*, December 18, 2014, https://www.cbo.gov/publication/49817.

[20] If corporate stock represents half of unrealized gains and 68% of realized gains, and overall unrealized gains is 58% of accruals, and the aggregate share of unrealized gains is 58%, the share of unrealized gains in corporate accruals would be 50% ([(58/42)X50]/[(58/42)X50+68]).

[21] The Corporation Complete Report Publication is a collection of aggregate statistics sorted in various ways, such as industry, size of total assets, and size of business receipts. The publications are available at the Internal Revenue Service website at https://www.irs.gov/statistics/soi-tax-stats-corporation-income-tax-returns-complete-report-publication-16.

[22] Net losses are not deductible for corporations, which means gains reported on tax returns can be larger than net gains which reflect a full deduction for losses. At the same time unused losses can be carried back and forward, which could mean gains reported on tax returns are larger than net gains in a given year.

[23] Internal Revenue Service, *Statistics of Income, Corporation Income Tax Returns Complete Report*, Table 5.3:

below indicate, of gains reported on corporate tax returns, about 57% are financial assets. Gains were 20% of total net gains (both individual and corporate) in 2018.

Examining data by minor industry, 24.5% of gains reported were in the information industry, with 43% of that amount in motion pictures, 38% in other information that includes Internet publishers, and 7% in software publishers (sound recording data are suppressed). The gains should primarily reflect gain on the sale of intellectual property (e.g., the rights to movies). The largest major industry, manufacturing, accounted for 13.6% of gains, with 20% of that amount due to pharmaceuticals, likely reflecting sales of intellectual properties and bringing the total for that intellectual property to 27.4%. Another 14.2% are in real estate, increasing the total for sales of property used in the trade or business to 41.6%. Of the remainder, 19.1% are in finance and insurance, likely reflecting financial assets, and the remainder a mixture of sales of real and financial assets.

Looking at the data from a different perspective, *long-term gains* attributable to sales of assets used in the trade or business reported on Schedule D of the 1120 are 42.6% of long-term gains, which in turn are 97% of total corporate capital gains.[24] Assuming that short-term gains are largely financial (and are about 3% of the total), about 60% of corporate capital gains reported on tax returns are likely from corporate stock. However, because corporate stock is more likely to result in losses, corporate stock may represent a smaller share of net gains without considering the loss restrictions.

Capital gain associated with tax-free reorganizations and like-kind exchanges are the major source of untaxed realized corporate capital gains, with the latter important in the real estate industry.

Capital Gains and Effective Tax Rates on Investment

The top rate on long-term capital gains is 23.8% (20% plus 3.8% net investment tax), but some gains are subject to rates of 0%, 15% or 18.3% (15% plus 3.8% net investment tax). According to the Treasury Department estimates, the average tax rate was 18.8% in 2014 and the average marginal tax rate (i.e., the tax on a small increase in gains) was 21.3% in 2016.[25] Several other features also cause the effective tax rate on long-term capital gains to differ from ordinary rates (such as those imposed on labor income): the deferral of tax, the effect of inflation, the forgiveness of tax at death, and holding assets in exempt retirement accounts.

Effective Marginal Tax Rate on Corporate Equity Income

Effective marginal tax rates measure the tax burden on a prospective investment and thus take into account deferral and inflation as well as the statutory tax rate.

An investment in a corporate stock that does not pay dividends provides the least complicated picture of the effects of the different elements. The top capital gains tax rate for corporate stock is 23.8% (a 20% tax rate and a 3.8% net investment income tax). As shown in the **Table 4**, the combined effects of deferral (which reduces taxes) and not indexing for inflation raise the

Returns of Active Corporations, other than Forms 1120S, 1120-REIT, and 1120-RIC, https://www.irs.gov/statistics/soi-tax-stats-corporation-income-tax-returns-complete-report-publication-16.

[24] Internal Revenue Service, *Statistics of Income, Corporate Income Tax Returns Line Item Estimates*, Schedule D, https://www.irs.gov/statistics/soi-tax-stats-corporation-income-tax-returns-line-item-estimates-publication-5108.

[25] See Treasury Department tables at https://home.treasury.gov/system/files/131/Average-Marginal-Tax-Rates-by-Type-of-Income-2015-Law.pdf.

effective rate above the 23.8% statutory tax rate for holding periods shorter than five years. Assets held for longer periods of time have lower rates both because they benefit the most from deferral and are penalized the least from taxing the inflation portion of the return.

Table 4. Effective Tax Rate on Return to Corporate Stock by Holding Period, for Top Long-Term Capital Gains Tax Rate of 23.8%

Holding Period (Years)	Effective Tax Rate	Effective Tax Rate with Indexing
No Dividends		
1	27.5%	23.0%
5	23.5	20.1
10	19.5	17.3
15	16.5	15.0
20	14.2	13.1
25	12.9	11.6
30	10.9	10.3
4% Dividend		
1	28.1	23.5
5	26.3	22.5
10	24.3	21.4
15	22.7	20.5
20	21.3	19.6
25	20.2	18.9
30	19.2	18.3

Source: See details in CRS Report R45229, *Indexing Capital Gains Taxes for Inflation*, by Jane G. Gravelle.

Note: Assumes a real after-tax appreciation rate of 7% with no dividend and 3% with a 4% dividend, and an inflation rate of 2%.

Data for 2015, the latest available, indicate that corporate stock held directly had an average holding period of around seven years and that 61% of sales were of assets held for five years or less. A stock held for seven years would have an effective tax rate of 21.3% if no dividends were paid.

Deferral has a smaller effect on a stock that earns a dividend. For example, the effective tax rate for a stock earning a 4% after-tax dividend is 28.1% when held for a year and 19.2% when held for 30 years, because the dividend share is taxed on a current basis. Inflation has about the same absolute effect on the tax rate, but because tax rates are higher, it takes longer to reach the effective tax rate that equals the statutory rate. The effective tax rate for a stock held for seven years is 25.5%.

In considering the importance of the capital gains tax on corporate equity investment, several adjustments are made that significantly lower the tax, as shown in **Table 5**. First, for a stock paying dividends, it is necessary to determine the share that is attributable to the capital gains tax, which is smaller because part of the return is taxed as a dividend (see last column of **Table 5**). The next adjustment reduces the tax by half to allow for approximately half of capital gains escaping tax at death. The table's next row adjusts for the gains received by individuals below the

top rate and for the effect of short-term gains taxed at ordinary rates. The next row reduces the tax to adjust for the 25% share of corporate stock held by taxable individuals compared with the 30% share from exempt shareholders. The final row adjusts for the fact that capital gains is applied to income after a reduction for corporate taxes paid. Note that this table does not include the effective tax rate on stock held by foreign shareholders, who in some cases may pay home country taxes.

Table 5. Effective Marginal Tax Rates on Corporate Stock Arising from Capital Gains

Tax Adjustments	Stock with No Dividend	Stock with Dividend	Tax on Dividend Stock Attributable to Capital Gains Tax
With 7-Year Holding Period	21.3%	25.2%	10.4%
Adjusted for Exclusion at Death (50% reduction)	10.7	20.4	5.2
Adjusted for Lower Aggregate Marginal Tax Rate	9.8	18.8	4.8
Adjusted for Share of Corporate Stock Held in Taxable Form (55% reduction)	4.5	8.5	2.2
Adjusted for Corporate Tax-Offset			
Temporary	4.3	8.1	2.1
Permanent	4.0	7.5	1.9

Source: CRS calculations. Adjustment for aggregate marginal tax rate based on data in Paul Burnham, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options*, December 18, 2014, https://www.cbo.gov/publication/49817. Adjustments for the 25% of corporate stock held by taxable individuals based on Steve Rosenthal and Theo Burke, "Who's Left to Tax? US Taxation of Corporations and Their Shareholders," Fall 2020, *NYU Tax Policy Colloquium*, October 27, 2020, https://www.law.nyu.edu/sites/default/files/Who%E2%80%99s%20Left%20to%20Tax%3F%20US%20Taxation%20of%20Corporations%20and%20Their%20Shareholders-%20Rosenthal%20and%20Burke.pdf. Corporate effective marginal tax rate on equity based on CRS Report R45186, *Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)*, by Jane G. Gravelle and Donald J. Marples.

Note: Adjustment for aggregate marginal tax rate assumes 3.4% of gains are realized short-term gains taxed at 32.3% and that long-term gains are taxed at 21.2%. Corporate effective marginal tax rate on equity are adjusted for 10% of the capital stock to reflect inventories taxed at the statutory rate. The rates are 5% for the temporary provisions and 12% for the permanent provisions.

These tax rates indicate that the capital gains tax increases taxes on corporate source income by 2%-4%. Traditionally dividends were around 4%, but recently stock repurchases have accounted for more than half of distributions and dividends are closer to 2%, so the rate is somewhere in between. These rates would be slightly increased if corporate capital gains on stock were included.

Capital Gains Tax Rates on Tangible Assets

Investments in buildings have similar effects, although they are subject to higher overall tax rates, because most of the tax is due to ordinary taxes on rents. The rates will also depend on whether assets have depreciation. If that economic depreciation is close to tax depreciation most of the gain will be entirely due to inflation. Based on the differences between the estimated tax and the tax with inflation adjustments, the tax is about 3% for commercial buildings and land, and about

2% for residential rental property for assets held 10 years.[26] These rates would be reduced by at least half because of gains that are never taxed due to step-up in basis at death, and slightly more for lower statutory rates, leading to a rate of 1% to 1.5%.

Economy-Wide Cash Flow Measure

An alternative way to measure the effect of the capital gains tax on investment is capital gains taxes divided by total capital income in the economy. For 2018 and 2019, capital gains taxes were reported at $174 billion and $162 billion, respectively, on individual income tax returns.[27] This measure is a different concept from the marginal effective tax rate; the latter captures the expected share of the pretax return that is taxed and accounts for timing differences. Based on estimates indicating that 58% of income is labor income,[28] capital income was $10.178 billion in 2018 and $10.558 billion in 2019.[29] These numbers indicate a tax rate of 1.7% for 2018 and 1.5% for 2019.

If the overall real return to capital in the economy is 7%,[30] the capital gains tax on individuals increases the required return by 0.07%, or seven basis points.

Capital Gains Realizations Response and Revenues

Over the past 30 years, a debate has ensued on the revenue effect of changing individual capital gains taxes.

Although taxes on capital gains as well as capital gains revenues and realizations have fluctuated over time, the variability in revenues and realizations observed in the data largely reflect the business cycle. According to CBO, individual capital gains averaged 4% of gross domestic product (GDP) from 1995 to 2018. This rate was affected by the fall in gains during the financial crises; from 1995 through 2007, before the downturn, gains were 4.4% of GDP. The highest levels were 6.4% in 2007, just before the recession, and 6.2% in 2000 toward the end of the dotcom growth and just before the 2001 recession. Gains were at a low of 1.8% in 2009 and 2.4% in 1995. Taxes on gains averaged 7.2% of individual income tax receipts from FY1995 to

[26] See CRS Report R45229, *Indexing Capital Gains Taxes for Inflation*, by Jane G. Gravelle.

[27] Amounts from Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, Individual Statistical Tables by Tax Rate and Income Percentile, Table 3.5, Tax Generated, https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-tax-rate-and-income-percentile.

[28] Michael D. Giandrea and Shawn Sprague, "Estimating the U.S. Labor Share," *Monthly Labor Review*, U.S. Bureau of Labor Statistics, February 2017, https://www.bls.gov/opub/mlr/2017/article/estimating-the-us-labor-share.htm#_edn8.

[29] U.S. Bureau of Economic Analysis (BEA), "National Income and Product Accounts," Table 1.7.5, https://apps.bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=2&isuri=1&1921=survey.

[30] The rate is derived from dividing national income attributable to profits by the private capital stock for 2018. National income is in Table 1.12 of the National Income and Product Accounts and was $18.273 trillion in 2019. Of that amount, about 70% is estimated to be labor income (compensation of employees plus 75% of income of proprietors). The stock of private fixed capital is $49.540 trillion from Table 2.1 of fixed assets, and it is increased by 45% to account for land and inventories, based on data in Paul Burnham, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options*, December 18 2014, https://www.cbo.gov/publication/49817. An additional $3.53 trillion is added to account for intangibles other than research and development. The calculation is 0.30X18.273/(49.540X1.45+3.530). NIPA data are at https://apps.bea.gov/itable/index.cfm.

FY2018 and 9.2% from FY1995 to FY2007. The highest levels were 10.1% in FY2018, 11.3% in 2001, and 11.1% in 1999; the lows were 5.0% in 2011 and 5.1% in 2012.[31]

Realizations were $944 billion in 2018, the last year of historical data and the first year they exceeded previous realizations since 2007. Revenues were projected at $170 billion in FY2018; they first exceeded FY2007 levels in FY2015. CBO projects relative gains and revenue receipts to rise over the next few years, with $239 billion projected for FY2023.

Capital gains could also be affected by the tax rate (called the realizations response). This issue became important in the public debate when President George H.W. Bush proposed a 30% exclusion in 1990. Treasury estimated a $12 billion gain in revenue over the first five years, whereas the JCT estimated a revenue loss of approximately equal size. Although the estimates seemed quite different, they both incorporated significant expected increases in gains realized because of the tax cut.

As a matter of theory, short-run responses should be larger than long-run responses, as taxpayers realize accumulated gains that were otherwise constrained by the tax rate. Transitory responses (i.e., responses to a temporary reduction in tax rates, for example, when high-income individuals experience lower than normal incomes or when tax changes are known to be temporary) should be significantly larger than the long-run response. In general, the long-run response is of the most interest for permanent policy changes.

Empirical evidence on capital gains realizations has not reached a clear consensus on the response and revenue effect.[32] Earlier studies that influenced the 1990 debate showed a large variation in estimated responses. Some of these studies used time series data on aggregate realizations and tax rates, attempting to control for the business cycle, although estimates varied significantly. Elasticities (the percentage change in realizations divided by the percentage change in tax rate) ranged from 0.27 to 0.89, with a 0.68 average.[33] These studies could not easily disentangle short-run, transitory, and long-run responses. Other studies looked at responses based on individual observations (i.e., microdata studies), finding a much wider range of elasticities, from 0.55 to 3.80, with a 2.06 average.

Recent statistical research suggests long-run responses were smaller than those in the literature preceding and during the 1990 debate, in part, because microdata studies were likely capturing transitory effects. These later studies, which were largely microdata, found elasticities ranging from 0.22 to 0.90, with a 0.52 average.[34] These studies indicate a revenue-maximizing tax rate (i.e., the rate at which increases begin to lose revenue) and a percentage of the static revenue loss that would be collected. The revenue-maximizing tax rate for post 1980's studies ranges from a revenue-maximizing rate of 24% for the largest estimated response to almost 100% for the smallest. These studies indicate a range of revenue collected relative to the static response, for a five-percentage point increase, of 3% for the largest response to 74% for the smallest.[35] Some of

[31] For revenue projections, actual and projected capital gains realizations and tax receipts, see Congressional Budget Office, "Budget and Economic Data," July 2021, https://www.cbo.gov/about/products/budget-economic-data#2. These are averages across the years, not weighted for gross domestic product (GDP).

[32] See CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle, for a review of this evidence. Data on elasticities from pre-1990 studies is in Table B.1. Data on the more recent studies are from Table 1 and Table 2. The revenue-maximizing tax rate is 1 divided by the coefficient in Table 1 of that report.

[33] From Table B-1 in CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle.

[34] Based on the functional form for estimation, elasticities rise with the tax rate. The reported elasticities are at a 22% tax rate.

[35] These numbers are from Table 1 and Table 2 of CRS Report R41364, *Capital Gains Tax Options: Behavioral*

these studies with large effects are probably capturing transitory or short-run responses. The most recent study, which controls for these effects, indicates an elasticity of 0.31, a revenue-maximizing tax rate of 71%, and a revenue gain of 63% of the static response.[36]

A different type of study, which is not a statistical study, is based on the recognition that gains cannot exceed accruals over a long period of time. That is, if realizations are 50% of accruals, gains cannot more than double even if tax rates and transactions costs are reduced to zero. Based on the data on realizations relative to accruals, the maximum response would lead to an elasticity of no more than 0.5, a revenue-maximizing tax rate no lower than 44%, and a revenue gain of at least 44% of the static loss.[37] This is a maximum response; for example, at the midpoint of that study, the elasticity would be 0.25, a revenue-maximizing tax rate of 88%, and a revenue gain of 71% of the static response.

The JCT assumes an elasticity of 0.68, a revenue-maximizing tax rate of 32%, and a revenue gain of 24% of the static response. This elasticity is consistent with time series studies before and during the 1990 debate but is higher than the average of the post-1990 studies (0.52), the maximum estimates from the study of accruals versus realizations (0.5), and the estimate for the most recent econometric study (0.31).

Under the presumption that the response rises with the tax rate, any feedback that reduces revenues would be larger, the larger the tax increase.

Arguments have also been made that a capital gains tax cut would induce additional savings, also resulting in a feedback effect as taxes are imposed on new income. This effect is uncertain, as it is not clear that an increase in the rate of return would increase savings (though savings could decrease if the income effect is more powerful than the substitution effect) and the magnitude would likely be small.[38] In addition, there is a debate about the effect of the capital gains tax on growth through its effect on innovation. Regardless of these empirical uncertainties, any effect of savings on taxable income in the short run is likely to be quite small due to the slow rate of capital accumulation. A related argument is that the tax cut would increase asset values; such an effect is only temporary, however, and would, if it occurs, only shift revenues from the future to the present.[39]

Distributional Effects

Capital gains are concentrated in the higher-income classes, and that concentration includes realized and unrealized gains. This distributional outcome is explained by the fact that higher income households own a disproportionate amount of assets in the economy.

Responses and Revenues, by Jane G. Gravelle, The revenue-maximizing tax rate is 1 divided by the coefficient in Table 1. This report contains a review of all of the empirical studies.

[36] Calculated from Agersnap, Ole, and Owen Zidar. "The Tax Elasticity of Capital Gains and Revenue-Maximizing Rates," *American Economic Review: Insights*, 34 vol. 3, no.4 (December, 2021), pp. 399-416. This calculation uses an alternative functional form to correspond with other estimates, and calculated for the long term. See of CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle.

[37] This study is an out-of-print CRS Report 91-240, *Limits to Capital Gains Feedback Effects*, by Jane G. Gravelle. The report is available from the author and was also published by *Tax Notes*, April 22, 1991, pp. 363-371.

[38] See CRS Report R43381, *Dynamic Scoring for Tax Legislation: A Review of Models*, by Jane G. Gravelle, for a discussion of the empirical evidence.

[39] For a discussion of savings and asset valuations, see testimony of Jane G. Gravelle, Congressional Research Service, before the Senate Finance Committee, February 15, 1995, and the House Ways and Means Committee, March 19, 1997.

Realized Gains

Capital gains are concentrated, even more than total income, in the top of the income distribution. **Table 6** shows Tax Policy Center estimates reporting the share of long-term net capital gain based on an expanded cash income measure. As indicated in the table, gains are concentrated in higher incomes with 92% in the top 20%, 75.4% in the top 1%, and 55.5% in the top 0.1%.

Table 6. Tax Policy Center: Distribution of Long-Term Capital Gains by Income Percentile, 2019

Income Percentile	Share of Capital Gains (%)	Share of Total Income (%)
Bottom 20%	0.2%	3.7%
20% to 40%	0.6	8.3
40% to 60%	2.0	14.0
60% to 80%	3.6	20.6
80% to 100%	92.0	53.4
Detail at Top:		
80% to 90%	3.3	14.3
90% to 95%	3.7	9.9
95% to 99%	9.6	12.9
Top 1%	75.4	16.7
Top 0.1%	55.5	7.8

Source: Urban-Brookings Tax Policy Center, https://www.taxpolicycenter.org/model-estimates/distribution-individual-income-tax-long-term-capital-gains-and-qualified-44.

The Penn-Wharton Budget Model reports a projection from their 2020 economic model, although it does not take into account the effect of COVID-19. The shares are similar to those in the previous table, although with slightly smaller amounts at the top and bottom.

Table 7. Penn-Wharton Budget Model: Distribution of Capital Gains by Income Percentile, 2020

Income Percentile	Share of Capital Gains (%)
Bottom 20%	0.1%
20% to 40%	0.3
40% to 60%	1.3
60% to 80%	3.8
80% to 90%	4.1
90% to 95%	5.2
95% to 99%	14.2
99% to 99.9%	19.0
Top 0.1%	52.0

Source: Penn Wharton Budget Model, "How are Capital Gains and Dividends Taxed?" October 20, 2020, https://budgetmodel.wharton.upenn.edu/issues/2020/10/20/capital-gains-and-dividend-tax.

The IRS provides data on distribution by percentiles that has more refinement at the top, but based on adjusted gross income. **Table 8** shows that the top 0.001% (1,482 returns) had 14.0% of net capital gains.[40] They also report a distribution by capital gains taxed at preferential rates, which would capture long-term gains reported on returns constrained by the limits on losses. The top 0.001 share is slightly lower but similar, 12.8%. By contrast, this group of taxpayers accounts for only 1.8% of total adjusted gross income. The share by the top 0.1% is similar to the shares in the previous tables, 50.7% for net gains and 46.5% for gains subject to tax.

Table 8. Capital Gains by Adjusted Gross Income Percentile, 2019

Descending Cumulative Percentages	Share of Net Capital Gains (%)	Capital Gains Subject to Preferential Tax Rates (%)	Share of Adjusted Gross Income (%)
.001	14.0%	12.8%	1.8%
.01	30.3	27.4	4.4
0.1	50.7	46.5	9.6
1	70.6	66.8	20.1
2	76.5	73.4	25.6
3	79.8	77.2	29.7
4	82.2	80.0	33.0
5	83.9	82.0	35.9
10	88.4	87.8	47.3
20	92.4	93.1	62.9
25	93.7	94.8	68.9
30	94.6	96.0	73.9
40	95.6	97.6	82.1
50	96.3	98.6	88.5

Source: Internal Revenue Service, Statistics of Income, "Number of Returns, Shares of AGI, Selected Income Items, Credits, Total Income Tax, AGI Floor on Percentiles, and Average Tax Rates," Table 1, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-rates-and-tax-shares#Early Release.

Unrealized Gains

Unrealized gains are not reported on tax returns. **Table 9** reports the distribution of gains from the Survey of Consumer Finance. The survey reports only the top 10%, as it does not have significant detail on the top income percentiles. The second column reflects the distribution of all gains, including personal residences. The third excludes the share of real property attributable to residences and the fourth adds the estimates for the Forbes 400, indicating that 85.4% of gains are in the top 10%. This share is similar to the gains for the top 10% in **Table 6** (88.7%), **Table 7** (85.3%), and **Table 8** (87.8%).

[40] The share of the top 400 returns, last reported for 2014, was 11% for net gains and 10% for gains subject to preferential rates. See Internal Revenue Service, Statistics of Income, "Top 400 Individual Income Tax Returns with the Largest Adjusted Gross Incomes," https://www.irs.gov/statistics/soi-tax-stats-top-400-individual-income-tax-returns-with-the-largest-adjusted-gross-incomes.

Table 9. Distribution of Unrealized Capital Gain by Income Percentile, Survey of Consumer Finances

Income Percentile	All Gains (%)	Gains Excluding Homes (%)	Gains Excluding Homes and Including the Forbes 400 (%)
Under 20%	3.3%	2.1%	1.8%
20% to 40%	3.9	1.2	1.0
40% to 60%	5.5	2.1	1.9
60% to 50%	8.9	5.0	4.6
80% to 90%	8.8	5.3	4.9
90% to 100%	69.6	84.3	85.4

Source: CRS calculations based on the Survey of Consumer Finance, "Unrealized Gains by Income Percentile," Interactive Chartbook, https://www.federalreserve.gov/econres/scfindex.htm and Urban Brookings Tax Policy Center, Unrealized Capital Gains, https://www.taxpolicycenter.org/statistics/unrealized-capital-gains.

Notes: The distribution is generated based on the mean in each class and the percentage of respondents reporting a gain. The allocation across asset types is based on Tax Policy Center data. The estimate for the Forbes 400 is based on a study that indicates the effective tax rate on total gains, including unrealized gains for this group, is 8.5%. (See Greg Leiserson and Danny Yagan, *What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans?* The White House, September 23, 2021), https://www.whitehouse.gov/cea/written-materials/2021/09/23/what-is-the-average-federal-individual-income-tax-rate-on-the-wealthiest-americans/#_ftn12. Based on the latest data for the distribution of income for the top 400 returns (2014), 65% of income is capital gains, 11% is dividends, 17% is exempt through itemized and other deductions, and the remaining 7% is ordinary income; the composite effective tax rate is 21.49%. See Internal Revenue Service, Statistics of Income, "The 400 Individual Income Tax Returns Reporting the Largest Adjusted Gross Incomes Each Year," 1992–2014, https://www.irs.gov/statistics/soi-tax-stats-top-400-individual-income-tax-returns-with-the-largest-adjusted-gross-incomes. The share subject to tax is, therefore, 8.5/21.49, or 40%. The Forbes 400 wealth for 2019 is $2.96 trillion (see "Forbes Releases 38th Annual Forbes 400 Ranking of the Richest Americans," October 2, 2019, https://www.forbes.com/sites/forbespr/2019/10/02/forbes-releases-38th-annual-forbes-400-ranking-of-the-richest-americans/?sh=63b3c91360e0). The adjustment for Forbes adds 60% of this wealth to unrealized capital gains. These calculations indicate that these individuals have about 10% of total unrealized capital gains.

The distribution in this table is less concentrated in the higher-income levels than for the measure of realized gains in the Tax Policy Center and IRS data. This is due to the exclusion of tax units, because they are either part of the primary economic unit or financially independent units sharing the same household. The number of units is 19% larger than the household units if financially independent units are added, and it is 35% larger than both these units and members of the primary unit filing separate tax returns and who are not claimed as dependents on other returns are included. If these additional returns fall in the lower income percentiles, the top 10% of the household units would reflect about 7% of total taxpaying units (10/135) and that share for taxpaying units would include part of the share in the 80% to 90% bracket in **Table 9**. Similarly, the bottom 20% bracket in the tax data is probably largely missing from **Table 9** and would probably have negligible accruals. Thus, the distribution of unrealized gains appears similar to the distribution of realized gains.

Efficiency Effects

Taxes can affect economic efficiency by causing a misallocation of investment and savings. This section discusses three types of distortions: the lock-in effect that interferes with the allocation of the investment portfolio, the effect of capital gains taxes on sectors and types of investments, and savings.

Lock-In Effect

A traditional criticism of the capital gains tax is that it creates a lock-in effect, as the tax reduces the incentive to sell and reinvest in an asset that is more desirable or earns a higher expected return. Thus, the realizations response has implications for economic efficiency as well as for revenue yield and, as discussed above, its magnitude is uncertain. The decision to hold or sell depends on how much higher the return on the new investment is compared with the old, along with other factors. The higher required increased return, the greater the lock-in effect. The lock-in effect is more pronounced for assets that have a low basis (which is generally associated with a longer holding period), for assets that earn more of their return in appreciation, for assets with a shorter future holding period, and perhaps more importantly for assets that are expected to be held until death. In the latter case, it is not merely a matter of deferring capital gains tax but avoiding it altogether. Estimates of the increase in return required to justify investments given capital gains taxes indicate that the avoidance of capital gains at death is a major incentive to hold on to assets.[41] The lock-in effect can also alter welfare by changing the amount of a portfolio invested in risky assets (i.e., stocks rather than bonds).

The broader question of whether a lock-in effect for certain individuals impedes efficient allocation of investment in the overall economy is less clear. For example, much of stock is held in retirement accounts and not subject to tax, so that these investors facilitate an efficient allocation of investment because they are not constrained by the lock-in effect.

For businesses, the lock-in effect might be more distorting, as owners continue to hold on to businesses that they would otherwise sell to others who might manage the business more effectively.

The lock-in effect could create incentives to retain housing that is no longer appropriate (such as downsizing in later years or relocating), but this effect is limited because of the $500,000 and $250,000 exclusions and very few homeowners are subject to the tax.[42] Taxes on gains from personal residences could also impede labor mobility.

Overall, the lock-in effect not only reduces potential revenues from raising capital gains taxes but also distorts investment decisions. Nevertheless, the lock in effect is not due to a capital gains tax per se, but a tax that is imposed only upon realization, and there are changes other than reduced rates such as mark-to-market (accrual taxation) or proposals to tax gains at death that could reduce this distortion.

Effects on Allocation of Business Investment Between Sectors, Forms of Finance, and the Dividend Payout Rate

In the past, an argument was made for lower capital gains taxes on corporate stock because corporate equity capital is subject to double taxation (once at the corporate level and once at the individual level), which discouraged investment in the corporate sector. However, now the corporate statutory rate, which was reduced from 35% to 21% in 2018, is considerably below the

[41] This point was first made by Charles C. Holt and John P. Shelton, "The Lock-in Effect of the Capital Gains Tax," *National Tax Journal*, vo. 15, no. 4 (December 1962), pp. 337-352, https://www.journals.uchicago.edu/doi/abs/10.1086/NTJ41790910?journalCode=ntj. See also Jane G. Gravelle, *The Economic Effects of Tax Capital Income* (The MIT Press: Cambridge, MA, 1994), pp. 136-140.

[42] See CRS Report RL32978, *The Exclusion of Capital Gains for Owner-Occupied Housing*, by Jane G. Gravelle, for a discussion of the scope of coverage.

average statutory rate for unincorporated businesses. Moreover, because of the share of gains not realized, and the share of corporate stock not owned by those subject to the tax, the corporate rate is generally below the individual rate.[43]

Debt is still favored over equity in both the corporate and noncorporate sectors, although that differential is largely traced to allowing nominal interest payments to be deducted, while most interest income is not subject to individual tax.

When dividends were taxed at rates higher than the capital gains rates, there was a disincentive to distribute income. Since 2003, these amounts are taxed at the same rate although a capital gain is still preferred because of the deduction for basis (while a dividend is taxed in full). This favorable tax treatment has led to more distributions in the form of stock repurchases, which has also lessened the effect on the level of distributions but now led to distortions in the form of distributions.

Savings, Economic Growth, and Entrepreneurship

Arguments have also been made that lower gains taxes would increase economic growth (by increasing saving) and entrepreneurship. Although evidence on the effect of tax cuts on savings rates and, thus, economic growth is difficult to obtain, most evidence does not indicate a large response of savings to an increase in the rate of return. Indeed, not all studies found a positive response, because a higher rate of return may allow individuals to save less while reaching their desired goal.[44] A more effective route to increasing savings may be to take revenues that might otherwise finance a tax cut and reduce the debt, which would increase national saving by reducing government borrowin.

Although arguments are made that lower gains taxes stimulate innovation and entrepreneurship, there is little evidence in history to connect periods of technical advance with lower taxes or even high rates of return. The extent to which entrepreneurs take tax considerations into account is unclear; however, there is some reason to doubt that capital gains taxes are important in obtaining large amounts of venture capital, because most of this capital is supplied by those not subject to the capital gains tax (i.e., pension funds, nonprofits, foreign investors).[45] Moreover, there is no evidence that longer corporate stock holding periods lead to more investments in long-term assets, including R&D, a rationale for lowering rates for assets with longer holding periods.[46]

Special Issues

Numerous circumstances lead to the reduction or deferral of realized capital gains. Some, but not all, of these are listed as tax expenditures, and the revenue estimates are shown in **Table 10**.

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[43] See CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle, for comparisons of the statutory and effective marginal tax rates for the sections. The average statutory rate for unincorporated business owners is estimated at 30% currently and 33% after 2025.

[44] See CRS Report R43381, *Dynamic Scoring for Tax Legislation: A Review of Models*, by Jane G. Gravelle, for a discussion of the empirical evidence.

[45] See "The Invisible Investors that Drive Venture Capital," ACV, April 15, 2021, https://acv-vc.medium.com/the-invisible-investors-that-drive-venture-capital-63e1d2d54ce6. For a discussion of arguments and issues relating to entrepreneurship, see William M. Gentry, "Capital Gains Taxation and Entrepreneurship," *Tax Law Review*, vol. 69, iss. 1 (Fall 2015), pp. 321-355, https://heinonline.org/HOL/Page?collection=journals&handle=hein.journals/taxlr69&id=339&men_tab=srchresults.

[46] See Mark J. Roe, "Stock Market Short-Termism's Impact," August 12, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171090.

Table 10. Estimated Revenue Loss from Selected Capital Gains Tax Expenditures, FY2023

($ in billions)

	Individuals	Corporations	Total
Exclusion on Gains on Personal Residences	$42.7	——	$42.7
Like-Kind Exchanges	6.0	2.5	8.5
Installment Sales	1.3	4.4	5.7
Small Business Stock	1.5		1.5
Opportunity Zones	0.4	1.3	1.7

Source: Joint Committee on Taxation, *Estimates Of Federal Tax Expenditures For Fiscal Years 2020-2024*, JCX-23-20, November 05, 2020, https://www.jct.gov/publications/2020/jcx-23-20/.

Notes: The JCT also has estimates for general provisions, including the lower rates on capital gains and dividends ($149.1billion), the exclusion of capital gains at death ($44.5 billion), and carryover basis for gifts ($4.8 billion). Because dividends account for less than 20% of the total of qualified dividends and capital gains, the loss for gains alone is about $120 billion. Note that their estimates do not allow for behavioral response. This list is not exhaustive, as there are other provisions that partially benefit from capital gains treatment or relief such as qualified stock options, involuntary conversions during disasters, sale of certain brownfield property by tax-exempt organizations, and capital gains on timber, coal, and iron ore royalties.

The Exemption for Owner-Occupied Housing[47]

Owner-occupied housing has had exclusions of various types for 70 years. The major justification for owner-occupied housing benefits is to eliminate the tax as a barrier to labor mobility. The exclusion also eliminates or reduces the lock-in effect, which may cause individuals to forego moving to a more desirable living situation (e.g., downsizing or moving to rental later in life). It also simplifies record keeping needed to document improvements—which increase the basis of the asset. This record keeping is complicated because it must distinguish between maintenance and improvements.

The exclusion originally eliminated tax for the vast majority of homeowners. One concern, however, is the cap on the deduction ($500,000 for joint returns and $250,000 for single returns), which has not been adjusted for inflation or housing prices since 1997. If the caps were adjusted for general inflation, they would be $800,000 and $400,000; if they were adjusted for changes in the average housing price, they would be $1,300,000 and $650,000. The possibility of becoming exposed to the tax means that many homeowners need to continue to keep records.

Tax-Free Reorganizations

If one corporation purchases the assets of another corporation, without special tax provisions, the acquired corporation pays a capital gains tax on the sale and the acquired corporation's stockholders pay tax on the gain on stock they receive in the acquiring company in exchange for the acquired corporation's stock, with cash payments taxed as a dividend. If a corporation purchases the stock of another corporation, there is no tax to the acquired corporation but the shareholders pay capital gains on the stock. For tax-free mergers that meet certain conditions, there are no capital gains taxes to either the company or the stockholder. The acquiring company and shareholders carry over the basis so that gain will be taxed on any future taxable sales. The

[47] See CRS Report RL32978, *The Exclusion of Capital Gains for Owner-Occupied Housing*, by Jane G. Gravelle, for a discussion of the scope of coverage.

only tax occurs when the corporation distributes property (such as cash) to shareholders. These rules allow the combined businesses to continue with the same shareholders without paying taxes. While mergers may create more efficient operations, there are concerns that these rules encourage corporate concentration and reduce competitiveness.

Similarly, when a corporation divides, typically by creating a subsidiary, and distributes or exchanges stock to some or all shareholders, shareholders are either treated as receiving a dividend or a taxable gain. The tax code also allows tax-free treatment of divisive reorganizations. The argument for this treatment is that the business is continuing although ownership has shifted for different parts of the business among the original shareholders. The major concern about tax-free divisive reorganizations is that they may be used to distribute earnings that would otherwise be taxed as dividends as tax exempt stock, which can subsequently be sold, with only the gain taxed. Another concern is firms with large amounts of passive assets that use the division to distribute earnings, or firms with changes in ownership prior to the division that undermine the objective of allowing a continuing business still owned by historical shareholders.[48]

Other Special Capital Gains Provisions

Several other special capital gains provisions exist; some explicitly granted in the tax law and some the outcome of interpretations of the law:

- Like-kind exchanges allow individuals to exchange real property without recognizing gain;[49]
- Installment sales allow taxpayers to defer recognition of gain until payments are made;[50]
- Carried interest is compensation to investment fund managers that depends on profits and is taxed as a capital gain;[51]
- Certain small business stock is eligible for exemption or lower rates up to limits if they are the original issue of certain small corporations;[52]
- Opportunity zones allow reinvestment of gains in certain economically distressed areas to benefit from deferral or exemption of capital gains;[53]
- Capital gains treatment is allowed for timber and coal and iron ore royalties; and

[48] See, e.g., Bret Wells, "Reform of Section 355," *American University Law Review*, vol. 68, iss. 2 (2018), https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=2080&context=aulr; Michael Schler, "Simplifying and Rationalizing the Spinoff Rules," *SMU Law Review*, vol. 56, no. 1 (2003), Article 9, https://scholar.smu.edu/cgi/viewcontent.cgi?article=1995&context=smulr; George K Yin, "Taxing Corporate Divisions," *SMU Law Review*, vol. 56, no. 1 (2003), Article 10, https://scholar.smu.edu/smulr/vol56/iss1/10/; and Herbert M. Beller, "Section 355 Revisited: Time for a Major Overhaul?" 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3232960 (forthcoming in *The Tax Lawyer*).

[49] See "Deferral of Gain on Like-Kind Exchanges," U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by the Congressional Research Service, 116th Cong., 2nd sess., December 2020, S. Prt. 116-53 (Washington: GPO, 2020), pp. 399-402, https://www.govinfo.gov/content/pkg/CPRT-116SPRT42597/pdf/CPRT-116SPRT42597.pdf for an overview.

[50] See "Deferral of Gain on Non-Dealer Installment Sales, ibid., pp. 395-398.

[51] See CRS Report R46447, *Taxation of Carried Interest*, by Donald J. Marples.

[52] See CRS Report RL32254, *Small Business Tax Benefits: Current Law*, by Gary Guenther, for further discussion.

[53] See CRS Report R45152, *Tax Incentives for Opportunity Zones*, by Sean Lowry and Donald J. Marples.

- Gain is excluded on charitable contributions of appreciated assets, even though the donor can take an itemized deduction for the full value. Gifts of appreciated property tend to be concentrated among high-income individuals.[54]

Policy Options

Proposals to increase capital gains taxes, along with the tax rate on qualified dividends, are motivated in part by revenue needs, but also because of low effective tax rates arising from the significant share of unrealized gain income and lower tax rates on capital gains among high-income individuals. For example, the top 0.001% of the distribution (1,482 taxpayers with adjusted gross income of at least $60 million) received 62% of their income from long-term capital gains and 11% from qualified dividends, along with 14% in deductions, leaving only 15% of income taxed at ordinary rates. Unrealized capital gains are larger than realized gains: based on the Forbes 400 study, they could be around 60% of accruals. Those assumptions imply that almost half of total income for this group is excluded due to unrealized gains.[55] Data on the wealthiest 25 individuals indicated that unrealized gains were almost 80% of income.[56]

Because of the potential reduction in realizations and the scope of unrealized gains, simply increasing tax rates on realized gains may be limited in the ability to raise revenues (or may be scored that way) and might not reach the income of wealthy individuals, so that alternative or complementary approaches to capturing this income have been proposed. An alternative is to tax wealth instead of income from wealth or to raise the corporate tax rate.[57] A complementary option is to tax gains as they accrue, so that taxes can no longer be avoided by holding on to assets. Another option is to treat death as a realization event and tax gains at that time. This approach would still allow for a significant deferral of the tax on gains but gains would eventually be taxed and the lock-in effect, particularly in later years, would be significantly reduced. An alternative option is to provide for carryover basis, so that assets passed on at death would still be subject to tax if sold by the heirs. This approach would also reduce the lock-in effect, although not as much as taxing gains at death.

Another area of revision in capital gains to consider is the effects of inflation, including indexing gains for inflation and correcting provisions stated in dollar amounts to reflect current prices. These changes would reduce capital gains taxes. Changes in smaller provisions have also been proposed.

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[54] See CRS Report R45922, *Tax Issues Relating to Charitable Contributions and Organizations*, by Jane G. Gravelle, Donald J. Marples, and Molly F. Sherlock.

[55] Internal Revenue Service, Statistics of Income, "Number of Returns, Shares of AGI, Selected Income Items, Credits, Total Income Tax, AGI Floor on Percentiles, and Average Tax Rates," Table 1, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-rates-and-tax-shares#Early%20Release. If 60% of accrued gains are realized, there is an additional 98% of income that is not realized (0.6/0.4 times 62%) and the total share of unrealized income would be 0.98/1.98, or 49%.

[56] See Paul Kiel, Jesse Eisinger, and Jeff Ernsthaler, "America's Highest Earners and Their Taxes Revealed," *Propublica*, April 13, 2022, https://projects.propublica.org/americas-highest-incomes-and-taxes-revealed/. According to the article, for 2015-2018, overall tax on reported income was 16%, the income tax paid was $13.6 billion, and the increase in wealth was $401 billion. This implies that $85 billion was reported ($13.6 billion divided by 0.16), which is approximately 21% of $401 billion.

[57] See CRS In Focus IF11823, *An Economic Perspective on Wealth Taxes*, by Mark P. Keightley and Donald J. Marples, for a discussion of wealth taxes. For a discussion of the advantages and disadvantages of various approaches, see Jane G. Gravelle, "Sharing the Wealth: How to Tax the Rich," *National Tax Journal*, vol. 73, no. 4 (December 2020), pp. 951-968.

Discussions of the President's 2023 budget proposals and revenue estimates are in the Treasury Green Book.[58]

Increased Tax Rates on Dividends and Capital Gains

Increasing the capital gains tax rate is constrained as a way to raise revenue, based on official scoring, because of the large realization response. Consider, as an illustration, increasing the tax rate on dividends and capital gains for the top 1% by five percentage points. A similar provision was included in the Ways and Means legislative recommendations for the Build Back Better Act (BBBA), projected to raise $123.4 billion from FY2022-FY2031.[59] For FY2023, the revenue increase was $14 billion. A static estimate of a similar change suggests a revenue gain of $52 billion.[60] The reason for the much lower estimate is the realizations response; adjusting for the JCT's response indicates a revenue gain of $15 billion, close to the JCT estimate.[61] The estimate, therefore, is very sensitive to the realizations assumption. For example, if the measure from the most recent econometric study were used, the revenue gain would be $35.4 billion, or over twice as large. If the highest measure is used, there would be a revenue loss from the capital gains and net gain of $4.6 billion; if the lowest estimate were used, the revenue gain would be $39.3 billion. Two options to consider are the measure from the most recent econometric study (revenue gain of $35.4 billion) and the upper limit from the study of realizations and accruals (revenue gain of $24.4 billion).

The BBBA (H.R. 5376) as passed by the House has a surcharge of 5% on modified adjusted gross income for amounts over $5 million and an additional 3% for amounts over $12.5 million. This surcharge applies to all income including realized capital gains and dividends.

Taxation of Gains as Accrued (Mark-to-Market)

An alternative or supplement to increasing taxes on capital gains is to tax accrued gains, sometimes referred to as mark-to-market as assets will be assigned market prices. Such proposals limit the treatment to high-income individuals, to reduce complexity. If accrued gains for the top 1% were taxed and unrealized gains are roughly the same as realized ones, in the steady state (once prior accrued gains were taxed), the estimated revenue gain would be $212 billion

[58] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals*, March 2022, https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf.

[59] Joint Committee on Taxation, *Estimated Budgetary Effects Of An Amendment In The Nature Of A Substitute To The Revenue Provisions Of Subtitles F, G, H, I, And J Of The Budget Reconciliation Legislative Recommendations* Relating *To Infrastructure Financing And Community Development, Green Energy, Social Safety Net, Responsibly Funding Our Priorities, And Drug Pricing, Scheduled For Markup By The Committee On Ways And Means On September 14, 2021*, JCX-42-21, September 13, 2021, https://www.jct.gov/publications/2021/jcx-42-21/.

[60] According the CB0 data, capital gains are projected at $1,275 billion in calendar year 2023. (See revenue projections, June 2021, https://www.cbo.gov/about/products/budget-economic-data#3.) Data for 2015 indicated that 99% of net gain was long-term gains, and the data in Table 8 indicate that the top 1% have about 70% of the gains, so multiplying $1,275 billion times 0.99 times 0.70 times yields $44.2 billion. For 2019, IRS data indicate that qualified dividends are 17% of capital gains for that group, so that adds $7.5 billion, for a total of $51.7 billion.

[61] The ratio of new realizations to old is $e^{(-b(t^*-t))}$, where t* is the new tax rate, t is the old rate, and b is the absolute value of the coefficient from a semi-log function. Using the coefficient of 3.1 from Table 1 in CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle, a new tax rate of 28.8 and an old rate of 23.8 results in realizations that are 85.6% as large. As a result, rather than revenues rising by 21% (0.288/0.238-1), they rise by 3.6% and the gain from capital gains is $7.6 billion. The coefficient for the most recent study is 1.4, the highest is 4.1, the lowest is 1, and coefficient for the upper limit is 2.27.

measured at gains levels for FY2023.[62] Moreover, capital gains rates could be raised without effects from the realization response, so that raising the capital gains tax rate by five percentage points would gain $88.4 billion ($44.2 for current realized gains and $44.2 billion for accrued unrealized gains).

A number of issues arise in taxing gains on an accrual basis. Although it would be straightforward to tax gains as they accrue on publicly traded assets such as stocks, and these stocks could be sold if money were needed to pay the tax, nontradeable assets present problems of both valuation and liquidity. One option would be to apply a lookback method that could tax gains only when realized, with an additional tax to adjust for the benefit of deferral. It might also include death as a realization event (or it could carry over the treatment to heirs). To equalize treatment between tradeable and nontradeable assets, gains on appreciated assets given to charities should be taxed at that time for these assets. Death is a time when valuation would occur for large estates in any case.[63] It would also be possible to allow or require taxpayers to pay an estimated tax in the current year, with the final tax settled upon sale.

Other issues include whether pre-existing unrealized gains should be grandfathered (deferred until realization) or taken into account over time, how to treat depreciable assets so as not to undermine tax incentives provided through accelerated depreciation, whether to index for inflation, and how to treat losses.[64]

Historically, a concern with taxation of gains at death (or carryover basis for inherited assets) is that heirs would not know the basis. It would be possible to provide some sort of safe harbor in those cases (e.g., 10% of the value is basis). This concern is less likely to be serious for high-income taxpayers who are more likely to have kept records.

Senator Wyden, chairman of the Senate Finance Committee, proposed a mark-to-market treatment of tradeable assets and a look-back for other assets.[65] More recently, he has proposed an updated version, called the "Billionaire's Tax," which would apply to those with net worth of more than $1 billion or income of more than $100 million for three consecutive years.[66] Gains on tradeable assets (such as stocks) would be marked to market each year and taxed as long-term capital gains. Gains on nontradeable assets would be deferred until realized, but subject to an interest charge on deferred assets. Transfers by death or gift would be taxable events (with exceptions for transfers to spouses or charities). This proposal is estimated to affect

[62] $1,275 billion times 0.70 times 0.238.

[63] Formulas for a look-back method that require only knowledge of the basis, sales price, and holding period and leaves the taxpayer with the same net of tax yield can be found in Appendix A of CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle. This approach is also discussed in David S. Miller, "A Comprehensive Mark-to-Market Tax for the 0.1% Wealthiest and Highest-Earning Taxpayers," January 4, 2016, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710738. There have also been proposals that use holding period, sales price, and an assumed interest rate to determine the tax. See Alan J. Auerbach, "Retrospective Taxation of Capital Gains," *American Economic Review*, vol. 81. no.1, (March 1991), pp. 167-178.

[64] For a more detailed discussion of these issues, see Jane G. Gravelle, "Sharing the Wealth: How to Tax the Rich," *National Tax Journal*, vol. 73, no. 4 (December 2020), pp. 951-968.

[65] Senator Ron Wyden, Senate Finance Committee, "Treat Wealth Like Wages," 2021, https://www.findknowdo.com/sites/default/files/news/attachments/2021/02/treat-wealth-wages-rm-wyden.pdf.

[66] See "Wyden Unveils Billionaires Income Tax," Senate Finance Committee, October 22, 2021, https://www.finance.senate.gov/chairmans-news/wyden-unveils-billionaires-income-tax. Revenue estimates are reported in Wyden Statement on Billionaires Income Tax Score, Senate Finance Committee, November 5, 2021, https://www.finance.senate.gov/chairmans-news/wyden-statement-on-billionaires-income-tax-score.

approximately 700 taxpayers (less than 0.001% of the population) and raise $557 billion over 10 years.

The President's FY2023 budget proposals include a minimum tax of 20%, a tax base that adds back unrealized gain, to be phased in for wealth between $100 million and $200 million. Additional taxes paid under the minimum tax would be credited against tax on future capital gains realizations. The tax would apply to existing unrealized gains, but taxes in the first year could be paid in nine installments. Tax in future years could be paid in five installments. Taxpayers who have less than 20% of assets in tradeable assets could elect to be taxed only on tradeable assets, with nontradeable assets taxed on realization, and subject to a deferral charge. Note that other parts of the budget proposal would raise capital gains tax rates to ordinary rates for taxpayers with $1 million or more of income and tax capital gains as realized by gift or at death. The budget proposals estimate revenue gains for the minimum tax for FY2023-FY3032 of $361 billion. The minimum tax would apply to less than 1/100 of one percent of individuals.[67]

Taxing Capital Gains at Death and by Gift

As noted earlier, the basis for assets transferred at death is increased (stepped up) to fair market value, so gains escape tax entirely. Assets transferred by gift carry over the original basis, so transferring by gift does not eliminate the tax. The JCT has estimated that the lack of taxation of gains at death reduces tax revenue by $44.5 billion and that carryover basis instead of realization by gift reduces tax revenue by $4.3 billion (see note in **Table 10**). Taxing gains at death would reduce, but not eliminate, the lock-in effect. For example, for a non-dividend paying stock with a growth rate of 7%, an inflation rate of 2%, and a tax rate of 23.8%, having been held for 20 years and with life expectancy of 7 years, would need a new asset to yield an additional 3.2% real return to justify switching. With taxation at death, the new asset would have to yield an additional 0.9% return.

As with mark-to-market proposals, there are issues with liquidity involving nontradeable assets. Concerns that heirs will not know the basis of assets also exist.

The FY2023 budget proposals include a provision to tax capital gains at ordinary rates and to tax gains at death and by gift.[68] The higher tax rates would apply to taxpayers with $1 million or more in taxable income. The taxation of gains at death and by gift would be eligible for a $5 million exclusion and property transferred to the spouse or charity would be exempt. The spouse would carry over the basis for future capital gains purposes. Certain family-owned businesses could defer the gain until the business is sold or no longer under family control and tax on gains from assets that are not liquid could be paid over 15 years. The increased tax rates would apply to around 0.3% of tax returns and the taxation at death would apply to about 0.5% of decedents.[69]

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[67] In 2016, the estimated threshold wealth for the top 0.01% was $82 million. See Matthew Smith, Owen Zidar, and Eric Zwick, "Top Wealth in America: New Estimates and Implications for Taxing the Rich," *PrincetonEconomics*, October 2021, https://economics.princeton.edu/working-papers/top-wealth-in-america-new-estimates-and-implications-for-taxing-the-rich/.

[68] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals*, March 2022, https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf.

[69] Returns with $1 million or less in adjusted gross income accounted for 0.35% of returns, and the share with taxable income would be smaller. See IRS Statistics of Income, "Individual Statistical Tables by Size of Adjusted Gross Income," Table 1.1, https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income. Estate tax returns filed for 2016 (the latest year available) and required for estates of $5.45 million were 13, 429, about 0.5% of the total deaths of 2,744,248 in 2016. See "Estate Tax Year of Death Tables," https://www.irs.gov/statistics/soi-tax-stats-estate-tax-year-of-death-tables. Center for Disease Control, Mortality in the United States 2016,

The budget proposals (both rate increases and capital gains at death) are estimated to gain $164.6 billion from FY2023 to FY2032.

H.R. 2286 (introduced by Representative Pascrell, 117th Congress) would also tax capital gains at death and by gift, with a number of similar rules, but with a $1 million exemption, and with gains on certain capital assets eligible to be paid over seven years with interest.

Carryover Basis for Capital Gains at Death

Under carryover basis, an asset inherited at death would retain the basis in the hands of the decedent. In this case, the gain would not escape taxation but would be subject to tax if and when the heir sold the asset. Carryover basis has been proposed as far back as 1942 and in two instances has been enacted into law. The first instance was in 1976, although the law was retroactively repealed in 1980 and never took effect. The second instance was in 2010. In the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), the estate tax was scheduled to be reduced and eventually eliminated in 2010 to be replaced by carryover basis. Although the estate tax was restored, executors in that year could elect to pay the estate tax or choose carryover basis, with a $1.3 million exemption. Estimates from researchers at the Department of the Treasury indicated that 60% of estates opted for the carryover basis. This preference rose with estate size: 48% of estates between $5 million and $10 million and 86% of estates over $20 million.[70] These results suggest that lacking knowledge of basis is not a serious problem.

This approach is not as effective in reducing the lock-in effect as taxing gains at death, because heirs can still delay taxation.

In its 2020 Budget Options report, CBO estimated that adopting carryover basis beginning in 2021 would raise revenue by $110 billion from FY2021 to FY2030, rising from $1.2 billion in FY2021 and $4.8 billion in FY2022 (the first full year) to $18.4 billion in FY2030.[71]

Inflation Adjustments

Since part of nominal capital gains reflects inflation, a true measure of economic income would adjust for this inflation. In addition, there are various caps on capital gains provisions that have not been adjusted for inflation, including the limit on losses and the caps on exclusions for owner-occupied housing. Indexing these caps for inflation that occurred since original enactment and continuing to index them would keep them at the level originally envisioned. (Changes are reported using the GDP price deflator and the consumer price index [CPI].)[72]

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https://www.cdc.gov/nchs/products/databriefs/db293.htm#:~:text=In%202016%2C%20a%20total%20of,at%20birth%20decreased%200.1%20year.

[70] Robert N. Gordon, David Joulfaian, and James M. Poterba, 2016. "Choosing between an Estate Tax and a Basis Carryover Regime: Evidence from 2010." *National Tax Journal*, vol. 69, no. 4, (December 2016), pp 981-1002.

[71] Congressional Budget Office, "Options for Reducing the Deficit: 2021 to 2030," December 2020, https://www.cbo.gov/system/files/2020-12/56783-budget-options.pdf.

[72] The GDP deflator is in BEA's National Income and Product Accounts, Table 1.1.4. Price Indexes for Gross Domestic Product, https://apps.bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=2&isuri=1&1921=survey. The CPI-U is at Bureau of Labor Statistics, Historical Consumer Price Index for All Urban Consumers (CPI-U): U.S. City Average, All items, by Month, https://www.bls.gov/cpi/tables/supplemental-files/historical-cpi-u-202203.pdf.

Adjusting the Basis of Assets for Inflation[73]

The tax on the inflation portion of nominal interest could be eliminated by increasing the basis of assets for inflation. That is, if prices have doubled since acquisition, the basis would be doubled. There is an argument for not taxing the inflation portion, although the effects of this change vary with the inflation rate. It has been less important during the recent years of relatively low inflation rates, although inflation has recently increased. (This increased inflation may be short-lived, however.) As shown in **Table 4**, the benefits of deferral offset the effects of inflation for corporate stock, except for relatively short-lived assets. Inflation, at least at recent low rates, has a small effect on effective tax rates, especially for assets held for a long period of time.

The small effects and deferral offsets weaken the case for inflation adjustments, although such adjustments are more justified if accrual taxation is adopted. There are two other common arguments against inflation indexing for capital gains. The first is that indexing capital gain in isolation leads to more tax arbitrage (such as borrowing and deducting nominal interest at ordinary rates while taxing only real capital gains at lower rates). The current limits on itemized deductions for investment interest constrain this effect because these amounts are limited to investment income outside of capital gains and tax-exempt interest. However, a taxpayer with a business can incur business loans that are effectively used to invest in assets yielding capital gains. This problem already exists but would become more serious with inflation indexing. In addition, it is difficult to determine the inflation adjustment for depreciable assets where depreciation does not match economic depreciation (because it is accelerated and not indexed for inflation). The second reason is that inflation indexing would complicate taxpayer compliance with the law, although for many taxpayers this adjustment can be made by investment firms that handle their accounts.

The revenue loss for indexing for inflation has been estimated at $178 billion over a 10-year period beginning in 2018.[74]

Two bills to index capital gains for inflation have been introduced in the 117th Congress: S. 3153 (Cruz) and H.R. 5838 (Davidson). These bills would index assets held for three years or more for inflation.

Indexing the Floor for the Application of the Net Investment Income Tax

Although the income levels for the ordinary capital gains tax rates are indexed for inflation because they refer to ordinary rates, the floor for the application of the 3.8% net investment income tax, adopted in 2010, is not. Using the GDP deflator, the $250,000 and $200,000 floors would increase to $308,000 and $246,000. Using the consumer price index, the floors would increase to $330,000 and $262,000.

Limits on Loss Offsets Against Ordinary Income[75]

During most of the tax code's history, capital losses have had limits on how much ordinary income they can offset. The primary reason is that investors could time their losses and gains to minimize taxes. During some periods of time, including the current period, another reason lends

[73] For a detailed analysis, see CRS Report R45229, *Indexing Capital Gains Taxes for Inflation*, by Jane G. Gravelle.

[74] Kyle Pomerleau, Economic and Budgetary Impact of Indexing Capital Gains to Inflation, Tax Foundation, September 4, 2018, https://taxfoundation.org/economic-budget-impact-indexing-capital-gains-inflation/.

[75] A discussion and history of methods of dealing with losses is found in out-of-print CRS Report RL31562, *An Analysis of the Tax Treatment of Capital Losses*, by Thomas L. Hungerford and Jane G. Gravelle, January 11, 2011, https://www.everycrsreport.com/files/20110110_RL31562_75d60c88f5da7b8939545e015c6234f5a068885b.pdf.

itself to offsetting income. When capital gains are taxed at lower rates than ordinary income, a dollar of loss reduces taxes by the ordinary rate (for high-income taxpayers, reduces each dollar loss by 37 cents, or 40.8 cents if the net investment income tax applies), while capital gains are taxed at the lower rate and increases each tax dollar by 23.8 cents.

It would be possible to adjust for the asymmetric treatment by allowing long-term losses to offset only a portion of income equal to the ratio of the capital gains rate over the ordinary rate. For example, at the top rates, losses could only offset 54% of ordinary income (0.20/0.37). At the same time, the $3,000 limit could be increased to reflect price changes since its adoption in 1978. It would be increased to approximately $11,000 based on the GDP price deflator and to $13,000 based on the CPI.

Indexing the Home Exclusion Caps

As noted earlier, indexing the $500,000 and $250,000 home exclusion caps to account for general inflation (using the GDP deflator) would increase the caps to $800,000 and $400,000; if caps were adjusted for changes in the average housing price, they would be $1,300,000 and $650,000. If the caps were adjusted for the CPI, they would be $890,000 and $445,000.

Indexing Limits for Small Business Stock

The provision allowing for exclusion of small business stock was adopted in 1993, with a limit of $10 million or 10 times basis for the exclusion, with exclusion applying to businesses with no more than $50 million in assets. Adjusting these amounts for inflation would lead to limits of $17 million and $86 million using the GDP deflator and $19 million and $96 million using the CPI.

Other Changes

Revisions in the Exclusion for Capital Gains on Owner-Occupied Housing

Other changes might be considered for the exclusion on owner-occupied housing. One option would be to eliminate the ceilings altogether (since the exclusion was initially envisioned as covering virtually all taxpayers), which would eliminate any need to keep records. Another option would be to allow surviving spouses to elect the full $500,000 exclusion as an alternative to step-up in basis of the decedent's share of assets, which would limit the effect, especially on widows who typically outlive their spouses, often by many years. Another option would be to substitute a larger lifetime exclusion, as the current exclusion, which can be used up to every two years, favors higher-income individuals who frequently turn over their housing relative to those with lower incomes who tend to stay in their homes for a longer time.

Carried Interest

President Biden's FY2023 budget proposals and numerous bills introduced in Congress would tax carried interest (i.e., income earned by investment fund managers that can be seen as payment for services) as ordinary income. Congressional bills include S. 1598 (Baldwin), S. 2617 (Wyden), S. 3022 (Warren), H.R. 1068 (Pascrell), H.R. 1376 (Ryan), H.R. 3903 (Grothman), H.R. 5648 (Pocan), and H.R. 6763 (Craig). The estimated revenue gain in the budget proposals is $6.636 billion over 10 years.

Like-Kind Exchanges

Like-kind exchanges were limited to real property in the Tax Cuts and Jobs Act, P.L. 115-97. The FY2023 budget proposals would eliminate like-kind exchanges, with an estimated revenue gain of $19.550 billion over 10 years. This change is consistent with the general thrust of proposals to eliminate lock-in effects that reduce tax revenue, because like-kind exchanges allow the effective sales of property without paying tax and contribute to the accumulation of assets that can be held until death.

Coal and Iron Ore Royalties

The FY2023 budget proposals include a provision to eliminate the treatment of coal royalties as capital gains, part of its package to eliminate subsidies for the production of fossil fuels. It is a small provision, estimated to raise $596 million over 10 years. Several bills have been introduced to eliminate capital gains treatment of coal royalties: S. 1167 (Sanders), S. 1298 (Wyden), and H.R. 2102 (Omar). These proposals do not include iron ore royalties.

Depreciation Recapture

As noted earlier, depreciation recapture for real property determined on the straight line basis is capped at 25%. The FY2023 budget proposals would recapture this income and tax it at ordinary rates, for a revenue gain of $6.320 billion over 10 years.

Charitable Gifts of Appreciated Property

Gifts of appreciated property provide a double tax benefit because the donor can take a charitable deduction for the full-market value without paying capital gains tax. This rule provides an incentive to donate appreciated property and inflate the value of the property in the case of assets that are not publicly traded. This issue could be addressed by allowing deductions only for cash contributions so that donors would have to sell the assets and donate the proceeds. It could also be accomplished by allowing a deduction for the basis, which would create an incentive to sell the assets and donate the proceeds, because the capital gains tax rate is lower than the ordinary rate. These approaches could create a problem for donations in which the property itself matters for the charitable purpose, such as a donation of art to an art museum. Another option would be to tax the appreciation directly, which would reduce but not eliminate the valuation problem.

In a proposal directed specifically at valuation issues, the Tax Reform Act of 2014 (H.R. 1) would have limited the charitable deduction to basis for certain property. Specifically, property related to the purpose of the charitable institution, certain property receiving special treatment, such as conservation easements, and publicly traded stock as long as it was no more than 10% of the total shares would have been exempted.

Transfers to Grantor Trusts

For income tax purposes, in certain grantor trusts, the grantor and the trust are treated as a unit to disregard transactions between them. Grantor trusts can be designed so that the trust's earnings flow through to the grantor and the grantor pays the income taxes. Because these taxes are not considered gifts to the trust, the earnings in the trust can grow tax free.

For estate and gift tax purposes, the trust can be designed so that assets are separate from the individual and are not included in the estate tax. Transfers to the trust are gifts, but distributions to beneficiaries are not treated as gifts.

Transactions between the trust and individual are disregarded for income tax purposes, thus, for example, a taxpayer can transfer appreciated assets into the trust in exchange for a promissory note, and the sale results in no tax consequences. The BBBA (H.R. 5376) and the FY2023 budget proposals contain a provision requiring appreciation to be recognized and taxed in these cases.

Tax-Free Corporate Divisions

The BBBA (H.R. 5376) would tighten the rules regarding recognition of gain to the parent (distributing) corporation in a tax-free division. This provision affects the treatment of the distributing corporation separating from its subsidiary. Under current law, the distributing corporation recognizes gain on the amount of the distributing corporation debt assumed by the subsidiary in excess of the basis of property transferred and on cash or property (known as boot) in excess of basis reduced by debt assumed. The distributing corporation can receive tax-free any newly issued securities of the subsidiary and use them to pay the distributing company creditors. This provision also reduces the basis by any securities the controlled corporation received, so that gain will be recognized to the extent of the sum of boot, assumed liabilities, and controlled corporation securities exceeds the basis of assets transferred.

This change would result in equal treatment of all forms of receipt other than the controlled corporation's stock, but would make it more difficult to reallocate debt between the parent and subsidiary.

Several law professors (Wells, Schler, Yin, and Beller) have made suggestions to reform the rules for tax-free divisive reorganizations to apply to the separation of an active business among its historic shareholders. These proposals would require a significant amount of assets in business assets (e.g., at least 50% in both the distributing corporation and the subsidiary) to limit the distribution of passive assets. Some proposals would treat distributions as taxable dividends when the subsidiary is excessively leveraged or to the extent the distributions represent passive assets. Proposals have also been made to ensure the historic shareholders are party to the reorganization by tightening requirements regarding continuity of interest to limit new shareholder acquisitions before and after the division.[76]

[76] Bret Wells, "Reform of Section 355," *American University Law Review*, vol. 68, iss. 2 (2018), https://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=2080&context=aulr; Michael Schler, "Simplifying and Rationalizing the Spinoff Rules," *SMU Law Review*, vol. 56, no. 1 (2003), Article 9, https://scholar.smu.edu/cgi/viewcontent.cgi?article=1995&context=smulr; George K Yin, "Taxing Corporate Divisions,' *SMU Law Review*, vol. 56, no. 1 (2003), Article 10, https://scholar.smu.edu/smulr/vol56/iss1/10/; and Herbert M. Beller, "Section 355 Revisited: Time for a Major Overhaul?" 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3232960 (forthcoming in *The Tax Lawyer*).

Appendix. History of Capital Gains Taxation[77]

The original 1913 income tax treated capital gains as ordinary income (with rates up to 7%). Subsequent to higher ordinary rates introduced during World War I, the 1921 law provided an alternative rate of 12.5% (the regular top rate was 73% at that time). Corporations were also eligible for an alternative rate. Tax rates were cut several times during the 1920s. Capital gain exclusions based on the holding period were enacted in 1924, and modified in 1938, to deal with bunching of gains in one year. In 1942, a 50% exclusion was adopted, with an alternative rate of 25%. Over time, the top rate on ordinary income varied, rising to 94% in the mid-1940s, and then dropping to 70% after 1964. In 1969, a new minimum tax increased the gains tax for some; the 25% alternative tax was repealed.

In 1978, the minimum tax on capital gains was repealed and the exclusion increased to 60% with a maximum rate of 28% (0.4 times 0.7). The top rate on ordinary income was reduced to 50% in 1981, reducing the capital gains rate to 20% (0.4 times 0.5). The Tax Reform Act of 1986 reduced tax rates further, but, in order to maintain distributional neutrality, eliminated some tax preferences, including the exclusion for capital gains. This treatment brought the rate for high-income individuals in line with the rate on ordinary income—28%. Corporations were also taxed at ordinary rates, with the new corporate rate at 34%. Corporation capital gains continued to be taxed at ordinary rates.

In 1989, President George H.W. Bush proposed a top rate of 15%, halving top rates. The Ways and Means Committee considered two proposals: Chairman Rostenkowski proposed to index capital gains and Representatives Jenkins, Flippo, and Archer proposed a 30% capital gains exclusion through 1991 followed by inflation indexation. The committee approved this change, but it was not enacted.

In 1990, the President proposed a 30% exclusion, setting the rate at 19.6% for high-income individuals. The House also passed a 50% exclusion with a lifetime maximum ceiling and a $1,000 annual exclusion, but this provision was not enacted into law. When rates on high-income individuals were set at 31%, however, the capital gains rate was capped at 28%.

In 1991, the President again proposed a 30% exclusion, but no action was taken. In 1992, the President proposed a 45% exclusion. The House adopted a proposal for indexation for inflation for newly acquired assets: the Senate passed a separate set of graduated rates on capital gains that tended to benefit more moderate-income individuals. This latter provision was included in a bill (H.R. 4210) containing many other tax provisions that was vetoed by the President.

No changes were proposed by President William Clinton or adopted in 1993 and 1994, with the exception of a narrowly targeted benefit for small business stock adopted in 1993. The value of the tax cap on capital gains (28%) became more important, however, in 1993 with the addition of new brackets of 36% and 39.6% for ordinary income.

[77] A detailed history of the individual income tax through 2006, discussing each tax act, is found in out-of-print CRS Report 98-473, *Individual Capital Gains Income: Legislative History*, by Gregg A. Esenwein, updated April 11, 2006, https://www.everycrsreport.com/files/20070411_98-473_5561ac21da8751b5fc5675c4bfcb14ea54a37cd7.pdf. A history of methods of dealing with losses is found in out-of-print CRS Report RL31562, *An Analysis of the Tax Treatment of Capital Losses*, by Thomas L. Hungerford and Jane G. Gravelle, January 11.2011, https://www.everycrsreport.com/files/20110110_RL31562_75d60c88f5da7b8939545e015c6234f5a068885b.pdf. For a history of top individual and corporate rates, see Mark Luscombe, Historical Capital Gains Rates, https://www.wolterskluwer.com/en/expert-insights/whole-ball-of-tax-historical-capital-gains-rates.

In 1994, the "Contract With America" proposed a 50% exclusion for capital gains, and indexing the basis for all subsequent inflation ,[78] while eliminating the 28% cap; this exclusion would be about a 40% reduction on average from then current rates. The Ways and Means Committee reported out H.R. 1215, which restricted inflation indexing to newly acquired assets (individuals could "mark to market"—pay tax on the difference between fair market value and basis as if the property were sold to qualify for indexation); did not allow indexation to create losses; and provided a flat 25% tax rate for corporations. The 1995 reconciliation bill (H.R. 2491) included these revisions but delayed the indexation provision until 2002. The President vetoed this bill. During the 1996 presidential election, Republican nominee Robert J. Dole proposed a slightly larger capital gains cut, and both candidates supported eliminating capital gains taxes on virtually all gains from home sales.

In 1997, President Clinton and Congress agreed to a tax cut as part of reconciliation. The Administration tax cut proposal included the change in tax treatment of owner-occupied housing. The House bill included a reduction in the 15% and 28% rates to 10% and 20%, about a 30% cut. Capital gains would have also been indexed for assets acquired after 2000 and held for three years; mark-to-market would have also been allowed. The Senate and the final bill did not include indexing. Under the final legislation, there was a maximum tax of 20% on capital gains held for a year. This change also would have taxed gain from assets held for five years and acquired after 2000 at a maximum rate of 18%. For gain in the 15% bracket and below, an 8% rate would apply to any gain on assets held for five years and sold after 2000, with no required acquisition date.

Under law prior to 1997, several rules permitted avoidance or deferral of the tax on gain on owner-occupied housing, including a provision allowing deferral of gain until a subsequent house is sold (rollover treatment) and a provision allowing a one-time exclusion of $125,000 on gain for those aged 55 and older. These provisions were replaced with a general $500,000 exclusion ($250,000 for a single individual), which cost only slightly more in revenue.

The capital gains issue was briefly revisited in 1998, when the holding period for long-term gains was moved back from the 18 months set in 1997 to the one-year period that has typically applied. A 1999 House bill would have cut the rates to 15% and 10%: the conference version would have cut rates to 18% and 8% and proposed indexing of future gains, but the bill was vetoed. Capital gains were discussed during the consideration of the economic stimulus bill at the end of 2002, but not included in any legislative proposal (and no proposal was adopted). The temporary provisions for lower rates of 15% for 2003-2008 for those in the higher brackets and to 5% in 2003-2007 and 0% in 2008 for taxpayers in the 15% bracket or lower were adopted in 2003. H.R. 4297, adopted in 2006, extended these lower rates for two more years. P.L. 111-312, enacted in 2010, extended the lower rates for an additional two years, through 2010. The American Taxpayer Relief Act of 2012, P.L. 112-240, made these lower rates permanent except for very high incomes.

Health reform legislation in 2010 provided for a tax of 3.8% on high-income taxpayers on various forms of passive income, including capital gains. The tax applies to passive income in excess of $250,000 for joint returns and $200,000 for single returns.

The tax revision in 2017 made numerous changes to individual tax deductions and rates, but kept the different rates of long-term capital gains linked to the old rate brackets. (These individual changes expire after 2025.) The capital gains rate for a given income could be affected by changes in itemized and standard deductions and the repeal of personal exemptions, which will

[78] The Republican Contract with America, 1994, https://global.oup.com/us/companion.websites/9780195385168/resources/chapter6/contract/america.pdf.

alter the point at which taxable income begins.[79] The revision also introduced a different measure of inflation, which will lead to narrower rate brackets and standard deductions and will lead, over time, to somewhat higher capital gains taxes. Gains in partnership interest derived from the performance of investment services (carried interest) are treated as long-term capital gains if held for at least three years (rather than the one-year period in prior law).

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[79] The new law increased the standard deduction and repealed personal exemptions, with the higher standard deduction amount more than offsetting the loss of the personal exemption for the taxpayer(s) and an increased child credit offsetting the loss of personal exemptions for children. For those formerly taking a standard deduction, the exempt amounts (amounts deducted before taxable income begins) were increased from $21,300 (a standard deduction of $13,000 and two personal exemptions of $4,150) to $24,000 for a married couple and from $10,650 (a standard deduction of $6,500 and a personal exemption of $4,140) to $12,000. Married couples with children and heads of household with more than one child found their exempt levels reduced. Individuals formerly taking the itemized deduction are more likely to find exempt levels reduced because some minor itemized deductions were eliminated and others are subject to limits or increased limits.