The Daily Dish

A Menu of Capital Gains Taxes

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Eakinomics: A Menu of Capital Gains Taxes

There is a lot of chatter about taxing capital gains, much of it confusing to the average mortal. Let's examine the issues.

I enjoy a good fantasy as much as the next person, so let's imagine that in 2010 a frustrated, conservative economist began a daily rant about federal policy. Let's brand it, say, Eakinomics. Much to his surprise (and the abject horror of the mental health profession) people subscribed by the multitudes and the impact and perceived importance of the enterprise grew yearly. (Like I said: fantasy.) Indeed, after 10 years he received an offer to sell the franchise for $100 million. (Serious fantasy.)

Stripped of the dramatics, this is the situation of many people, especially small/family businesses. There is zero basis (i.e., acquisition cost) and $100 million in capital gains, an average gain of $10 million per year. What are the tax implications of this situation?

1. Current law. Under current law, the capital gain will only be taxed if the capital gain is "realized" – that is, Eakinomics is sold for $100 million. If so, the maximum tax rate is 20 percent. Notice that if it is sold, suddenly the annual income goes from zero to $100 million. The economist would suddenly be "rich" and show up in the top 1 percent, only to return to the bottom end the next year. Lesson: It is not just that the rich have capital gains. It is that people are transitorily perceived to be rich because they realize their capital gains.

   Alternatively, Eakinomics could remain unsold, and gains could continue to accumulate at $10 million a year. Eventually, the franchise is left to his children (truly a dream come true for any child). Let's suppose that happens in 20 years. By then, the market value would be $300 million. The children would receive a "step-up in basis" – the tax code pretends that the children acquired it for $300 million. If they subsequently (how dare they) sell Eakinomics, they would owe taxes only on the difference between the sales price and $300 million.

   Those are the income tax proposals. Meanwhile, over in the estate tax, the $300 million would be part of the estate and taxed at rates up to 40 percent.

2. Biden proposal. The American Families Plan Proposal is to tax capital gains as ordinary income and to raise the top income tax rate to 39.6. There is also a surtax of 3.8 percent from the Affordable Care Act that applies to ordinary income, so the combined capital gains rate would more than double to 43.4 percent. Notice that if Eakinomics were sold this year, the net-of-tax amount would be $56.6 million. If this remaining sum were subsequently taxed in the estate at a 40 percent rate, the overall taxes would total $66 million out of the $100 value today.

3. Accrual taxation. There have been numerous proposals to tax capital gains as they accrue, instead of

when they are realized. In this case, assuming a nice, even $10 million a year in rising value, the tax would be $2 million annually, instead of $20 million in one chunk at the end of 2020. Notice as well that much, much “poorer” people (worth only $10 million) would be paying capital gains taxes.

4. Deemed realization. There are a variety of proposals (notably the Sensible Taxation and Equity Promotion (STEP) Act) that “deem” a realized capital gain when there are transfers. For example, suppose the economist gives Eakinomics as a gift to his children instead of bequeathing it at death. At the moment of transfer, it would be deemed to have been realized and the tax would be due. The same treatment would apply if Eakinomics were placed in a trust. (The truly horrific part of the STEP Act is that it taxes old transfers retroactively; deeming assets transferred long in the past to be realized every 21 years.)

Roughly speaking, that list is what is under discussion. What do we learn from this survey? Lesson one is that the same economic activity is being taxed no matter whether one person (the original owner), multiple people (the children), or a legal entity owns the capital. The amount of economic activity affected determines the impact of the tax. The second lesson is that thinking about capital gains taxation as a tax on the rich can be misleading, especially if the taxpayer is only temporarily rich because of realizing a long-held capital gain. The third lesson is that the cumulative tax rate under the Biden proposal can be prohibitive, and policymakers should take seriously concerns about deterring risk-taking and productivity enhancing activities such as writing Eakinomics. Finally, because people do respond to tax incentives, aggressive capital gains taxers are increasingly trying to dictate when realization takes place, so as to make those responses irrelevant.