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Citizens for Tax Justice

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McCain's Proposal to Increase the Tax Loophole for Capital Gains Would Be Unfair and Counterproductive

Richest One Percent Would Receive Over Three Fourths of Benefits from McCain's Newest Tax Cut

Americans are in no mood to subsidize the well-off or Wall Street. Presidential candidate John McCain has proposed expanding a massive tax loophole that does *both*.

The tax loophole for capital gains subsidizes people whose income comes from investments rather than wages, as well as the Wall Street brokers who depend on their business. Senator McCain proposes to increase this loophole by lowering the top income tax rate on capital gains for 2009 and 2010 to a super-low 7.5 percent. Over three fourths of the benefits would go to the richest one percent of taxpayers in 2009, as illustrated in the nearby table.

Share of Benefits in 2009 from McCain's Proposal to Slash Tax Rate for Capital Gains to 7.5%

Income Group	Share of Total Benefits
Lowest 20%	**0.0%**
Second 20%	**0.0%**
Middle 20%	**0.0%**
Fourth 20%	**1.0%**
Next 15%	**7.0%**
Next 4%	**15.7%**
Top 1%	**76.2%**
ALL	**100.0%**

Source: ITEP Microsimulation Tax Model, October, 2008

McCain also proposes to allow taxpayers to count $15,000 worth of capital losses against their other income to lower their income tax liability for 2008 and 2009. (The current limit is $3,000.)

We Already Subsidize People Who Live Off Their Wealth Too Much

When someone sells an asset for more than was originally paid to acquire it, the profit is generally a "capital gain." For some people who have a lot of assets and who buy and sell frequently (through their brokers usually), capital gains can actually be the bulk of their income. Like all income, capital gains are subject to the federal personal income tax. Unfortunately, there is already a loophole in the income tax for people who have this sort of income — a top tax rate of 15 percent for capital gains.

To understand why we already subsidize capital gains too much, consider someone earning a wage of $50,000 annually. He is taxed at progressive rates, and a portion of his income is actually taxed at 25 percent. He also pays the federal payroll tax of around 15 percent. (Technically he pays only half of the payroll tax and his employer pays the other half, but economists generally agree that it's all ultimately borne by the employee.)

Now consider a person with a much higher income who lives off capital gains. Unlike the wage-earner, this person's income is never taxed at a rate greater than 15 percent. Effectively, this means that those of us who are earning wages and paying income taxes at ordinary rates are subsidizing those who live off their capital gains.

McCain's Proposal to Expand the Subsidy for Those Who Don't Have to Work

Senator McCain proposes to increase this egregious tax subsidy by reducing the top tax rate for capital gains to an astoundingly low 7.5 percent for 2009 and 2010. Over three fourths of the benefits of this change would be received by the richest one percent in 2009.

Why McCain's Proposed Rate Reduction Only Benefits the Rich

There are two reasons why this proposed rate reduction for capital gains does virtually nothing to help the middle-class and is so targeted to the rich.

First, the rich have most investment income that is subject to the lower capital gains rate. While it's true that many middle-income people have investments today, most are in 401(k) plans, Individual Retirement Accounts (IRAs) or other similar retirement savings vehicles. Taxes on these investments are deferred until retirement, at which point they are taxed as "ordinary income," meaning they don't benefit from the tax cuts for capital gains.

Second, even those very few low-income and middle-income households receiving capital gains cannot possibly benefit from McCain's proposed rate reduction because most will already enjoy a tax rate of *zero* percent in 2009 and 2010. People whose taxable income does not exceed the bottom two income tax brackets enjoy a tax rate of zero percent for capital gains (while everyone else enjoys a low rate of 15 percent for capital gains) under current law.

Taxing Capital Gains Like Any Other Income Has Been Done Before — Under Reagan

There was a time when the federal income tax treated all income equally. President Reagan actually signed a tax reform law that applied the same income tax rates to all income, regardless of whether it came in the form of wages or investment income.

The top rate for capital gains was then lowered to 20 percent during the Clinton Administration. President Bush increased this loophole significantly in 2003 when the top rate for capital gains was lowered to 15 percent (and the lowest rate was reduced to zero). The 2003 law also created a new loophole by taxing corporate stock dividends at the same low rates (0 percent and 15 percent) as capital gains, further biasing the tax code in favor of investment income. Like almost all the Bush tax cuts, these changes expire at the end of 2010.

McCain's Proposal to Change the Treatment of Capital Losses

When people sell an asset for less than they paid to acquire it, the loss is generally a "capital loss." Capital losses can be counted against capital gains for tax purposes, meaning a person who has $20,000 of capital losses and $20,000 of capital gains simply has no capital income for federal income tax purposes and thus no income tax is due on capital income.

But there is a limit on the extent to which capital losses can be used to reduce "ordinary" income (wages, interest, and anything besides capital gains and dividends). Under current law, only $3,000 of capital losses can be used to reduce ordinary income for income tax purposes.

Without a limit on the amount of capital losses used to reduce ordinary income, investors could choose to cash in only their losses and get a big tax break, even though they typically also have unrealized capital *gains* that they choose not to cash in. (An unrealized capital gain is an increase in the value of an asset that has not yet been received as a profit because the asset has not been sold). Without a capital loss limit, some people who actually have large incomes and large (albeit unrealized) capital gains would be treated as if they had low incomes for tax purposes.

Thus, eliminating the capital loss limit entirely would be a disaster for tax policy, while increasing it from its current $3,000 level would simply be an expensive boon mostly for well-off people. Senator McCain proposes to increase the capital loss limit from $3,000 to $15,000.

Incentives to Dump Assets?

Proponents of tax cuts for capital gains argue that such cuts encourage investment, but historical data show that such tax cuts have little, if any, effect on investment. But even if tax cuts do affect investment, one would have to wonder why this would lead anyone to support a *temporary* cut in the income tax rate for capital gains. In theory, any temporary break for capital gains encourages investors to sell off their assets before the tax break expires. It's not immediately obvious that we want to encourage investors to sell stocks before McCain's proposed capital gains tax break expires at the end of 2010, since a wave of selling would be likely to depress the stock market even further.

Temporary Rate Cut Would Very Likely Lead to Permanent Tax Cut

On the other hand, maybe proponents of this sort of tax rate reduction for capital gains have no intention of ever allowing it to expire. There is really no such thing as a temporary tax cut under the logic of the anti-tax lawmakers and activists who McCain is apparently trying to placate.

These anti-tax lawmakers sometimes talk unwary members of Congress into supporting a tax cut by saying that the cost will be small because the tax cut will be temporary. But, inevitably, when the expiration date nears, the anti-tax lawmakers propose making the tax cut permanent, and accuse anyone who opposes their efforts of wanting a "tax increase." This is exactly what has happened with the Bush tax cuts, which expire at the end of 2010.

Return to Reagan's Policy

The federal income tax should not be used to subsidize the lucky few who can live off their wealth rather than earn a wage. Lawmakers who want to make the tax code work for the vast majority of Americans should join us in advocating a return to President Reagan's approach of taxing investment profits at the same income-tax rates as wages and other kinds of income.