Increasing Progressivity by Reforming the Taxation of Capital Income

Testimony before the Subcommittee on Select Revenue Measures

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Chairman Thompson, Ranking Member Smith, and Members of the Subcommittee, thank you for inviting me to testify on how the wealthy face a fundamentally different tax system than other Americans. My name is Jason Oh. I am a tax law professor at the UCLA School of Law and the faculty director of the Lowell Milken Institute for Business Law and Policy. My primary areas of research are tax law and policy and the political economy of taxation.

In my testimony, I will briefly discuss several features of the income and estate taxes that limit the revenue collected from the wealthiest Americans. I will then discuss some possible reforms for raising taxes on the wealthy and increasing the overall progressivity of the fiscal system. There are a few key takeaways. First, the income tax struggles to tax capital income effectively. Second, we can make that system more robust through several reforms: repealing stepped-up basis, shifting to mark-to-market for more assets, and increasing the capital gains rate. Third, these reforms work better in tandem. Finally, some options for reform are more effective than others given the legislative uncertainty about how long reforms will last.

The preferential rate on long-term capital gains, the realization requirement, the ability to borrow against appreciated assets, and stepped-up basis reduce the tax liability of the wealthy and undermine the progressivity of the income tax.

The income tax is intended to be progressive: as a household earns more income, it should pay tax at a higher average rate. The income tax achieves much of its progressivity through a system of increasing marginal tax rates.[1] As a household earns more income, the rate of tax on each additional dollar increases.

Despite this system of progressive marginal rates, some of the wealthiest households pay effective tax rates that are lower, sometimes much lower than the top marginal rate on ordinary income. Simply increasing the top marginal rate will not substantially increase the tax burden for these wealthy households. A few key features of how capital income is taxed drive this result.

First, the wealthy earn a disproportionate percentage of their income in the form of capital gains and dividends. Under current law, long-term capital gains and qualified dividends are taxed at a

[1] Progressivity is best measured after accounting for all taxes and transfers. This section will discuss the progressivity of the income tax both because it is the focus of this hearing and because the income tax is one of the primary tools for achieving progressivity in the fiscal system.

maximum rate of 20%,[2] substantially lower than the 37% top rate on labor income. In 2019, the top 1% realized more capital income ($1.44 trillion) than labor income ($1.31 trillion).[3] The top 0.1% of households earned more than twice as much capital income as labor income.[4] The preferential rate on long-term capital gains substantially reduces the overall progressivity of the income tax. The Treasury Department estimates that the preferential rate on long-term capital gains is the fourth largest tax expenditure at an annual cost of over $100 billion.[5]

Second, the wealthy have more control over when and how much income they realize. Appreciated capital assets are disproportionately owned by the wealthiest Americans. The realization requirement generally waits for the sale of an asset before income is taxed. If a capital asset increases in value from $100,000 to $100 million, that increase in value is not taxed until the asset is sold. The realization requirement also allows taxpayers to selectively harvest their capital losses to offset capital gains that they do realize. The realization requirement creates great flexibility for when and how much capital gain a household will recognize.

Third, wealthy households can extract cash from appreciated assets without triggering tax. The wealthy can simply borrow using their appreciated assets as collateral. Borrowing against these assets does not trigger the realization of taxable income, even if the amount borrowed exceeds the asset's basis. Depending on the assets pledged and the amount borrowed, the interest rates on these secured loans can be very low. By borrowing, the rich can fund their lifestyles using the economic value of their appreciated assets without paying any income tax.

Fourth, stepped-up basis creates a strong incentive for wealthy households to avoid selling their capital assets. Under current law, untaxed capital gain disappears when the taxpayer dies. The heirs of the deceased taxpayer never pay tax on this capital gain either. The Treasury Department estimates that stepped-up basis is the sixth largest tax expenditure, costing over $50 billion each year.[6]

This is just a quick summary of the basic contours of the income tax faced by wealthy households with substantial capital assets. It is a tax system of lower rates and voluntary recognition of income, the timing of which is controlled by the taxpayer. The rich can pull money out of investments without any tax and evaporate capital gain by holding onto assets until

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[2] Long-term capital gains above a certain limit are also subject to a 3.8% Medicare surtax.
[3] U.S. Dept. of the Treasury, Distributional Analysis of the U.S. Tax System, https://home.treasury.gov/system/files/131/Distribution-of-Income-by-Source-2019.pdf.
[4] Id.
[5] U.S. Dept. of the Treasury, Tax Expenditure Estimates 2021, https://home.treasury.gov/system/files/131/Tax-Expenditures-2021.pdf. The Treasury Department separately estimates that the preferential rate on qualified dividends costs over $30 billion annually.
[6] U.S. Dept. of the Treasury, Tax Expenditure Estimates 2021, https://home.treasury.gov/system/files/131/Tax-Expenditures-2021.pdf.

death. These are basic structural features of the income tax.[7] We haven't even mentioned tax evasion[8] or itemized deductions,[9] both of which are much more important for the wealthy.

The rest of America faces an income tax of higher rates, involuntary timing, and consumption tied to paying taxes.

Contrast this with the income tax for other Americans. The maximum tax rate on labor income is substantially higher than the preferential rate on long-term capital gain. Households have almost no control over when income is taxed - they pay tax when income is earned or received. These households have virtually no choice in paying their income tax liability because almost all of their income is subject to wage withholding or information reporting.[10] Thus, the level of tax compliance among lower- and middle-income households is actually higher than for the wealthy.[11] Unlike the wealthy, most lower- and middle-income households lack substantial assets against which to borrow. Consumption is closely tied to their currently taxable income. Their charitable and other expenses yield limited tax benefits because most of these households do not itemize their deductions.[12]

Repealing stepped-up basis, transitioning to a mark-to-market system, and raising the capital gains rate will improve the progressivity of the tax system and raise substantial revenue. But it is important to pursue these reforms in tandem.

How can we improve the taxation of wealthy taxpayers so that the tax system is more progressive at the top of the income and wealth distribution? Can we simultaneously raise revenue to fund important federal spending priorities?

The first measure is to repeal stepped-up basis. There are two basic approaches. One approach would be to adopt carry-over basis: the transferee would inherit the deceased's basis. Any appreciation would be preserved for future taxation when the transferee sells the asset. This

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[7] It is notable that the Treasury Department and Joint Committee on Taxation treat the realization requirement as a basic feature of a normal income tax and therefore do not even include the realization requirement in their tax expenditure estimates.

[8] The Center for Equitable Growth recently estimated that the tax gap is much larger among the wealthy than lower- and middle-income households. John Guyton et al., Tax Evasion at the Top of the Income Distribution: Theory and Evidence, https://equitablegrowth.org/working-papers/tax-evasion-at-the-top-of-the-income-distribution-theory-and-evidence/.

[9] For example, the rules governing the charitable contribution deduction are much more generous to the wealthy. Conceptually deductions should be limited to the cost basis of the relevant property. This is the rule in other contexts like the casualty loss deduction. Taxpayers with appreciated property can deduct not just their basis but the FMV of the donated property (if the asset has been held for over a year).

[10] John Guyton et al.

[11] Id. (their model finds that unreported income as a fraction of actual income is 7% for the bottom 50% of households and 20% for the top 1%). Much of this gap is driven by the relative importance of pass-through income for wealthy households.

[12] The Tax Foundation estimates that the total percentage of taxpayers that itemized deductions was 13.7% in 2019. The percentage of itemizers in the top 1% was 91.5%. Tax Foundation, How Many Taxpayers Itemize Under Current Law, https://taxfoundation.org/standard-deduction-itemized-deductions-current-law-2019/

approach has the advantage of avoiding valuation issues and equalizing the income tax treatment of lifetime and testamentary gifts. The CBO has estimated that this approach would raise roughly $110 billion over the ten-year budget window.[13] The second approach is to treat death as a realization event (perhaps with an exemption and some carveouts). The latter approach has the advantage of raising revenue more quickly.

The second important change is to address the realization requirement. As discussed above, the income tax is woefully ineffective at taxing those who have substantial appreciated assets, avoid realizing gains. and borrow to fund their lifestyles. This technique is less effective if stepped-up basis is repealed. However, many wealthy households will continue to avoid selling their capital assets because of the deferral advantage of delaying the payment of tax. Delaying realization also gives taxpayers a valuable option on future Congressional action either lowering the capital gains rate or reinstating stepped-up basis.

There are several proposals for addressing the problems caused by the realization requirement. These range from repeal (i.e., a shift to mark-to-market taxation) to deferral charges applied when assets are sold.[14] Some proposals are better than others. A deferral charge regime would neutralize the deferral advantage of waiting to realize capital gains. But that reform would do nothing to curb the option value of waiting for future legislative change.[15]

A mark-to-market approach would repeal the realization requirement and include in income the yearly increase in the value of a taxpayer's assets. This would address the option value issue by currently taxing the wealthy but creates a set of drafting challenges including the valuation of illiquid assets, the treatment of debt, and the deductibility of unrealized losses (when assets decline in value).[16] Evaluating in detail the relative merits of these approaches is outside the scope of my testimony, but it is important to center the realization requirement when we discuss why the income tax struggles to tax the wealthy.[17]

An increase in the capital gains rate to match ordinary income could raise significant revenue if accompanied by repeal of stepped-up basis and a shift to mark-to-market. But raising the capital gains rate without these other changes may be much less effective.[18]

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[13] Cong. Budget Office, Options for Reducing the Deficit, 2021-2030, https://www.cbo.gov/system/files/2020-12/56783-budget-options.pdf.

[14] Deferral charges are designed to neutralize the time-value-of-money advantage of delaying gain recognition. The charge would be applied when the capital asset is sold.

[15] David Kamin & Jason Oh, The Effects of Capital Gains Rate Uncertainty on Realization, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3365305.

[16] Lily Batchelder & David Kamin, Taxing the Rich: Issues and Options, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3452274. The authors discuss a number of different versions of mark-to-market reform. For example, mark-to-market could apply to all assets or just to publicly traded securities.

[17] See id. for discussion of various options.

[18] Raising the capital gains rate would address certain problems even if the other reforms were not enacted. For example, it would end the carried interest debate and tax private equity fund managers at the same tax rate as everyone else who works for a living. A higher capital gains rate would effectively shut down conversion tax shelters that convert ordinary income into capital gain. The higher capital gains rate would raise additional revenue from taxpayers (like entrepreneurs who sell their companies) who do not control the timing of gain recognition.

Consider a scenario where only two of these three reforms are enacted. For example, President Biden proposes to increase the capital gains rate and end stepped-up basis but retain the realization requirement.[19]

To figure out how this change would affect the pace of realizations requires an estimate of the elasticity of capital gain realization. This elasticity measures how realizations change when the capital gains rate increases. There is both a permanent response to the tax rate change and a transitory response. There are many studies using a variety of methodologies to measure these elasticities. Depending on which elasticity a model uses, projections will show the proposed capital gains rate either losing or gaining revenue (assuming the realization requirement stays in place).

I am not sure what elasticity we should assume. The proposed capital gains rate of 39.6% (43.4% including the Medicare surtax) is well outside the range of capital gains rates that have been historically observed. There is no reason to expect that the elasticity of capital gains realization should be constant. To the contrary, David Kamin and I have argued that we should expect elasticities to vary significantly.[20]

Holding onto assets will remain attractive because it gives taxpayers a valuable option on future Congressional action either lowering the capital gains rate or reinstating stepped-up basis. The proposed capital gains rate would be the highest in more than half a century. Taxpayers could realistically expect Republicans to reduce capital gains rates the next time they control Congress.

This would not be the first time that Congress equalized the capital gains and ordinary income tax rates. In the Tax Reform Act of 1986, the rates were equalized at 28%. In the decade following that reform, the ordinary income rate increased to 39.6% and the capital gains rate dropped to 20%. Rate harmonization is not necessarily permanent.[21]

Because any reform is subject to future legislative uncertainty, I think it's particularly important to combine the capital gains rate increase with both a repeal of stepped-up basis and reform of the realization requirement. A mark-to-market regime would, of course, also be subject to legislative uncertainty. But even if it were repealed and even if wealthy households decided to hold onto their capital assets, a mark-to-market regime would raise revenue in the interim.

Another way to raise additional tax revenue from the wealthy is to improve the federal estate and gift tax or adopt a federal wealth tax or a federal value-added tax (VAT). But the political viability of these alternatives seems uncertain at best.

An alternative (or additional) approach would be to use something other than the income tax to increase taxes on the wealthy. The progressivity of the overall tax system is much more

[19] Senator Ron Wyden, the Chairman of the Senate Finance Committee, has been outspoken about his desire to pursue mark-to-market reform.
[20] David Kamin & Jason Oh, The Effects of Capital Gains Rate Uncertainty on Realization, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3365305.
[21] Will Tax Reform Be Stable?, 165 Univ. of Pennsylvania Law Review 1159 (2017).

important than the progressivity of the income tax in isolation. Some possibilities include a more robust estate and gift tax, a federal wealth tax, or VAT. Each of these instruments have different strengths and weaknesses, but they all would achieve greater taxation on wealthy households without requiring changes to the income tax.

The estate and gift tax applies to gratuitous transfers of money and property. As currently designed the estate and gift tax does little to raise revenue[22] or to address large accumulations of hereditary wealth. The estate and gift tax includes an unlimited spousal exemption and a combined exemption for married couples of $22.36 million. Congressionally sanctioned planning techniques like grantor-retained annuity trusts and charitable split interest trusts along with judicial surrender on valuation have completely undermined the estate tax.[23] It is regularly called a “voluntary tax” and even the largest estates often pay little in estate tax. There seems little political enthusiasm for expanding or reforming the estate tax. President Biden omitted estate tax reform from his recent proposals.

I am skeptical whether the current Supreme Court would uphold an annual wealth tax. Despite its prevalence around the globe, a federal VAT has been a political nonstarter for decades in the United States.

Given the political (and judicial) reluctance to embrace these alternative approaches, the remaining option is to improve the taxation of capital income as discussed above. It may be advisable to focus on capital income taxation even if the other taxes were politically viable. It can often be easier to improve an existing fiscal instrument than creating a new one from scratch. Many of the challenges facing a switch to mark-to-market (like valuing assets annually) would have to be solved in other approaches like a wealth tax.

Increasing the progressivity of the fiscal system is best addressed through both tax and spending changes.

Although we often discuss the progressivity of taxes, the more important measure of progressivity is the net effect of tax and spending policies. Pairing tax increases on the wealthy with spending programs focused on low and middle-income households could dramatically improve the progressivity of the overall fiscal system. There are several such spending programs in President Biden’s proposals including (1) making the expanded child tax credit permanent, (2) expanding access to childcare for low-income families, (3) increased Medicaid funding, and (4) universal access to pre-kindergarten.[24]

Thank you again for the invitation. These are pressing issues for the American public, and I look forward to addressing them with you.

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[22] The estate and gift tax raises less than 1% of federal revenue.

[23] As an example of the latter, consider the recent Tax Court decision that Michael Jackson’s image rights are only worth $4 million. Determining the value of illiquid or unique assets like Mr. Jackson’s image rights is difficult, but in the estate and gift tax, it is possible to cut in half the value of even publicly-traded, exchange-listed stock with a minimum of structuring.

[24] https://joebiden.com/caregiving/