TAX REFORM AND THE TAX TREATMENT OF CAPITAL GAINS

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Abstract

Leonard E. Burman, Daniel Patrick Moynihan Professor of Public Affairs, at the Maxwell School of Syracuse University, presented testimony on “Tax Reform and the Tax Treatment of Capital Gains” before the House Committee on Ways and Means and the Senate Committee on Finance, September 20, 2012.

JEL: H21, H23, H24, H26

Key Words: capital gains; individual income taxation; tax shelters; tax reform; income distribution
Executive Summary

Capital gains are the profits on the sale of assets such as shares of stock, land, real estate, or a business. Capital gains on assets held at least a year are generally taxed at a lower rate than other income—top tax rate of 15 percent compared with rates up to 35 percent for other kinds of income. The main justification for the lower tax rate is to encourage investment and to offset the corporate income tax, which presumably reduces profits on stock shares. Critics of lower tax rates argue that they undermine the progressivity of the income tax and can also fuel the proliferation of tax shelters aimed at taking advantage of the lower tax rates.

In this testimony delivered before the tax writing committees of the US House of Representatives and the Senate, Len Burman discusses a variety of issues that affect the decision about how best to tax capital gains:

- Taxing capital gains at a lower rate than other income creates incentives to invest in inefficient tax shelters and other economic distortions.
- Capital gains are disproportionately realized by extremely wealthy taxpayers. A tax preference for capital gains inevitably provides large benefits to very high-income people.
- Taxing capital gains differently from other income is a major source of complexity in the tax code.
- Taxing capital gains on realization discourages sales of assets: the so-called “lock-in effect.”
- The corporate income tax and the capital gains tax may create an economically inefficient double-tax on corporate investment, although there are large disparities in the overall effective tax rate on corporate income.
- A portion of capital gains is really inflation and thus not income; however, that is true of all forms of capital income. Indeed, the implicit inflation surtax on capital gains is somewhat lower than on other forms of capital income because of the ability to defer tax payment until assets are sold.
- Some argue that the right tax base is not income but consumption, in which case capital gains should not be taxed; however, even if one accepts the premise, it's not clear that exempting only one form of capital income from tax is an improvement.
- Some argue that a lower tax rate on capital gains is necessary to encourage risk-taking and entrepreneurship.

Burman concludes that, while targeted relief from capital gains tax may be warranted for some corporate stock, the current blanket income tax preference for capital gains is very poorly targeted and, on balance, may do more harm than good to the economy. The capital gains tax preference also creates gross inequities, significantly undermining the progressivity of the income tax.

Capital gains reform was the lynchpin of the 1986 reform and several recent bipartisan reform proposals. It could be an important element of the next tax reform. The best option, Burman
argues, would be to tax capital gains as ordinary income and use the revenue gained to lower individual and corporate income tax rates. Reform might also tackle the largest capital gains tax loophole—the non-taxation of capital gains held until death. Mitigating this loophole could substantially reduce the lock-in effect and help protect the capital gains tax base. The testimony also discusses a potentially politically feasible option to tackle the “angel of death loophole”—the non-taxation of capital gains on assets held until death—in the context of estate tax reform.
“Chairman Camp, Chairman Baucus, Ranking Member Levin, Ranking Member Hatch, and Members of the Committees: Thank you for inviting me to share my views on tax reform and the tax treatment of capital gains. I am speaking for myself alone. My views should not be attributed to any of the organizations with which I am affiliated.

No issue ignites such fierce passions as the taxation of capital gains. Columbia law professor Michael Graetz (1997) referred to the epic battle between President George H. W. Bush and Senate Majority Leader George Mitchell as “the madness of two Georges.” President Bush was convinced that cutting tax rates on capital gains would turbocharge the economy and actually increase tax revenues. He could not understand why Democrats in the Senate would stand in the way. Senator Mitchell, however, was convinced that cutting capital gains tax rates would simply provide an unfair windfall to the wealthiest people in society.

How should capital gains be taxed? Under an income tax the answer is that capital gains should be taxed in full as they are earned, not when realized. Capital gains are income, not really different in substance from interest, rents, and royalties: other kinds of capital income that are taxed as ordinary income. Under the pure comprehensive income tax, corporate income would be allocated to shareholders and taxed as ordinary income, in the same way that S-corporations and partnerships are taxed.

Obviously we don't tax capital gains or corporations that way. Capital gains are taxed only when realized, and gains on assets held for at least a year are generally taxed at a lower rate than other income. Capital gains on assets held until death or donated to charity, however, are never subject to income tax. And corporations are subject to a separate tax that is not integrated with the individual income tax. The consequence is that some corporate income may be subject to two layers of tax: the corporate income tax plus the individual income tax on capital gains and dividends.

Although most taxpayers are subject to a maximum statutory capital gains tax rate of 15 percent, various provisions of the tax code can raise the effective rate on capital gains. For example, the provisions that phase out tax benefits with income all have the effect of imposing a surtax on capital gains (and other forms of income). The phaseout of the alternative minimum tax (AMT) exemption can add up to seven percentage points to the effective capital gains tax rate. In addition, the Medicare surtax scheduled to apply to high income taxpayers under the Affordable Care Act will add 3.8 percentage points to the effective tax rate on capital gains and other forms of nonlabor income starting in 2013.

Thus, the effective federal tax rate on capital gains, while usually significantly lower than the tax rate on labor income, can vary significantly.
Issues in Taxation of Capital Gains

If capital gains cannot be taxed on an accrual basis and corporate income is subject to a separate tax, it is not obvious how best to tax capital gains. There are a number of factors that weigh on the decision:

- Taxing capital gains at a lower rate than other income creates incentives to invest in inefficient tax shelters and other economic distortions.

- Capital gains are disproportionately realized by extremely wealthy taxpayers. A tax preference for capital gains inevitably provides large benefits to very high-income people.

- Taxing capital gains differently from other income is a major source of complexity in the tax code.

- Taxing capital gains on realization discourages sales of assets: the so-called “lock-in effect.”

- The corporate income tax and the capital gains tax may create an economically inefficient double-tax on corporate investment, although there are large disparities in the overall effective tax rate on corporate income.

- A portion of capital gains is really inflation and thus not income; however, that is true of all forms of capital income. Indeed, the implicit inflation surtax on capital gains is somewhat lower than on other forms of capital income because of the ability to defer tax payment until assets are sold.

- Some argue that the right tax base is not income but consumption, in which case capital gains should not be taxed; however, even if one accepts the premise, it's not clear that exempting only one form of capital income from tax is an improvement.

- Some argue that a lower tax rate on capital gains is necessary to encourage risk-taking and entrepreneurship.

In my testimony, I shall address each of these issues in turn.

To summarize, while targeted relief from capital gains tax may be warranted for some corporate stock, the current blanket income tax preference for capital gains is very poorly targeted and, on balance, may do more harm than good to the economy. The capital gains tax preference also creates gross inequities, significantly undermining the progressivity of the income tax.

Capital gains reform was the lynchpin of the 1986 reform and several recent bipartisan reform proposals. It could be an important element of the next tax reform. The best option, in my view, would be to tax capital gains as ordinary income and use the revenue gained to lower individual and corporate income tax rates. Reform might also tackle the largest capital gains tax loophole—the non-taxation of capital gains held until death. Mitigating this loophole could substantially reduce the lock-in effect and help protect the capital gains tax base. I discuss a potentially politically feasible option to tackle the “angel of death loophole” in the context of estate tax reform.
A Capital Gains Tax Differential Creates Significant Economic Distortions

Whatever its benefits, the difference in tax rates between capital gains and other income is a prime factor behind individual income tax shelters. Since ordinary income is taxed at rates up to 35 percent while long-term capital gains are taxed at a maximum rate of 15 percent, there is a 20 percent reward for every dollar that can be transformed from high-tax compensation, say, to low-tax capital gains.

The basic idea is to make an investment that generates deductions, such as for interest, lease payments, or depreciation, to reduce (or eliminate) current income tax liability and ultimately get the money back in the form of a capital gain. Because of the rate differential between capital gains and ordinary income, a tax shelter can return significantly less than a dollar for every dollar invested and still be profitable. Before enactment of the Tax Reform Act of 1986, taxpayers could use accelerated depreciation and interest deductions to shelter current income. Investment in “see-through office buildings” in the early 1980s and other dubious tax shelter investments were the result. This produced a boom in investment in commercial real estate, far beyond anything that could be justified by economic fundamentals. Effectively, capital was being steered away from productive investments into relatively unproductive uses simply because the latter generated huge tax benefits.

The Tax Reform Act of 1986 clamped down on many of those tax shelters through the passive loss limitation, limits on interest deductibility, elimination of investment tax credits, and the curtailment of accelerated depreciation. But the single biggest factor in stamping out those tax shelters was the taxation of capital gains at the same rate as other income. My research with Tom Neubig concluded that the very complex passive loss limit and investment interest limits were probably superfluous as long as capital gains and ordinary income were taxed at the same rate. (Burman and Neubig, 1987) But those limitations became increasingly important as ordinary income and capital gains tax rates diverged in the decades after tax reform.

In 2012, the biggest tax shelter may arise from the fact that certain forms of compensation are taxed as capital gain. For example, managers of private equity funds hold a “carried interest”—a right to receive a share (typically 20 percent) of the profits produced by an investment fund over and above any share corresponding to their actual cash investment. As a result, a significant portion of their compensation is ultimately taxed as capital gain, rather than ordinary income. Private equity managers also receive fees that are taxed as ordinary income, but if the investments are successful, that is a small portion of their compensation.

Besides for the obvious inequity of people with multi-million dollar earnings being taxed at lower rates than middle-income workers—a disparity that at least in part motivated the Buffett Rule—this is also economically inefficient. While there probably would be a role for private equity funds even in the absence of the capital gains tax break, it is surely true that more people and capital are drawn to such firms by the tax breaks.

Data compiled by the Internal Revenue Service suggest a marked shift in the kinds of assets that generate capital gains over time. In 1997, more than half of capital gains came from corporate stock, either held directly or indirectly through mutual funds. Only 30 percent was generated by so-called pass-through entities: S-corporations, partnerships, trusts and estates. (See Table 1.) Ten years later, corporate stock was less than 40 percent of all long-term gains while pass-through entities comprised more than 44 percent. Over that same period, there was also a very large increase in the dollar amount of pass-through gains—296 percent—compared with a 91
percent increase for stocks and mutual funds. The growth of private equity firms, which are typically organized as partnerships, and other investment partnerships might be a significant factor in this shift.

Table 1. Percent Distribution of Net Long-Term Gains, by Asset Type, 1997 v. 2007

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>1997</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate stock and mutual funds (except muni bond funds)</td>
<td>53.7</td>
<td>38.7</td>
</tr>
<tr>
<td>Pass-through (S corporations, partnerships, estates, and trusts)</td>
<td>30.1</td>
<td>44.4</td>
</tr>
<tr>
<td>Business</td>
<td>7.4</td>
<td>7.4</td>
</tr>
<tr>
<td>Land</td>
<td>3.8</td>
<td>3.4</td>
</tr>
<tr>
<td>Other</td>
<td>5.1</td>
<td>6.1</td>
</tr>
</tbody>
</table>


Thus, the lower tax rate on long-term capital gains produces several distortions: (1) It encourages investments purely for tax purposes that would not make any sense without the tax savings, draining capital away from other more productive investments. (2) Since tax shelters that can pass legal muster or escape detection tend to be extremely complex, brilliant financial planners, lawyers, and accountants turn their talents to this lucrative, but socially unproductive line of work. (3) Similarly, the enormous tax savings available likely lure too many highly productive people into the private equity business, drawing them away from other potentially more socially valuable enterprises.

The larger the rate differential between capital gains and other income, the larger these distortions will be. This doesn’t prove that a low rate on capital gains is on balance counterproductive, but it does suggest that any benefits from a capital gains preference must be very significant to offset the substantial incentive it creates to engage in tax sheltering.

The Benefits of Lower Capital Gains Tax Rates Are Extremely Concentrated At the Top

The benefits of a capital gains tax preference are extremely concentrated among those with very high incomes. In 2010, the highest-income 20 percent realized more than 90 percent of long-term capital gains according to the Tax Policy Center. (See Figure 1.) The top 1 percent realized almost 70 percent of gains and the richest 1 in 1,000 households accrued about 47 percent. It is hard to think of another form of income that is more concentrated by income.
The concentration of capital gains has also been growing over time. The IRS has published aggregate data from the income tax returns of the highest-income 400 taxpayers from 1992 to 2009. In 2009, the “fortunate 400” had adjusted gross incomes of at least $77 million. That small group, which corresponded to 0.00028 percent of taxpayers, realized 16 percent of all gains ($37 billion). (See Figure 2.) That share is an all-time high because, even though ultra-high income households’ capital gains fell in 2009, the capital gains of other less well off taxpayers fell even more. But Figure 2 shows that the trend toward increased concentration has tended to increase over time.
Based on surveys (e.g., Pew 2011), a majority of Americans favors a more progressive tax system. A higher level of progressivity could be achieved without raising top ordinary income tax rates by reducing or eliminating the capital gains tax preference. (This approach was taken in 1986 and proposed by the Bowles-Simpson debt reduction commission.) Alternatively, if capital gains tax rates are to be kept low, it will be very difficult if not impossible to cut top income tax rates as part of tax reform while satisfying the public's preferences with respect to the distribution of tax burdens.

The Preferential Taxation of Capital Gains Complicates the Tax Code

If capital gains were taxed the same as other income, defining them would be fairly straightforward. The prime source of complexity would be the relatively simple matter of defining what events trigger the realization of gain. Classifying income as capital gain or wages or rents would have no tax consequence. However, when capital gains are taxed at much lower rates than other income, the tax code needs complex rules to delimit the boundary between capital gains and other income. In addition, complex anti-tax shelter provisions, such as the passive loss rule, limitations on the deductibility of interest, and a host of other provisions are necessary to deter abuse. Tax lawyers have told me that half of the Internal Revenue Code is devoted to defining the difference between capital gains and ordinary income. If capital gains were taxed as ordinary income, much of that complexity could be eliminated.

Additional complexity arises from the peculiar way we have chosen to favor capital gains. For most of the history of the income tax, a portion of long-term capital gains was simply disregarded in calculating gross income. For example, in 1986, 60 percent of long-term capital gains
gains were excluded from income. Effectively, this lowered the top tax rate on capital gains from 50 percent, the rate that applied to ordinary income for high-income taxpayers, to 20 percent. A $1,000 capital gain contributed just $400 to taxable income. This was fairly straightforward.

As noted, the Tax Reform Act of 1986 taxed capital gains as ordinary income, at rates up to 28 percent — the top rate set under the new law. However, some lawmakers were concerned that ordinary income tax rates would creep up over time and they did not want the capital gains tax rate to rise as well. The compromise was a provision limiting the maximum capital gains tax rate to 28 percent. When ordinary income tax rates increased in 1990 and again in 1993, the maximum 28 percent tax rate became a tax preference compared with the ordinary income tax rates that rose as high as 39.6 percent.

In 1997, President Clinton and Congress agreed to reinstate an explicit preferential tax rate for capital gains. However, instead of restoring a partial exclusion for capital gains, they created an alternate rate schedule. At that time, there were two rates on assets held over a year: 10 percent for low-bracket taxpayers and 20 percent for those in higher tax brackets. (Lower tax rates were also scheduled for assets held longer than five years, but they never took effect.) When the top rate was cut to 15 percent in 2003, the alternate rate schedule still prevailed.

Implementing the alternate rates is extremely complicated as a cursory glance at the 37-line tax computation worksheet for the schedule D makes apparent. The same complex calculations also must be done under the alternative minimum tax, because the alternative capital gains tax rate schedule applies there too. It would be much simpler, if the capital gains preference is to be retained, to return to a partial exclusion.

**Taxing Capital Gains Upon Realization Creates A “Lock-In Effect”**

Under our income tax, taxpayers do not pay tax on capital gain until the asset is sold and the gain is “realized.” Even without an explicit capital gains tax preference, the ability to defer tax until realization is valuable. For example, if you hold a bond that pays a 5-percent interest rate, you have to pay tax on the interest income every year. At a 35 percent tax rate, this reduces the after-tax return to 3.25 percent. However, if you invest in an asset that produces capital gains at a rate of 5 percent per year and hold the asset for 10 years, you need not pay capital gains tax until sale. If the gain were taxed at the full 35 percent rate, the after-tax annual return would be 3.49 percent. The annual effective tax rate is 30.3 percent. If the capital gains asset is held 20 years, the effective tax rate falls to 25.7 percent. (The tax rate on the bond stays the same—35 percent.)

This is an example of the well-known fact that income deferral is valuable, and that valuable benefit is an intrinsic feature of a realization-based capital gains tax.

However, taxation upon realization has a significant downside: the “lock-in effect.” Taxpayers have an incentive to hold onto assets to postpone realizing the gain. This can be economically inefficient if taxpayers hold onto assets that are underperforming. It's not much of a problem for publicly traded corporate stock since the biggest actors in the market — institutional investors and foreign investors — are unaffected by the individual capital gains tax so prices should reflect market participants' best guess of intrinsic values. But lock-in may be significant for assets like a business, where the owner might be induced to hold even when a buyer might be able to run the business better. The lock-in effect is exacerbated by the fact that capital gains on assets held until death are generally exempt from income tax.
Beside for the efficiency costs of lock-in, there's also the possibility that raising capital gains tax rates would not increase revenues. At higher tax rates, there's more of an incentive to hold. At some sufficiently high tax rate selling would decline to the point where revenues could actually decrease when rates go up.

Both the Joint Committee on Taxation (JCT) and Treasury's Office of Tax Analysis built substantial behavioral responses into their estimates of the revenue effect of raising capital gains tax rates. In consequence, raising rates much above 28 percent or so would likely not be scored as increasing capital gains revenue (although there might be a small additional revenue gain from deterring income tax sheltering). Recent research by economists at the CBO and JCT (Dowd, McClelland, and Muthitacharoen, 2012) suggests that the revenue-maximizing tax rate might be even lower (although the paper does not explicitly estimate that rate).

Jane Gravelle (2010) of the Congressional Research Service surveyed the literature on the responsiveness of capital gains to tax rates and concludes that the revenue-maximizing tax rate is probably significantly higher than 28 percent. She argues that the level of responsiveness suggested by Dowd, et al. (2012) and others would imply that realizations would far exceed the amount of accrued gains if capital gains taxes were eliminated, which clearly cannot be true over the long run.

University of Connecticut economist George Plesko found indirect evidence that other factors are likely much more important to realization decisions than tax rates. He compared corporate and individual capital gains over time and found that the two series are highly correlated. (Figure 3 is based on data provided by Plesko and my own calculations.) This is surprising since the tax rates on individual and corporate capital gains often changed at different times. If tax rates were the primary determinant of realizations, one would expect the two time series to diverge in 1981, 1997, and 2003, when individual capital gains taxes were cut while corporate rates stayed the same. That did not appear to happen.
Lock-in might constrain the tax rates that could be imposed on capital gains under current law, but another option to reduce lock-in is to tax capital gains at death or impose “carryover basis”—a provision that would require heirs to pay tax on the entire accumulated capital gains when they sell an inherited asset (rather than just the gain accrued since inheriting it). Carryover basis was briefly enacted for very wealthy taxpayers along with repeal of the estate tax in 2010, but carryover disappeared when the estate tax returned in 2011.

A final issue created by taxation upon realization is that deductions for capital losses must be limited. Currently, taxpayers may only deduct up to $3,000 of net capital losses against other income. Losses in excess of this amount may be carried over to later tax years, but not currently deducted. The loss limit is necessary because otherwise well diversified investors would be able to shelter virtually all of their income from tax by selectively realizing losses and deferring capital gains. However, the loss limit can be a hardship for investors with only a single asset that is sold at a large loss.

Evidence from the 1980s (the most recent available) suggests that taxpayers with net losses in excess of the $3,000 annual deduction limit were usually able to deduct them within a year or two. (Auerbach, Burman, and Siegel, 2000) Thus, although the asymmetric treatment of gains and losses might create a burden, especially for the risky investments most likely to generate losses, the evidence suggests that the loss limit is not especially onerous for most taxpayers.

**Taxing Capital Gains Double Taxes Corporate Stock**

One argument for a lower tax rate on capital gains is that corporations already pay income tax, so any tax on individual capital gains and dividends amounts to double taxation. The ideal solution to this problem is to integrate the corporate and individual tax systems. There are various ways to do this, but integration basically amounts to taxing corporations the same way we tax S-
corporations and partnerships. Income would be allocated to shareholders and taxed at the 
shareholder level annually.

Economists have long been enamored of this solution, but it has never gained much traction with 
policymakers. If integration is not possible, is a lower tax rate on capital gains an appropriate 
offset to the double taxation of corporate stock? Table 1 suggests that a blanket capital gains tax 
preference is a very poorly targeted offset to double taxation of corporate income. In 2007, only 
39 percent of long-term capital gains were on corporate stock or mutual funds. While it is 
possible that some of the capital gains in pass-through entities is attributable to corporate stock, 
it's likely that most capital gains are from other sources.

Moreover, there is wide disparity in the taxation of corporate income. McIntyre, et al. (2011) 
reported that “a quarter of the companies in our study paid effective federal tax rates on their 
U.S. profits of less than 10 percent. … [A]n almost equal number of our companies paid close to 
the full 35 percent official corporate tax rate.” (p. 1) Corporations in some industries benefit 
from special tax breaks and some are more aggressive or effective at avoiding taxation than 
others. It is clear that a blanket reduction in capital gains (and dividend) tax rates provides too 
little relief for some companies and too much for others.

Burman (2003) proposed that capital gains and dividend tax relief be tied to the amount of tax 
paid at the company level and that capital gains on assets other than corporate stock should be 
fully taxed. However, allocating corporate taxes to shareholders is complex and policymakers 
rejected a similar proposal when made by President George W. Bush (although he would not 
have eliminated the capital gains preference for non-corporate stock).

Altshuler, Harris, and Toder (2010) suggest an alternative approach to providing relief from 
double taxation: tax capital gains at rates up to 28 percent and dividends in full and use the 
revenue gained to pay for corporate tax rate reductions. They estimate that the top corporate tax 
rate could be reduced from 35 percent to 26 percent or less on a revenue-neutral basis. They also 
point out that this reform would be more progressive than the current system.

A Significant Portion of Capital Gains Simply Reflects Inflation

It is certainly true that when an asset is held for a long time, much of the apparent gain simply 
reflects inflation. That is an argument for indexing the whole tax system for inflation (Shuldiner 
1993), not a preference targeted at capital gains. In fact, the benefit of deferral may offset part or 
all of the inflation tax. (Burman 1999) This isn't true for assets that pay annual income such as 
bonds and rental properties. So if there is an argument for selective inflation relief, it would 
apply with most force to income other than capital gains.

The other concern is that the correct inflation adjustment would be very different from a flat 
reduction in tax rate. Indexing involves increasing the cost basis of a capital asset to reflect 
inflation since it was purchased before computing capital gain. At a constant inflation rate and 
real rate of return, this would correspond to an exclusion that declined with the holding period. 
And, of course, the appropriate amount of relief would depend on the inflation rate, which varies 
over time. The alternative rate schedule applied to capital gains under current law is clearly a 
very poor proxy for inflation indexing.
Moreover, if capital gains are taxed at lower rates when capital expenses are not adjusted for inflation, there remains the incentive to use the unindexed deductions to shelter current income while ultimately realizing income that is taxed at only a fraction of the nominal value. In other words, the distortion created by differential tax rates remains.

**Capital Gains Would Not Be Taxed Under A Consumption Tax**

Some argue that the proper tax base is not an income tax but a consumption tax. Under a consumption tax, capital gains and other returns to savings would not be taxed. Therefore, eliminating the tax on capital gains is a step in the direction of a better tax system.

Whether consumption tax or income tax is the appropriate base is obviously a contentious issue, but even accepting the premise that we should have a consumption tax, taking one step in the direction of a consumption tax — by exempting capital gains alone from tax — does not necessarily represent an improvement. The problem, just as in the case with indexing for inflation, is that a low or zero tax rate on capital gains when the rest of the income tax is left alone creates huge incentives for tax sheltering, as discussed above.

If the concern is that capital income is overtaxed, then the appropriate solution is to reduce the taxation of all capital income, not just capital gains. One option for doing this is to adopt a value-added tax and use the revenue raised to lower income tax rates. This was the approach taken by the Bipartisan Policy Center (2011) Debt Reduction Task Force. A more radical alternative would be to adopt a dual income tax, as is used in Scandinavian countries. Such a system explicitly taxes capital income at a lower rate than other income.

**Do We Need Lower Tax Rates On Capital Gains To Encourage Entrepreneurship and Risk-Taking?**

Capital gains taxes have mixed effects on risk-taking. Given that most losses are ultimately deductible, the capital gains tax includes a kind of risk-sharing. Investors have to share gains with the government, but losses are also shared. Moreover, economist James Poterba (1989) has found that much of the capital that finances new investment comes from foreigners and pension funds and is thus not subject to capital gains taxes and unaffected by capital gains tax breaks.

One other area of concern is the effect of the capital gains tax on entrepreneurial activity. In fact, the income tax treats investments of “sweat equity” very favorably. Entrepreneurs do not have to pay tax on the value of their labor until it produces income. Effectively, investments in one’s own business are expensed in the sense that tax is avoided altogether on the value of the uncompensated labor invested. Like an IRA or 401(k), this makes entrepreneurial capital tax-free. To the extent that entrepreneurial capital ultimately produces returns in the form of capital gains, entrepreneurs effectively pay a negative tax rate on their own labor input because the contributed labor is expensed while the ultimate return is only partially taxed. And capital gains that are considered “small business” may qualify for a zero rate, creating an even bigger subsidy.
There Is No Obvious Relationship between Capital Gains Taxes and Economic Growth

The heated rhetoric notwithstanding, there is no obvious relationship between tax rates on capital gains and economic growth. Figure 4 shows top tax rates on long-term capital gains and real economic growth (measured as the percentage change in real GDP) from 1950 to 2011. If low capital gains tax rates catalyzed economic growth, we’d expect to see a negative relationship—high gains rates, low growth, and vice versa—but there is no apparent relationship between the two time series. The correlation is 0.12, the opposite sign from what capital gains tax cut advocates would expect, and not statistically different from zero. Although not shown, I’ve tried lags up to five years and using moving averages, but there is never a larger or statistically significant relationship.

I also posted this chart on my blog on Forbes.com and offered the data to all comers. A half dozen or so people, including at least one outspoken critic of taxing capital gains, took me up on the offer, but nobody to my knowledge has been able to tease a meaningful relationship between capital gains tax rates and the GDP out of the data.

Does this prove that capital gains taxes are unrelated to economic growth? Of course not. Many other things have changed at the same time as tax rates on capital gains and many other factors affect economic growth. But the graph should dispel the notion that capital gains taxes are a very important factor in the health of the economy. Cutting capital gains taxes will not turbocharge the economy and raising them would not usher in a depression.
Options for Reform

As members of these two committees know better than most people, tax reform will be a challenging undertaking. It is also tremendously important. The tax code is unfair, inefficient, and much too complex. Changing the way we tax capital gains can help improve the tax code in all three dimensions. It could also improve the odds of a successful tax reform.

First, taxing capital gains at full rates can make it possible to significantly cut individual and corporate income tax rates. This was what made the Tax Reform Act of 1986 work. Since capital gains are so highly concentrated among high-income taxpayers, taxing capital gains allows disproportionate cuts in income tax rates without reducing the overall progressivity of the income tax or sacrificing overall revenues.

Second, if the lock-in effect is a serious concern, then Congress might consider either taxing capital gains at death or reinstating carryover basis. Either measure would substantially reduce the tax incentive to hold assets until death, reduce the distortions created by lock-in, and raise revenues that could be used for income tax rate reduction and/or deficit reduction.

Alternatively, lock-in might be addressed as part of permanent reform of the estate tax. (Temporary estate tax relief is scheduled to expire at the end of 2012, at which time the exemption level will fall from $5.12 million exemption to $1 million and the top estate tax rate increase from 35 percent to 55 percent.) As part of that reform, taxable estates might be allowed a tax credit for basis, effectively rebating capital gains taxes paid on estate tax returns. (Jerry Auten, the Treasury Department’s staff expert on capital gains, suggested this approach many years ago. Burman (1997) derives the tax credit rate, which depends on the capital gains tax rate and the estate tax rate.) The credit provides the same economic incentive as taxing capital gains at death, but in the form of an estate tax break rather than a penalty. It obviously only applies to those who expect to owe estate tax, but since most capital gains are realized by people with very high incomes, such an approach could substantially reduce lock-in on most capital gains, even if only affecting a minority of capital gains taxpayers.

Third, a real reform might consider corporate tax integration. The U.S. Treasury (1992) laid out several options to eliminate the double taxation of corporate income, without favoring tax-avoiding corporations over others that pay full rates or providing tax relief for assets other than corporate shares.

And, if major reform proves infeasible, Congress might consider replacing the schedule of alternative tax rates with a partial exclusion, as existed prior to 1987. That would significantly simplify compliance, especially for those brave souls who still complete their tax forms by hand.
References


http://www.irs.gov/taxstats/article/0,,id=203102,00.html


