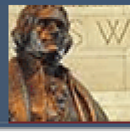

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Preferential Capital Gains Tax Rates

Deborah Kobes, Leonard E. Burman

Note: This report is available in its entirety in the Portable Document Format (PDF).

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The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) cut the top tax rate on long-term capital gains from 20 percent to 15 percent, the lowest level since World War II. JGTRRA also cut the rate on dividends to 15 percent; previously dividends had been taxed as ordinary income. In contrast, capital gains have been taxed at lower rates than ordinary income for most of the history of the income tax.

Since 1934, capital gains tax preferences have generally been affected by means of an exclusionÂthat is, a portion of long-term capital gains were excluded from tax. For example, from 1982 to 1986, 60 percent of long-term capital gains were excluded from tax. Since the top tax rate on ordinary income was 50 percent, this implies a top effective tax rate on capital gains of 20 percent. Before 1978, capital gains were subject to different tax rates as well as an exclusion. Since 1991, long-term capital gains have been subject to alternative lower rates only.

Since 1978, capital assets generally have been required to be held for at least one year to qualify for lower tax rates, although a half-year holding period requirement applied from 1984 to 1986 and prior to 1976.

Tax rates on ordinary income decreased while capital gains taxes increased in the 1970s, although the former remained much higher than the latter. The Revenue Act of 1964 significantly lowered all tax rates on ordinary income. The top rate, which applied to joint filers earning at least $200,000, was cut from 90 to 70 percent. The Tax Reform Act of 1969 phased in from 1970 to 1976 and raised alternative capital gains tax rates, making the maximum tax rate on capital gains 49 percent, the highest level since 1921.

Maximum Tax Rate

The late 1970s and early 1980s brought decreases to the top rates for both ordinary income and capital gains. The top tax rate on ordinary income dropped 20 percentage points to 50 percent in 1982. The capital gains exclusion increased from 50 percent to 60 percent in 1979. As a result of the exclusion and rate cut, capital gains tax rates fell from a maximum of 39.875 percent including an add-on minimum tax, which was widely applicable in 1978, to 20 percent in 1982.

The tax rate differential was eliminated by the Tax Reform Act of 1986 (TRA86) at the same time that top ordinary income tax rates were slashed to 28 percent. When tax rates on ordinary income increased in 1991, the top capital gains tax rate was held fixed at 28 percent. It was subsequently cut to 20 percent in 1997 and to 15 percent in 2003. In comparison, the top tax rate on ordinary income is now 35 percent.[1]

1. For a discussion of the issues surrounding the taxation of capital gains, see Leonard E. Burman, The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed (Washington, DC: Brookings Institution Press, 1999).

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