CTJ Citizens for Tax Justice

September 20, 2012

Media contact: Anne Singer
(202) 299-1066 x27
www.ctj.org

Ending the Capital Gains Tax Preference would Improve Fairness, Raise Revenue and Simplify the Tax Code

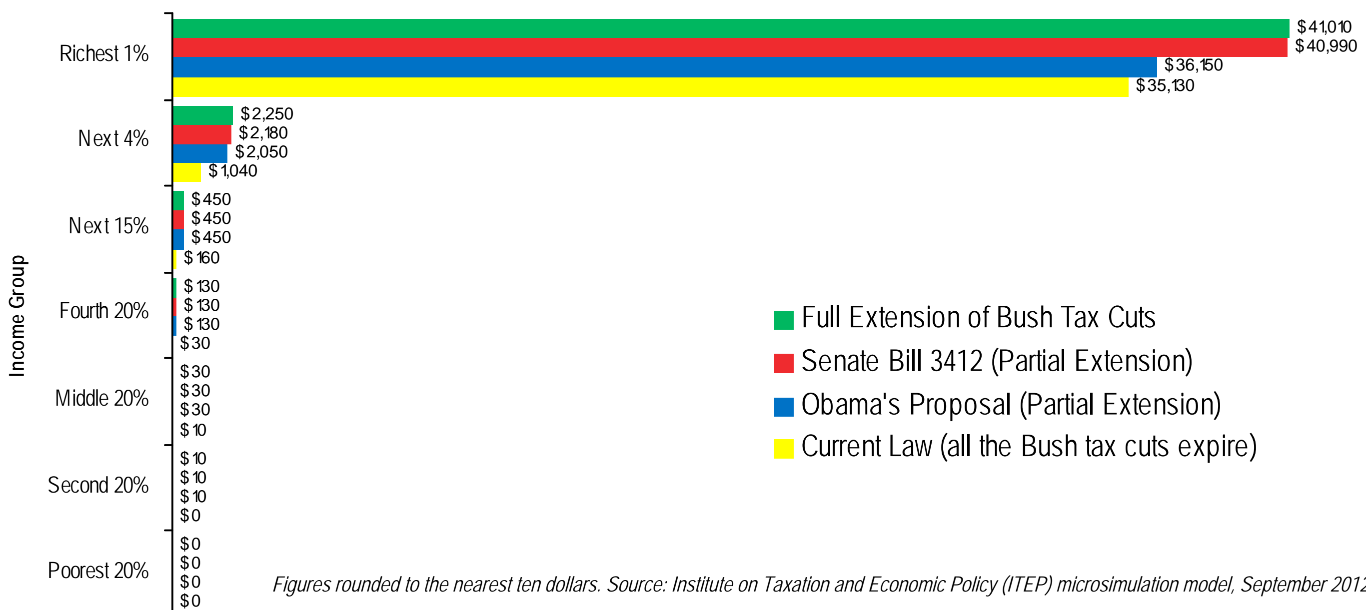
The tax break that allows Warren Buffett, Mitt Romney and other extremely wealthy Americans to pay a smaller share of their income in taxes than many middle-income people is the special low income tax rate for capital gains, which are the profits made from selling assets for more than they cost to purchase. This tax break was made more generous and expanded to apply to stock dividends as part of the Bush tax cuts, and it is a major reason why the Bush tax cuts go disproportionately to the richest one percent of taxpayers.[1] This report addresses several points about capital gains:

1) The capital gains tax preference mainly benefits the richest one percent of Americans.
2) It reduces revenue, despite claims to the contrary.
3) It gives rise to tax shelters and makes the tax code overly complicated.
4) These problems will be mitigated, but certainly not eliminated, by the reform of the Hospital Insurance tax coming into effect in 2013.
5) The way to fully resolve the problems described here is to eliminate the special, low personal income tax rates for capital gains so that they are taxed just like any other income.

1. The Capital Gains Tax Preference Mainly Benefits the Richest One Percent of Americans.

The income tax break for capital gains (and stock dividends) goes mainly to the richest one percent of Americans. While Congress is debating different approaches to the expiring Bush-era tax cuts which will determine the income tax rates for capital gains, none of these approaches fundamentally changes the fact that the tax preference is extremely targeted to the richest one percent, as illustrated below.

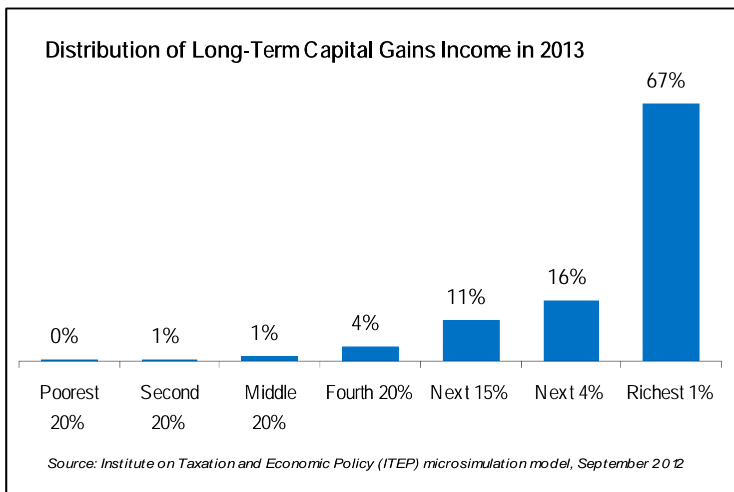
Average Capital Gains & Dividends Income Tax Break Under Different Scenarios in 2013
(compared to taxing capital gains and dividends at ordinary tax rates)

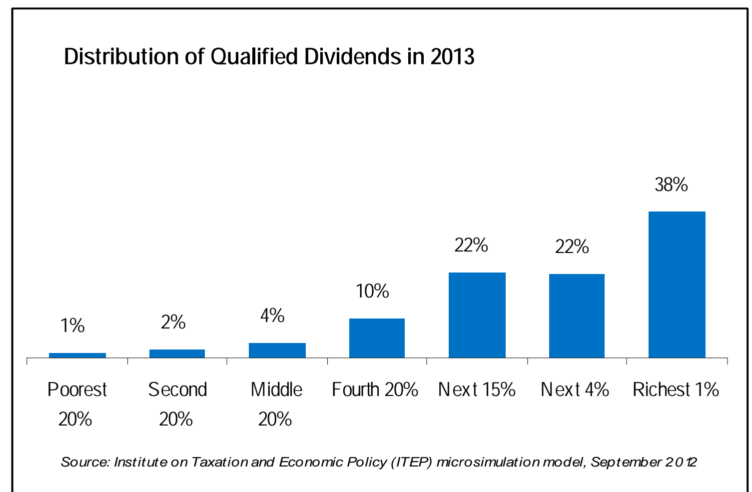


Under current law, the Bush tax cuts will expire at the end of 2012, including the Bush-era changes in income tax rates for capital gains and stock dividends. If Congress allows this to happen, it would mean that in 2013 the top income tax rate on capital gains will be 20 percent, while stock dividends will be taxed like any other income (at income tax rates as high as 39.6 percent). A full extension of the Bush tax cuts would mean that in 2013, both capital gains and stock dividends will be taxed at a top rate of 15 percent, as they are today.

The other two scenarios that have been debated are in between current law (in which the Bush tax cuts completely expire) and a full extension of the Bush tax cuts. For example, President Obama's proposal would extend this part of the Bush tax cuts, but not for capital gains or stock dividends that fall into the top two income tax brackets.[2] Senate Bill 3412, which was recently approved by the Senate, is based on President Obama's approach but would extend more of the Bush-era tax cut for stock dividends. A detailed explanation of the four scenarios is in the appendix.

Under any of these scenarios, the lower tax rates for capital gains and stock dividends mostly benefit the richest Americans for two reasons. First, the richest Americans receive most of the capital gains and stock dividends, as illustrated in the graphs below. The richest one percent of taxpayers receive 67 percent of the long-term capital gains (the type of capital gains eligible for the low income tax rate) and the richest five percent receive 60 percent of the qualified stock dividends (the type of dividends eligible for the low rate). Second, the difference between the regular tax rate and the tax rate on capital gains and dividends is larger for people at the top of the income scale.

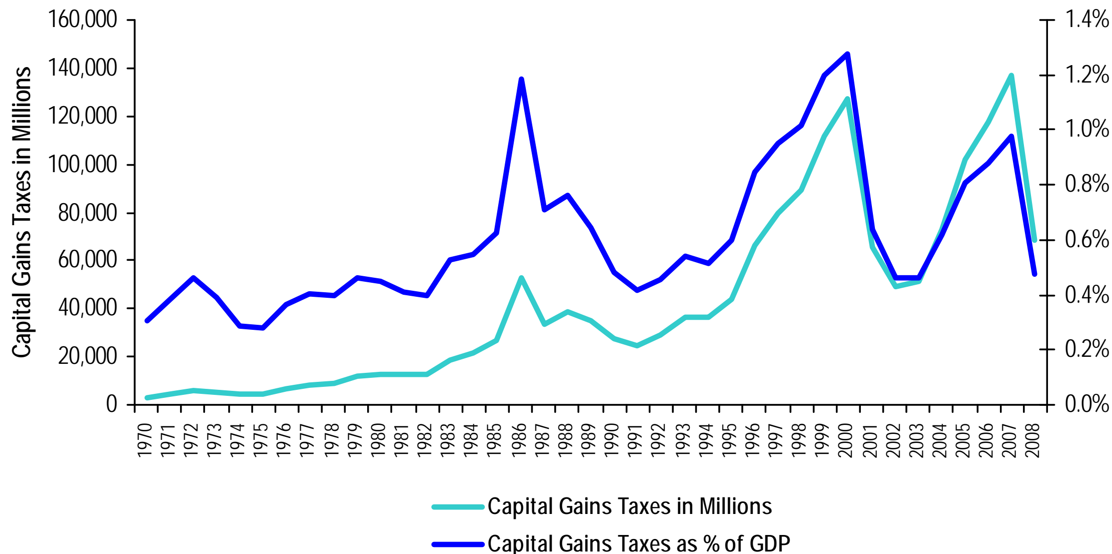




2. The Capital Gains Tax Preference Reduces Revenue Just Like Any Other Tax Break

Some observers (most prominently the editorial board of the Wall Street Journal) argue that lowering tax rates on capital gains actually results in an increase in the amount of taxes paid on capital gains.[3] The argument is that a lower capital gains tax rate results in more people investing in and selling assets and thus more taxes paid on the gains on asset sales. This resulting revenue increase, it is argued, can be larger than the revenue loss caused by the reduction in the tax rate for capital gains. This argument (which is part of "supply-side economics") is not supported by the evidence. The rise and fall of taxes collected on capital gains is not correlated with tax rates but rather with the rise and fall of the stock market and the economy generally.

Proponents of supply-side economics cannot demonstrate that the three spikes in capital gains taxes collected over the last four decades (shown in the graph below) were caused by reductions in the tax rate for capital gains. The first spike, in the 1980s, actually occurred because the income tax rate for capital gains was *raised* under the Tax Reform Act of 1986, which was signed into law by President Reagan and which resulted in a tax system that applied the same rates to all types of income. People rushed to cash in their assets before the higher rate went into effect, and once it did, asset sales logically fell from the artificial high point they had reached.

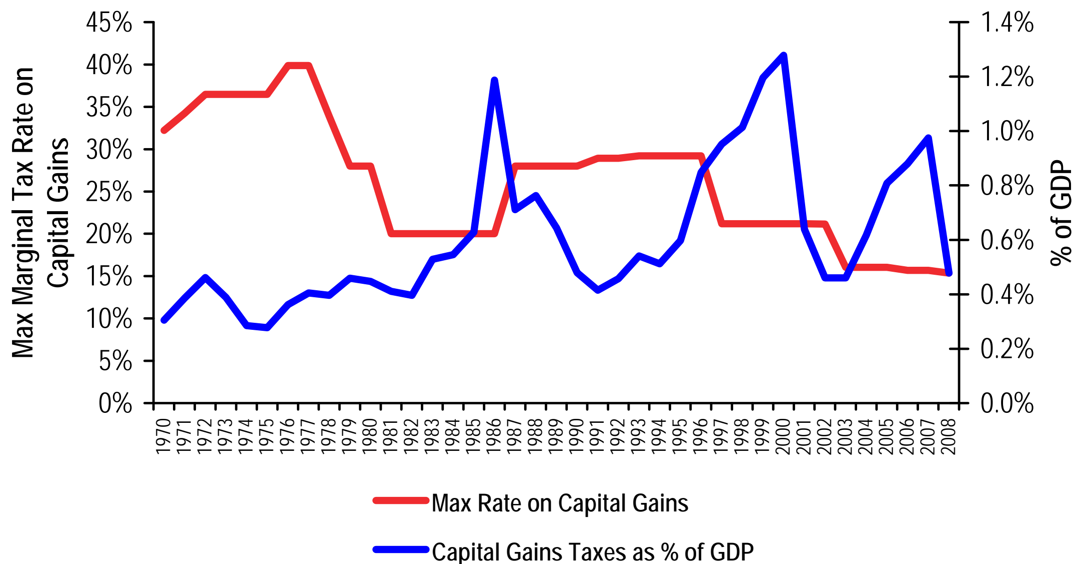


Source: U.S. Department of Treasury, "Capital Gains and Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954-2008," December 30, 2010.

The other two spikes are correlated with the tech bubble that burst in 2000 and the housing and financial bubble that burst in 2008.

Supply-siders essentially argue that the revenue collected from capital gains taxes is inversely correlated with the tax rates on capital gains. No such correlation is readily apparent in the graph on the following page that compares the top marginal tax rates on capital gains (the rate that applies to most capital gains because most of it goes to the rich) to capital gains tax revenue as a percentage of GDP. For example, the graph shows that after the Bush tax cut for capital gains was enacted in 2003, capital gains tax revenue failed to reach the heights seen during the Clinton years, when the top rate was higher, and this revenue plummeted sharply in 2008 even though there was no change in the rate that year.

While no government entity or reputable economist has entirely adopted the supply-side argument, there is still debate over how much the behavioral responses of investors *do* affect the revenue impact of changes in tax rates for capital gains.



Source: U.S. Department of Treasury, "Capital Gains and Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954-2008," December 30, 2010.

There is a debate taking place now between two Congressional entities — the Joint Committee on Taxation (JCT) and the Congressional Research Service (CRS) — over how changes in capital gains tax rates affect revenue.[4] In a March 8 report, we concluded that CRS (as well as tax experts like Leonard Burman) take the more plausible approach to this question and that JCT significantly overestimates the behavioral effects of capital gains changes. In our March 8 report, we use the findings of CRS and Leonard Burman to estimate that at least $533 billion can be saved over a decade by ending the capital gains tax preference, assuming the Bush tax cuts are also allowed to expire.[5]

3. The Capital Gains Tax Preference Gives Rise to Tax Shelters and Makes Our Tax Code Overly Complicated

The income tax preference for capital gains creates an incentive for individuals to devise various schemes to disguise other types of income as long-term capital gains income to benefit from the lower tax rate. This is true despite the great effort that drafters of the tax code have put towards preventing these abuses. Hundreds of pages of the tax code and regulations are devoted to defining what is or is not a capital gain, and many other sections of the code (sections related to the Alternative Minimum Tax, incentive stock options, distributions from corporations, and many others) have language distinguishing how capital gains should be treated. Most of this would, of course, be unnecessary if all income was simply taxed at the same rates under the personal income tax, because then no one would engage in schemes to disguise other types of income as capital gains.

One of the most famous of these schemes is the practice used by private-equity managers like Mitt Romney to receive their compensation in the form of "carried interest," which allows them to tell the IRS that their compensation is actually capital gains income and thus eligible for the lower rates.[6] In effect, this means that the federal government is subsidizing managers of private equity funds (also known as buyout funds) through the tax code, when there is no obvious public interest in doing so. But if capital gains were simply taxed the same as any other type of income under the personal

income tax, there would be little reason for anyone to attempt to disguise their compensation as capital gains in this manner.

4. The Hospital Insurance Tax Reform Coming into Effect in 2013 Will Mitigate, But Not Eliminate, These Problems

A tax provision coming into effect in 2013 as part of health care reform modestly reduces the bias towards wealth in our tax code. It will apply an additional 3.8 percent tax to capital gains and dividend income, as well as other types of income, for taxpayers with incomes above $250,000 (above $200,000 for unmarried taxpayers).

This new tax provision will make social insurance taxes (taxes that pay for Social Security and Medicare) a bit fairer. Social Security and Medicare have always been funded by payroll taxes — taxes that apply to earnings but not to investment income. This is another reason why people who live of their investment income pay a lower percentage of their income in taxes than people who live on earnings. This unfairness will be reduced, but not eliminated, by the reform of the Hospital Insurance (HI) tax that funds part of Medicare and which will subject both earned income and investment income to a top HI tax rate of 3.8 percent.[7]

Even after this change goes into effect, it will still be the case that many extremely wealthy investors will pay a smaller share of their incomes in social insurance taxes and personal income taxes than many people who live on earnings.

In a report from October of last year, we estimate that in 2011, a third of taxpayers with incomes exceeding $10 million received the majority of their income from investments and, as a result, had an average effective tax rate (including both social insurance taxes and personal income taxes) of 15.3 percent. The report also demonstrates that 90 percent of taxpayers with incomes between $60,000 and $65,000 received less than a tenth of their income from investments and, as a result, had an average effective tax rate of 21.3 percent.[8] The report goes onto conclude that the reform of the Hospital Insurance tax coming into effect in 2013 will reduce, but not eliminate, this unfairness. If the HI tax reform had been in effect in 2011, that group of multimillionaires who received most of their income from investments would have had an effective tax rate of 18.7 percent.

5. The Special, Low Income Tax Rates for Capital Gains Should Be Repealed So that All Income Is Taxed at the Same Rates Under the Personal Income Tax

Our report from October of last year also concluded that the only straightforward way to end the phenomenon of multimillionaires paying lower effective tax rates than middle-income people is to end the tax preference for capital gains and stock dividends in the personal income tax. In other words, Congress must change the personal income tax so that it applies the same rates to all income.

This is not a new or radical proposal. In fact, this was an essential part of the of the tax reform that President Reagan and a divided Congress enacted in 1986. In the years that followed, Congress and several presidents undid much of that reform, opening up tax loopholes and bringing back the tax preference for capital gains. Many people in Washington are calling for tax reform, but there is much disagreement over what that tax reform is. To start off, we should agree that any proposed tax overhaul that does not eliminate the capital gains preference is not worthy of the term “reform.”

Appendix: Four Scenarios for Capital Gains Taxation in 2013

Scenario 1: Current Law (All the Bush Tax Cuts Expire)
The income tax rules in effect before the Bush tax cuts were enacted (and which will come back into effect next year if Congress does not act to extend those tax cuts) include special, low income tax rates for capital gains, with a top rate of just 20 percent. If these rules come back into effect, the richest one percent of Americans would enjoy an average income tax break of **$35,130** on capital gains in 2013, compared to what they would pay if capital gains were simply taxed just like any other income.

Scenario 2: Full Extension of the Bush Tax Cuts
If the Bush tax cuts are extended, that tax break for the richest one percent would be increased to an average of **$41,010** in 2013. The Bush tax cuts set the capital gains income tax rates even lower, with a top rate of just 15 percent, and also apply the same special, low rates to certain stock dividends.

Scenario 3: President Obama's Proposed Partial Extension of the Bush Tax Cuts
Under President Obama's proposal, the richest one percent of Americans would enjoy an average capital gains and dividends income tax break of **$35,950** in 2013. Under the President's proposal, the reduced rates for capital gains and stock dividends would continue to be in effect for income that does not fall into the top two income tax brackets. Capital gains in the top two income tax brackets would once again be taxed at a rate of 20 percent and stock dividends in the top two income tax brackets would once again be taxed at the ordinary income tax rates.

Scenario 4: Senate Bill 3412 (Partial Extension of the Bush Tax Cuts)
S. 3412, which was championed by Democratic leaders in the Senate, is based on President Obama's proposal but differs in that it would extend more of the tax cut for stock dividends for the wealthy. Whereas the President's proposal would tax dividends in the top two income tax brackets at ordinary income tax rates, S. 3412 would tax dividends in the top two brackets at 20 percent, the same rate as would apply to capital gains. The average tax break for capital gains and dividends in 2013 would be **$40,990** for the richest one percent of Americans if this proposal becomes law.

For other income groups, however, the average income tax break on capital gains and dividends would be far smaller in any of these scenarios, and would be virtually non-existent for the poorest three-fifths of Americans. Taxpayers not among the richest 2 percent would receive the same tax break for capital gains and dividends under Obama's proposal as they would receive under a full extension of the Bush tax cuts.[9]

Capital Gains and Dividends Tax Breaks Under Four Scenarios in 2013

(compared to taxing capital gains and dividends at ordinary tax rates)

U.S.	Current Law		Obama's Proposal		Senate Bill 3412		Full Extension of Tax Cuts	
Taxpayers	Average Break	as % of Income	Average Break	as % of Income	Average Break	as % of Income	Average Break	as % of Income
Poorest 20%	$ —	—	$ —	—	$ —	—	$ —	—
Second 20%	—	—	10	0.0%	10	0.0%	10	0.0%
Middle 20%	10	0.0%	30	0.1%	30	0.1%	30	0.1%
Fourth 20%	30	0.0%	130	0.2%	130	0.2%	130	0.2%
Next 15%	160	0.1%	450	0.4%	450	0.4%	450	0.4%
Next 4%	1,040	0.4%	2,050	0.7%	2,180	0.8%	2,250	0.8%
Richest 1%	35,130	2.3%	36,150	2.4%	40,990	2.7%	41,010	2.7%
ALL	$420	0.6%	$540	0.7%	$590	0.8%	$590	0.8%

Figures rounded to the nearest ten dollars. Source: Institute on Taxation and Economic Policy (ITEP) microsimulation model, September 2012.

[1] Another recent report demonstrates that if the Bush tax cuts are fully extended, 31.8 percent of the tax cuts would go to the richest one percent of taxpayers in 2013. Citizens for Tax Justice, "U.S. Taxpayers and the Bush Tax Cuts: Obama's Approach vs. Congressional GOP's Approach," June 20, 2012. http://www.ctj.org/bushtaxcuts2012/us.pdf

[2] President Obama proposes to allow the income tax rates in effect at the end of the Clinton years (rates on capital gains and dividends as well as rates on ordinary income) to come back in effect for income in the top two income tax brackets. He proposes to adjust the brackets so that no married couple with adjusted gross income (AGI) below $250,000, and no single person with AGI below $200,000, could possibly fall into the top two income tax brackets. As a result, only 1.9 percent of U.S. taxpayers would lose any portion of their Bush income tax cuts (including income tax cuts for capital gains and stock dividends) in 2013. See CTJ, "U.S. Taxpayers and the Bush Tax Cuts," cited above.

[3] The Wall Street Journal has made this argument frequently in editorials, including "Dynamic Scoring," January 29, 2008; "Washington's Tax Oracles," July 21, 2010; "Obama's Revenue Soup: A History Lesson on Capital Gains Taxes," April 9, 2012.

[4] See "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, June 2012; Jane Gravelle, "Capital Gains Tax Options: Behavioral Responses and Revenue," Congressional Research Service, August 10, 2010.

[5] Citizens for Tax Justice, "Policy Options to Raise Revenue," March 8. http://ctj.org/pdf/revenueraisers2012.pdf

[6] Several reports from CTJ explain why the "carried interest" loophole should be closed. For example, see Citizens for Tax Justice, "Will the 'Carried Interest' Loophole Finally Be Closed?" May 12, 2010, http://ctj.org/pdf/carriedinterest2010.pdf; Citizens for Tax Justice, "Senators Defend 'Carried Interest' Loophole for Investment Fund Managers in the Name of the Poor, Minorities, Small Businesses and Cancer Patients!" June 3, 2010. http://www.ctj.org/pdf/carriedinterestdefense.pdf CTJ's director Robert McIntyre was also the first to estimate that Mitt Romney had an effective tax rate around 14 percent because his carried interest income is taxed as capital gains. See Michael Sherer, "What Mitt Romney Has to Lose–and Obama Has to Gain–from the 'Buffett Rule,'" TIME, October 3, 2011. http://swampland.time.com/2011/10/03/what-mitt-romney-has-to-lose-and-obama-has-to-gain-from-the-buffett-rule/?xid=feed-yahoo-top-linkbox

[7] Until certain provisions of the health care reform law take effect next year, the Hospital Insurance (HI) tax that funds part of Medicare is simply a 2.9 percent tax on all earnings. Self-employed people pay the entire HI tax, and employed people pay half the tax directly while the other half is paid by their employers directly (although economists agree that employers pass their half onto their employees in the form of reduced compensation). Under the health care reform law, the HI tax on earnings will have a second rate of 3.8 percent for earnings over $250,000 for married taxpayer and over $200,000 for single taxpayers. (The tax increase will be paid directly by employees, not employers.) There will also be a 3.8 percent tax that applies to most types of investment income (including capital gains and stock dividends) to the extent that this income accounts for AGI in excess of $250,000 for married couples and in excess of $200,000 for single taxpayers.

[8] Citizens for Tax Justice, "How to Implement the Buffett Rule," October 19, 2011. http://www.ctj.org/pdf/buffettruleremedies.pdf

[9] Even low-income taxpayers can benefit from the special, low rates on capital gains and stock dividends, but the vast majority of low-income taxpayers have very little or none of this income. For all of the income tax brackets, there is a set of "ordinary" income tax rates (the income tax rates that most people are talking about when they discuss tax rates) and lower rates for capital gains. Under the rules in place at the end of the Clinton years (and which will come back into effect in 2013 if Congress does nothing) capital gains are taxed at 20 percent in each income tax bracket except for the very bottom bracket, in which the rate is 10 percent. Under the rules in effect now as part of the Bush tax cuts, the 20 percent rate is lowered to 15 percent and the 10 percent rate is lowered to zero percent. (The zero percent rate applies in the bottom two income tax brackets because another part of the Bush tax cuts spilt the bottom bracket into two separate brackets.) In addition, the Bush tax cuts also allow "qualified" stock dividends to be taxed at the capital gains rates instead of the "ordinary" rates. President Obama would leave these Bush-enacted rules in place except that in the top two income tax brackets, capital gains would once again be taxed at 20 percent and stock dividends would be taxed at the ordinary income tax rates that will apply (36 percent and 39.6 percent).