THE CAPITAL GAINS RATE - HISTORICAL PERSPECTIVES ON "RETROACTIVE" CHANGES

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In light of the U.S. presidential election on 3 November 2020, many investors and business owners expecting a liquidity event are focused on the possibility that the current capital gains rate (generally, 23.8 percent) could be subject to significant change, including potentially taxing long-term capital gains at higher ordinary income rates for certain filers. While overarching considerations weigh heavily in the context of voting decisions and private business sales alike, history suggests that, faced with the prospect of a potentially changing federal income tax rate, waiting to see legislative change might foreclose opportunities to realize gains at current favorable rates. In particular, the conventional wisdom is that any significant U.S. tax bill enacted after the election (and assuming a Democratic victory in the presidential race as well as Democratic gains in the Senate), would not be enacted until well into in calendar year 2021. This leads to the question of whether gains from transactions completed in 2021, but prior to such legislative change, could be subject to a higher capital gains rate.

A historical review suggests that any tax legislation enacted in 2021 could have retroactive effect to transactions completed at any time in 2021. In recent years, such retroactive rate changes have occurred as late into the year as August. The chart below sets forth a list of recent tax legislation impacting individual income tax rates and, often, capital gains rates specifically. Of course, this history does not encompass or limit the universe of potential changes. Certain proposals, such as the marking-to-market of capital gains, may impact the timing of capital gains in addition to the rate. Conversely, proposals such as indexing capital gains to inflation could effectively reduce the rate of tax by applying the same rate to a lower tax base.

Legislation Timing	**Rate Change**	**Rate Change(s)**
Taxpayer Relief Act of 1997 (Pub. L. 105–34) ▪ Introduced 24 June 1997 ▪ Signed 5 August 1997	Reduced the maximum capital gains rate from 28 percent to 20 percent.	Effective for taxable years ending after 6 May 1997 (i.e., for the full calendar year in which it was signed).
IRS Restructuring and Reform Act of 1998 (Pub. L. 105–206) ▪ Introduced 21 October 1997 ▪ Signed 22 July 1998	Eliminated a multi-tiered capital gain structure for assets held more than one year but not more than 18 months, unifying 20 percent capital gains rate.	Effective for amounts properly taken into account after 31 December 1997 (i.e., for the full calendar year in which it was signed).
Economic Growth and Tax Relief	Generally reduced the ordinary	Initially effective for taxable years

Legislation Timing	Rate Change	Rate Change(s)
Reconciliation Act of 2001 (Pub. L. 107–16) ▪ Introduced 15 May 2001 ▪ Signed 7 June 2001	individual income tax rates and provided for a limited capital gains reduction.	beginning after 31 December 2000 (i.e., for the full calendar year in which it was signed).
Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) (Pub. L. 108–27) ▪ Introduced 27 February 2003 ▪ Signed 28 May 2003	Reduced the maximum capital gains rate to 15 percent and subjected dividends to the same rate of tax as capital gains, which change was subsequently extended twice.	Generally effective for taxable years ending on or after 6 May 2003, but special transition rules applied to apportion capital gains realized during the 2003 calendar year to pre- and post-effective periods and a sunset rule applied to the changes.
American Taxpayer Relief Act of 2012 (Pub. L. No. 112–240) ▪ Introduced 24 July 2012 ▪ Signed 2 January 2013	Made permanent the capital gains rate changes in the JGTRRA but provided for a maximum rate of 20 percent.	Effective for taxable years beginning after 31 December 2012 (i.e., for the full calendar year in which it was signed).
The Tax Cuts and Jobs Act of 2017 (TCJA) (Pub. L. No. 115–97) ▪ Introduced 2 November 2017 ▪ Signed 22 December 2017	Generally modified or expanded individual income tax brackets and reduced the top rates.	Effective for taxable years beginning after 31 December 2017.

Notably, these examples involved only rate decreases, which are typically easier to implement on a retroactive basis from a political standpoint. Rate increases generally have been scheduled by prior legislation. However, this recent experience does not foreclose the possibility that a capital gain rate increase could be implemented on a retroactive basis. Most recent significant tax law legislation included at least some retroactive elements. The only change to individual income rates or brackets in recent experience that applied solely to prospective tax years was the TCJA, signed into law in December of 2017 and first applicable for calendar year 2018. While the most significant recent capital gains rate change, provided by the JGTRRA, was largely prospective, it was still, in part, retroactive and included a complicated transition rule that functionally split the single calendar year 2003 into two periods for purposes of computing the capital gains tax. It, nevertheless, remains possible that we see even further retroactivity for certain concepts where the sponsors of the legislation believe the public has had fair warning.

Where life's only certainties are death and taxes, and only one of those is even marginally predictable, the tax implications of a transaction would ideally be known at the time of closing. However, because tax legislation enacted at any time in 2021 could potentially apply to all transactions occurring in 2021, investors and business owners expecting a liquidity event should consider completing their intended transactions on or before 31 December 2020 if they would like more assurance that they will benefit from the current long-term capital gains rate.

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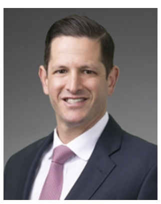

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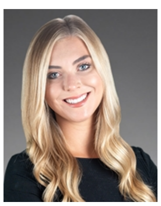

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