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Reforming the Taxation of Capital Gains

1. Introduction

The federal tax code is too long — more than 74,000 pages — too complicated, too confusing, and too expensive for taxpayers. It needs to be radically changed. But, there is the right way to do it and the wrong way.

We should move to taxing income one time at one rate. Today we tax the same dollar over and over. When you earn it, when you save it, when you invest it and if you are stupid enough to die, the government takes another bite.

Comprehensive, pro-growth tax reform should be a priority in 2017 and a key part of reform should be reducing (or eliminating) this double taxation. One important way to do this is by reducing the capital gains & dividends tax, which is levied on already taxed income that is reinvested in the economy. While the focus is often on capital gains taxes paid by individuals, reducing the corporate income tax to 20 percent or less has the effect of lowering corporate capital gains taxes (which are taxed as ordinary income) to a level similar to individual capital gains taxes.

In addition, lawmakers should oppose efforts to incrementally increase the taxation on capital gains through taxing carried interest as ordinary income. They should also look at ways to improve the taxation of income derived as capital gains. One way would be preserving and expanding section 1031 "like-kind exchanges" as part of tax reform.

Another way to ensure lower capital gains taxes is to index capital gains taxes to inflation through Treasury's legal authority. Under the current system, inflation cancels out a significant portion of any "gain" made by an investor. Ending this inflation penalty will only increase investment and economic growth.

2. Capital Gains/Dividends Taxes Should be Reduced, Not Increased

Why Does the Tax Rate on Capital Gains/Dividends Matter? The capital gains and dividends tax is levied on income that has already been subjected to individual income taxes and is then reinvested into the economy in a way that increases productivity and leads to the creation of new jobs, higher wages, and increased economic growth. This double taxation makes no sense from the perspective of encouraging investment and stronger growth and it should be reduced wherever possible. Conversely, it makes no sense to increase taxes on income earned as a capital gain or dividend because of the adverse effect it would have on the economy.

Taxing capital gains and dividends as ordinary income would decrease GDP by more than 3 percent over the long term and cost 700,000 jobs according to the Tax Foundation. It would also reduce household income for all American families by more than 4 percent. In contrast, eliminating the double taxation of capital gains would increase household income across the board by an average of 3.8 percent, would lead to 2.7 percent higher GDP, and would create more than 500,000 new jobs.

What Policy Changes and Proposals Have Been Made to Capital Gains Recently? Over the course of his Presidency, Barack Obama hiked the top capital gains tax rate from 15 to 20 percent and then Obamacare imposed a 3.8 percentage point "surtax" on capital gains. His budget proposals called for a hike in the rate to 28 percent from the current 23.8 percent top-rate, and have called for limiting the use of section 1031 "like-kind exchanges," a common-sense section that allows investors to pay taxes only when they cash-out — not if they choose to reinvest earnings into another asset.

While campaigning for President, Democrat candidate Hillary Clinton proposed going further in the direction of higher capital gains taxes. She called for a byzantine capital gains tax with six brackets for those whose total taxable income puts them in the 39.6 percent bracket. This proposal was supposed to fix the problem of short-term investment, even though investors make decisions based on value, not length of time.

In addition, Clinton called for raising taxes on "carried interest" capital gains earned by investment partnerships, despite the fact that taxing these partnerships would impact pensions, 401(k)s, charities and colleges.

In contrast, House Republicans have proposed reducing the capital gains tax in their "Better Way" tax reform blueprint. The plan reduces taxes on investment income by creating a 50 percent deduction on a taxpayer's bracket. This means capital gains and dividends rates would be 6 percent, 12.5 percent, and 16.5 percent, far below the existing 23.8 percent.

Unlike capital gains taxes paid by individuals, corporate capital gains are taxed as ordinary income, meaning they are subject to a 35 percent rate. As a result, reducing the corporate income tax rate to 20 percent (as proposed by House Republicans) or 15 percent (as proposed by President Trump) is a significant cut in the corporate capital gains tax that brings it into line with capital gains taxes paid by individuals.

How Do These Rates Compare to the Rest of the World? The US has the some of the highest capital gains and dividends rates amongst the 35 developed countries in the Organisation for Economic Development and the five member BRICS (Brazil, Russia, India, China and South Africa), as noted by a study prepared by Ernst and Young. After including the second layer of corporate level taxation, the only country with a higher rate is France.

The top US integrated rate for distributions made as capital gains (which includes both corporate tax, and state taxes) sits at 56.3 percent, while the OECD/BRIC average sits at 40.3 percent.

Similarly, the top US integrated rate for distributions made as dividends (which includes both corporate tax) for capital gains sits at 56.2 percent, while the OECD/BRIC average sits at 44.5 percent.

The differential between the US top integrated rate for dividends and top integrated rate for capital gains is because of differentials in state tax rates.

3. Carried interest is a Capital Gain and Should be Treated As One

While it is important to reduce marginal capital gains tax rates, it is also important not to incrementally increase the capital gains tax by taking aim at specific provisions. One proposal that has been raised on several occasions is to tax carried interest capital gains as if it were ordinary income (which would subject it to a top rate of 39.6 percent). There is zero difference between carried interest and other types of capital gains and this proposal is step one in taxing all capital gains and dividend income as if it were ordinary income.

There is a widespread misconception that treating carried interest as a capital gain is a loophole. But the truth is, carried interest is identical to all other capital gains and there is little justification for treating it as ordinary income. Carried interest is simply the share of an investment partnership allocated to the investor. These partnerships occur when individuals with capital and individuals with expertise pool their resources together.

Those who derive income from carried interest capital gains don't have some special deal -- they pay the same capital gains rates as everyone else. All income from a partnership is derived from a long-term investment in a business or real estate and so all income is treated as a capital gain.

While supporters of higher taxes on carried interest capital gains call it a matter of fairness, it would actually have negative, wide reaching impacts on the economy. Enacting this change would hurt pension funds, charities, and colleges that depend on investment partnerships as part of their savings goals. In addition, small businesses would find themselves increasingly shut out from investment money available to them from these partnerships.

In addition, increasing taxes on carried interest capital gains would raise a miniscule amount of revenue. According to the Joint Committee on Taxation, taxing carried interest as ordinary income would raise just $19.6 billion over the next decade, barely a rounding error when measured against the projected $41.7 trillion that the Congressional Budget Office estimates will be raised over that time frame. When accounting for effects on the economy, the Tax Foundation estimates revenue from taxing carried interest as ordinary income would fall to just $13 billion.

4. Sec. 1031 Like-Kind Exchanges Should be Preserved and Strengthened

Just like carried interest, section 1031 "like-kind exchanges" have come under fire as a potential pay-for in comprehensive tax reform. However, repeal would move the code toward higher taxes on investment, which in turn hurts economic growth and reduces income. The provision should serve as a model for the taxation of all investments and should be retained in any overhaul of the tax code as a complementary provision to full business expensing.

Section 1031 of the tax code allows taxpayers to defer paying taxes on certain types of assets when they use those earnings to invest in another, similar asset. This can be done again and again, provided the transaction involves a similar type of property.

This provision has existed in the tax code for more than 100 years and is used on assets such as real estate, machinery for farming and mining, and equipment such as trucks and cars. Because an investor doesn't have to pay tax until they cash out, section 1031 eliminates a barrier to investment, which in turn promotes the more efficient allocation of capital resources.

Like-Kind Exchanges Compliment the Goals of Pro-Growth Tax Reform: The House GOP "Better Way" tax reform blueprint takes many steps that compliment section 1031. For instance, the blueprint replaces the convoluted system of depreciation with immediate, full business expensing of all tangible assets (such as equipment) and intangible assets (such as intellectual property), but not land. This allows business owners to make decisions based on the merits of the transaction, not because of government induced tax barriers. In turn, this means a more efficient allocation of resources.

A move toward full expensing of assets will streamline business activity by allowing the efficient purchase of new assets and Section 1031 should be considered complimentary to this goal. 1031 allows less productive assets to be replaced with more productive assets, and therefore eliminates any lock-in effect that would otherwise discourage business activity. This is especially important for land assets that are excluded by the blueprint, which in many cases represents a significant portion of many properties. Because of the exclusion of land, repeal of like-kind exchanges – even with full expensing – may have the effect of impeding otherwise productive transactions.

Repealing Section 1031 is Economically Destructive: Sec. 1031 grants important flexibility for a taxpayer to make the most economically efficient investment decisions in a way that benefits – not hinders economic growth and efficiency. If Section 1031 were to be repealed, it would create a lock in effect that would discourage certain types of otherwise productive transactions. Conversely, this would result in less productive deployment of capital in the economy which would hurt economic growth and capital while raising little revenue.

Because of this lock-in effect, repeal could cost the U.S. economy as much as $13.1 billion in lost GDP year after year, according to a study conducted by Ernst and Young. This GDP loss would also result in investment falling by $7 billion every year and would reduce income by an estimated $1.4 billion.

Like-Kind Exchanges Should Be a Model for All Capital Gains: Under like-kind exchange rules, you only have a gain when you decide to cash out. The gain is the difference between the final sale amount and the original purchase, and is embedded over the years in the business. In effect, it becomes due when the business activity effectively ends.

There's no reason this cannot work for other capital gains. If you buy a stock for $100 and sell it for $150, you should be able to plow that $150 into new stock purchases without having to pay tax along the way.

This would also have the added effects of promoting tax simplicity and economic efficiency. Investors would no longer have to report each and every stock and mutual fund transaction on their taxes every year, simplifying tax filing for millions of Americans. It also would make all capital markets—for everything—more efficient.

Every time the government takes money out of the pool of capital investment, capital grows more slowly and we're all poorer than we otherwise would be. The key to wealth creation is to leave capital—untouched by government – free to grow for as long as possible.

5. Index Capital Gains to Inflation Through Treasury's Regulatory Authority

One path forward on the taxation of capital gains is to index the tax to inflation. This could be done by legislation, or through the Treasury Department's regulatory authority as outlined in a legal memo entitled "The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains," which was prepared by lawyers at the firm Shaw, Pittman, Potts & Trowbridge.

The tax code defines a capital gain as the value of an asset at the time of sale minus the "cost." The Treasury, since the inception of the IRC, has interpreted "cost" to mean the original purchase price at the time of the purchase. Central to this discussion is whether this interpretation is required by the IRC.

Existing Law Discourages Long-Term Investment: The capital gains tax, without an inflation index, discourages long-term investment by exposing long-term investors to greater inflation-risk than short-term investors.

An investor who makes a capital investment of $1,000 in 1980 and sells that capital for $2,000 in 1996 will be taxed for a $1,000 gain. When adjusted for inflation, the investor realized a gain of just $241 (1,000 in 1980 - $1759 in 1996).

Another investor made a capital investment of $1,000 in 1996 and sold for $2,000 just one year later. The short-term investor's real after-tax gain is much higher. Thus, the tax code provides incentive for speculation, as opposed to long-term investment.

Existing Law Discriminates Against Certain Decisions: A basic principle of any just tax system, including the U.S. code, is that taxpayers in equivalent circumstances should pay equivalent taxes. Tax economists refer to this as the principal of "horizontal equity." Referring to our earlier example, suppose that our long-term investor sells his $1,000 investment for $1,000, or no gain. In real economic terms, these two taxpayers are in identical circumstances. Both saw no real capital gain. However, one will pay a tax on $759 of "income," while the other pays no tax at all.

In the absence of inflation-indexing, many investors are forced to pay capital gains taxes on real capital losses. In such circumstances, capital gains taxes amount to a levy on capital. Intuition tells us that a capital levy was never the intent of Congress when it created the IRC in 1913, or its many revisions thereafter. The history of congressional action concerning capital gains and the IRC since 1941 supports this conclusion.

Can Treasury Interpret "Cost" In This Instance? The ability of the Treasury to interpret "cost" to account for inflation turns on three specific questions. First, is the IRC sufficiently ambiguous to allow for administrative interpretation of "cost" in this instance? Second, does regulatory or legislative history offer an implied interpretation that could preclude Treasury's authority? Finally, does case law support Treasury authority in this specific instance?

The IRC defines a capital gain in terms of its "adjusted basis." Later, it specifically defines "basis" in terms of "cost." However, nowhere in the statute is "cost" specifically defined. Following the Chevron logic, this report concludes that the IRC is sufficiently ambiguous, and that "interpreting cost to refer to the true economic consequences of the taxpayers investment is as reasonable as interpreting it to refer only to the nominal dollars expended to purchase the asset."

The legislative history of the IRC, and capital gains in particular, is in my opinion, the most subjective portion of the analysis. Overall, however, it supports Treasury discretion. In 1918, when capital gains were explicitly written into the IRC, the economics of prices was well established, but not yet a part of mainstream public policy discussions. Virtually no questions of inflationary effects were raised in debate.

It could be argued that Congress' repeated failure to write specific inflation-indexing language into the IRC in its frequent revisions amounts to an implicit rejection of such an interpretation of "cost." However, two factors undercut this assertion. First until 1986, capital gains enjoyed a significant preference, most often a 50% exemption. In congressional debates, this exemption was frequently cited as sufficient to offset inflation's effect on capital gains. In 1986, Treasury recommended an inflation index and elimination of the preference in its original proposal for fundamental tax reform. Unfortunately, Congress took the advice to eliminate the preference, but ignored inflation indexing. Furthermore since 1986, inflation indexing legislation has been passed in both houses of Congress, but has never been enacted.

Of all the arguments presented, IRC case law appears to be the strongest argument for Treasury discretion. In fact, the study could site no instances of cases that contradicted their conclusion. On the contrary, numerous cases directly and specifically support Treasury discretion. The most poignant and pertinent is *U.S. v Ludey* (1927). Ludey dealt with the issue of adjustment to "cost" in capital gains. The court agreed with Treasury, which had defined "cost" with an adjustment for depreciation, that Congress did not intend to tie the agency to a particular definition of "cost," to the exclusion of other economic principals.