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Return of the 20% Capital Gains Rate for Certain High Income Individuals

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Focus on Tax Policy: An Introduction

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This section of The Contemporary Tax Journal includes tax policy work of SJSU MST students. We offer it here and on the journal website to showcase the range of tax knowledge the students gain from the program and to provide a public service. We think the analysis of existing tax rules and proposals using objective tax policy criteria will be of interest to lawmakers and their staff, and individuals interested in better understanding taxation.

One of the learning objectives of the SJSU MST Program is: *To develop an appreciation for tax policy issues that underpin our tax laws.*

Students learn about principles of good tax policy starting in their first MST class - Tax Research and Decision-making. The AICPA's tax policy tool, issued in 2001,[1] which lays out ten principles of good tax policy, is used to analyze existing tax rules as well as proposals for change.

Beyond their initial tax course,SJSU MST students examine the principles and policies that underlie and shape tax systems and rules in the Tax Policy Capstone course. In other courses, such as taxation of business entities and accounting methods, students learn the policy underlying the rules and concepts of the technical subject matter in order to better understand the rules and to learn more about the structure and design theory of tax systems.

The seven tax policy analyses included in this section join the growing archive of such analyses on the journal website (under "Focus on Tax Policy").

1) Transferability of the Research Tax Credit.
2) Return of the 20% Capital Gains Rate for Certain High Income Individuals.
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1 AICPA. (2001) Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals. Available here. Professor Nellen was the lead author of this AICPA document.

Return of the 20% Capital Gains Rate for Certain High Income Individuals

By: Victoria Lau, ***MST Student***

"The American Taxpayer Relief Act of 2012" (P.L. 112-240, 1/2/13) introduced a maximum 20% rate[1] on adjusted net capital gain for high income individuals with taxable income over $450,000 if they are married or $400,000 if they are single. Prior law remains effective for individuals with taxable income below these thresholds: married individuals pay 15% tax on capital gains when their taxable income is between $72,000 and $450,000; and are not liable for capital gains tax when their income is below $72,000. The applicable taxable income thresholds by filing status are listed in *Table 1.*

1 IRC §1(h)(1)(D), as amended by PL 112-240 §102.

Net Capital Gain and Qualified Dividend				
Taxable Income by Filing Status				
	MFJ	Single	MFS	HOH
0%	$72,500	$36,250	$36,250	$48,600
15%	Up to $450,000	Up to $400,000	Up to $225,000	Up to $425,000
20%	Over $450,000	Over $400,000	Over $225,000	Over $425,000
25%	Unrecaptured Gain from Sale of Depreciable Real Property			
28%	Gain from Sale of Collectibles and §1202 Small Business Stock			

Table 1: Five-tier Capital Gain Rate Structure, effective as of Jan. 1, 2013[2]

Adjusted net capital gain includes net capital gain and qualified dividends as provided under IRC §1(h)(3). It excludes certain gains and they are taxed under different rates: individuals pay 28% tax on gains from sale of collectibles and certain small business stock,[3] and 25% tax on unrecaptured depreciation from sale of real property.[4]

The definition of capital gain is broad and the rules are provided in Subchapter P Capital Gains and Losses. Capital gains and losses are classified as long-term if the taxpayers held the property for more than a year before it is sold; otherwise, they are classified as short-term.[5] Net capital gain generally means the excess of long-term capital gain over net short-term capital loss.[6] Qualified dividend income, comprises dividends received from domestic and certain foreign corporation, is added to net capital gain for preferential treatment under §1(h)(11).

Income other than capital gains, except for short-term gains, is subject to the higher ordinary rates, up to 39.6% in 2013.[7]

The maximum capital gains rate of 20% applied prior to 2003. The lawmakers reduced the maximum rate to 15% when they enacted the "Jobs and Growth Tax Relief Reconciliation Act of 2003" (P.L. 108-27, 5/28/2003). It was a temporary reduction to last until December 31, 2008. But the lawmakers extended it twice. It was first extended to the end of 2010 when they enacted the "Tax Increase Prevention and Reconciliation Act of 2005" (P.L. 109-222, 5/17/2006); and extended again to the end of 2012 by "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (P.L. 111-312, 10/23/2009).

This analysis uses the ten principles of good tax policy outlined in the ***AICPA Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals, to evaluate the resumption of the 20% maximum capital gain rate as compared to the maximum 15% rate effective from 2003 to 2012.***

2 IRC §1(h)(1) provides the capital gains rates and Rev Proc 2013-15 §2.01 provides the regular income tax brackets for 2013.

3 IRC §§1(h)(4) and (5).

4 IRC §§1(h)(3) and (6).

5 IRC §1222

6 IRC §1222(11).

7 IRC §1(a) and §1(h).

Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

Equity is commonly assessed based on the concept of horizontal and vertical equity. For horizontal equity, similarly situated taxpayers should pay the same amount of tax and vertical equity provides that taxpayers with greater ability to pay should pay more tax.

Under the new law, two similarly situated taxpayers with the same amount of taxable income may pay different amounts of tax on their capital gain if their mix of capital gain and other taxable income is different. For example, two married taxpayers have income of $500,000. If one taxpayer has capital gain of $50,000 and other income of $450,000; he will pay 20% tax on all of his capital gain. If the other taxpayer has $250,000 of capital gain and the remaining in earned income, $200,000 of his capital gain will be taxed at the lower 15% rate. This horizontal inequity only applies though, to approximately 4% of taxpayers who have income in excess of $500,000; above the 20% capital gain rate thresholds. [8]

Although horizontal equity is not met for this 4% of high income taxpayers, they pay more tax on their capital gain due to the new tax rate. This 4% of taxpayers accounted for 68% of the $970 billion capital gains reported in 2007.[9] Taxpayers with adjusted gross income (AGI) over $1 million (making up 1.5% of taxpayers) reported $566 billion capital gains, or an average of $1.6 million of capital gain each.[10]

The conclusion as to whether or not the new maximum capital gain rate attains vertical equity depends on the perception of the evaluator which is influenced by past experience, and information or misinformation available.[11] Some taxpayers believe the preferential rate benefits all taxpayers; for example, Krugman claimed that "low capital gains rates are being showered on everyone."[12] Many lower income taxpayers do not own capital assets, such as a home or stock. If they are homeowners, the national medium home price is $178,000[13] so gains realized by most taxpayers when they sell their home are not taxed. IRC §121 allows married individuals to exclude gains of up to $500,000 ($250,000 for single individuals) from income when they sale their home provided certain conditions are met.

Equity should also be evaluated in the context of the entire tax system because taxpayers are subject to a range of different types of tax.[14] The effective income tax rate, combining ordinary income and capital gain, is not progressive above a certain income level. The reason is that higher income earners have a greater portion of their total income from capital gains;[15] therefore, higher income earners can have an effective tax rate lower than taxpayers with only earned income. In 2007, when the maximum capital gain rate was 15%, the effective income tax rate was 24.1% for individuals with AGI between $1 and $2 million and fell to 19.4% for taxpayers with AGI above $10 million.[16]

Including the 3.8% Medicare tax on unearned income,[17] the effective tax rate on the income for this group of taxpayers will exceed 23.8% in 2013. This rate is still lower than the effective tax rate of 34.4%[18] if the taxpayer earns $1 million from employment. Thus the new rate structure adds progressiveness to the income tax structure compared to the rate structure prior to 2013.

Equity can also be evaluated in relation to time: whether or not the total tax obligation of the taxpayer is appropriate over the long-run and not distorted by changes in income and wealth. Capital gain is calculated in annual tax periods; therefore, a taxpayer engage in property transactions that may trigger the 20% maximum rate may reduce his annual income by spreading the dispositions over several tax periods. Benefits from a reduced tax rate may be offset by inflationary or opportunity costs. Time-related equity is inherent in a tax system with accounting periods[19] because tax liabilities are calculated using a short term 12-month measure and inflation affects the value of a dollar.[20]

8 IRS SOI. (2007) Tax Stats for 2007: Table 2a on Returns with Short-Term and Long-Term Capital Gains and Losses by Size of AGI and Selected Asset Type. Approximately 4% of returns with long-term gain transactions are filed by taxpayers with AG in excess of $500,000. Retrieved from http://www.irs.gov/uac/SOI-Tax-Stats-Sales-of-Capital-Assets-Reported-on-Individual-Tax-Returns

9 *Ibid.*

10 *Ibid.*

11 AICPA, (2007). Guiding Principles for Tax Equity and Fairness,New York, NY. p 3. Retrieved from https://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TAXLEGISLATIONPOLICY/Pages/TaxReform.aspx

12 Root, W. (2012, Jan. 24). Paul Krugman Is Wrong About Capital Gains Taxes.Forbes, Retrieved from http://www.forbes.com/sites/wayneroot/2012/01/24/paul-krugman-is-wrong-about-capital-gains-taxes/

13 National Association of Realtors. (2013, Feb. 11). Fourth Quarter Metro Area Home Prices Show Strongest Performance in Seven Years. Retrieved from http://www.realtor.org/news-releases/2013/02/fourth-quarter-metro-area-home-prices-show-strongest-performance-in-seven-years

14 AICPA. (2005). Understanding Tax Reform: A Guide to 21st Century Alternatives. New York, NY. p 11. Retrieved from http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/TaxReformStudies/DownloadableDocuments/AICPA_Understanding_Tax_Reform%20(2005).pdf

15 IRS SOI Tax Stats. (2010). Individual Income Tax Returns Table 1 – Individual Income Tax, All Returns, Sources of Income and Adjustments for 2010. Retrieved from http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Returns

16 Sullivan, M. (2009, Dec. 14). Economic Analysis: Is the Income Tax Really Progressive? Tax Notes.Retrieved from http://www.taxanalysts.com/www/features.nsf/Articles/53521CB22AEB44AA85257B1D006058FC?OpenDocument

17 IRC §1411 introduces the 3.8% tax on net investment income over $250,000 for married taxpayers and $200,000 for single taxpayers.

18 Calculated on regular income of $1,000,000 per IRC §1(h) and Rev Proc 2013-15 §2.01.

19 IRC §441(b) provides that the taxpayer's annual accounting period is a calendar year or a fiscal year.

20 AICPA. Tax Equity and Fairness, 2007, p. 7.

Certainty

The tax rules should specify when the tax is to be paid, how it is to be paid and how the amount to be paid is to be determined.

Frequent expiration and extension creates uncertainty. P.L. 112-240 provides certainty. It is a permanent extension of the 15% preferential rate;[21] and the 20% rate is a permanent provision.

However, taxpayers with a mix of capital gain and other income close to the thresholds may not know whether they pay the maximum 20% rate when they sell or dispose of property. They may earn more income after the sale thus increasing their taxable income above the thresholds. This uncertainty may impact close to 3 million taxpayers; the 12% that reported capital gains with AGI between $200,000 and $1,000,000.[22] The portion of taxable income subject to the lower 15% rate would not be material for taxpayers earning over $1,000,000.

Convenience of Payment

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

P.L. 112-240 does not impact this tax principle for most taxpayers because it does not change how and when capital gain tax is paid.

However, the 3 million taxpayers with a mix of capital gain and other income close to the thresholds may not be able to calculate their estimated tax payments accurately because they may not know whether or not their annual taxable income is above the thresholds when they sell their property.

Economy of Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

To support the new law, the IRS will need to revise applicable forms and instructions.

The IRS will also incur costs to educate taxpayers, tax practitioners and tax administrators on how to calculate the tax using the new 20% rate. A taxpayer only pays at 20% tax on the portion of capital gain when combined with other taxable income exceeds the threshold. Taxpayers may think that the 20% rate applies to all capital gain when the taxable income exceeds the top bracket.

Simplicity

Tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost efficient manner.

P.L. 112-240 increases the number of capital gain rates to five (0%, 15%, 20%, 25% and 28%) thus increasing complexity.

In determining whether the 20% applies, the taxpayer must calculate his taxable income and capital gain. Only the excess of capital gain when combined with other taxable income over the threshold amounts is subject to the 20% rate. The use of more than one value to determine applicability of the 20% rate adds complexity.

21 P.L. 112-240 (1/2/2013) §102(a) struck out PL 108-27 §303 which contains the sunset date of December 31, 2008.

22 IRS SOI Tax Stats, 2010.

Neutrality

The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

The resumption of the 20% rate influences taxpayers' decisions in two ways.

First, taxpayers accelerated their gain realization in 2012 before the anticipated increase became effective[23]. The 20% rate also applies to qualified dividends; so many companies declared special dividends or moved up dividend payments toward the end of 2012. Some companies even borrowed to pay the special dividends.[24]

Second, the government anticipates that with the higher capital gain rate, taxpayers will hold on to their assets for longer period; thus realizing fewer capital gains.[25] The reason for this is the "lock-in" effect created by the realization requirement where income from appreciation of assets is not taxed until sale or disposal. Thus taxpayers in evaluating new investment alternatives need the expected return to cover the capital gain tax liability that would be imposed.[26] An increase in capital gain rate may amplify the disincentive for taxpayers to dispose of their assets at a gain.

One government study on taxpayers' sensitivity to changes in the capital gain rates concluded that taxpayers are less sensitive to a long-term permanent rate change than a short-term transitory change.[27]

23 Collins, M & Rubin, R. (2012, Oct.19). Wealth Advised to Sell for Gains Before Unfriendly 2013. *Bloomberg BusinessWeek*. Retrieved from http://www.businessweek.com/news/2012-10-19/wealthy-advised-to-sell-for-gains-before-unfriendly-2013

24 Talley, K. & Russolillo S. (2012, Nov. 28) Costco to Spend $3 Billion on Special $7 Dividend. *The Wall Street Journal*. Retrieved from http://online.wsj.com/article/SB10001424127887324705104578147513153831692.html

25 Elmendorf, D. (2009, Sep. 25). Letter from the CBO Director to Congressman Bilbray. pp. 2-3. Retrieved from http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/106xx/doc10629/09-25-letter_bilbray.pdf

26 Cameron, D. & Manning, E. (2012). Federal Taxation of Property Transactions, New York, NY: LexisNexis. p. 69.

27 United States Congress (2012, Jun. 15). JCX-56-12 New Evidence on the Tax Elasticity of Capital Gains: A Joint Working Paper of the Staff of the Joint Committee on Taxation and the Congressional Budget Office. JCX 56-12. Retrieved from https://www.jct.gov/publications.html?func=fileinfo&id=4472.

Economic Growth and Efficiency

The tax rules should specify when the tax is to be paid, how it is to be paid and how the amount to be paid is to be determined.

Some commentators and academics consider that the disincentive for taxpayers to sell their assets due to the "lock-in" effect hampers mobility of capital investment in the economy.[28] They believe that a higher capital gain rate alters capital flow thus reducing economic growth and efficiency.[29] Combined with the 3.8% Medicare tax on unearned income, the average rate (including average state rate) is 27.9%, significantly higher than the OECD average of 16.4%.[30] This may reduce the attractiveness of U.S. investment and hamper domestic economic growth.

A counter argument to this view is that a large portion of capital gains is earned by tax-exempted pension funds.[31] While individual taxpayers are discouraged to sell their assets, the GAO reported that its impact on the allocation of capital is minimal.[32]

28 *Ibid,* p. 70.

29 Pomerleau, K. (2013, Feb 20). The High Burden of State and Federal Capital Gains Taxes. Tax Foundation. Retrieved from http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-taxes.

30 *Ibid.*

31 CBO (2002, Oct 9). Capital Gains Taxes and Federal Revenues. p. 5. Retrieved from http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/38xx/doc3856/taxbrief2.pdf

32 *Ibid.*

Transparency and Visibility

Taxpayer should know that the tax exists and how and when it is imposed upon them and others.

As illustrated under the certainty principle, the majority of the taxpayers should know the true cost of a transaction and how the increase in rate affects them. Only about 12% of taxpayers (with income between $200,000 to $1,000,000, and a mix of capital gain and other income) may have difficulty identifying when the new rate applies.

Minimum Tax Gap

A tax should be structured to minimize noncompliance.

The government estimates that misreporting of income from capital assets contributed $11 billion[33] toward the total federal tax gap of $345 billion in 2001.[34] Taxpayers are more likely to comply if income is subject to information reporting or withholding. From 2011, brokers are required to report basis for sales of securities.[35] There are no withholding and other reporting obligations for capital gains.

P.L. 112-240 is unlikely to increase the noncompliance rate for majority of the taxpayers because the new law does not change how and when these taxpayers pay capital gain tax. However, the capital gain tax calculation is more complex for 12% of taxpayers (with income from $200,000 to $1,000,000 and a mix of capital gain and other income). If these taxpayers do not understand the new calculation, their noncompliance risk may increase.

33 GAO. (2006, Jun.). Capital Gains Tax Gap, GAO-06-603. Retrieved from http://www.gao.gov/products/GAO-06-603

34 IRS. (2006, Feb. 16) IRS Updates Tax Gap Estimates, IR-2006-28. Retrieved from http://www.irs.gov/uac/IRS-Updates-Tax-Gap-Estimates

35 Reg §1.6045A-1 Statements of information required in connection with transfers of securities.

Appropriate Government Revenues

The tax system should enable the government to determine how much tax revenue will likely be collected and when..

Historical data and economic forecasts should allow the government to estimate the impact of the new rate on revenue with reasonable accuracy.

The capital rate change in P.L. 112-240, including the permanent extension of the 15% and the return of the 20% rate, is estimated to reduce government revenue by $289 billion over the next 10 years: $58 billion from capital gain and $231 billion for dividends.[36] Baseline for this analysis is for adjusted net capital gain to be taxed at ordinary rates. Specific analysis of the effect of the 20% increase is not readily available from government sources.

36 United States Congress. (2013, Feb.). General Explanation of Tax Legislation Enacted in the 112th Congress. JCS-2-13.

Ratings Summary

Equity and Fairness	+
Certainty	+
Convenience of Payment	+/-
Economy in Collection	-
Simplicity	-
Neutrality	-
Economic Growth and Efficiency	+/-
Transparency and Visibility	-
Minimum Tax Gap	-
Appropriate Government	+/-

Conclusion

The resumption of the 20% capital gain rate improves equity and certainty when compared to the temporary 15% rate in place from 2003 to 2012. Unlike previous changes to capital gain rate, P.L. 112-240 is a permanent provision. The new maximum rate impairs the principle of neutrality and simplicity. Furthermore, the requirements for economy of collection, transparency and minimum tax gap are not fully met. More data is necessary to conclude fully on economic growth and efficiency, and appropriate government revenue.

Possible Improvements

Tax changes are often influenced by factors other than the desire to introduce good tax policy. The resumption of the 20% capital gain rate was largely introduced to remedy a perception of inequity: high earners are not paying their “fair share.”[37] Revenue raised may be

37 Obama, B. (2012, Nov. 6). President Barack Obama: My Vision for America. CNN Opinion. Retrieved from http://www.cnn.com/2012/11/02/opinion/obama-vision-for-america

offset by changes in taxpayers' behaviors, for example, by deferring realization.

Lawmakers should set simplicity as a high priority when designing tax law. The National Taxpayer Advocate ranked complexity of the tax code as the most serious problem facing taxpayers in the 2012 annual report to Congress. In addition to the simplicity principle, the new 20% maximum rate impairs the principle of economy of collection, transparency and minimum tax gap.

Lawmakers could enact a two-tiered capital gain tax system with a 0% rate for individuals with taxable income below $72,500 (married taxpayers are subject to the 25% ordinary income tax rate beyond this amount) and a 20% for individuals with income above this amount. The 20% rate could apply to all capital gains including collectibles, small business stock and recapture depreciation from real property. Such a change meets the tax policy principle of simplicity and vertical equity.