S.818 Capital Gains Relief and Simplification Act of 2001

July 20, 2001

NY2:#4427333

Introduction

This report* briefly summarizes the provisions of S818, entitled "The Capital Gains Relief Simplification Act of 2001," and offers some preliminary comments on it in terms of tax policy issues.

Overview

S.818 was introduced in the Senate on May 2, 2001 by Senator Hatch for himself and Senators Torricelli, Kyl and Murkowski. The five basic changes the bill would make in the current law are:

1) A 100% exclusion for the first 1,000 capital gains for individuals and $2,000 for married couples filing jointly.

2) A deduction of 50% net of capital gains above the exclusion amount. The deduction would effectively lower capital gains tax rates to half the marginal tax rate and would cut maximum capital gains tax rates from:

20% to 19.3% for taxpayers in the 38.6% income tax bracket;
20% to 17.5% for taxpayers in the 35% income tax bracket;
20% to 15.0% for those in the 30% income tax bracket;
20% to 13.5% for those in the 27% income tax bracket; and
10% to 7.5% for those in the 15% income tax bracket.[1]

The rates would decrease in future years as regular rates decrease.

3) The legislation also would shorten the holding period to qualify for long-term capital gains tax rates from more than one year to more than six months.

4) Taxpayers would be allowed to deduct up to $10,000 of their capital losses against ordinary income, rather than the $3,000 allowed under current law. The $10,000 would be further increased based on an annual cost-of-living-adjustment.

5) The proposed bill would increase the $250,000 ($500,000 for joint filer) exclusion of gain from a sale of a principal residence based on an annual cost-of-living adjustment. The bill also would suspend the five

---

* This Report, prepared by the Tax Policy Committee, was authored principally by the Committee's Co-Chairs, M. Carr Ferguson and David S. Miller.

[1] Technically, capital gains are taxed at ordinary income rates. In 1986, Congress imposed a cap of 28% on net capital gains recognized by individuals. In 1997, Congress lowered the cap to 20%. *See* section 1(h). The cap acts as the effective tax rate with respect to net capital gains for taxpayers in brackets above 20%.

year period applicable to excluding gain from the sale of a principal residence for members of the uniformed services and foreign service and other certain employees on overseas assignments.

Policy Issues

1. The simplification promised in the bill title is compromised by the following provisions:[2]

- A reintroduction of a 50 percent deduction (current law taxes capital gains at ordinary income rates but then limits the tax rate to the special rate ceiling described above),

- Indexing the amount of the capital losses allowed as deductions against ordinary income, and

- Special rules governing real estate depreciation recapture, sales between related parties, separate return filing spouses, estates or trusts and special rules for pass-through entities, conversion of long-term into short-term gains on the sale of "collectibles."

2. While these provisions might incent sales at the margins, they seem more designed to promote market activity than economic growth. Tax revenue collected from increased trading in the first year would be offset by the reduction in the rates and the increase in capital loss deductions from $3,000 to $10,000 for individuals.

3. By reintroducing the deduction for a 50 percent of net capital gains, the effective rates for capital gains would vary with the graduated rates on income.

4. Reducing the holding period necessary for long-term capital gains would ameliorate the so called "lock-in effect," which might improve somewhat the efficiency of capital markets, particularly when coupled with the slight reduction in rates for the upper brackets (from 20% to 19.3%).

5. Whether capital gains rate reduction encourages investment in capital assets has been a subject of debate for many years. If the bill attracts serious support, we can expect this argument to heat up.

---

[2] The Joint Committee on Taxation has recommended as a simplification measure that the current rate system for capital gains be replaced with a deduction equal to a fixed percentage of the net capital gain. Joint Committee on Taxation, Testimony of the Staff of the Joint Committee at a Hearing of the Subcommittees on Oversight and Select Revenue Measures of the House Committee on Ways and Means Concerning Complexity of the Internal Revenue Code (July 17, 2001).

6. The increase in the number of tax brackets at which the remaining half of net capital gains would be taxed, with the slight gain in progressivity, also adds complexity to the law.

7. The bill could increase incentives for individuals to sell gain property solely for tax purposes. Taxpayers who otherwise do not have any capital gains at year end would be incented to sell stocks with $1,000 built-in gains and then repurchase the stock to achieve a tax-free basis step-up. Conversely taxpayers with losses will be motivated to sell their built-in loss stock to use the losses against ordinary income, subject to the wash-sale rules, and later repurchase the stock.

8. The increase from $3,000 to $10,000 of the amount of capital losses that may be used to offset ordinary income would stimulate larger tax-motivated sales of loss property subject to wash sale rules and other safeguards.[3] The $3,000 offset, which was enacted in 1976, would be worth about $9,274.40 in year 2000 dollars. (Source: www.westegg.com/inflation/ (The Inflation Calculator)). Therefore, arguably the increase merely preserves what Congress enacted in 1976.

Conclusion

The Tax Policy Committee questions whether the bill will simplify current law. Although the bill will reduce the lock-in effect and stimulate sales of appreciated capital assets held between six and twelve months, it would, on balance, increase complexity and effectively reduce the progressivity of tax rates in many cases. The bill, if enacted, will also reopen the continuing debate on reduced rates for capital gains.

---

[3] But, the increase in the allowable capital loss utilization would result in a regressive change, because wealthy taxpayers are more likely to be able to use the change than low-income taxpayers.