

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue top and bottom. The globe in the top bulb is dark blue, and the globe in the bottom bulb is light blue. The text is centered within the hourglass.

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Individual Capital Gains Income: Legislative History

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April 11, 2007

Abstract. Since 1913, there has been considerable legislative change in the tax treatment of capital gains income and loss. This report provides a brief history of those changes. To establish a perspective, an overview of the current law tax treatment of capital gains income and losses is presented first. The remainder of the report then focuses on the legislative changes that have affected the tax treatment of capital gains income and losses since 1913.

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CRS Report for Congress

Individual Capital Gains Income: Legislative History

Updated April 11, 2007

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Prepared for Members and
Committees of Congress

Individual Capital Gains Income: Legislative History

Summary

Since the enactment of the individual income tax in 1913, the appropriate taxation of capital gains income has been a perennial topic of debate in Congress. Almost immediately legislative steps were initiated to change and modify the tax treatment of capital gains and losses. The latest changes in the tax treatment of individual capital gains income occurred in 1998 and 2003. It is highly probable that capital gains taxation will continue to be a topic of legislative interest in the 109th Congress.

Capital gains income is often discussed as if it were somehow different from other forms of income. Yet, for purposes of income taxation, it is essentially no different from any other form of income from capital. A capital gain or loss is merely the result of a sale or exchange of a capital asset. An asset sold for a higher price than its acquisition price produces a gain, an asset sold for a lower price than its acquisition price produces a loss.

Ideally, a tax consistent with a theoretically correct measure of income would be assessed on real (inflation-adjusted) income when that income accrues to the taxpayer. Conversely, real losses would be deducted as they accrue to the taxpayer. In addition, under an ideal comprehensive income tax, any untaxed real appreciation in the value of capital assets given as gifts or bequests would be subject to tax at the time of transfer.

Since 1913, at least twenty major legislative acts have affected the taxation of capital gains income and loss. Over this period, the definition of what constitutes a capital asset has been steadily expanded. There have been periods when capital losses were not deductible, periods when they were fully deductible, and periods when they were only partially deductible. Likewise, there have been periods when capital gains income has been partially taxed, fully taxed, or excluded from tax.

The logical question to ask after reviewing past legislative changes is why, after 80 years, is there still controversy over the appropriate means of taxing capital gains income and loss? From a purely economic perspective, the appropriate means of taxing gains and losses from capital assets under a tax that measures income comprehensively is relatively clear. Indeed, workable procedures for an approach more consistent with the ideal tax treatment have been outlined in great detail in the past.

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Individual Capital Gains Income: Legislative History

Since the enactment of the individual income tax in 1913, the appropriate taxation of capital gains income has been a perennial topic of debate in Congress. Almost immediately after the passage of the Revenue Act of 1913, legislative steps were initiated to change and modify the tax treatment of capital gains and losses. These legislative initiatives continue today with the latest change in the tax treatment of individual capital gains income occurring in legislation passed in 2003.

Capital gains income is often discussed as if it were somehow different from other forms of income. Yet, for purposes of income taxation, capital gains income is essentially no different from any other form of income from capital, such as interest or dividend income. A capital gain or loss is merely the result of a sale or exchange of a capital asset. If the asset is sold for a higher price than its acquisition price, then the transaction produces a capital gain. If an asset is sold for a lower price than its acquisition price, then the transaction produces a capital loss.

Ideally, a tax consistent with a theoretically correct measure of income would be assessed on real (inflation-adjusted) income when that income accrues to the taxpayer. Conversely, real losses should be deducted as they accrue to the taxpayer. In addition, any untaxed real appreciation in the value of capital assets given as gifts or bequests should be subject to tax at the time of transfer.

Under the current income tax, however, nominal (non-inflation adjusted) capital gains income is taxed when it is realized (sold or exchanged) by the taxpayer. Capital losses (within certain limits) are also deducted on a nominal basis when they are realized by the taxpayer. Currently, the untaxed appreciation in the value of capital assets transferred at death is not subject to tax.

Obviously, the current law tax treatment of capital gains and losses is at variance with the approach that would be applied if income were measured in a theoretically correct manner. Putting theory into practice, however, is not easy. Appropriately taxing income and losses from the sale of capital assets involves difficulties such as differentiating between real and nominal gains and losses, and accounting for tax deferral. Moreover, the taxation of capital gains income affects resource allocation, the distribution of the tax burden, and the revenue yield of the individual income tax.¹

¹ These issues are analyzed in CRS Report 96-769, *Capital Gains Taxes: An Overview*, by Jane G. Gravelle.

Since 1913, there has been considerable legislative change in the tax treatment of capital gains income and loss. This report provides a brief history of those changes. To establish a perspective, a brief overview of the current law tax treatment of capital gains income and losses is presented first. The remainder of the report then focuses on the legislative changes that have affected the tax treatment of capital gains income and losses since 1913.

Current Law Tax Treatment — 2006

Under current law, capital assets are separated into four categories. Assets that have been held for 12 months or less are considered short-term assets. Assets that have been held longer than 12 months are considered long-term assets. Collectibles (art work, antiques, coins, stamps, etc.) are the third category of assets and the fourth category of capital gains assets includes the portion of gain attributable to previously taken depreciation deductions on section 1250 property (depreciable real estate).

Short-term capital gains are taxed at regular income tax rates. For assets sold or exchanged on or after May 6, 2003, and before January 1, 2011, the maximum tax rate on long-term capital gains is 15%. The maximum tax rate on long-term gains is 5% for taxpayers in the 10% and 15% marginal income tax brackets. Collectibles held longer than 12 months are taxed at 28%. The un-recaptured section 1250 gain attributable to depreciation deductions is taxed at a maximum tax rate of 25%.²

Net capital losses are deductible against up to \$3,000 of ordinary income, that is, non-capital gain income. Any portion of the net loss in excess of the \$3,000 limit can be carried forward and used to offset gains in succeeding tax years. Excess net losses can be carried forward indefinitely and without limit on the amount of losses that can be carried forward.

Under current law, taxpayers are allowed to exclude from taxable income up to \$500,000 (\$250,000 in the case of single returns) of the gain from the sale of their principal residences. To qualify the taxpayer must have owned and occupied the residence for at least two of the previous five years prior to the date of sale.

Under current law, capital gains transferred at time of death are not subject to tax. On transfer at death, the basis of the asset (original cost plus changes in the value due to improvements or depreciation) is stepped up to the market value of the asset on the date of death.

² For more information on depreciation recapture see archived CRS Report 97-858, *Depreciation Recapture After the Taxpayer Relief Act of 1997*, by Gregg A. Esenwein. Available from author.

An Overview of Legislative Changes since 1913³

Revenue Act of 1913

The Revenue Act of 1913, enacted after the adoption of the Sixteenth Amendment to the Constitution, established the framework for the current individual income tax. It did not include any specific provisions covering the tax treatment of capital gains income. Capital gains on transactions entered into for profit were considered regular income and were taxed in full at normal tax rates. Capital losses, unless they were losses specifically associated with a taxpayer's trade or business, were not deductible.

Revenue Act of 1916

The Revenue Act of 1916 was primarily concerned with raising revenue through a general increase in the marginal tax rates applicable to individuals. In addition, however, it contained provisions which allowed deductions for capital losses on transactions not associated with a taxpayer's primary trade or business. Deductible capital losses, however, could not exceed a taxpayer's capital gains income.

Revenue Act of 1918

The Revenue Act of 1918 was one of the largest tax increases in American history. An important change related to capital gains income involved the removal of the restriction on deductible losses. For the first time, capital losses in excess of capital gains were deductible against ordinary income.

Revenue Act of 1921

The Revenue Act of 1921 marked a significant change in the tax treatment of capital gains income. For the first time, capital assets were specifically defined in the individual income tax code and were separated into long and short term assets. Assets held longer than two years were considered long-term while assets held two years or less were considered short-term.

Gains on short-term assets were included in income and taxed at normal tax rates. Losses on short-term assets were deductible against ordinary income.

Net gains on long-term assets were, at the taxpayer's election, subject to a flat tax of 12.5% instead of taxes assessed at the regular and surtax rates. However, to qualify for this election, the total tax owed by the taxpayer including regular taxes

³ The information contained in this report on legislative changes through 1949, draws from two primary sources. The first source is, *The Federal Income Tax*, by Roy G. and Gladys C. Blakey, published in 1940. The second source is, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, by Anita Wells, National Tax Journal, March 1949. For legislative changes after 1949, the primary sources of information include the Conference Committee Reports and the General Explanations of the individual tax acts prepared by the Joint Committee On Taxation.

and taxes on long-term capital gains could not be less than 12.5% of the taxpayer's total net income. If the combined tax fell below 12.5% of net income then taxes on long-term capital gains were assessed at regular rates.

Losses on assets held longer than two years were deductible in full against any other type of income. This system, however, created an asymmetrical treatment of long-term gains and losses. Long-term losses were deductible in full at regular income tax rates, which, including surtax rates, went as high as 56%. On the other hand, long-term gains were taxed at only 12.5%, which meant that long-term losses could be deducted at much higher rates than those applied to long-term gains.

Revenue Act of 1924

The Revenue Act of 1924 corrected the imbalance in the tax treatment of long-term capital losses created by the 1921 Act, by establishing a symmetrical treatment between long-term gains and losses. A tax credit of 12.5% was allowed for net long-term losses. If this produced a tax that was less than the tax if net long-term losses were deducted at regular rates, however, then net long-term losses would have to be deducted at regular rates.

Other changes in the 1924 Act included repeal of the provision that prohibited the use of the alternative 12.5% rate on long-term gains if it produced a total tax liability on net income below 12.5%.

The definition of a capital asset was also changed by eliminating the provisos that assets be acquired for profit or investment in order to be considered capital assets. This change allowed taxpayers selling their residential property to treat the resulting gains or losses as capital gains or losses.

Revenue Act of 1932

This act changed the income tax treatment of short-term (held two years or less) losses on sales of stocks and bonds. Short-term losses on stocks and bonds were deductible only to the extent of gains from the sale of these same types of assets. Losses that exceeded gains in a given year could be carried forward to the next year and used to offset gains from the sales of stocks and bonds in that year. (This loss carry forward was repealed, prior to its becoming effective, by the National Industrial Recovery Act.)

National Industrial Recovery Act

One provision of this 1933 legislation repealed the loss carry-forward for short-term losses on the sale of stocks and bonds.

Revenue Act of 1934

The Revenue Act of 1934 instituted a sliding inclusion scale for the recognition of gains and losses based on how long a capital asset had been held. The gain or loss to be included for income tax purposes was 100% if the asset had been held less than

one year, 80% if the asset had been held less than two years, 60% if the asset had been held less than five years, 40% if the asset had been held less than 10 years, and 30% if the asset had been held longer than 10 years.

Net recognized gains were included in income and taxed at normal and surtax rates. Recognized capital losses were netted against recognized capital gains. If losses exceeded gains, then losses up to the amount of recognized gains plus \$2,000 were deductible.

Revenue Act of 1938

The 1938 Act included major changes in the tax treatment of gains and losses from the sale of capital assets. Gains and losses were classified as short-term if the capital asset had been held 18 months or less and long-term if the asset had been held for longer than 18 months.

Short-term losses were deductible up to the amount of short-term gains. Short-term losses in excess of short-term gains could be carried forward for one year and used as an offset to short-term gains in that succeeding year. The carryover could not exceed net income in the taxable year the loss was incurred. Net short-term gains were included in taxable income and taxed at regular tax rates.

Long-term gains and losses were subject to two alternative methods of determining the tax on those gains or losses. Under the first method, a percentage of long-term gains or losses was recognized and included in taxable income and taxed at regular tax rates. If the asset had been held for more than 18 months but for 24 months or less, then 66.66% of the gain or loss was recognized. If the asset had been held for longer than 24 months, then 50% of the gain or loss from the sale of that asset was recognized and included in taxable income. Net recognized long-term losses could be deducted against other forms of income without limit.

The 1938 Act also adopted an alternative method of taxing long-term gains and losses (assets held longer than 18 months) that was calculated as follows. Regular taxes on taxable income excluding any net long-term capital gains would be computed. To this partial tax, a flat tax of 30% of the net long-term capital gain would be added. If this alternative method produced a tax liability that was less than the tax assessed under the standard method, then the taxpayer could pay the lower amount of tax.

The 30% flat tax was applied against recognized net long-term gains. That means the maximum tax on assets held longer than 18 months but less than 24 months would be 20% (30% of the 66.66% of the gain that was recognized), and the maximum tax on assets held longer than 24 months would be 15% (30% of the 50% of the gain that was recognized).

The alternative tax treatment of net long-term capital losses worked in a similar fashion. Regular taxes on taxable income excluding any net long-term capital losses would be calculated. From this partial tax an amount equal to 30% of the net long-term capital gain would be deducted. If this alternative method produced a tax that

was greater than the tax assessed under the standard method, then the taxpayer was obligated to pay the higher amount of tax.

A final change in the 1938 Act involved a change in the definition of capital assets. After 1938, depreciable property used in a trade or business was no longer considered a capital asset for income tax purposes. As a result, losses on this type of property were no longer subject to the limitations on losses on the sale of capital assets and hence, were deductible in full.

Revenue Act of 1942

This wartime tax legislation made several changes in the individual income tax treatment of capital gains and losses. These changes included a reduction in the holding period, a slight increase in the tax rate on long-term gains, a limit on the loss offset against ordinary income, and creation of a five-year carryforward for losses.

Under prior law, to qualify as a long-term capital asset, the asset had to be held for over 18 months. The 1942 Act reduced this holding period to six months. Gains on assets held less than six months were included in taxable income and taxed at regular tax rates.

The 1942 Act increased the tax rate on long-term gains. Under prior law, the alternative tax rate on recognized long-term gains was a flat 30%, which resulted in a maximum tax rate on long-term gains of 15% (the recognized portion of the gain, 50%, taxed at a flat 30% rate). The 1942 Act increased the alternative tax rate on long-term gains to 50%, which in turn increased the maximum tax rate on long-term gains to 25% (the recognized portion of the gain, 50%, taxed at a flat 50% rate).

The 1942 Act also changed the tax treatment of capital losses in two significant ways. First, it consolidated the tax treatment of short- and long-term losses. Second, it established a \$1,000 limit on the amount of ordinary income that could be offset by combined short- and long-term net capital loss. Finally, it created a five-year carry forward for net-capital losses that could be used to offset capital gains and up to \$1,000 of ordinary income in succeeding years.

New provisions in the 1942 Act changed the tax treatment of certain business property. Under these new provisions in Section 117(j) of the tax code, gains on the sale or involuntary conversion of real and depreciable property used in a trade or business would be treated as capital gains. Losses, however, would continue to be treated as ordinary losses.

Revenue Act of 1943

Through expansion of provisions in Section 117(j) and 117(k), the Revenue Act of 1943 extended capital gains tax treatment to timber. Owners of timber or those with contracts to cut timber were permitted to treat the income from the sale of the timber as capital gains income, while losses were treated as ordinary losses.

Revenue Act of 1951

The Revenue Act of 1951 made three changes affecting the tax treatment of capital gains and losses. First, under Sections 117(j) and 117(k) it extended capital gains tax treatment to the sales of land with unharvested crops, sales of livestock, and coal royalties.

Second, it amended the tax treatment of gains and losses that, since 1942, had allowed taxpayers to use \$1 in short-term losses to offset \$2 in long-term gains. Under prior law, since only 50% of a long-term gain was included in income, allowing short-term losses to offset recognized long-term gains (the 50% included in taxable income) on a dollar for dollar basis created a situation where \$1 of short-term losses was actually offsetting \$2 of long-term gain. The 1951 Act eliminated this two for one offset.

Finally, the 1951 Act allowed a taxpayer to “roll over” the capital gains he received from the sale of his personal residence if, within one year, the taxpayer used the gain to acquire a new residence of equal or greater value.

Revenue Act of 1964

The Revenue Act of 1964 made three changes in the tax treatment of capital gains and losses. It extended, under Sections 117(j) and 117(k), capital gains tax treatment to iron ore royalties. It also repealed the five-year loss carryover for capital losses and replaced it with a unlimited loss carryover. Net losses, however, were still deductible against only \$1,000 of ordinary income in any given year.

The 1964 Act introduced the first exclusion for the capital gain arising from the sale of a principal residence. Under these new provisions, the first \$20,000 of capital gain from the sale of a personal residence by a taxpayer aged 65 years or older who had owned the house for at least eight years and lived in the house for at least five years was excluded from tax.

Tax Reform Act of 1969

The Tax Reform Act of 1969 made several major changes in the tax treatment of capital gains and losses. It increased the alternative tax rate on large amounts of capital gains income, it restricted the deductibility of long-term losses, and it created an add-on minimum tax on tax preference items, one of which was the excluded portion of long-term gains.

The act eliminated the 50% alternative tax rate on net-long term gains in excess of \$50,000 for joint returns (\$25,000 for single returns). This alternative tax rate on long-term gains had originally been enacted in 1938 and was modified in 1942.

Net-long term gains in excess of these amounts were taxed at regular income tax rates, which at the time went as high as 70%. Hence, the maximum rate on long-term capital gains rose from 25% under prior law, to 35% (50% of gain included in taxable

income taxed at a 70% rate). This change was phased-in over a three-year period and was fully in effect by 1972.

The act imposed a 50% limitation on the amount of net long-term losses that could be used to offset ordinary income. Under prior law, even though only 50% of net long-term gains were subject to tax, net long-term losses could be deducted in full and used to offset up to \$1,000 of ordinary income. The act repealed this provision and established a new 50% limit on the deductibility of net long-term losses, subject to the same \$1,000 limit on ordinary income. In addition, the law specified that the nondeductible portion of net long-term losses could not be carried forward to be deducted in succeeding years.

The 1969 Act created a new 10% minimum tax on tax preference items. This tax was adopted because of concern that wealthy taxpayers were escaping taxation through excessive use of tax preferences. The tax was 10% of the value of all tax preference items in excess of a \$30,000 basic exemption amount and regular income taxes owed. Final tax liability was determined by adding the minimum tax to the regular income taxes owed. The excluded portion of net long-term capital gains was considered a tax preference item for purposes of this add-on minimum tax.

Finally, the act capped the tax rate on personal service income at 50% (regular tax rates went to 70%). However, the 1969 Act required that the amount of personal service income eligible for treatment under this maximum tax rule be offset on a dollar for dollar basis by the excluded portion of capital gains income.

Tax Reduction Act of 1975

The Tax Reduction Act of 1975 increased from 12 months to 18 months the capital gains tax free roll over time allowed between the sale of a principal and the acquisition of a new principal residence.

Tax Reform Act of 1976

The Tax Reform Act of 1976 changed the length of time a capital asset had to be held to qualify for preferential treatment, increased the capital gains loss offset against ordinary income, increased the minimum tax rate, and for the first time eliminated the practice of stepping up the basis of property passing from a decedent to an heir.

Prior to the 1976 Act a capital asset had to be held only six months to qualify for long-term capital gains treatment. The 1976 Act increased the holding period to nine months for tax year 1977 and to one year for tax years beginning after 1977.

Under prior law, net capital losses could offset up to \$1,000 of ordinary income. The 1976 Act increased the capital loss offset to \$2,000 in 1977 and \$3,000 for tax years starting after 1977.

Another change in the 1976 Act affecting capital gains income was an increase from 10% to 15% in the add-on minimum tax rate on tax preference items.

The act also increased the one-time exclusion from capital gains taxes for the sale of a principal residence by a taxpayer aged 65 years or older from \$20,000 to \$35,000.

The final change in the 1976 act involved the elimination of the practice of stepping up the basis of property when it was passed from generation to generation. Under prior law, the basis of property passed from a decedent to an heir was stepped up to reflect the fair market value of the property on the date of death. The stepped up basis was then used to determine the amount of gain or loss occurring when the property was sold by the heirs. The 1976 act changed this practice so that the basis of property passed from a decedent to an heir would no longer be stepped up but, rather, the basis of the property would be carried over and remain unchanged from the basis when held by the decedent. These new rules were to become effective for property transferred after December 31, 1976.

Revenue Act of 1978

The 1978 Act changed the taxation of capital gains and losses in several ways. First, it repealed the 25% alternative tax on an individual's first \$50,000 of net-long term gain. Second, it increased the exclusion for net long-term capital gain from 50% to 60%. Third, it decreased the age limit for eligibility for the one-time exclusion of gain from the sale of a principal residence from 65 to 55 years. In addition, it increased the amount of gain eligible for the one-time exclusion to \$100,000. Finally, it allowed taxpayers who had owned and occupied a property as their principal residence for a period aggregating three out of the last five years immediately preceding the sale of the property to qualify for the one-time exclusion from capital gains taxation on the sale of a principal residence.

The act also affected the tax treatment of capital gains and losses by introducing a new alternative minimum tax for individuals in addition to the old add-on minimum. The excluded portion of capital gains income was deleted from the list of tax preferences subject to the add-on minimum tax. Instead, the excluded portion of capital gains income along with certain itemized deductions were added back to gross income to form the tax base for the alternative minimum tax. The tax rates for the alternative minimum tax went up to 25% on alternative minimum taxable income in excess of \$100,000. If the tax computed under the alternative minimum tax was larger than a taxpayer's regular and add-on minimum tax, the taxpayer was obligated to pay the alternative minimum tax.

The 1978 act removed the excluded portion of capital gains income as an offset to the amount of personal service income eligible for the treatment under the maximum tax rate rule. (Since 1969, the tax rate on personal service income was capped at 50% even though regular tax rates went as high as 70%. The excluded portion of capital gains income, along with other tax preference items, reduced, on a dollar-for-dollar basis, the amount of personal service income that was subject to this cap.)

Finally, the 1978 act postponed the implementation of the carryover basis rules enacted in the 1976 act. Under the 1978 Act, the carryover basis rules would apply to property transferred after December 31, 1979.

Crude Oil Windfall Profit Tax Act of 1980

This act repealed the carryover basis provisions enacted in the 1976 Reform Act. In its place, it re-established the process of stepping up the basis of property to reflect its fair market value at the time of death of the decedent.

Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act increased from \$100,000 to \$125,000 the amount of capital gain eligible for the one-time exclusion from tax on the sale of a principal residence by a taxpayer aged 55 years or older. The act also increased the tax-free roll over period for the sale of a principal residence from 18 to 24 months.

Indirectly, because of reductions in the top personal income tax rate from 70% to 50%, the 1981 Act also reduced the maximum tax rate on long-term capital gains income from 28% to 20% (40% of long-term gain included in taxable income times 50% tax rate).

Deficit Reduction Act of 1984

This act temporarily reduced the holding period from 12 months to six months for determining whether an asset was considered a short-term or long-term capital asset. Assets held longer than six months qualified for the preferential tax treatment accorded long-term capital gains income.

This provision was effective for assets acquired after June 22, 1984, and before January 1, 1988. After 1988, the holding period to qualify as a long-term capital asset reverted back to 12 months.

Tax Reform Act of 1986

The Tax Reform Act of 1986 repealed the net capital gain deduction for individuals. Both short-term and long-term capital gains income were included in taxable income and taxed in full at regular income tax rates. Statutory rates under the act were reduced from a maximum of 50% to 33% (28% statutory rate plus 5% surcharge).

The tax treatment of capital losses was unchanged. Losses could be netted against gains and any excess losses could be deducted against up to \$3,000 of ordinary income. Net losses in excess of this amount could be carried forward indefinitely.

Revenue Reconciliation Act of 1990

This act established a 28% maximum tax rate on net-long term capital gains income. Under the act, the maximum statutory income tax rate was set at 31%.

Taxpayer Relief Act of 1997

This act made multiple changes to the tax treatment of capital gains income. First, it lowered the maximum tax rate on long-term (assets held longer than 18 months) capital gains income to 20% (10% for taxpayers in the 15% tax rate bracket for regular income tax purposes). Second, it kept the maximum capital gains tax rate on assets held more than 12 months but less than 18 months at 28%. Third, it kept a 28% maximum tax rate on the gain from the sale of collectibles held longer than 12 months. Fourth, it instituted a 25% tax rate for the gain resulting from the sale of depreciable real property (section 1250 property) attributable to previous depreciation deductions. Fifth, it reduced, beginning for tax years after 2000, the maximum tax rate on the gains from property held longer than five years. Under this provision, any gain from assets held five years or longer which would otherwise have been taxed at 10% would instead be taxed at 8%. For assets, held five years or longer and whose holding period began after December 31, 2000, which would otherwise have been taxed at 20% would instead be taxed at 18%.

Finally, the act repealed both the rollover provisions and the one-time exclusion provision for the sale of owner occupied housing. In its place it established an exclusion of \$500,000 (\$250,000 in the case of singles) on the gain from the sale of a personal residence. The new exclusion would only be allowed once every two years.

The act also contained conforming amendments establishing these maximum capital gains tax rates as the maximum tax rates for capital gains income under the alternative minimum tax.

Internal Revenue Service Restructuring and Reform Act of 1998

This act eliminated the 18-month holding period for long-term capital gains income enacted in the Taxpayer Relief Act of 1997. In its place, it re-established a 12-month holding period as the requirement for preferential long-term capital gain tax treatment.

The Jobs and Growth Tax Relief Reconciliation Act of 2003

In May 2003, the 108th Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003. Under this act, the maximum tax rate on long-term capital gains income was reduced to 5% (0% for 2008) for taxpayers in the 10% and 15% marginal income tax brackets. The maximum capital gains tax rate was reduced to 15% for taxpayers in marginal income tax brackets exceeding 15%. The act also repealed the special capital gains tax rates for assets held five years or longer. These changes were effective for assets sold or exchanged on or after May 6, 2003, and before January 1, 2009.

These rates were also made applicable to the alternative minimum tax.

The American Jobs Creation Act of 2004

This act addressed the issue of combining like-kind exchanges with the exclusion of capital gains taxes on the sale of a principal residence. As of October 22, 2004, the exclusion from capital gains taxes on the sale of a principal residence no longer applies if the principal residence was acquired in a like-kind exchange within the past five years.

The Tax Increase Prevention and Reconciliation Act of 2005

This act was passed by Congress in May 2006. The act extends through the end of 2010 the reduced tax rates on capital gains income that were enacted in 2003 and which were originally scheduled to expire at the end of 2008.

This act also provided that the sale or exchange (before January 1, 2011) of a musical composition or a copyright of a musical work that was created by an individual's personal effort would be considered the sale of a capital asset and subject to the lower capital gains tax rates.

Tax Relief and Health Care Act of 2006

This act made the capital gains tax treatment of self-created musical works permanent. The act also allowed specified members of the intelligence community to suspend the five-year test required for sale of a principal residence during periods when they are serving extended duty.

Legislative Proposals in the 110th Congress

It is highly unlikely that the rules governing the taxation of capital gains income will remain unchanged for any length of time. Capital gains taxes are a perennial topic of debate for Congress.

Multiple bills addressing the tax treatment of capital gains income have been introduced in the 110th Congress.

- **S. 102.** Introduced January 4, 2007, by Senator John Kerry. This bill would repeal the lower capital gains and dividend tax rates for 2009 and 2010.
- **S. 138.** Introduced January 4, 2007, by Senator Charles Schumer. This bill would allow surviving spouses to apply the tax-free joint return limitation of \$500,000 for the sale of a principal residence for two-years after the date of death of their spouse.
- **S. 374.** Introduced January 24, 2007, by Senator Pete Domenici. This bill would provide for capital gains tax treatment on the sale of art and collectibles.
- **S. 402.** Introduced January 25, 2007, by Senator Blanche Lincoln. This legislation would allow a 60% deduction for qualified timber gains.

- **S. 502.** Introduced February 6, 2007, by Senator Mike Crapo. This bill would make the lower tax rates on capital gains and dividends permanent.
- **S. 892.** Introduced March 15, 2007, by Senator James Inhofe. This legislation would index assets for the purpose of determining capital gain or loss.
- **H.R. 397.** Introduced January 10, 2007, by Representative Jim Saxton. This legislation would allow taxpayers to defer the recognition of capital gains on reinvested distributions from regulated investment companies.
- **H.R. 721.** Introduced January 30, 2007, by Representative Artur Davis. Companion bill to S. 402.
- **H.R. 1261.** Introduced March 1, 2007, by Representative Mike Pence. This bill would index capital assets for purposes of determining capital gain or loss.

The logical question to ask after reviewing past legislative changes and new legislative proposals is why after 80 years are we still unable to agree on the appropriate means of taxing capital gains income? From a purely economic perspective the appropriate way of taxing capital gains income and loss is relatively clear. Under a tax system that measures income in a comprehensive manner, real capital income and loss would be treated as regular income and taxed or deducted as it accrues to the taxpayer. Untaxed real gains would be taxed when transferred as gifts or bequests.

Several workable procedures for an approach more consistent with a comprehensive measure of income have been proposed in the past.⁴ Putting theory into practice, however, would make the tax code more complex. Under a more comprehensive approach to taxing income, taxing capital gains income and losses would involve differentiating between real and nominal gains and losses and accounting for tax deferral.

⁴ For example see U.S. Treasury Department, *Blueprints for Basic Tax Reform*. Washington, January 1977; and *Tax Reform for Fairness, Simplicity, and Economic Growth*, Washington, November 1984.

Appendix: Statutory Marginal Tax Rates on Long Term Capital Gains Income; 1913 to 2010

Year	Maximum tax rate on ordinary income (%)	Maximum statutory tax rate on long-term capital gains income (%)	Holding period for long-term capital gains treatment (years)
1913-1921	7 - 77	7 - 77	—
1922-1933	24 - 73	12.5	2
1934-1937	63 - 79	18.9 - 23.7	1
1938-1941	79 - 81.1	15	1.5
1942-1951	82 - 94	25	0.5
1952-1953	92	26	0.5
1954-1963	91	25	0.5
1964-1967	70 - 77	25	0.5
1968	75.3	26.9	0.5
1969	77	27.5	0.5
1970	71.8	30.2	0.5
1971	70	32.5	0.5
1972-1975	70	35	0.5
1976	70	35	0.5
1977	70	35	0.75
1978	70	33.8	1
1979-1980	70	28	1
1981	70	20	1
1982-1983	50	20	1
1984-1986	50	20	0.5
1987	38	28	1
1988-1990	28	28	1
1991-1992	31	28	1
1993-1996	39.6	28	1
1997	39.6	20	1.5
1998-2001	39.6	20	1
2002	38.6	20	1
2003-2010	35	15	1

Source: “The Labyrinth of Capital Gains Tax Policy,” by Leonard E. Burman. Brookings Institution Press, Washington, D.C. 1999.