Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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RAISING TODAY'S LOW CAPITAL GAINS TAX RATES COULD PROMOTE ECONOMIC EFFICIENCY AND FAIRNESS, WHILE HELPING REDUCE DEFICITS

By Chye-Ching Huang and Chuck Marr

The large tax preferences that capital gains enjoy over "ordinary" income, such as salary and wages, add to budget deficits, widen income inequality, and do little if anything to promote economic growth. Recent bipartisan deficit commissions have called for eliminating or sharply reducing these tax preferences, as the landmark 1986 Tax Reform Act did. By doing so as part of a package that reduces deficits and reforms the tax code, policymakers could help put the nation's fiscal house in order and make the tax code fairer and more efficient.

The tax code now strongly favors capital gains — increases in the value of assets, such as stocks and real estate — over ordinary income. Not only is the capital gains tax rate far below the top tax rate on ordinary income, but taxpayers can delay paying taxes until they realize their capital gains (usually when they sell assets). In many cases, taxpayers can avoid paying capital gains tax altogether; about half of all capital gains are never subject to capital gains tax, according to the Congressional Research Service (CRS).[1]

The large preference for capital gains is economically inefficient, regressive and costly:

- **Economically inefficient.** As Leonard Burman, the former director of the Urban-Brookings Tax Policy Center (TPC) and one of the nation's foremost tax policy experts, has written:

  > Virtually every individual income tax shelter is devoted to converting fully taxed income into capital gains. If you can transform $10 million of wages into gains, you can save over $2 million. With that kind of payoff, there is a whole industry devoted to inventing schemes [to take advantage of this tax shelter].[2]

  Taking advantage of these schemes involves spending resources (on, for instance, lawyer and accountant fees) that people might put to more productive use. Burman has also commented:

  > [Tax s]helter investments are invariably lousy, unproductive ventures that would never exist

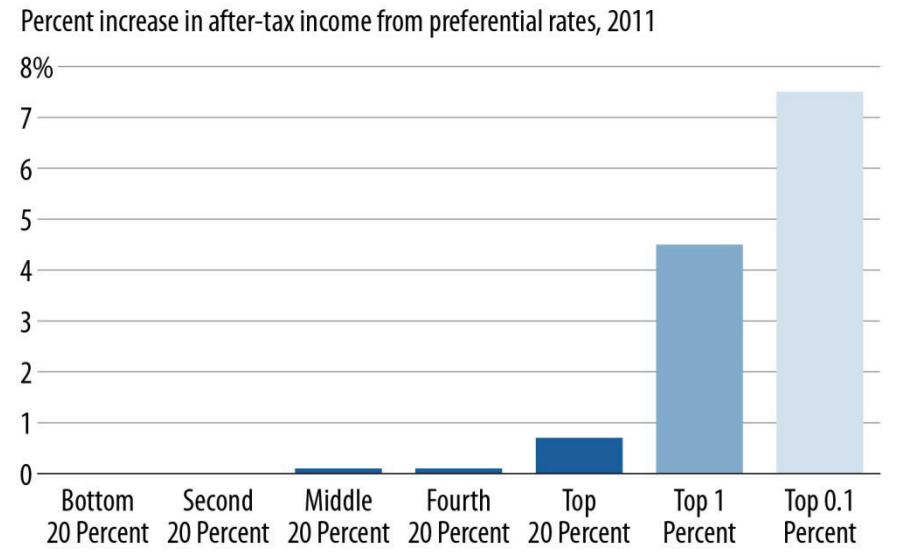
[1] Jane Gravelle, "Limits to Capital Gains Feedback Effects," *Tax Notes* 51, April 22, 1991, pp. 363-371

[2] Leonard E. Burman, "Mitt Romney's Teachable Moment on Capital Gains", Forbes.com, January 18, 2012, http://www.forbes.com/sites/leonardburman/2012/01/18/mitt-romneys-teachable-moment-on-capital-gains/.

but for tax benefits. And money poured down these sinkholes isn't available for more productive activities. What's more, the creative energy devoted to cooking up tax shelters could otherwise be channeled into something productive. . . . Bottom line: low rates for capital gains are as likely to depress the economy as to stimulate it.[3]

- **Regressive.** Capital gains are heavily concentrated at the top; the top 1 percent of taxpayers will receive *71 percent* of all capital gains in 2012, according to TPC.[4] This means that the benefits of the tax breaks for capital gains flow overwhelmingly to the highest-income taxpayers, while delivering negligible benefits to the large majority of taxpayers. TPC estimates, for example, that the benefits of the preferential rates on capital gains and dividends raised the after-tax incomes of the top 0.1 percent of taxpayers by 7.5 percent — an average of $356,750 for each such taxpayer in 2011, while raising after-tax incomes among the middle fifth of households by just 0.1 percent, or an average of $23. (See Figure 1.)

Figure 1
Preferential Rates for Capital Gains and Dividends Provide Biggest Benefits to the Top



Source: Urban-Brookings Tax Policy Center (Table T12-0137)

The tax preferences for capital gains are a key reason why the tax code violates the "Buffett rule," which essentially says that people at the top shouldn't face lower tax rates than middle-income households. By making the tax code less progressive, these tax preferences also worsen after-tax income inequality, which has risen to historic levels in recent decades. Between 1996 and 2006, "changes in capital gains and dividends were the largest contributor to the increase in

[3] Leonard E. Burman, "Under the Sheltering Lie," *Marketplace* Commentary, December 20, 2005, http://www.taxpolicycenter.org/publications/template.cfm?PubID=900918.

[4] Tax Policy Center Table T09-0942.

the overall income inequality,"[5] according to CRS.

- **Inequitable.** The tax breaks for capital gains also are inequitable in another way. A taxpayer who earns most or all of his income from a salary will pay much more of it in taxes than a taxpayer who makes the same amount of income primarily in the form of capital gains. In 2011, households with incomes between $100,000 and $200,000 who got more than two-thirds of their income from investments taxed at the preferential capital gains and dividend rates owed only *5 percent* of their incomes in federal income and payroll taxes, on average, TPC data show. That's about a *quarter* of the 19.2 percent rate faced by households who earned the same total income but received less than one-tenth of it from capital gains and dividends.

- **Costly.** In light of the sacrifices that Americans will almost certainly have to make to reduce deficits, retaining a tax preference for high-income Americans that costs tens of billions of dollars each year should not be a priority.

The arguments that proponents make to defend tax breaks for capital gains do not withstand scrutiny.

- **There is no evidence that tax breaks for capital gains contribute to economic growth at all, let alone by enough to outweigh the costs of these tax breaks.** University of Michigan tax economist Joel Slemrod, another of the nation's leading tax policy experts, has found that "there is no evidence that links aggregate economic performance to capital gains tax rates."[6] Similarly, TPC has found no statistically significant correlation between capital gains rates and real GDP growth during the *last 50 years*.[7] In addition, a new CRS report analyzing capital gains tax rates and economic growth finds that "analysis of such data suggests the reduction in the top [capital gains] tax rates have had little association with saving, investment, or productivity growth".[8]

- **Capital gains tax breaks have little effect on most seniors.** Despite claims that reducing the tax preferences for capital gains would hurt the elderly, most elderly households have low or moderate incomes and thus do not face the top income tax rates, so they cannot benefit from having capital gains taxed at a much lower rate than those top rates. TPC estimates that in 2011, nearly 60 percent of elderly households had cash incomes below $40,000 and, for those filers, investment income made up only 6.1 percent of their overall incomes, on average. The preferential rates on capital gains and dividends are worth *less than $6 a year* to these elderly households, on average (less than 0.1 percent of their after-tax incomes).[9]

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[5] http://taxprof.typepad.com/files/crs-1.pdf at page 1.

[6] Joel Slemrod, "The Truth About Taxes and Economic Growth" Interview in *Challenge*, vol. 46, no. 1, January/February 2003, pp. 5–14. http://www.challengemagazine.com/Challenge%20interview%20pdfs/Slemrod.pdf.

[7] Troy Kravitz and Leonard Burman, "Capital Gains Tax Rates, Stock Markets, and Growth," Tax Policy Center, November 7, 2005. See also Leonard Burman, "Capital Gains Tax Rates and Economic Growth (or not)," Forbes blog, March 15, 2012, http://www.forbes.com/sites/leonardburman/2012/03/15/capital-gains-tax-rates-and-economic-growth-or-not/. Burman also found no statistically significant effect lagged up to five years: Leonard Burman, *The Labyrinth of Capital Gains Tax Policy,* Washington, D.C., Brookings Institution, 1999, pp. 81.

[8] Thomas L. Hungerford, "Taxes and the Economy: Analysis of the Top Tax Rates Since 1945," Congressional Research Service, September 14, 2012.

[9] Tax Policy Center Tables T12-0009 and T12-0136.

For the 21 percent of elderly households with incomes between $50,000 and $100,000, average after-tax income would have been less than one-third of one percent lower in 2011, if there were no difference between the tax rate on capital gains and dividends and the tax rate on ordinary income. The average increase in taxes for those filers would have been $195.

- **Charges that the capital gains tax leads to double taxation of corporate profits are overblown and do not justify a blanket tax preference for *all* capital gains.** Effective corporate tax rates are often very low, and many capital gains are never subject to capital gains tax.

- **Inflation is not a sound reason for the current preferential treatment of capital gains.** Some capital gains reflect inflation instead of real increases in purchasing power. But the fact that capital gains are taxed when they are realized rather than when they accrue allows taxpayers to defer payment of taxes, which helps offset the taxation of gains that merely reflect inflation. Moreover, inflation does not justify the complete exemption of many *real* capital gains from taxation, and the inflation component of *other* types of investment income, such as interest, is subject to taxation as well.

Major tax reform and deficit reduction efforts have recognized the need to reduce the tax preferences for capital gains. A key element of the landmark 1986 tax reform legislation, for example, was elimination of the differential between the capital gains tax rate and the top income tax rate. As a 1984 Treasury Department report explained about the need to reform the taxation of income from investments, including capital gains:[10]

> The taxation of *capi*tal and business income in the United States is deeply flawed. . . . It contains subsidies to particular forms of investment that distort choices in the use of the nation's scarce capital resources. It provides opportunities for tax shelters that allow wealthy individuals to pay little tax, undermine confidence in the tax system, and further distort economic choices.

More recently, the Bipartisan Policy Center's Debt Reduction Task Force — chaired by Pete Domenici, the former Senate Budget Committee chairman, and Alice Rivlin, former director of the Office of Management and Budget and the Congressional Budget Office —stated that eliminating the preferential rates for capital gains and dividends "will establish equal treatment among taxpayers with different sources of income and eliminate the incentive to use tax shelters to convert ordinary income into capital gains."[11] It added, "Eliminating the capital gains differential will also reduce the compliance and administrative costs associated with sophisticated tax-planning strategies."

Similarly, the illustrative tax reform proposal in the Bowles-Simpson debt reduction plan would eliminate the differential between capital gains and ordinary income rates. (The Bowles-Simpson

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[10] Treasury Department, "Tax Reform for Fairness, Simplicity, and Economic Growth," The Treasury Department Report to the President, November 1984.

[11] Debt Reduction Task Force, "Restoring America's Future," Bipartisan Policy Center, November 2010, http://bipartisanpolicy.org/library/report/restoring-americas-future.

plan states that if policymakers choose instead to retain a lower capital gains tax rate, they should offset the cost by setting tax rates on ordinary income higher than in the illustrative plan.)

Why Rein in the Tax Preferences for Capital Gains?

Capital gains enjoy large tax breaks compared to salary and wages. These include the following (the appendix at the end of this paper provides more detail):

- **Preferential rates.** The top rate on most capital gains is 15 percent, while the top rate on salary and wages is 35 percent. If the Bush tax cuts for high-income households expire on schedule at the end of 2012, an equally large gap will remain between the top ordinary income tax rate (39.6 percent) and the rate on most capital gains (20 percent).

- **Deferral.** Unlike other forms of income such as salary and wages, which are taxed in the year that they accrue, capital gains taxes can be delayed until the taxpayer chooses to "realize" the capital gain (usually by selling the asset).

- **Complete exemption.** About half of capital gains are never subject to tax at all, for reasons including the forgiveness of capital gains at death and specific exemptions for certain types of capital gains and assets (for example, the exclusion of capital gains on the sale of many primary residences from capital gains tax).

These large preferences are: (1) economically inefficient, (2) regressive and problematic on equity grounds, and (3) costly, as detailed below.

Low Capital Gains Rate Is Economically Inefficient

The tax breaks for capital gains are inefficient, for two reasons. First, they skew investment decisions by encouraging taxpayers to invest in assets that deliver capital gains, even if those assets are less productive than others on a pre-tax basis and would therefore not have attracted investment but for the tax break. They thereby divert investment away from where it would be most productive. Second, they create a large incentive for taxpayers to reclassify ordinary income as capital gains for tax purposes.

Congress has exacerbated the problem by enacting provisions that allow high-income taxpayers to take even greater advantage of the preferential treatment of capital gains. For example:

- The "carried interest" tax break allows hedge fund managers to treat compensation for their services not as salary taxed at ordinary income tax rates but as a capital gain. (See box.) The Joint Committee on Taxation (JCT) estimates that eliminating this preference would save roughly $17 billion in revenues over 2012-2022.[12]

- The "blended rate" tax break allows a portion of capital gains from the buying and selling of some types of derivative contracts (a type of financial instrument) to be taxed at the long-term

[12] JCT re-estimate of President's Budget FY 2013, https://www.jct.gov/publications.html?func=startdown&id=4412.

capital gains rate even if the contract is held for less than a year and by a dealer whose business is trading in such contracts.[13] JCT estimates that this tax preference will cost $4.4 billion over 2011-2015.[14] The President has proposed eliminating this preference for equity and commodities dealers, which JCT estimates would save $2.7 billion from 2012 to 2021.[15]

- Congress has enacted industry-specific tax breaks that allow some profits from certain forestry, coal mining, and iron ore activities to be treated as capital gains even though they are not capital gains under normal tax rules.[16]

"Carried Interest" Compensation Exploits Capital Gains Tax Preferences

Managers of private equity funds typically receive as compensation a management fee plus 20 percent of the fund's profits above a threshold level. This right to 20 percent of the profits is known as "carried interest." Currently, the managers' carried interest is taxed as capital gains, meaning that it faces a top tax rate of only 15 percent, regardless of how affluent a fund manager is and what tax bracket he or she falls in.*

The carried interest that fund managers receive is compensation for the work they perform in managing a fund's investments, *not* a return on capital of their own that they have invested. Fund managers tend to contribute a modest amount of capital to the funds they manage, but any gains they receive on those investments are taxed at the capital gains rate and would continue to be taxed that way under proposals to eliminate the tax preference for carried interest.

The current preferential treatment means that a hedge fund manager earning $10 million or more could face a lower tax rate than a middle-income schoolteacher or policeman. Most tax policy analysts believe that the tax code should treat compensation received as carried interest the same as it treats income that other Americans receive for the work they perform.

*For further discussion see Aviva Aron-Dine, "An Analysis of the 'Carried Interest' Controversy," Center on Budget and Policy Priorities, July 31, 2007; and Chuck Marr and Gillian Brunet, "Compromise Provision to Narrow 'Carried Interest' Tax Loophole Should Not Be Weakened Further," Center on Budget and Policy Priorities, June 9, 2010.

Regressivity

Income inequality has risen dramatically over the last few decades, and the tax system has become less effective at leaning against this trend. Reining in the tax preferences for capital gains would mark a step forward.

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[13] The American Bar Association notes that "Gain or loss from property held in connection with a dealer's business ordinarily is treated as ordinary income, in accordance with the long-standing rule of the Code that ordinary rather than capital treatment is appropriate for taxpayers engaged in the normal course of their business activities." ABA, "Options for Tax reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," p. 42.

[14] Joint Committee on Taxation, "Estimates Of Federal Tax Expenditures For Fiscal Years 2011-2015," JCS-1-12, January 17, 2012.

[15] JCT re-estimate of President's Budget FY 2013, https://www.jct.gov/publications.html?func=startdown&id=4412.

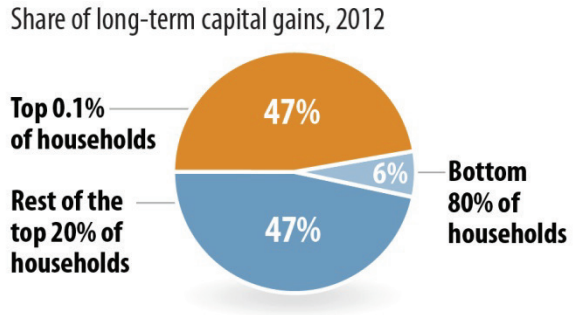
[16] http://subsidyscope.org/tax_expenditures/db/group/285/.

Capital Gains Are Heavily Concentrated at the Top

The top *one-tenth of 1 percent* (0.1 percent) of taxpayers will receive *47 percent* of all capital gains in 2012, according to TPC (See Figure 2). Moreover, the top 1 percent of taxpayers will receive 71 percent of all capital gains. Meanwhile, the bottom 80 percent will receive only 6 percent of all capital gains.

Even more striking, the latest available IRS data show that in 2009, 12 percent of all capital gains subject to the preferential rates went to the 400 highest-income taxpayers in the nation. These very wealthy individuals received an average of more than $99 million apiece in capital gains income that year, even though 2009 was a year in which financial markets were depressed. These taxpayers had average adjusted gross incomes of roughly $202 million that year.[17]

Figure 2
Capital Gains Highly Concentrated Among the Very Wealthy



Source: Tax Policy Center (Table T09-0492)

Because capital gains are so highly concentrated at the top of the income scale, the preferential rates for capital gains are highly regressive: they raise after-tax incomes by much more for very high-income taxpayers than for low- and moderate-income taxpayers. TPC estimates that, in 2011, the tax breaks provided by the preferential rates on capital gains and dividends raised after-tax incomes by 7.5 percent — an average of $356,750 apiece — for the top 0.1 percent of taxpayers. In contrast, they raised after-tax incomes by just 0.1 percent — an average of $23 — among the middle fifth of households. (See Figure 1.) Moreover, these figures reflect only the preferential rates, not the other capital gains tax benefits described in the Appendix.

Similarly, very high-income people derived the biggest benefits from the 2003 reduction in the top capital gains rate from 20 percent to 15 percent. TPC estimates that in 2005, that tax cut alone increased the after-tax incomes of the top 0.1 percent of filers by 2.2 percent — about $75,800 on average — compared to just 0.03 percent, or about $10, among the middle 20 percent of filers. (See Figure 3.) These tax cuts are one reason why the federal tax system as a whole has became weaker in leaning against rising income inequality in recent decades.[18]

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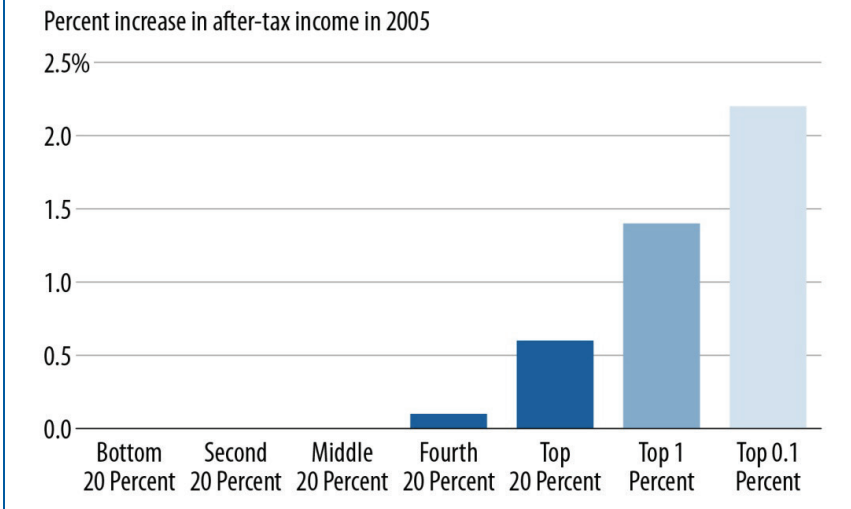
[17] The $99 million figure represents average capital gain subject to the preferential rates for these. Internal Revenue Service, "The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2008," http://www.irs.gov/pub/irs-soi/09intop400.pdf. (The top 400 taxpayers received 16 percent of all net capital gains less loss reported in AGI in2009, nearly $93 million apiece on average.)

[18] Chye-Ching Huang, "Why the Tax System Is Doing Less About Growing Inequality," Center on Budget and Policy Priorities, *Off the Charts Blog*, November 4, 2011, http://www.offthechartsblog.org/why-the-tax-system-is-doing-less-about-growing-inequality/.

Figure 3

2003 Capital Gains Rate Cut Was Highly Regressive



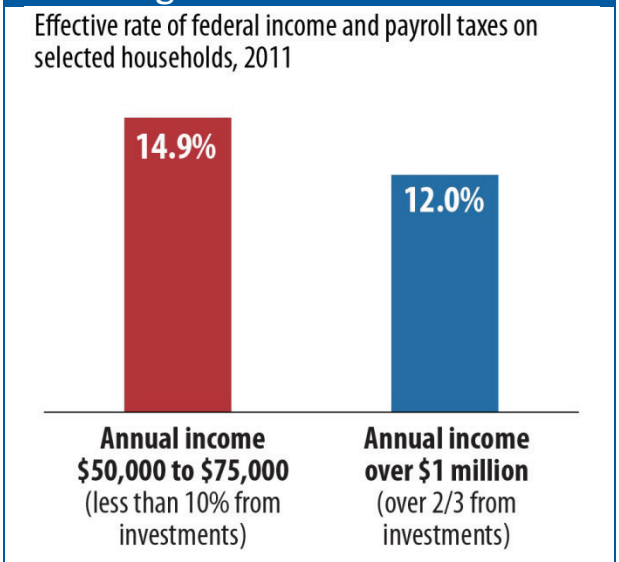
Source: Urban-Brookings Tax Policy Center (Table T05-0069)

Capital Gains Preferences Weaken Progressivity of Tax Code

The federal tax system as a whole (including payroll and excise taxes as well as income taxes) is modestly progressive, meaning that high-income households pay, on average, a somewhat larger share of their incomes in tax than low- and moderate-income households do. The preferential rate for capital gains, however, weakens the progressivity of the tax code. It is a key reason why the tax system violates the "Buffett rule," which essentially states that high-income taxpayers should not pay a smaller percentage of their incomes in federal taxes than middle-income Americans.[19] Because of various tax preferences — in particular, those for capital gains — a significant group of high-income taxpayers, particularly those who derive the bulk of their income from capital investments, pays taxes at a lower rate than many middle-class families.

Figure 4

Typical Middle-Class Households Face Higher Tax Rates Than Some High-Income Households



Source: Tax Policy Center (Table T11-0317)

Households with incomes between $50,000 and $75,000 that receive most of their income from

[19] Named after billionaire investor and philanthropist Warren Buffett, who has said it is objectionable that his secretary should pay more of her income in taxes than he does.

their paychecks (as middle-class people generally do) paid an average of 14.9 percent of their income in federal income and payroll taxes in 2011, according to TPC. This "effective tax rate" is *higher* than the rate faced by people with incomes over $1 million who receive more than a third of their income from capital gains and qualified dividends. Millionaires who receive one-third to two-thirds of their income from these preferential sources face a 14.6 percent average rate; millionaires who derive more than two-thirds of their income from these sources face a 12.0 percent average rate (see Figure 4).

Capital Gains Also Contribute to Growth in Pre-Tax Income Inequality

The preferential tax treatment of capital gains has helped drive the growth in inequality in after-tax incomes. But changes in the amount and distribution of capital gains have also contributed to the growth of *before*-tax income inequality:

- Congressional Budget Office (CBO) analysis of the 1979-2007 period finds that changes in the distribution of capital gains increased inequality in market incomes (i.e., incomes before counting government benefits and taxes). There were two reasons why. First, capital gains income became more highly concentrated at the top of the income distribution over that period. Second, the share of the nation's total household income consisting of capital gains (rather than types of income that are less highly concentrated at the top of the income scale, like salary and wages) went up.[20]

- CRS found that between 1996 and 2006, "changes in capital gains and dividends were the largest contributor to the increase in the overall income inequality." CRS cited the same reasons as CBO above: "Capital gains and dividends were a larger share of total income in 2006 than in 1996 (especially for high-income taxpayers) and were more unequally distributed in 2006 than in 1996."[21]

Equity Issues

Under the current tax code, two households that have the same amount of income and are otherwise similar in their expenses and family situations may end up paying very different amounts of tax depending on whether they generate most of their income from wages and salaries or from tax-preferred investments. This violates the principle of "horizontal equity," which states that people with equal ability to pay taxes should pay the same amount.

For example, as Figure 5 shows, in 2011, households with incomes between $100,000 and $200,000 who got more than two-thirds of their income from investments taxed at the preferential rates owed only 5 percent of their incomes in federal income and payroll taxes, on average. That is about a *quarter* of the 19.2 percent rate faced by households that earned the same amount of income but got less than 10 percent of it from capital gains and dividends.[22]

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[20] Congressional Budget Office, "Trends in the Distribution of Household Income Between 1979 and 2007," October 25, 2011, http://cbo.gov/publication/42729.

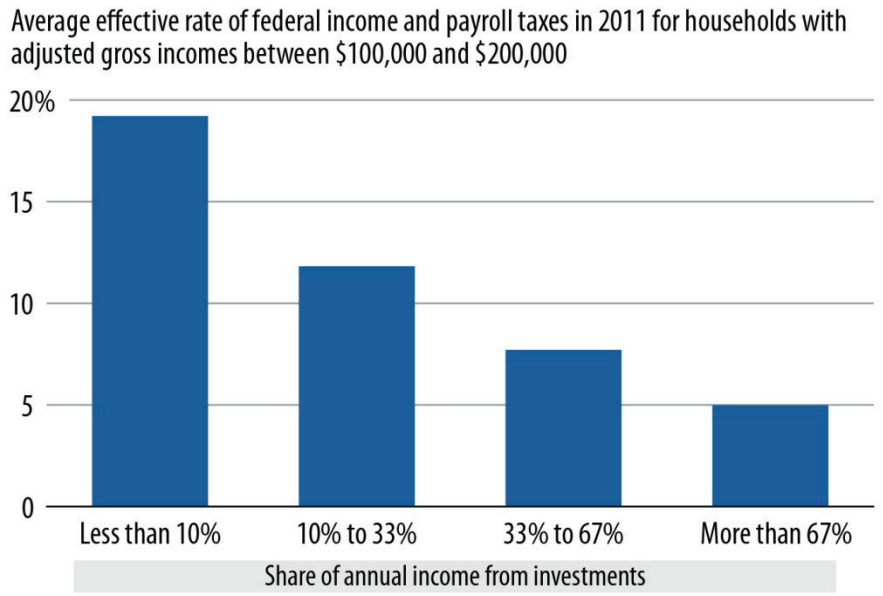
[21] Thomas L. Hungerford, "Changes in the Distribution of Income Among Tax Filers Between 1996 and 2006: The Role of Labor Income, Capital Income, and Tax Policy," Specialist in Public Finance, December 29, 2011, http://taxprof.typepad.com/files/crs-1.pdf, page 1.

[22] TPC table T11-0317. Even considering income taxes alone, households with incomes between $100,000 and $200,000 who received more than two-thirds of their income from investments taxed at the preferential rates owed an average of

Such inequities are one reason why the Rivlin-Domenici task force recommended eliminating the differential tax treatment of capital gains and ordinary income. It noted that doing so "will establish equal treatment among taxpayers with different sources of income."[23]

Figure 5

Households That Get Most of Their Income than in Capital Gains and Dividends Pay Much Less Tax on Average Than Other Households



Source: Urban-Brookings Tax Policy Center (Table T11-0317)

Cost

The preferential tax treatment of capital gains adds billions of dollars to deficits. Even modest steps to reduce it could contribute to deficit reduction.

Letting the capital gains rate return in 2013 to 20 percent for couples with adjusted gross incomes over $250,000 ($200,000 for single filers), as the Obama Administration has proposed, would save about $36 billion over ten years, the Treasury Department estimates. That is more than the projected budget over the full ten-year period for the Food and Drug Administration, which, among other things, helps ensure that foods and medicines are safe. (See Figure 6.)

JCT estimates that the preferential rates on capital gains and long-term dividends together will cost $457 billion over 2011-2015, compared to taxing capital gains and dividends at the normal individual marginal tax rates. The actual savings would be somewhat less than this, since this

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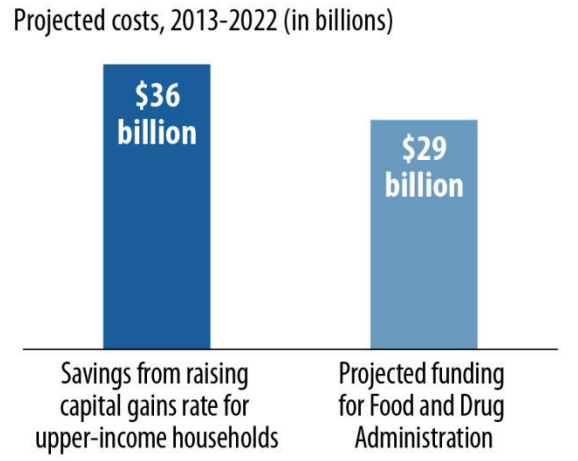
only 3.9 percent of their incomes in federal income and payroll taxes, less than half of the 10.9 percent rate faced by households that earned the same income but got less than 10 percent of it from capital gains and dividends.

[23] The Debt Reduction Taskforce, "Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System,", Senator Pete Domenici and Dr. Alice Rivlin, Co-Chairs, Bipartisan Policy Center, November 2010, p. 42.

estimate does not account for the likely behavioral changes that would result. People would likely realize their capital gains less often if capital gains were taxed at the same rates as ordinary income. But the savings would still be large.[24]

Figure 6

Administration's Capital Gains Tax Proposal Saves Significant Revenues



Sources: Office of Management and Budget and Congressional Budget Office

Arguments for Maintaining Tax Preferences Do Not Hold Up Under Scrutiny

Defenders of the tax preferences for capital gains argue that they support growth and that reducing them would not yield significant revenues, would harm the elderly, and would increase "double taxation," among other things. The evidence does not support these claims.

Reducing Capital Gains Preferences Would Not Impede Growth

There is no sound evidence that taxing capital gains at levels far below ordinary income increases economic growth at all — let alone by enough to outweigh the significant economic cost of doing so. As noted tax economist Joel Slemrod has explained, "there is no evidence that links aggregate economic performance to capital gains tax rates."[25] Similarly, a CRS report issued in September 2012 that analyzes top marginal tax rates on capital gains and GDP finds "the reduction in the top tax rates [since 1945] have had little association with saving, investment, or productivity growth".[26]

Figure 7 illustrates that there is no statistically significant correlation between the top capital gains rate and economic growth over the last 60 years.[27] Leonard Burman has said of this graph: "Many other things have changed at the same time as [capital] gains rates and many other factors affect economic growth. But the graph should dispel the silver bullet theory of capital gains taxes. Cutting

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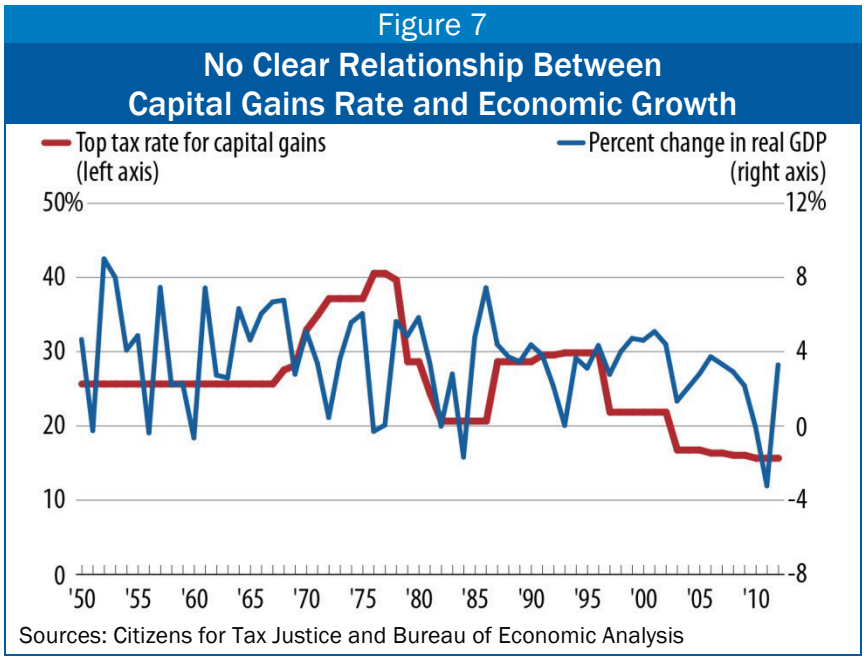
[24] Former JCT chief of staff and Georgetown University professor John Buckley has noted that "a 10-point increase in the maximum capital gains rate will raise annual revenue that will be significant by almost any standard." John L. Buckley, "Tax Expenditure Reform: Some Common Misconceptions," *Tax Notes* 255, July 18, 2011, http://www.taxanalysts.com/www/features.nsf/Articles/89D3D4A485D3BD79852578D2006C1E8D?OpenDocument

[25] Joel Slemrod, "The Truth About Taxes and Economic Growth" Interview in *Challenge*, vol. 46, no. 1, January/February 2003, pp. 5–14. http://www.challengemagazine.com/Challenge%20interview%20pdfs/Slemrod.pdf.

[26] Thomas L. Hungerford, "Taxes and the Economy: Analysis of the Top Tax Rates Since 1945," Congressional Research Service, September 14, 2012. The study found this to be true for both the top capital gains and top marginal income tax rates.

[27] Troy Kravitz and Leonard Burman, "Capital Gains Tax Rates, Stock Markets, and Growth," Tax Policy Center, November 7, 2005. See also Leonard Burman, "Capital Gains Tax Rates and Economic Growth (or not)," Forbes blog, March 15, 2012, http://www.forbes.com/sites/leonardburman/2012/03/15/capital-gains-tax-rates-and-economic-growth-or-not/. Burman also found no statistically significant effect lagged up to five years: Leonard Burman, *The Labyrinth of Capital Gains Tax Policy,* Washington, D.C., Brookings Institution, 1999, pp. 81. CRS conducts a statistical analysis of this relationship and finds no strong relationship between real per capita GDP growth rates and top capital gains tax rates; Thomas L. Hungerford, "Taxes and the Economy: Analysis of the Top Tax Rates Since 1945," Congressional Research Service, September 14, 2012.

capital gains taxes will not turbocharge the economy and raising them would not usher in a depression."



Further, as discussed below, there is no sound evidence that taxing capital gains at lower rates than salary and wages boosts the stock market, investment, or entrepreneurship.

Indeed, eliminating tax preferences for capital gains and dividends can improve the economic efficiency of the tax code by reducing incentives to divert capital into inefficient tax shelters.[28]

2003 Capital Gains and Dividends Tax Cut Didn't Boost the Stock Market

Capital gains rates have little apparent effect on stock-market growth.[29]

There is no evidence, for example, that the capital gains and dividend tax cut in 2003 boosted the stock market. Federal Reserve economists concluded in 2005 that the tax cuts had little effect on the market.[30] During this period, European and U.S. stocks moved *together*, both after the announcement of the U.S. tax cut and after the tax cut itself. (See Figure 8.) If the tax cut had boosted U.S. stocks, U.S. stocks should have performed better relative to European stocks, but they did not. As a *Wall Street Journal* article summarized the Federal Reserve study, "the tax cut … was a

[28] Leonard Burman, *The Labyrinth of Capital Gains Tax Policy,* Washington, D.C., Brookings Institution, 1999.

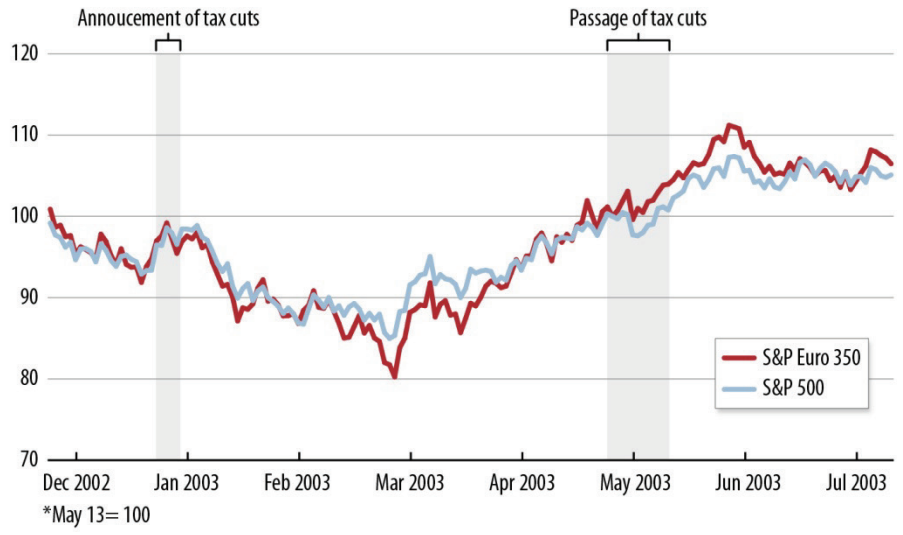
[29] Troy Kravitz and Leonard Burman, "Capital Gains Tax Rates, Stock Markets, and Growth," Tax Policy Center, November 7, 2005. See also Leonard Burman, "Capital Gains Tax Rates and Economic Growth (or not)," Forbes blog, March 15, 2012, http://www.forbes.com/sites/leonardburman/2012/03/15/capital-gains-tax-rates-and-economic-growth-or-not/. Burman also found no statistically significant effect lagged up to five years: Leonard Burman, *The Labyrinth of Capital Gains Tax Policy,* Washington, D.C., Brookings Institution, 1999, pp. 81.

[30] Gene Amromin, Paul Harrison, and Steven Sharpe, "How did the 2003 Dividend Tax Cut Affect Stock Prices?" Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., 2006, http://www.federalreserve.gov/pubs/feds/2005/200561/200561pap.pdf.

dud when it came to boosting the stock market."[31]

Figure 8

2003 Capital Gains and Dividend Tax Cut Did Not Boost U.S. Stock Values



Note: Indexed to 100 at May 13, 2003.

Source: chart based on Gene Amromin, Paul Harrison, and Steve Sharpe, "How did the Dividend Tax Cut Affect Stock Prices?" October 11, 2005, figure 2.

One reason is that pension funds, nonprofits, and foreigners who are not subject to the capital gains tax hold a significant portion of the nation's publicly traded stocks.

Capital Gains Tax Preferences Don't Boost Private or National Savings Rates or Investment

Supporters claim that capital gains tax preferences help economic growth by boosting saving and investment, but there is no evidence that this is the case.

Increases in capital gains tax rates (to reduce the preferential treatment of capital gains) can decrease the returns to saving, but there is no evidence that this causes private saving rates or national saving and investment to fall. If a taxpayer has a fixed savings goal, such as a fixed amount to help pay for a child's college education, an increase in marginal tax rates might lead the taxpayer to work and save *more* in order to offset the effect of the tax increase (this is known as the "income effect").[32] That incentive to work and save more leans against the incentive to work and save less as a result of the lower after-tax return (this is known as the "substitution effect").

[31] Karen Richardson, "Did the Dividend Tax Cut Work? Policy Change Didn't Boost Market's 'Aggregate' Value, Federal Reserve Report Says," *Wall Street Journal*, December 6, 2005, p. C3.

[32] See Thomas L. Hungerford, "The Economic Effects of Capital Gains Taxation," Congressional Research Service, June 18, 2010.

The empirical evidence suggests that for capital gains tax cuts of the magnitude enacted over recent decades, these two effects roughly offset each other.[33] CRS' analysis of data since 1945 finds no statistically significant relationship between the top capital gains tax rates and either private saving or private investment.[34] As CRS points out, "saving rates have fallen over the past 30 years while the capital gains tax rate has fallen from 28% in 1987 to 15% today (0% for taxpayers in the 10% and 15% tax brackets) . . . [which] suggests that changing capital gains tax rates have had little effect on private saving."[35] CRS concludes that, on the whole:

> Many economists note that capital gains tax reductions appear to have little or even a negative effect on saving and investment. . . . Consequently, capital gains tax rate reductions are unlikely to have much effect on the long-term level of output or the path to the long-run level of output (i.e., on economic growth).

These findings match billionaire investor Warren Buffett's observation that "I have worked with investors for 60 years and I have yet to see anyone — not even when capital gains rates were 39.9 percent in 1976-77 — shy away from a sensible investment because of the tax rate on the potential gain. People invest to make money, and potential taxes have never scared them off."[36]

Moreover, if the revenues generated by raising capital gains rates closer to ordinary income rates are used to reduce budget deficits (which represent public *dissaving*), a capital gains tax increase would likely *increase* national saving and investment. CRS states, "Capital gains tax rate increases appear to increase public saving and may have little or no effect on private saving. Consequently, capital gains tax increases likely have a positive overall impact on national saving and investment."[37]

No Evidence that Capital Gains Tax Preferences Support Entrepreneurship

Some have also argued that raising capital gains taxes would discourage high-income taxpayers from creating and investing in new firms. A CRS study finds little support for this claim, either, for the following reasons:[38]

- Much of the formal venture capital to new firms comes from venture capital institutions that are not subject to the capital gains tax, such as non-profits (like universities) that use their capital gains for tax-exempt purposes and foreign institutions that are not subject to the US income tax. Such entities would be unaffected by an increase in the capital gains rate.

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[33] In the words of the CRS, "most empirical evidence does not support a large savings response" to changes in capital gains rates. Jane G. Gravelle, "Economic and Revenue Effects of Permanent and Temporary Capital Gains Tax Cuts," Congressional Research Service, September 17, 2003, at p.4

[34] Thomas L. Hungerford, "Taxes and the Economy: Analysis of the Top Tax Rates Since 1945," Congressional Research Service, September 14, 2012 at p. 6.

[35] Thomas L. Hungerford, "The Economic Effects of Capital Gains Taxation," Congressional Research Service, June 18, 2010, at p. 11.

[36] "Stop Coddling the Super-Rich," *New York Times*, August 14, 2011, http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html

[37] Thomas L. Hungerford, "An Analysis of the 'Buffett Rule,'" Congressional Research Service, October 7, 2011.

[38] Jane G. Gravelle, "Capital Gains Taxes, Innovation and Growth," *Congressional Research Service,* Updated July 14, 1999.

- Some gains in the value of new stock that certain small corporations issue are entirely exempt from the capital gains tax.[39] Thus, raising capital gains taxes could actually encourage investment in new firms by *widening* the tax advantage that new firms have over existing ventures.

- Some argue that a capital gains tax increase would impede new ventures from using stock options to attract skilled executives. But the types of stock options that firms commonly offer executives are not subject to capital gains tax.[40]

As CRS notes, reducing capital gains tax rates could actually have some *negative* effects on investment in risky new ventures. One reason is that the capital gains tax can "act as insurance for risky investments by reducing losses as well as gains — it decreases the variability of returns." This is because, while taxes are levied on capital gains, taxpayers can claim tax deductions for capital losses.[41] CRS concludes that "the capital gains tax, therefore, may have little effect on risk-taking and may even encourage it."[42]

Further, as noted above, capital gains tax preferences are inefficient, so eliminating them could make the tax code more efficient. Leonard Burman has noted that "Lower capital gains tax rates fuel inefficient tax shelters that entail a significant economic cost" and that "removing [capital gains tax breaks] could improve both efficiency and equity."[43] The Rivlin-Dominici task force stated that "Eliminating the capital gains differential will also reduce the compliance and administrative costs associated with sophisticated tax-planning strategies [designed to exploit that differential]."[44]

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[39] *All* capital gains from the sale of certain stock issued in a new corporation were excluded from taxation in 2011 by the Tax Relief Act of 2010. The American Reinvestment and Recovery Act of 2009 previously increased the exclusion for such capital gains from 50 percent to 75 percent in 2009 and 2010. The exclusion for such capital gains under current law is 50 percent for 2012 and beyond.

[40] For many types of stock options commonly issued, when the employee — including executive employees — exercises the option, the difference between the option price paid by the employee and the fair market value of the stock is treated as ordinary income to the taxpayer and is subject to the ordinary income tax rates, not capital gains tax rates.

[41] Capital losses can be deducted in full against capital income. To be sure, a maximum of $3,000 of capital losses can be deducted against *other* types of income in any tax year. But empirical research shows that about 75 percent of taxpayers are not normally subject to the $3,000 limit, because they have capital gains available to offset capital losses or their capital losses are less than $3,000: Alan J. Auerbach, Leonard E. Burman, and Jonathan M. Siegel, "Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data," in "Does Atlas Shrug?" ed. Joel B. Slemrod (Cambridge, MA: Harvard University Press, 2000), pp. 355-388

[42] Thomas L. Hungerford, "The Economic Effects of Capital Gains Taxation," Congressional Research Service, June 18, 2010.

[43] Statement of Leonard E. Burman, Daniel Patrick Moynihan Professor of Public Affairs Maxwell School, Syracuse University Before the Senate Committee on Finance Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains, and Dividends, September 14, 2011.

[44] The Debt Reduction Taskforce, "Restoring America's Future", Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System", Senator Pete Dominici and Dr. Alice Rivlin, Co-Chairs, Bipartisan Policy Center, November 2010, p. 35.

Capital Gains Tax Cuts Are Poor Stimulus

Capital gains tax cuts are poor economic stimulus. As CRS found, "a capital gains tax cut appears the least likely of any permanent tax cut to stimulate the economy in the short run; a temporary capital gains cut is unlikely to provide *any* stimulus."[45] The purpose of economic stimulus is to encourage an immediate increase in aggregate demand by boosting consumer spending. But the main beneficiaries of capital gains tax cuts are high-income taxpayers (since they own the vast majority of assets), and high-income households are much more likely than low-income households to save rather than spend a significant portion of any new resources they receive. To boost consumer spending in a weak economy, stimulus resources should be directed at those who will spend these funds quickly.

For the same reason, extending the 2003 capital gains rate cut is unnecessary for the economy today. Allowing the 15 percent rate to rise to 20 percent as scheduled in 2013 would be one of the more economically benign deficit-reduction options to adopt while the economy is recovering.

Revenue Gains Would Be Significant

If capital gains tax rates are raised, taxpayers might slow the rate at which they sell their capital assets in order to delay the tax. Such a slowdown would offset at least part of the revenue gain from raising the rates. Some have cited estimates that a 28.5 percent rate maximizes capital gains tax revenues in order to argue that raising rates above that limit would generate a net revenue *loss*.[46] There are a number of weaknesses with this argument, however.

First, the 28.5 percent figure is from a 1990 JCT estimate.[47] CRS has recently examined empirical work conducted since then on how capital gains realizations respond to tax increases. The CRS study concludes that new research suggests JCT's estimate was likely too low.[48]

In addition, JCT's 28.5 percent estimate represented the rate at which *capital gains* revenues are maximized, not *total* revenues. If policymakers shrink the gap between the capital gains rate and the top marginal rate on ordinary income, ordinary income tax revenues are likely to rise, as taxpayers

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[45] Jane G. Gravelle, "Economic and Revenue Effects of Permanent and Temporary Capital Gains Tax Cuts," Congressional Research Service, September 17, 2003.

[46] http://taxvox.taxpolicycenter.org/2012/02/14/how-would-the-buffett-rule-would-affect-marginal-tax-rates/

[47] Joint Committee on Taxation, "Explanation Of Methodology Used To Estimate Proposals Affecting The Taxation Of Income From Capital Gains", JCS-12-90, March 27, 1990.

[48] Jane G. Gravelle, "Capital Gains Tax Options: Behavioral Responses and Revenues," Congressional Research Service, August 10, 2010. In contrast to other recent studies, a new working paper by CBO and JCT economists finds relatively high changes in capital gains realizations in response to capital gains taxes, implying that the revenue-maximizing capital gains rate may be below 28.5 percent. See Tim Dowd (Joint Committee on Taxation), Robert McClelland (CBO), and Athiphat Muthitacharoen (CBO), "New Evidence on the Tax Elasticity of Capital Gains: Working Paper 2012-09", June 15, 2012, http://www.cbo.gov/publication/43334. However, in a 2010 critique of studies similar to the new CBO-JCT paper, CRS argued that capital gains realizations cannot rise permanently above the level of capital gains that are accruing. Based on data on capital gains accruals, CRS found capital gains rates that maximize capital gains revenues well above 30 percent. The CRS result implies that studies such as the new CBO-JCT paper may be picking up temporary spikes and declines in realizations around the time of a tax change — trends that cannot be sustained permanently.

stop converting as much of their ordinary income into capital gains to take advantage of the differential. The capital gains tax rate that maximizes *total* tax revenues is thus likely to be higher than the rate that maximizes revenues just from the capital gains tax.

The capital gains rate that maximizes total revenues depends on both the capital gains rates and the difference between the tax rates on capital gains and the rates on ordinary income. As discussed above, while the capital gains rates are scheduled to rise somewhat under current law, so are the ordinary income tax rates, so policymakers would have to raise the capital gains rate by more than is currently scheduled in order to shrink the gap between the tax rates on capital gains and the rates on ordinary income.

Raising Capital Gains Rates Would Have Little or No Impact on Most Elderly Households

Some argue that reducing the tax preferences for capital gains would harm the elderly, noting that elderly households are more likely to have some capital gains or dividend income than younger households. The data show, however, that among the elderly — as among the population as a whole — capital income is highly concentrated among a small group of high-income households. Any implication that raising dividends and capital gains tax rates would significantly affect more than a small minority of seniors would be misleading.

TPC estimates that in 2011:[49]

- Just 2.1 percent of all capital income[50] went to elderly filers with incomes below $40,000, a group that makes up nearly 60 percent of elderly filers.

- Just 5.5 percent of all capital income went to elderly filers with incomes below $75,000, a group that makes up 79 percent of elderly filers.

Most elderly households receive little benefit from the lower tax rates for capital gains and dividends and would face little if any tax increase if those rates were raised. TPC figures show:[51]

- Nearly 60 percent of elderly filers had incomes below $40,000 in 2011. Taxing capital gains and dividends *at the same rates* as salary and wages would have reduced their after-tax incomes by much less than one-tenth of 1 percent, on average — or less than $6. (See Figure 9.)

- For the 21 percent of elderly households with incomes between $50,000 and $100,000, average after-tax income would have been less than one third of one percent lower in 2011 if the differential between the tax rate on capital gains and dividends and the tax rate on ordinary income had been completely eliminated. (The average increase in taxes for those filers would have been $195.)

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[49] TPC Table T12-0009.

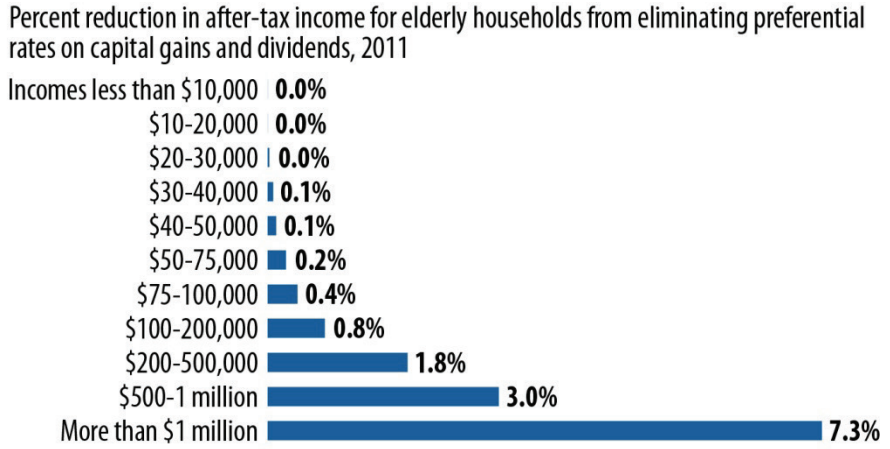
[50] The Tax Policy Center defines capital income as including taxable and non-taxable interest income, income from dividends, realized capital gains or losses, and imputed corporate tax liability.

[51] TPC table T12-0136.

- Nearly *all* elderly households (96 percent) had incomes below $200,000 in 2011. The Administration's proposal to allow the capital gains rate to rise modestly for upper-income households wouldn't affect these households at all.

Figure 9

Raising Capital Gains and Dividends Rates Would Have Little Or No Impact on Most Elderly Households



Note: Elderly households refer to tax units with either head or spouse (if filing jointly) age 65 or older

Source: Urban Brookings Tax Policy Center, Table T12-0136.

"Double Taxation" Charge Does not Justify Blanket Preference for Capital Gains

Critics often claim that capital gains tax constitutes "double taxation." For example, if a taxpayer earns a salary, invests part of that income, and the asset appreciates, some people mistakenly believe that all of the invested salary income is taxed twice: first as ordinary income and again as a capital gain when the taxpayer sells the asset. In reality, capital gains taxes are imposed only on the appreciation in the asset's value, not the owner's "basis" (original investment) in the asset. The appreciation in the value of the asset, above the amount initially invested, is new income that has not been taxed under the income tax.

There is a legitimate concern about double taxation where corporate stock is concerned. If a company makes a profit but does not pay out that profit as a dividend, the profit will usually cause the company's stock price to go up. When a shareholder sells that stock and pays capital gains tax on the increase in the stock price, the capital gains tax does tax the part of the gain in stock value that reflects the company's earnings, which may have already been subject to the corporate income tax.

This concern is often overblown, however, for two reasons.

- Much of the capital gain on corporate stock is never subject to the capital gains tax. As discussed above, many institutional investors are exempt from capital gains taxes on corporate stock, and there are many reasons why individual investors may not pay capital gains taxes on

the corporate stock that they hold (for example, because they hold the stock until death).

- JCT estimates that the average effective corporate tax rate is 25 percent[52] and that the capital gains taxes that individual investors pay on corporate profits raise that figure by only 3.6 percentage points; taxes on dividends add another 1.6 percentage points. Thus, when taking into account the tax on corporate profits *plus* capital gains and dividend taxes, the average effective tax rate on corporate profits is roughly 30 percent.[53] This is still below the top statutory corporate tax rate of 35 percent. (This focus on the double taxation of corporate profits often ignores the fact that wages are also taxed twice, being subject to both income and payroll taxes.)

Even if double taxation of corporate income were considered a legitimate concern, it does not justify a blanket tax preference for all capital gains. As Leonard Burman points out, "lots of corporations manage to avoid much of their corporate tax and many capital gains are on assets other than corporate stock".[54] The large tax preferences for capital gains are poorly targeted to this concern because they attach to all capital gains, not just gains on corporate stock.[55]

Other Arguments for Retaining Preferences Also Unconvincing

Other arguments for retaining the preferential treatment of capital gains are also unconvincing.

- **"Lock-in."** Some argue that reducing or eliminating capital gains tax preferences would "lock in" investors to their current portfolio by giving them an incentive to delay realizing their capital gains, thereby distorting decisions about when to sell assets and which assets to sell.[56] The empirical evidence, however, shows that "lock-in is much less of a problem in practice than

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[52] Joint Committee on Taxation, "The Income And Payroll Tax Offset To Changes In Excise Tax Revenues," JCX-59-11, December 23, 2011, p. 6, http://www.jct.gov/publications.html?func=startdown&id=4378.

[53] *Id.* JCT explains that "the additional 5.2 percent is 1.6 percent dividends tax plus a 3.6 percent capital gains tax, where the marginal tax rate at the individual level on dividends and capital gains is 15.1 percent and 16.1 percent applied to the taxable portion of corporate profits that show up as qualified dividends and capital gains, respectively. The tax rates on dividends and capital gains are determined from the Joint Committee staff's individual tax model."

[54] "Do capital gains taxes help or hurt our economy?" washingtonpost.com live discussion, September 12, 2011, http://live.washingtonpost.com/capital-gains-tax-rates.html.

[55] Economists sometimes refer to *any* type of income tax as being "double taxation" because income taxes, unlike consumption taxes, create a tax penalty for saving rather than consuming income immediately. (In practice, as discussed in the text, because the "income effect" and the "substitution effect" push in opposite directions, the practical effect on aggregate national saving rates is ambiguous.) This is not a good argument, however, for a tax preference for capital gains; it is an argument either for a preferential rate for all income from saving, not just capital gains (i.e., interest as well), or for replacing the income tax with a consumption tax. It is beyond the scope of this paper to consider the case for moving to a consumption tax system. It should be noted, however, that consumption taxes can have problems of their own: they are generally regressive, and it is unclear whether their touted efficiency gains can be realized and sufficient government revenues raised, once the transition issues involved are taken into account. See See Alan J. Auerbach, "The Choice Between Income and Consumption Taxes: A Primer", NBER Working Paper No. 12307, Issued in June 2006

[56] Leonard Burman and David White, "Taxing Capital Gains in New Zealand", (2003) 9(3) New Zealand Journal of Taxation Law & Policy 355-386, http://www.taxpolicycenter.org/UploadedPDF/1000569_taxing_capital_gains_nz.pdf. at p. 377.

economists and tax practitioners would imagine."[57]

For example, much of the evidence of "lock-in" found by earlier studies simply reflected a temporary shifting of capital gains realizations around the time of a change in the capital gains tax rate.[58] This indicates that in the long run, capital gains tax rate changes have less of an effect on how long taxpayers hold on to assets.

Policymakers could reduce lock-in by eliminating or reducing some costly capital gains tax breaks that encourage taxpayers to hold on to assets. For example, the combination of the forgiveness of capital gains taxes on assets at death and a greatly shrunken estate tax encourages taxpayers to hold on to assets until their death. Action to strengthen the estate tax rules, such as by restoring the estate-tax parameters in effect in 2009, would be helpful.[59]

- **"Bunching."** Some argue that if capital gains were taxed at ordinary income tax rates, that could lead to perverse results, whereby a taxpayer who realized all of his capital gains in one year and whose gains lifted him or her into the top tax bracket that year would pay the top statutory tax rate on those gains, while a taxpayer who realized her capital gains gradually and who remained in a lower tax bracket as a result would pay lower rates on his or her gains. As the data discussed above show, however, the large majority of capital gains flow to very high-income taxpayers who would face the top income tax rate in any event.

  Further, as Leonard Burman has noted, isolated transactions account for only a small fraction of total capital gains realizations; "most gains are reported by wealthy investors who hold many assets and sell assets frequently."[60] A new JCT study confirms that most capital gains are realized by taxpayers who realize capital gains frequently. It also shows that "taxpayers who realize gains remain approximately at the same income class in the subsequent year regardless whether they recognize gains in the subsequent year". JCT concludes:[61]

  > '[B]unching' of capital gains is not itself a compelling argument in favor of a reduced rate on capital gains. That is, most taxpayers do not appear to realize capital gains in a lumpy manner that causes their income to be significantly higher in the year of the gains realization.

- **Inflation.** CBO notes, "a preferential rate on nominal [capital] gains provides a rough adjustment for the fact that some gains reflect inflation instead of real increases in purchasing

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[57] *Id.*

[58] *Id.*

[59] Leonard Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, Brookings Institution Press, 1999 at 139. Under the 2009 estate tax parameters, the top estate tax rate was 45 percent, after taking a $3.5 million per person (effectively $7 million per couple) exemption from the estate tax. The current parameters set the top estate tax rate at 35 percent, after taking a $5 million per person (effectively $10 million per couple) exemption.

[60] *Id*, at 103.

[61] Joint Committee on Taxation, "Present Law and Background Information Related to the Taxation of Capital Gains," September 14, 2012, JCZ-72-12 at p. 37. The data also show that incomes for taxpayers who realize any capital gains are no more volatile on average (as measured by transitioning into a different income class) than for taxpayers who realize no capital gains at all.

power."[62] But CBO also points out that there are other ways to adjust for inflation than to tax capital gains at a preferential rate; further, the inflation component of other types of investment income, such as interest, is subject to taxation as well. It should also be noted that taxing capital gains when they are realized rather than when they accrue allows taxpayers to defer payment of taxes, which, as JCT notes, is a counterweight to the taxation of gains that merely reflect inflation.[63] In any event, inflation does not justify the exemption of a large share of *real* capital gains from taxation.

- **Risk taking.** Some argue that the capital gains tax discourages risky investment that might lead to losses because taxpayers can use only up to $3,000 per year of capital losses to offset their tax liability from other types of income. In practice, research indicates that this loss limit does not inhibit risk taking because most taxpayers are able to use the full amount of their capital losses quickly to offset other capital gains. (The $3,000 limit does *not* apply to offsets for capital gains). The research shows most taxpayers fully use up their capital losses within one or two years.[64]

  Furthermore, deferral of the taxation of capital gains can *encourage* risk-taking investment. Unlike a bond that generates a risk-free rate of return in the form of interest — which is taxed as ordinary income as it is earned — the taxation on any capital gains from a risky investment can be delayed indefinitely. And, as noted above, some investments in particularly risky start-up businesses enjoy exemptions from capital gains tax altogether.

Conclusion

The benefits of the many tax preferences for capital gains flow overwhelmingly to those at the top of the income distribution, and those preferences do little for economic growth while adding significantly to deficits. Given the nation's fiscal problems and rising income inequality, policymakers should rein in these preferences as a major component of tax expenditure reform.

A good first step would be to allow the 2003 cut in the top capital gains rate to expire as scheduled at the end of 2012. The current low rate is not only costly but also poor economic stimulus and unnecessary to support the economic recovery.

Policymakers should also restore the estate tax, which they cut in 2010 (on top of large cuts in previous years), to its 2009 parameters, as the President's budget proposes. As noted above, one major reason why about half of all capital gains are never taxed is that capital gains are forgiven at death. The estate tax serves as an important backstop to the capital gains tax, and the major weakening of the entire tax for the estates of the wealthiest three-tenths of 1 percent of people who die, which was enacted on a temporary basis at the end of 2010 and is scheduled to expire on December 31 of this year, should not be extended.

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[62] Congressional Budget Office, "How Capital Gains Tax Rates Affect Revenues: the Historical Evidence," March 1988, p. xii.

[63] Joint Committee on Taxation, "Present Law and Background Information Related to the Taxation of Capital Gains," September 14, 2012, JCZ-72-12 at p. 32.

[64] A Auerbach, L Burman and J Siegel, "Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data," in J Slemrod (ed), *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (2000), p. 355.

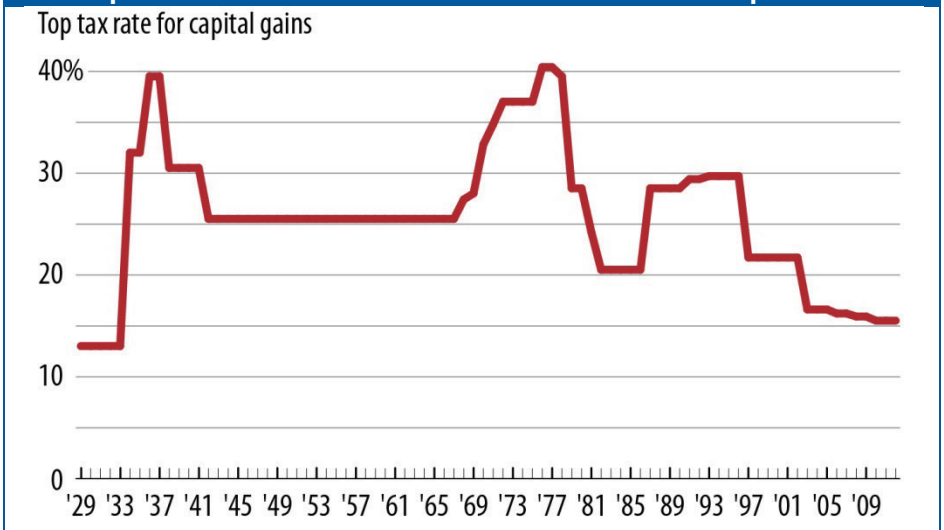
Appendix: Capital Gains Enjoy Significant Tax Preferences

Capital gains are taxed much more lightly than salary and wages. The most visible preference is their low tax rates, but filers can also delay paying tax on capital gains in a way that they cannot do with regard to ordinary income; in fact, many capital gains are never taxed.

Preferential Rates

Capital gains on assets that have been held for more than one year are generally taxed at a substantially reduced rate when the gain is realized: currently a 15 percent tax rate for taxpayers in an income tax bracket *above* the 15 percent bracket. (People in or below the 15 percent bracket owe no capital gains tax.) This is far below the top marginal tax rate on ordinary income — currently 35 percent — and is the lowest rate on long-term capital gains since the Great Depression. (See Figure 10.)

Figure 10
Capital Gains Tax Rate Lowest Since Great Depression



Source: Citizens for Tax Justice

The capital gains tax rate will remain well below the top rate on salary and wages even if tax rates rise in 2013 as scheduled. Under current law (i.e., if the Bush tax cuts are allowed to expire), the top rate on long-term capital gains will rise from 15 percent to 20 percent. But the top marginal income tax rate will also rise, to 39.6 percent.[65] (The *effective* rate on capital gains will increase modestly in 2013 due to a provision included in the health reform law to help offset the costs of the law's extension of health insurance coverage to more Americans. Under that provision, filers with incomes above $250,000 for a married couple filing jointly and $200,000 for single filers will pay a

[65] If the 2001 and 2003 tax cuts for high-income taxpayers are allowed to expire, some high-income taxpayers will also face a slightly higher marginal rate by virtue of the personal exemption phase-out (the "PEP" provision) and the phase-out of itemized deductions (the "Pease" provision). These changes will not reduce the percentage-point differential between the capital gains and ordinary income rates, however, because these provisions increase the effective marginal rate on *both* capital gains and ordinary income for taxpayers in the phase-out ranges for these provisions.

3.8 percent Medicare tax on their net investment income, including capital gains, *or* their modified adjusted gross income above $250,000, whichever is smaller.)

Deferral of Tax Until Realization — or Later

When an asset gains value, a taxpayer generally owes tax on those gains only when he or she "realizes" the gain, usually by selling, exchanging, or gifting the asset or when it is transferred after his or her death.[66] For example, Warren Buffett had taxable income of about $40 million in 2010, but his net worth rose by $10 billion in that year — nearly all of it in the form of unrealized capital gains not subject to capital gains tax that year.[67] By contrast, filers must pay tax on wage and salary income in the year they earn it.

There are practical reasons for not taxing capital gains until they are realized.[68] It can be difficult to value the capital gain on some types of assets until the gain has been realized; when the asset is sold in an arm's-length transaction, the price paid gives an objective way to measure the capital gain. Also, in some situations there is a risk that if gains are taxed as they accrue, taxpayers might not have enough cash on hand to pay the tax and would have to sell the asset and pay a portion of the proceeds in tax.

Nevertheless, the ability to delay paying capital gains tax until the gains are realized constitutes a significant tax benefit.[69] As CBO notes, "Because of the time value of money, such a deferral lowers the effective tax rate on the gains to less than the taxpayer's statutory tax rate."[70] Data from the Survey of Consumer Finances show that only a small share of capital gains are realized in any given year: in 2010, of households with capital gains, only 11.6 percent realized any capital gain at all, and the median household that chose to realize a capital gain only realized 2.1 percent of its total capital gains.[71]

In some cases, the tax code also allows taxpayers to delay paying tax on capital gains income *even beyond* the year in which the gain is realized. For example:

- Gifts do not trigger capital gains tax. JCT estimates that not counting gifts as a realization of a

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[66] See Joint Committee on Taxation, "Estimates Of Federal Tax Expenditures For Fiscal Years 2011-2015", JCS-1-12, January 17, 2012, at p. 6.

[67] .Arthur B. Laffer, "Class Warfare and the Buffett Rule", Wall Street Journal, January 11, 2012, http://online.wsj.com/article/SB10001424052970203462304577138961587258988.html.

[68] Congressional Budget Office, "Deferral and Forgiveness of Tax on Unrealized Capital Gains", *Online Tax Guide*, accessed December 21, 2011.

[69] Taxpayers who have capital assets can also engage in "loss harvesting" — that is, realizing capital *losses* on assets that have depreciated in order to offset the tax liability on their capital *gains* and/or to offset tax liability on up to $3,000 of ordinary income in any year. Unused losses in excess of the $3,000 limit are carried forward to later years.

[70] Congressional Budget Office, "Deferral and Forgiveness of Tax on Unrealized Capital Gains", *Online Tax Guide,* accessed at Dec 21, 2011. For a worked example, see Leonard Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, at 48 to 51. See also: Joint Committee on Taxation, "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II", September 4, 2007, JCX-63-07 at pages 6-7 for an explanation of the benefit of deferring taxation more generally.

[71] Survey of Consumer Finances, 2011.

capital gain and cost $27 billion over 2011-2015.[72]

- Bartering or exchanging property generally triggers capital gains tax, but some types of barter or exchange are exempted.[73] JCT estimates that these exemptions will cost $15 billion over 2011-2015.[74]

- When a person sells an asset and is paid in installments, the general rule is that capital gains tax is triggered in the year of the sale.[75] But some taxpayers are permitted to delay capital gains tax from the sale until the installment payments are received. JCT estimates that this preference will cost $35.5 billion over 2011-2015.[76]

One consequence of the ability to defer capital gains tax liability is that some taxpayers are able to use their capital gains to help fund current consumption without having to pay tax yet on the capital gain. David S. Miller, former New York State Bar association tax section chair and partner at Cadwalader, Wickersham & Taft LLP, notes that wealthy people "can use complex transactions not available to most Americans to get cash from their appreciated stock without paying any taxes at all."[77] For example, one scheme allows taxpayers to receive cash in return for a promise to transfer stock in the future; instead of treating this as a sale of the stock that triggers capital gains tax on the stock, the code does not impose capital gains tax at the time that the taxpayer receives the cash.[78]

Complete Exemption from Taxation

About half of all capital gains are *never* subject to capital gains tax, according to CRS economist Jane Gravelle.[79] The tax code provides many opportunities to avoid capital gains tax altogether, including the forgiveness of capital gains at death and specific exemptions for certain types of capital gains.

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[72] Joint Committee on Taxation, "Estimates Of Federal Tax Expenditures For Fiscal Years 2011-2015", JCS-1-12, January 17, 2012.

[73] Pew Charitable Trusts, *Subsidyscope.org Tax Expenditure Database,* http://subsidyscope.org/tax_expenditures/db/group/95/. To be eligible for the preferential treatment, real estate can be exchanged only for real estate, and personal property can be exchanged only for personal property. Within these categories, the actual items exchanged may be quite dissimilar. See Calvin H. Johnson, "Impose Capital Gains Tax on Like-Kind Exchanges," Tax Notes, October 27 2006, at 475 for further detail on the provision.

[74] Joint Committee on Taxation, "Estimates Of Federal Tax Expenditures For Fiscal Years 2011-2015," JCS-1-12, January 17, 2012.

[75] The amounts of the installment payments that are attributable to the purchase price of the asset (and that exceed the seller's acquisition cost for the asset) are taxed as capital gains. Installment payment amounts that represent interest (the price that the purchaser pays for being able to defer payments for acquiring the asset) are taxed as ordinary income received by the seller.

[76] Joint Committee on Taxation, "Estimates Of Federal Tax Expenditures For Fiscal Years 2011-2015," JCS-1-12, January 17, 2012.

[77] Jesse Drucker, "Buffett-Ducking Billionaires Avoid Reporting Cash Gains to IRS", *Bloomberg.org*, Nov 21, 2011, http://www.bloomberg.com/news/2011-11-21/billionaires-duck-buffett-17-tax-target-avoiding-reporting-cash-to-irs.html

[78] *Id.*

[79] Jane Gravelle, "Limits to Capital Gains Feedback Effects," *Tax Notes* 51, April 22, 1991, pp. 363-371.

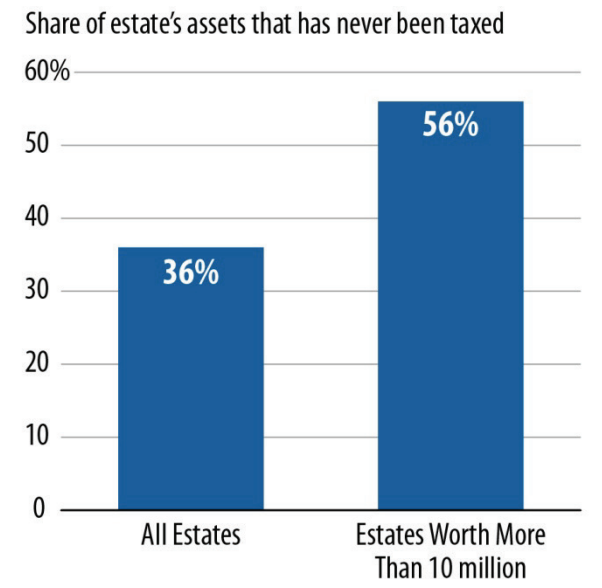
Forgiveness of Capital Gains at Death

If a taxpayer holds on to an asset until he or she dies, neither the taxpayer's estate nor the heirs will ever pay tax on the increase in the asset's value between the time the taxpayer acquired it and the time of the taxpayer's death. This is called a "stepped-up basis," meaning that the heirs' "basis" in the asset (the value from which they calculate future taxable capital gains) is "stepped up" to equal the market value of the asset at the time of the grantor's death.

This is why the estate tax is an important backstop for the capital gains tax. Although estates pay no capital gains tax on unrealized capital gains, estates that are large enough may be subject to the estate tax on those assets. This is the case in 2012 if an estate is worth more than $5 million per person (effectively $10 million per couple); if the estate is smaller than that, all unrealized gains in the estate will face neither capital gains tax nor estate tax.[80] Unrealized capital gains make up about 36 percent of the value of all estates and about 56 percent of the value of estates worth more than $10 million, according to estimates by economists from the Massachusetts Institute of Technology and the Federal Reserve Board, using Federal Reserve data.[81] (See Figure 11.)

Figure 11

Large Share of Capital Gains Has Never Faced Capital Gains Tax



Source: James Poterba and Scott Weisbenner, NBER, 2000.

Other Exemptions

The code allows some capital gains to go completely untaxed. For example:

- A taxpayer in the 15 percent income tax bracket or a lower bracket faces a capital gains tax rate of zero. High-income taxpayers with capital gains can take advantage of this zero rate through tax planning activities, such as gifting appreciating assets to children or to elderly parents if they are in the lower tax brackets. No capital gains tax is paid on the assets' transfer or realization.[82]

- Gains on certain types of assets are exempt from capital gains tax. For example, up to $250,000

[80] See id for discussion of rule re 2010, 2011, 2012 and beyond.

[81] James M. Poterba and Scott Weisbenner, "The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death," *Rethinking Estate and Gift Taxation*, William G. Gale, James R. Hines, Jr., and Joel Slemrod, eds. Brookings Institution, 2001.

[82] Some gift tax may be owed, but not if the annual transfer is less than $13,000 in 2012. In addition, gifts over that amount do not trigger gift tax if the total amount gifted by the donor during his or her lifetime does not exceed the unified lifetime gift and estate tax exemption, currently $5 million per person ($10 million for a married couple filing jointly). See Gillian Brunet, "Estate Tax Rules Should Expire After 2012: Shrinking the Tax Beyond the 2009 Level Is Unaffordable and Unnecessary," Center on Budget and Policy Priorities, May 26, 2011.

of capital gain on the sale of a principal residence ($500,000 for a married couple filing jointly) is excluded. JCT estimates that this exclusion will cost $123 billion over 2011 to 2015.

- Some gains in the value of new stock issued by certain small corporations are exempt from the capital gains tax.[83] JCT estimates this preference will cost $2 billion over 2011 to 2015.[84]

  Transfers to charities attract no gift tax or capital gains tax on any unrealized appreciation donated to the charity (and charities pay no capital gains tax on appreciated assets).

- Many institutions are exempt from capital gains tax, such as non-profits that use their capital gains for tax-exempt purposes and foreign institutions not subject to U.S. income tax.

[83] Under the Tax Relief Act of 2010, capital gains on the sale of certain stock issued in a new corporation in 2011 qualify for a 100 percent exclusion from capital gains taxes. (The 2009 Recovery Act had raised the exclusion from 50 percent to 75 percent for stock issuances in 2009 and 2010.) Under current law, the exclusion rate is 50 percent from 2012 onward.

[84] Assumes current law exclusion rates.