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Preferential Treatment of Capital Gains

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Focus on Tax Policy: An Introduction

By: Professor Annette Nellen, *SJSU MST Program Director*

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.
- 3) Surtax on Millionaires.
- 4) Excessive Compensation – How Much is Too Much?
- 5) Increase and Make Permanent the Research Tax Credit.
- 6) Preferential Treatment of Capital Gains.
- 7) Repeal of the Inclusion of Social Security Benefits in Gross Income.

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.

Preferential Treatment of Capital Gains

By: Jenny Phan, *MST Student*

The maximum tax rate for capital gains under the federal income tax is currently 20%,¹ while the top rate for ordinary income is 39.6%. There are three main justifications for this preferential treatment of capital gains:

1. alleviate the “bunching effect;”
2. to account for inflation; and
3. to spur investment and stimulate the economy.

This paper briefly discusses each of these justifications and why each may be flawed. The ten principles of good tax policy are applied to the preferential treatment of capital gains to evaluate its merits.

The “bunching effect” arises when the accumulated gain is all realized in the year of sale and, consequently, potentially pushes the taxpayer into a higher marginal tax rate than would have been the case if the gain had been taxed each year (even though not realized). Capping the capital gains rate at 20% prevents taxpayers from being forced into the higher rate for ordinary income. However, tax on any gain was deferred while the taxpayer held the property and, thus, perhaps justifies a non-preferential rate.²

The next justification for a preferential rate is that part of the gain actually represents inflation rather than any real purchasing power. However, a definite maximum rate of 20% regardless of how many years the investment is held after one year is not a proper adjustment for inflation. Instead, upon sale, the basis of the capital asset could be adjusted for the effects of inflation based on the time period the asset was held. Another approach is to gradually lower the rate each year to ensure that inflation is properly accounted for. These approaches better serve the principle of equity and fairness because it ensures that taxpayers who held the investment for merely a year and one day will not benefit from the preferential 20% rate when inflation has not yet had the kind of impact to merit the lower rate.

The last justification is that a lower capital gains rate serves the goal of encouraging investments, which in turn, creates jobs and facilitates economic growth. However, there is no evidence that a lower capital gains tax rate leads to economic growth. Two recent separate studies, one done by Leonard Burman from Syracuse University’s Maxwell School and another from the Congressional Research Service, found that there is no causation or even correlation between capital gains tax rates and economic growth.³

The justifications for a lower rate on capital gains may not hold up. However, application of the ten principles of good tax policy will reveal some justification for the preferential rate. The policy analysis below 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 Proposal.

¹ Some high income taxpayers may have an additional tax of 3.8% imposed on their capital gains under IRC § 1411.

² Cameron, D. & Elliott M. (2012) .Federal Taxation of Property Transactions. LexisNexis.

³ Greeley, B. (2012, Oct.). Keep Looking for the Economic Benefit. *Bloomberg Businessweek*. pp.31-32. .

Principles of Good Tax Policy Evaluation

in the Preferential Treatment of Capital Gains

Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

There are generally two aspects of equity: horizontal and vertical. Horizontal equity requires that taxpayers with the same amounts of income pay the same amounts of tax.⁴ Vertical equity requires that taxpayers with more income pay more in taxes.⁵ Consider two taxpayers, A and B. A has ordinary income of \$100,000 from wages. B has income of \$100,000, but \$50,000 of it is capital gain income. A will be taxed at his marginal rate while B will only be taxed at his marginal rate on \$50,000 while the other \$50,000 of his income will be taxed at 15% (B has not reached the threshold yet for the top 20% capital gains rate). Assuming both A and B are single, using 2013 tax rates, A's tax liability will be approximately \$18,493 while B's tax liability will only be \$13,429. While A and B have equal amounts of income, they will not have the same tax liabilities. Horizontal equity, therefore, is not met.

Assuming A and B have different amounts of income: \$200,000 and \$180,000 respectively. However, the \$200,000 of A's income is all from capital gain. A's \$200,000 will be taxed at 15% because it has not yet reached the threshold for

⁴ AICPA (2007). Tax Policy Concept Statement 4 – Guiding Principles for Tax Equity and Fairness. New York, NY. p. 5. Retrieved from <http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/Advocacy/DownloadableDocuments/TPCS%204%20-%20principles%20for%20tax%20equity%20and%20fairness.doc>

⁵ *Ibid.* p.3.

Certainty

The tax rules should clearly 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.

Even though it may seem simple that the top rate on capital gains is 20%, it may not be as simple to figure the amount of tax liability. One may think, for example, that if an individual is in the top bracket, then the entire capital gains will be taxed at 20%. However, this may not be the case. The taxpayer must figure which portion of the gain is taxed at 15% and which is taxed at 20%. If the individual is in the top bracket, either a portion of the capital gains will be taxed at 15% and the rest at 20% or the entire amount will be taxed at 20%. In addition, if this individual has capital gains from unrecaptured depreciation on real property or collectibles, both of which have different capital gains rate (25% and 28%, respectively),⁶ the tax computation is even less clear. Certainty, therefore, is not met.

⁶ IRC §1(h).

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.

The preferential rate on capital gains does not affect when or how taxpayers pay their tax liability. However, at the time of the property transaction, a taxpayer may not know his annual taxable income to determine whether the estimated payment should be made at the 20% rate, the 15% rate or a combination of the two rates.

Economy of Collection

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

Since the 20% rate is new for 2013,⁷ there will likely be an increased compliance and administrative burden for taxpayers and the government. Taxpayers need to comprehend and adjust to the new rule. The government needs to ensure taxpayers are applying the new rule and applying it properly. Economy in collection, therefore, is not met.

Simplicity

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

During the Senate Finance Committee and House Ways and Means Committee hearing on Tax Reform and the Tax Treatment of Capital Gains, Senator Max Baucus (D-MT) said that the rules on capital gains are too complex. There are over 20,000 pages in the IRC devoted to capital gains and this “invites people to use all kinds of shenanigans to game the system.”⁸

Although it may be simple for taxpayers to understand whether they are subject to the 20% or 15% rate, they may have more difficulty in figuring their tax liability. For example, they may think that their entire capital gains amount is subject to the 20% rate because they are in the top bracket. However, this may not be the case because a portion of it may be subject to the 15% rate. Also, if they have capital gains from depreciation or collectibles, subject to 25% and 28% respectively, their tax calculations are even more complex. Simplicity, therefore, is not met.

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.

Even though the rate on capital gains is increased to a top rate of 20%, it is still less than the rate on ordinary income. According to Dr. Burman, taxpayers are encouraged to engage in activities that produce capital gain income, such as private equity and hedge funds in order to benefit from the preferential rate. There is also an incentive to find ways to convert their ordinary income to capital gain income.

The usual argument, which violates the neutrality principle, for a lower rate on capital gains is that it encourages investments, which then stimulates the economy. However, as noted above, studies found that there is no significant correlation between the capital gains rate and economic growth. Neutrality is not met.

Transparency and Visibility

Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

Taxpayers are likely aware of the new 20% rate given the high-attention paid to the capital gains rate. However, it may be difficult to know their overall marginal rate as well as their capital gains rate because of multiple rates.

⁷ The 20% maximum capital gains rate was added by the “American Taxpayer Relief Act of 2012” (P.L. 112-240, 1/2/13).

⁸ Baucus, M. (2012, Sep. 20). Opening Remarks from Committee on Finance and Committee on Ways and Means: Tax Reform and Capital Gains. Retrieved from <http://www.finance.senate.gov/imo/media/doc/20120920%20MSB%20Opening%20Statement.pdf>

Economic Growth and Efficiency

The tax system should not impede or reduce the productive capacity of the economy.

Tax law should not impede or reduce an economy's productive capacity. Tax law should encourage economic growth.⁹ During the Senate Finance Committee and House Ways and Means Committee hearing on Tax Reform and the Tax Treatment of Capital Gains, Dr. Burman discussed the negative impacts of a lower capital gains rate on the economy. He contended that people make investments that do not make economic sense when evaluated without the tax break on capital gains. People invest in things that are entirely inefficient¹⁰ and that only make sense to invest in because of the lower capital gains rate. This is money that could have gone to more productive investments. Also, there is a waste of human capital because, according to Dr. Burman, there are very intelligent people dedicating their time to trying to figure out ways to convert ordinary income to capital gain. There is an entire industry dedicated to doing just this, and this is time and energy that these people could have spent on doing more productive things for the economy.

The typical argument for a low capital gains rate is that it spurs investments. For example, during the Senate Finance Committee

⁹ AICPA. (2009). *Tax Reform Alternatives: Tax Reform Alternatives for the 21st Century*. (New York, NY). p. 15.

¹⁰ Burman, L. (2012, Sep. 20). Statement before the House Committee on Ways and Means and Senate Committee on Finance: *Tax Reform and the Tax Treatment of Capital Gains*. Retrieved from <http://www.finance.senate.gov/imo/media/doc/092012%20Burman%20Testimony.pdf>

and House Ways and Means Committee hearing on Tax Reform and the Tax Treatment of Capital Gains, Mr. Verrill, from the Angels Capital Association, pointed out that angel investors provide 90% of the outside equity raised by start-ups that are too small to qualify for bank loans or support by venture capital firms. He contends that raising the capital gains rate would reduce angel investments in these companies.¹¹ However, studies done by Dr. Burman and the Congressional Research Service, covering periods between 1950-2011 and 1945-2010, respectively, showed that there is no significant correlation between a lower capital gains rate and economic growth. Perhaps these two conflicting testimonies can be explained by economics professor Harald Uhlig from the University of Chicago. Professor Uhlig contends that it's possible that a lower capital gains rate promotes economic growth, but "the effect is too small to see among the wars and recessions of the 20th century."¹² A more comprehensive study should be done to evaluate the true impact of the capital gains rate on the economy.

¹¹ Burman, 2012.

¹² Greeley, 2012.

Minimum Tax Gap

A tax should be structured to minimize non-compliance.

People are still incentivized to convert ordinary income to capital gains because of the lower rate on capital gains. However, there is no tax gap if they are doing this legitimately.

Appropriate Government Revenue

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

The government should be able to predict how much more revenue will be collected with the new 20% rate if it can accurately predict how many taxpayers with capital gain income will be subject to the new rate.

Rating 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 new preferential treatment on capital gains only meets the principle of appropriate government revenues. It partially meets principles of convenience of payment, transparency and visibility, and minimum tax gap. It fails five principles: equity and fairness, certainty, economy in collection, simplicity and neutrality, and arguably also fails economic growth and efficiency. This rule is, therefore, weak, and because the justifications for it are also weak, one must wonder why this rule is still in place and who really benefits from this rule? According to Dr. Burman, the top 400 earners in 2009 had 16% of the capital gains. According to Senator Baucus, the capital gains rate is the main reason why many wealthy individuals pay lower taxes. It seems that comprehensive tax reform may not be fully realized unless the issue of the capital gains rate is addressed.

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