



Capital Gains Tax Preference Should Be Ended, Not Expanded

By Galen Hendricks and Seth Hanlon | September 28, 2020

In an era of profound inequality, few issues illustrate such stark differences in economic priorities as capital gains taxes. Capital gains accrue overwhelmingly to the wealthy and receive favorable tax treatment in several ways. Cutting capital gains taxes would confer another windfall on the wealthy, exacerbate the tax preference for income from wealth over income from work, increase inequality, and drain revenue. By contrast, raising capital gains taxes and closing loopholes would make the wealthy pay more of their fair share, lessen tax code disparities, reduce inequality, and raise substantial revenue for the country.

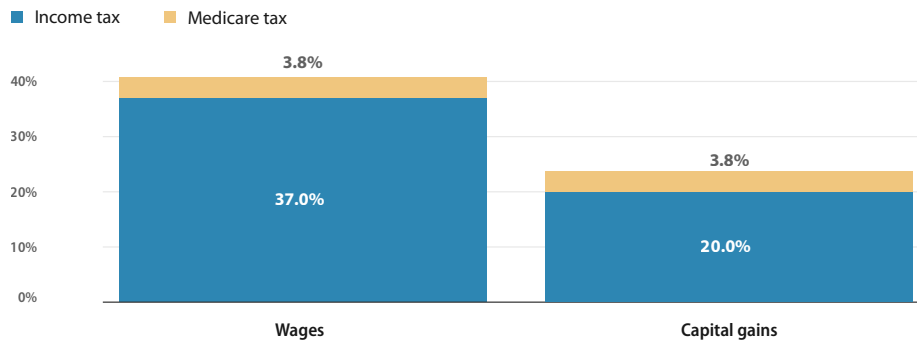
Capital gains and dividends accrue overwhelmingly to the wealthy and are taxed at preferential rates

A capital gain is the profit from selling an asset such as a stock or other financial instrument, an interest in a business, or real estate. The gains from the sale of such assets held more than one year are considered long-term gains and taxed at special low rates. While ordinary income such as wages and salaries is taxed at rates ranging from 0 percent for low levels of income to 37 percent for the highest level of incomes, long-term capital gains are taxed at 0 percent, 15 percent, and 20 percent. Most corporate dividends that are paid to shareholders are also taxed at these favorable rates. There is also a 3.8 percent Medicare tax on high-income taxpayers' net investment income, including capital gains and dividends. The 3.8 percent net investment income tax (NIIT) was enacted in companion legislation to the Affordable Care Act in 2010 and essentially parallels the Medicare tax on wages.¹

The vast majority of capital gains and dividends reported on tax returns are received by individuals at the very top of the income spectrum. According to the Tax Policy Center (TPC), the richest 1 percent of Americans reported an estimated 75 percent of all long-term capital gains in 2019, with the richest 0.1 percent—people with annual incomes exceeding \$3.8 million—bringing in more than half of all gains.²

FIGURE 1
Capital gains are taxed at preferential rates

Top marginal tax rates on wages and long-term capital gains

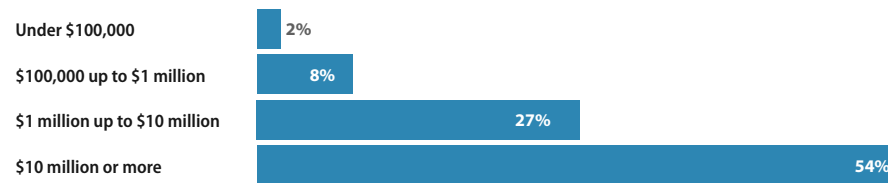


Note: Wages are subject to a maximum 3.8 percent Medicare tax, with 1.45 percent paid by both employers and employees, and an additional 0.9 percent tax on wages exceeding \$200,000 (\$250,000 for couples). Capital gains are subject to the 3.8 percent net investment income tax. Source: Tax rates are based on the Internal Revenue Code. See 26 U.S.C. Section 1 and 1411, available at <https://uscode.house.gov/browse/prelim@title26&edition=prelim> (last accessed September 2020).

The richest 1 percent of Americans reported 52 percent of qualified dividends—those eligible for the same lower rates as long-term capital gains. The richest 0.1 percent reported 31 percent of qualified dividends. (In total, there was nearly \$1 trillion in capital gains reported in 2019 and \$224 billion in qualified dividends, according to TPC estimates.)³

FIGURE 2
The wealthy pay special low rates on much of their income

Percentage of taxable income taxed at preferential rates for capital gains and dividends, by income level



Note: Data are for tax year 2018. Source: U.S. Internal Revenue Service, "SOI Tax Stats - Individual Income Tax Returns Publication 1304 (Complete Report): Table 3.5" (Washington: 2018), available at <https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-publication-1304-complete-report> (last accessed September 2020).

In recent decades, the increasing concentration of capital gains in the hands of the wealthy, and the reduction in tax rates on capital gains, have been substantial factors behind the increase in economic inequality.⁴

Because of the stepped-up basis loophole, a large share of wealthy people's capital gains escapes taxation

Lower rates are not the only way the tax code gives preferential treatment to capital gains, however. Unlike wages or salaries, which are taxed when earned, capital gains are not taxed as the asset grows in value—they are taxed only when the asset is sold. This gives owners of capital assets the ability to defer tax. And a giant loophole in the tax code allows a large share of these deferred capital gains to escape income taxes entirely. If a person holds an asset for their entire life, the asset's appreciation in value is never subject to income taxes. This loophole is known as stepped-up basis.⁵ In fact, unrealized capital gains—in other words, untaxed capital gains—make up more than half of the wealthiest decedents' estates.⁶ That means that much of the wealth accumulation of billionaires and multimillionaires is never subject to income tax. The stepped-up basis rule also leads to inefficiency through a lock-in effect: For tax reasons, people hold onto assets for their entire lives that they would otherwise sell.

There are other loopholes and preferences that allow wealthy people to avoid entirely or at least defer capital gains taxes. Through like-kind exchanges, real estate investors can defer paying tax on a property's gain in value if they subsequently buy a similar property. Investors holding stocks can strategically select which ones to sell at what time to harvest losses while deferring taxes on gains. They can also avoid capital gains tax if they donate assets that have grown in value to a charity, even while claiming the charitable deduction against their ordinary income. A special small-business tax exclusion allows investors in startups that hit it big to avoid taxes on their gains.⁷ Opportunity Zones—the newest capital gains tax loophole—are often touted as a community development initiative intended to encourage investments in low-income communities; however, they are fundamentally capital gains tax shelters that are neither required to produce jobs or other community benefits nor have been shown to do so.⁸

In sum, capital gains enjoy very favorable treatment under the tax code, as they are taxed at preferential rates and provide asset owners with opportunities to defer or avoid tax altogether.

Cutting capital gains taxes would result in a massive, unnecessary tax cut for wealthy Americans

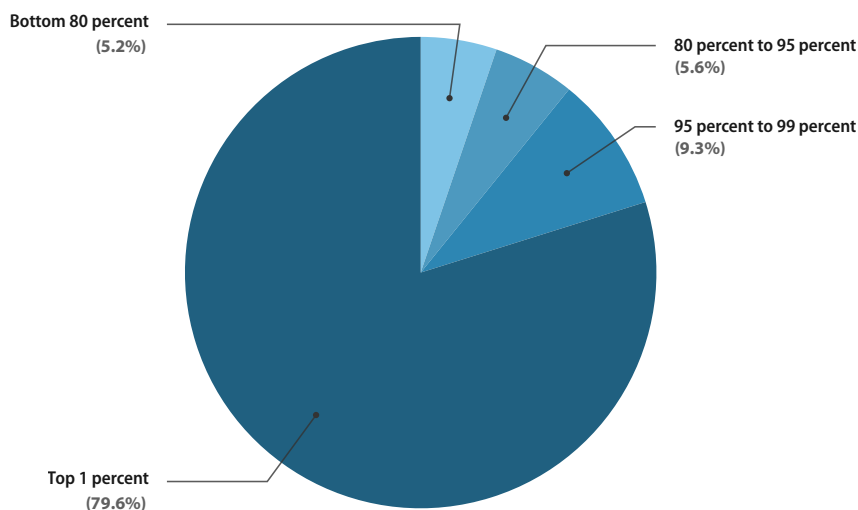
Despite the fact that inequality has only increased since the pandemic began,⁹ some in the administration have said that next year they would seek to cut the top capital gains rate further. President Donald Trump has said that he wants to cut the top rate from 20 percent to 15 percent.¹⁰ Moreover, Republican state officials, backed by the Trump administration, are seeking to repeal the Affordable

Care Act (ACA) in its entirety through a lawsuit that is now pending in the U.S. Supreme Court.¹¹ If the ACA is repealed, it would likely eliminate the 3.8 percent tax on net investment income, including capital gains and dividends.

Cutting the top rate on capital gains would overwhelmingly benefit the very wealthy. As figure 3 shows, the top 1 percent enjoy 80 percent of the benefit of the now-existing preferential rates,¹² and they would benefit even more if those rates were cut further. The Institute on Taxation and Economic Policy estimates that 99 percent of the tax cut from cutting the capital gains rate from 20 percent to 15 percent would go to the richest 1 percent of Americans.¹³

FIGURE 3
Capital gains tax breaks overwhelmingly benefit the wealthy

Share of total benefit from the preferential rates on capital gains and dividends, by income percentile



Note: Data are for tax year 2019.
Source: Tax Policy Center, "T20-0137 - Tax Benefit of the Preferential Rates on Long-Term Capital Gains and Qualified Dividends, Baseline: Current Law, Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2019," available at <https://www.taxpolicycenter.org/model-estimates/individual-income-tax-expenditures-april-2020/t20-0137-tax-benefit-preferential> (last accessed September 2020).

The uber-wealthy within the top 1 percent would get even larger tax cuts. According to the most recent tax data, the highest-income 0.001 percent of Americans in 2017—those with incomes of at least \$63.4 million per year—had \$165 billion in long-term capital gains and qualified dividends. If the top capital gains rate had been cut to 15 percent and the 3.8 percent NIIT repealed, that select group of Americans would have paid nearly \$14 billion less in taxes, or more than \$9.6 million less per person.¹⁴

The wealthy would also benefit from a separate proposal to cut capital gains taxes floated by Trump administration officials, which would index capital gains for inflation. The Trump administration considered implementing this change by regulation, but Secretary of the Treasury Steven Mnuchin correctly concluded that such a change would require legislation.¹⁵ Eighty-six percent of the benefit from indexing capital gains would flow to the top 1 percent of Americans.¹⁶

Working- and middle-class Americans, on the other hand, would get nothing—zero—from cutting the capital gains rate from 20 percent to 15 percent or from eliminating the 3.8 percent NIIT. Most taxpayers already fall into the 0 percent capital gains tax bracket, which extends up to \$40,000 in taxable income for singles and \$80,000 for couples. (Taxable income is income after subtracting deductions, including the standard deduction.) This means that even if they report capital gains or qualified dividends on their tax return, they do not have to pay tax on them. Only the highest-income 0.8 percent of Americans had capital gains or dividends in the current 20 percent bracket in 2018.¹⁷

In fact, few middle-class taxpayers have any capital gains or dividends to report on their tax returns in the first place. That is because most either do not own capital assets or aren't subject to capital gains taxes on the assets they do own. The latter is because the primary sources of capital gains and dividends for middle-class Americans are already shielded from the tax. For example, the sale of one's home is not subject to capital gains taxes on the first \$250,000 of gain, or the first \$500,000 for married couples. And the vast majority of financial assets that middle-class families own are held in pension funds or retirement savings accounts such as 401(k)s, which aren't subject to capital gains tax at all. Roughly half of Americans do not own stock either directly or through 401(k)s.¹⁸

There is no evidence that cutting capital gains rates would help the economy

As policymakers look to pull the United States out of the current economic crisis, they should look to policies other than cutting capital gains rates, which would be one of the least effective forms of economic stimulus. In the near term, cuts to the capital gains rate would reward investments already made in the past, creating a windfall for wealthy people who do not need a tax cut and are least likely to spend any additional cash.

In the long run, cutting capital gains would also do little to help the economy. There is no historical correlation between capital gains rates and economic growth.¹⁹ And tax rates have little effect on savings, as Jane Gravelle of the Congressional Research Service explains:

Arguments have also been made that lower gains taxes will increase economic growth and entrepreneurship. Although evidence on the effect of tax cuts on savings rates and, thus, economic growth is difficult to obtain, most evidence does not indicate a large response of savings to an increase in the rate of return. Indeed, not all studies find a positive response, because a higher rate of return may allow individuals to save less while reaching their desired goal.²⁰

Meanwhile, the Penn Wharton Budget Model finds that raising capital gains taxes instead would increase long-run economic growth because the effect on private savings and investment would be so small that it is outweighed in the model by the effect of lower public debt.²¹

The lower rates for capital gains also create inefficiency and waste by enabling tax shelters, with well-heeled individuals designing transactions to characterize their income as low-taxed capital gains.²² The infamous carried interest loophole is one example: Managers of private equity and other investment funds characterize much of their income as capital gains rather than as ordinary income, as should be the case with compensation for services.²³ Equalizing the capital gains and ordinary income tax rates would have the effect of closing the carried interest loophole.

Both capital gains rates and the tax base have a substantial impact on revenues

With \$1.2 trillion of capital gains and dividends reported in 2018, cutting capital gains tax rates would lose a substantial amount of revenue, while increasing rates would raise a substantial amount of revenue.²⁴ Some economists argue that raising capital gains rates will actually cause a loss in revenue because a higher tax rate would lead more asset holders to avoid realizing their gains by selling.²⁵ But the current maximum capital gains rate of 23.8 percent (including the 3.8 percent NIIT) is below the rate that official estimators believe is revenue maximizing, which is about 30 percent.²⁶ More importantly, new research by Princeton University economists suggests the revenue-maximizing rate is even higher, at 38 percent to 47 percent.²⁷

Another critical point is that those estimates of the revenue-maximizing rate are based on the existing rules for taxing gains, allowing asset holders to defer taxes and avoid capital gains tax entirely by holding assets for their lifetimes. The revenue-maximizing rate would be higher under a system that eliminated stepped-up basis and taxed gains at death. A mark-to-market system that taxed gains annually regardless of whether they are realized would entirely eliminate the ability to defer taxes on gains and allow for even larger revenue increases.

Conclusion: Income from wealth should be taxed like income from work

Cutting capital gains taxes would be extremely misguided. Instead, Congress should work to rebalance the tax code by increasing rates on capital gains and dividends and equalizing the treatment of capital income and income from wages and salaries. There are currently several proposals that work to achieve this goal.

The Obama administration proposed eliminating the stepped-up basis loophole and raising the capital gains rate.²⁸ Sen. Ron Wyden (D-OR) has a comprehensive mark-to-market plan that would tax wealthy individuals' capital assets on the gain in their market value each year whether or not the gains are realized, effectively eliminating the ability to defer tax liability—while also taxing them at the same rates as ordinary income.²⁹ Enacting policies along these lines would be an important step toward creating a more fair and equitable tax system.

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Endnotes

- 1 The 3.8 percent net investment income tax applies to individuals with more than \$200,000 of adjusted gross income (\$250,000 for couples). The Medicare tax on wages is 2.9 percent—with half paid by employees and half by employers—and ACA implemented an additional 0.9 percent tax on earnings exceeding \$200,000 (\$250,000 for couples).
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- 3 Ibid.
- 4 Thomas L. Hungerford, “Changes in Income Inequality Among U.S. Tax Filers between 1991 and 2006: The Role of Wages, Capital Income, and Taxes,” available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2207372.
- 5 Capital gains are measured by subtracting an asset owner’s basis in the asset—which is, generally speaking, the price the owner paid for it—from the sales proceeds. But if bequeathed to an heir, the bequest does not trigger tax on the gain, and the heir’s basis in the asset is stepped up to the fair market value when the decedent died. The gain that occurred during the decedent’s lifetime is never subject to income taxes. There are three ways to address this loophole. The most modest would give heirs the same basis as the decedent but without any tax paid at the time of bequest; this is known as carryover basis. Another approach would impose tax on the gain at the time of the bequest. A more comprehensive reform known as market-market would require capital gains to be taxed on an annual basis whether realized or not.
- 6 Chuck Marr, Samantha Jacoby, and Kathleen Bryant, “Substantial Income of Wealthy Households Escapes Annual Taxation Or Enjoys Special Tax Breaks” (Washington: Center on Budget and Policy Priorities, 2019), available at <https://www.cbpp.org/research/federal-tax/substantial-income-of-wealthy-households-escapes-annual-taxation-or-enjoys>.
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- 11 Nicole Rapfogel and Emily Gee, “The Health Care Repeal Lawsuit Could Strip Coverage from 23 Million Americans,” Center for American Progress, June 24, 2020, available at <https://www.americanprogress.org/issues/healthcare/news/2020/06/24/486768/health-care-repeal-lawsuit-strip-coverage-23-million-americans/>.
- 12 Tax Policy Center, “T20-0137 - Tax Benefit of the Preferential Rates on Long-Term Capital Gains and Qualified Dividends, Baseline: Current Law, Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2019” (Washington: 2020), available at <https://www.taxpolicycenter.org/model-estimates/individual-income-tax-expenditures-april-2020/t20-0137-tax-benefit-preferential>.
- 13 Steve Wamhoff, “Analysis: Trump’s Proposed Capital Gains Break Almost Exclusively Benefits Top 1 Percent,” Institute on Taxation and Economic Policy, August 18, 2020, available at <https://itep.org/analysis-trumps-proposed-capital-gains-break-almost-exclusively-benefits-top-1-percent/>.
- 14 Authors’ calculation based off of IRS, “SOI Tax Rates - Individual Statistical Tables by Tax Rate and Income Percentile: Table 3,” available at <https://www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-tax-rate-and-income-percentile> (last accessed September 2020). The 3.8 percent NIIT cut applies to income from taxable interest, ordinary dividends, and net sales of capital assets, while the top capital gains rate cut would only apply to income from net sales of capital assets, and qualified dividends.
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