Toward Sensible Capital Gains Tax Reform

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Capital Gains Taxation: Boring but Very Likely Relevant in the Near Future Given Massive U.S. Deficits

No matter who gets elected (Trump or Biden), the US is facing massive budget deficits that the nation will have to deal with. It is likely that even a Trump administration would have to increase taxes.

If Joe Biden is elected President and the Democrats gain control of the Senate, there is a good chance that the Trump Tax Legislation of 2017 will be changed materially. Under the Biden plan, long-term capital gains taxes would be significantly increased for many making less than $1 million a year; and for those making more than $1 million, their capital gains would henceforth be taxed as ordinary income.

Furthermore, under his plan, capital gains would be taxed at death. Under present law an estate can pass on assets to heirs without incurring capital gains taxes because no capital gains are recognized. Any capital gains are passed on to the heirs and would only be realized upon sale of the relevant asset by the heirs.

It is, of course, not clear what a final tax bill would look like after all the political maneuvering which would most likely take place before the passage of a final bill.

The purpose of this article is to examine why we have a capital gains tax and to examine what a fair tax treatment of capital gains might look like. The ideas expressed in this article are not my own. I give credit for these to my mentor and teacher at Lehigh University, the late Professor Eli Schwartz. He taught a class in Public Finance when I was at school and I also had the honor of being his student assistant for two years.

Professor Schwartz eventually became the Dean of the Economics Department at Lehigh University. He was an expert in various facets of corporate finance and economics and an original thinker. He wrote books and taught classes on related financial and economics topics.

Rationale for a Capital Gains Tax

What was the rationale for introducing a capital gains tax (which are taxed at lower rate than ordinary income)? An example will make this clear. Suppose you buy a property for say $100,000 and in five years you sell it for $150,000. If there had been no capital gains tax, you would have to pay an ordinary income tax on the $50,000 gain. This does not seem fair because some of this gain is due to inflation and is not a “real” gain in the lexicon of economists. Just to give a very simplified example: suppose that in that five-year time period, the general price level increases by say 25%. This means that $25,000 of the price increase is due to inflation and only $25,000 is “real”. Put another way, you have not gained $50,000 in purchasing power in the five-year period. You have in fact gained "only" $25,000 in purchasing power. Given this state of affairs, it is unfair to tax all of these monetary gains of $50,000 at ordinary income taxes.

Clearly capital gains over a period of time are not the same as ordinary income. It was for this reason that the capital gains tax was put into effect to make sure that capital gains taxes are lower than ordinary income.

I have asked numerous people in business and finance why there should be a capital gains tax and the answer in too many cases is that it is good for the stock market. That may be the effect of the capital gains tax, but it is not a convincing answer as to why such a tax is needed.

Capital gains taxes are paid on the gains (when realized) of assets such as real estate, stocks, and any other investment assets such as artwork. Capital gains taxes are generally exempt from some profits made on the sale of one's primary home. Under current law, the first $250,000 of capital gains is exempt for single taxpayers and $500,000 for those filing joint tax returns. Given the fact that most people's wealth is tied up in their home, this is not much of a tax break in an era when houses are worth a lot more than they used to be. The Biden plan would hurt even middle level income people if they decided to sell their primary residence.

A Fair Way to Tax Capital Gains

The fair way to treat capital gains according to Professor Schwartz is as follows: when a gain is realized (in our example, the $50,000 when the real estate is sold), we should only tax the "real" gain and that should be at ordinary income. That is, the $25,000 increase that was due to inflation should not be taxed while the $25,000 remainder should be taxed at ordinary tax rates.

How to Tax Capital Gains Taxes on Primary Residences

As mentioned before, capital gains on the sale of a primary residence is to not tax the first $250,000 ($500,000 for married tax filers). A doubling of the capital tax rate as proposed by Biden would hurt many middle-income citizens and would not be acceptable to many people when (and if) the Biden proposal is subjected to close scrutiny. Let's assume that a married couple bought their house 40 years ago for $200,000 and now sells it for $1,200,000. This is a capital gain of $1,000,000 with $500,000 of this being subject to a capital gains tax. Under Biden's proposal, the capital gains tax on this $500,000 would increase in most cases. I doubt if such an outcome will be politically acceptable. The amount of the exemption would most likely have to be increased.

Reaction of Wealthy People to Biden's Proposed Increases in the Capital Gains Tax

The Biden proposal would not be easily accepted by well to do investors who enjoy favorable treatment with historically low capital gains rates today. There would be a huge increase in the capital gains tax for many making under $1 million a year; and the elimination of any capital gains treatment for those earning over $1 million/year.

"Carried Interest" loophole

There is also the well-known "carried interest" loophole which allows fund managers to claim what is really salary income as capital gains. The result is that they pay taxes on their compensation at about half the rate that ordinary income taxpayers incur. This is why Warren Buffett has made the comment that his secretary has a higher tax rate than he does. This loophole allows Steve Schwartzman, the Head of Blackstone (one of the major fund managers in the world) to get taxed at rates lower than most people in the country. This loophole needs to be eliminated.

Conclusions

Before we can discuss capital gains taxation, we need to understand the underlying rationale for a capital gains tax. The proposal that we eliminate the capital gains tax and replace it by adjusting capital gains for inflation and then taxing "real gains" at ordinary income tax rates, makes sense from a fairness point of view. Nevertheless, there is no chance at all in my view that such a proposal would ever be considered. There are too many powerful interests who benefit from capital gains taxation who would block any such proposal.

But I do think that we would all be better served if we understood why there is a capital gains tax in the first place and then we might have a better discussion as to how best to treat capital gains in the tax code. We should make sure that the middle class is not subjected to increases in taxation just because their one valuable asset (their primary home) went up in value over the years.

We should also not allow fund managers who are not putting up their own money to get what is ordinary income taxed at lower capital gains rates. Fair is fair.