



Tax Policy Center
Urban Institute and Brookings Institution

THE TAX POLICY

BRIEFING BOOK

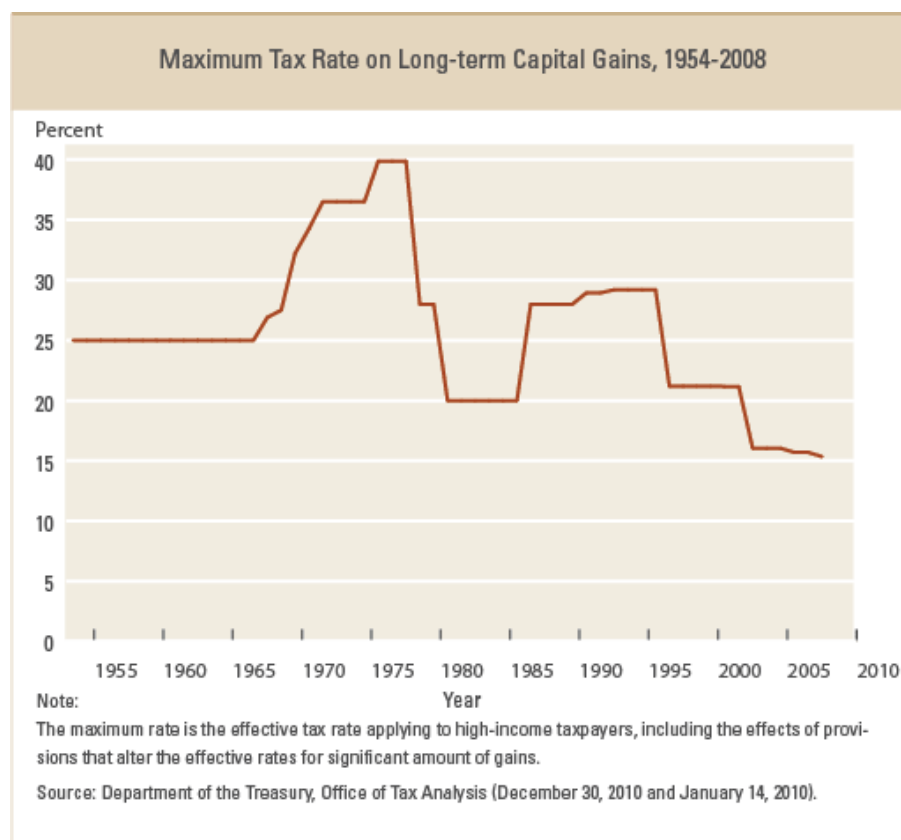
*A Citizens' Guide for the
2008 Election and Beyond*

CAPITAL GAINS AND DIVIDENDS

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Capital Gains: How are they taxed?

Capital gains are profits from the sale of a capital asset, such as shares of corporate stock, a business, a parcel of land, or a piece of art. Capital gains are generally included in taxable income but are often taxed at a lower rate; under current law, for example, most long-term capital gains face a top rate of 15 percent. Complicated rules impose a range of tax rates on different kinds of gains and can make it difficult for taxpayers to calculate their tax liability.



Underlying Data: [Download](#)

- A capital gain occurs when a capital asset is sold or exchanged at a price higher than its basis (its purchase price plus commissions and the cost of improvements net of depreciation). Similarly, a capital loss occurs when an asset is sold for less than its basis. Gains and losses (like other forms of capital income and expense) are all measured in nominal terms—that is, unadjusted for inflation.
- Capital gains and losses are considered long term if the asset was held for over one year, and short term if held for a year or less.
- Taxpayers in the 10 and 15 percent tax brackets pay no tax on most long-term gains; under EGTRRA provisions, extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and taxpayers in higher brackets face a 15 percent rate on long-term capital gains. In 2013, when all the temporary provisions expire, those rates will revert to pre-2001 levels: 10 percent for those in the 15 percent tax bracket or lower and 20 percent for all others. Recaptured real estate depreciation (that is, gains up to the amount

of depreciation deductions previously claimed) is taxed at ordinary income tax rates up to a maximum of 25 percent. Gains on art and collectibles are taxed as ordinary income up to a maximum 28 percent rate. The maximum rates apply under both the ordinary income tax and the alternative minimum tax (AMT). The figure shows how the maximum long-term capital gains tax rate has changed over the years.

- Capital losses may be used to offset capital gains and up to \$3,000 of other taxable income. The unused portion of a capital loss may be carried over to future years.
- Taxpayers may realize up to \$250,000 of gains on their principal residence tax-free. Married taxpayers filing jointly may exclude up to \$500,000 from tax.
- The basis for an asset received as a gift equals the donor's basis. However, the basis of an inherited asset is "stepped up" to the value of the asset on the date of the donor's death. The step-up provision effectively exempts from income tax any gains on assets held until death. Assets inherited from people who died in 2010 (when the estate tax was repealed) qualified only for a limited step-up of \$3 million for gifts made to a spouse plus \$1.5 million for gifts made to anyone. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 allowed estates of people who died in 2010 to choose between the 2010 law and the 2011 law, under which heirs get full step-up in basis but the estate is potentially taxable. (See [What did the 2001-2010 Tax Acts do to the Estate, Gift and Generation Skipping Transfer Taxes?](#)).
- Individuals may exclude up to 50 percent of capital gains on stock held for more than five years in a domestic C corporation with gross assets under \$50 million on the date of the stock's issuance.
- C corporations pay the regular corporate rates on the full amount of their capital gains and may use capital losses only to offset capital gains, not other kinds of income.
- Capital gains may face effective tax rates above the statutory rates because of phase-outs in the tax code. For example, taxpayers in the phase-out range of the AMT exemption incur an implicit surtax of 6.5 percent (for taxpayers in the 26 percent AMT bracket) or 7 percent (for taxpayers in the 28 percent AMT bracket).
- If you find this description mind-numbingly complex, you have captured the essence of capital gains taxation.

See Also

Capital Gains: [What is the effect of a lower tax rate?](#)

Data Sources

[Department of the Treasury, Office of Tax Analysis](#) (December 30, 2010).

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Further Reading

Auten, Gerald, "[Capital Gains Taxation](#)," in *Encyclopedia of Taxation and Tax Policy*, 2nd ed. (Washington: Urban Institute, 2005).

Burman, Leonard E., Alan J. Auerbach, and Jonathan M. Siegel, "[Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data](#)," in *Does Atlas Shrug?: The Economic Consequences of Taxing the Rich*, ed. Joel B. Slemrod (Cambridge, Mass.: Harvard University Press, 1997).

Kobes, Deborah, and Leonard E. Burman, "[Preferential Capital Gains Tax Rates](#)," *Tax Notes* (January 19, 2004).

Leiserson, Greg, "[The 15 Percent Rate on Capital Gains: A Casualty of the Alternative Minimum Tax](#)" (Washington: Urban Institute, 2007).

Capital Gains: What is the effect of a lower tax rate?

Throughout most of the existence of the income tax, capital gains have been taxed at lower rates than ordinary income. Some argue that the lower tax rate offsets taxes paid at the corporate level, encourages risk taking and entrepreneurship, offsets the effects of inflation, and prevents "lock-in" (the incentive to hold assets too long for tax purposes). Critics complain that the lower tax rate disproportionately benefits the wealthy and encourages tax sheltering.

Benefit of Lower Tax Rates on Long-term Capital Gains, Current Law, 2013					
Cash income level (thousands of 2011 \$)	Percent of returns with tax benefit	Benefit as percent of after-tax income	Share of total federal tax change	Average tax savings (\$)	
Less than 10	0.0	0.0	0.0	0	
10-20	0.2	0.0	0.0	0	
20-30	0.6	0.0	0.0	1	
30-40	1.7	0.0	0.0	1	
40-50	3.3	0.0	0.1	4	
50-75	5.8	0.0	0.5	13	
75-100	9.6	0.1	0.8	33	
100-200	16.3	0.1	4.4	126	
200-500	29.7	0.4	8.5	828	
500-1,000	41.0	1.2	9.8	5,587	
More than 1,000	52.0	4.7	75.9	84,740	
All	5.7	0.7	100.0	359	

Source: Urban-Brookings Tax Policy Center Microsimulation Model (0411-2)
Notes:
Tax units with negative cash income are excluded from the lowest income class but are included in the totals. Includes both filing and non-filing units but excludes dependents.

- Roughly half of all capital gains represent profits on the sale of corporate stock. However, about half of those profits are never taxed at the corporate level because of various tax breaks that benefit corporations. A lower rate of tax on capital gains appropriately offsets corporate taxes only in a minority of cases.
- Assets that pay returns in the form of capital gains probably are riskier than average, and so a lower capital gains tax rate may in fact encourage risk taking; however, taxing gains while allowing deductions for losses on a symmetric basis reduces the after-tax variance of returns. Although loss deductions are limited in a given year, they may be carried forward: a study published in 1997 found that most losses are deductible either immediately or soon after realization. Under current law in 2011, taxpayers can use capital losses to offset capital gains and up to \$3,000 of non-gain taxable income. Taxpayers can carry the remaining capital losses forward to future years.
- It is true that part of almost any nominal capital gain is due simply to inflation. But inflation actually affects the returns on assets that are taxed currently (interest, dividends, rents, and royalties) more than it affects capital gains. And adjusting capital gains for inflation, either directly or through a lower tax rate, creates tax shelter opportunities if expense items (such as interest and depreciation) are not similarly indexed.

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- A capital gains tax discourages sales of assets—the so-called lock-in effect—which may be inefficient. However, a 1994 study found that this effect was very small for permanent changes in capital gains tax rates (but not for temporary changes).
- The benefits of low tax rates on capital gains accrue disproportionately to the wealthy. In 2013, an estimated 94 percent of the tax benefit of low rates on capital gains will go to taxpayers with cash incomes over \$200,000, and three-fourths of the benefits will accrue to millionaires.
- Low tax rates on capital gains are an important part of many individual income tax shelters, which employ sophisticated financial techniques to convert ordinary income (such as wages and salaries) to capital gains. For top-bracket taxpayers, tax sheltering can save 20 cents per dollar of income sheltered. Tax sheltering is economically inefficient because the resources that go into designing and managing tax shelters could be used instead for productive purposes, and many tax shelter investments pay subpar returns, turning a profit only after considering the tax benefits.
- The low rate on capital gains complicates tax filing. A significant portion of tax law and regulations is devoted to policing the boundary between returns on capital assets and ordinary income. And the alternative schedule for capital gains compounds the complexity: the entire back side of the schedule D is devoted to calculating the alternative rate.
- For most of its history, the U.S. income tax excluded a portion of long-term capital gains from income and taxed the remainder at ordinary rates. This is a much simpler way to convey a preference to capital gains.

See Also

Capital Gains: [How are capital gains taxed?](#)

Data Sources

Tax Policy Center, "[Historical Capital Gains and Taxes](#)"

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Further Reading

Auerbach, Alan, Leonard E. Burman, and Jonathan M. Siegel, "[Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data](#)," in *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, edited by Joel B. Slemrod (Cambridge, Mass.: Harvard University Press, 2000).

Burman, Leonard E., [The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed](#) (Washington: Brookings Institution Press, 1999).

_____, "[Taxing Capital Income Once](#)," *Tax Notes* (January 23, 2003).

_____, "[End the Break on Capital Gains](#)," *Washington Post* (July 30, 2007).

Burman, Leonard E., and William C. Randolph, "Measuring Permanent Responses to Capital Gains Tax Changes in Panel Data," *American Economic Review* (September 1994), 794-809.