TAXING CAPITAL GAINS OF HIGH-INCOME TAXPAYERS

Robert McClelland and Lillian Hunter

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EXECUTIVE SUMMARY

The current tax treatment of long-term capital gains—the profits from selling assets, such as stocks, businesses, and real estate, that have been held for at least a year— faces efficiency and equity challenges. For example, some wealthy taxpayers can escape paying capital gains taxes altogether by passing on assets to their heirs, because they are not taxed until the assets are sold.

In recent years, with mounting federal deficits, policymakers have put forward various proposals to raise the tax rate on long-term capital gains for high-income taxpayers. Although members of the next Congress and new administration may propose to reduce the tax rate, others may look to an increase as a way to offset the cost of extending expiring provisions of the Tax Cuts and Jobs Act of 2017 (TCJA) or address historical federal debt levels. This brief examines the feasibility of proposals to increase capital gains taxes on high-income households, offers considerations for creating new proposals, and explores potential implementation challenges.

Current Law on Long-Term Capital Gains

Under current US tax law, long-term capital gains are taxed at a rate of 23.8 percent for high-income individuals, while short-term capital gains and ordinary income are taxed at a maximum of 40.8 percent.

Recent proposals have aimed to increase the tax rate on long-term capital gains for high-income individuals. As part of the 2025 fiscal year budget, for example, President Biden proposed raising the capital gains tax rate to 39.6 percent for individuals with incomes over $1 million, and taxing unrealized gains at death for estates exceeding $5 million ($10 million for joint filers).

Considerations for a New Capital Gains Tax Proposal

To create a tax system that raises revenue in a more efficient and equitable manner, policymakers should consider the following:

- **Setting an appropriate tax rate:** While increasing the capital gains tax rate can generate more revenue, it may also incentivize taxpayers to defer realizing their gains or rush to realize them before the new policy is enacted. Policymakers should aim to find the right balance between increasing revenue and minimizing tax avoidance behaviors. That may not be the same rate as ordinary income.
- **Adjusting income thresholds:** Policymakers can set an income threshold for higher long-term capital gains taxes. A threshold at $1 million or below would apply to more taxpayers and reduce opportunities for them to avoid the tax.
- **Reforming the step-up in basis:** Step-up in basis allows taxpayers to pass on unrealized capital gains to heirs tax free. Eliminating or modifying it would ensure unrealized gains are taxed, preventing the permanent avoidance of capital gains taxes.

Increasing the tax rate on long-term capital gains for high-income individuals has the potential to reduce federal deficits and address wealth inequality. But careful design and implementation are necessary to prevent tax avoidance by high-income and wealthy families.

INTRODUCTION

To address the growth in deficits and substantial income inequality, members of Congress and the executive branch have put forward new approaches to taxing the very rich. Several tax proposals have been offered in recent years, but one that has gained a lot of traction is raising the tax rate on long-term capital gains for people with incomes above a threshold. Former President Obama, in his state of the union address in 2015, proposed to tax the long-term capital gains for those with more than $500,000 in income at the same rate as ordinary income. More recently, President Biden proposed a similar increase on long-term capital gains for those with taxable incomes of more than $1 million. However, taxpayers may have significant latitude in avoiding these taxes.

In this brief, we explore the feasibility of implementing a tax increase on long-term capital gains for the highest-income taxpayers. First, we review current law and how it has evolved over time in relation to ordinary income taxes. Second, we offer several considerations for developing a tax on capital gains targeted at high-income taxpayers. Finally, we turn to recent proposals, shedding light on unrecognized problems that may arise if implemented as well as suggesting improvements.

I. WHAT ARE LONG-TERM CAPITAL GAINS?

Any of the profits made from holding a capital asset—such as share of stock, businesses, plots of land, or works of art—for at least a year are considered long-term capital gains. When a taxpayer sells a capital asset (called realizing), they owe taxes on the amount of the sale price that exceeds the purchase price plus fees and commissions (called cost basis).

Under current law, realized long-term capital gains are taxed at a maximum rate of 23.8 percent, while the top rate on short-term capital gains (profits from assets held for less than a year) is 40.8 percent, which is the same as for ordinary income (e.g., wages and salaries).[1] Taxpayers may use short-term losses to offset short-term gains and long-term losses to offset long-term gains. Up to $3,000 in losses can be used to offset ordinary income as well, and additional losses can be carried forward to offset future gains.

The preferential tax advantage on long-term capital gains compared with ordinary income tends to disproportionately benefit those at the top of the income distribution. In 2021, people with more than $1 million in adjusted gross income realized $1.3 trillion in long-term gains, representing nearly 70 percent of all long-term capital gains; more than 42 percent were realized by those with more than $10 million. Capital assets also generate a tax burden only when sold, therefore any accumulated value remains untaxed before a sale.

Furthermore, capital assets may be transferred to an heir without incurring capital gains taxes. When a capital asset is transferred via inheritance, the cost basis becomes the current fair market value rather than the original purchase price (called step-up in basis). In effect, when a capital asset is passed down, any previous increases in value permanently escape capital gains taxation.

Problems with Current Law

Since the 1970s, federal tax experts have recognized that the tax advantage on long-term capital gains creates a serious deficit in federal tax revenues and perpetuates wealth inequality. Because people with more wealth have a greater ability to purchase and hold capital assets, long-term capital gains are highly concentrated at the top of the income distribution, with a large share of wealthy taxpayers' incomes receiving preferential tax treatment. On average, 40 percent of the adjusted gross income of those who earned at least $1 million in 2021 was in the form of long-term capital gains.[2]

Proponents of the current arrangement see the lower tax as offsetting taxes already paid at the corporate level, spurring economic growth, and mitigating the tax penalty on savings under the individual income tax.[3] C corporations are taxed on their profits, and dividends or capital gains from sale of their stock are taxed again at the individual level. The preferential rate reduces the amount of double taxation on corporate stocks and, more generally, reduces the income tax system's bias against saving. The extra savings and investment stimulated by that rate can increase economic growth.

However, by allowing the cost basis to adjust to fair-market value when capital assets are transferred to an heir, the current law permits assets to permanently avoid taxation, resulting in loss of federal tax revenue. This not only contributes to wealth inequality but also causes investors to "lock in" to poorly balanced and less productive portfolios.[4]

Under some conditions, taxpayers can even utilize their unrealized gains while they are still alive, using a strategy known as buy-borrow-die (McCaffery 2016). For example, a person can borrow funds using their capital assets as collateral, rather than selling their assets to generate a profit and incurring a tax bill. When the person passes away, their heirs must repay the loan and any accrued interest, but they do not owe capital gains taxes because of the step-up in basis. As long as the asset gains more value than the total interest due, the heirs inherit at least as much as the original value of the asset.

Proposals to Raise the Long-Term Capital Gains Tax

Historically, taxes on long-term capital gains have been lower than on income taxes. Over the past two decades, the two rates have often moved in parallel, increasing or decreasing at roughly the same time (figure 1).[5] But the parameters for what qualifies as taxable long-term capital gains has varied over time.

From 1934 to 1986, only a portion of long-term capital gains was taxed. For example, from 1978 to 1986, only 40 percent of gains was taxable. The definition of long term has also varied: in 1938, assets were long-term if held for 18 months; in 1942, it was cut to six months; and in 1977, it was raised to the current value of one year.

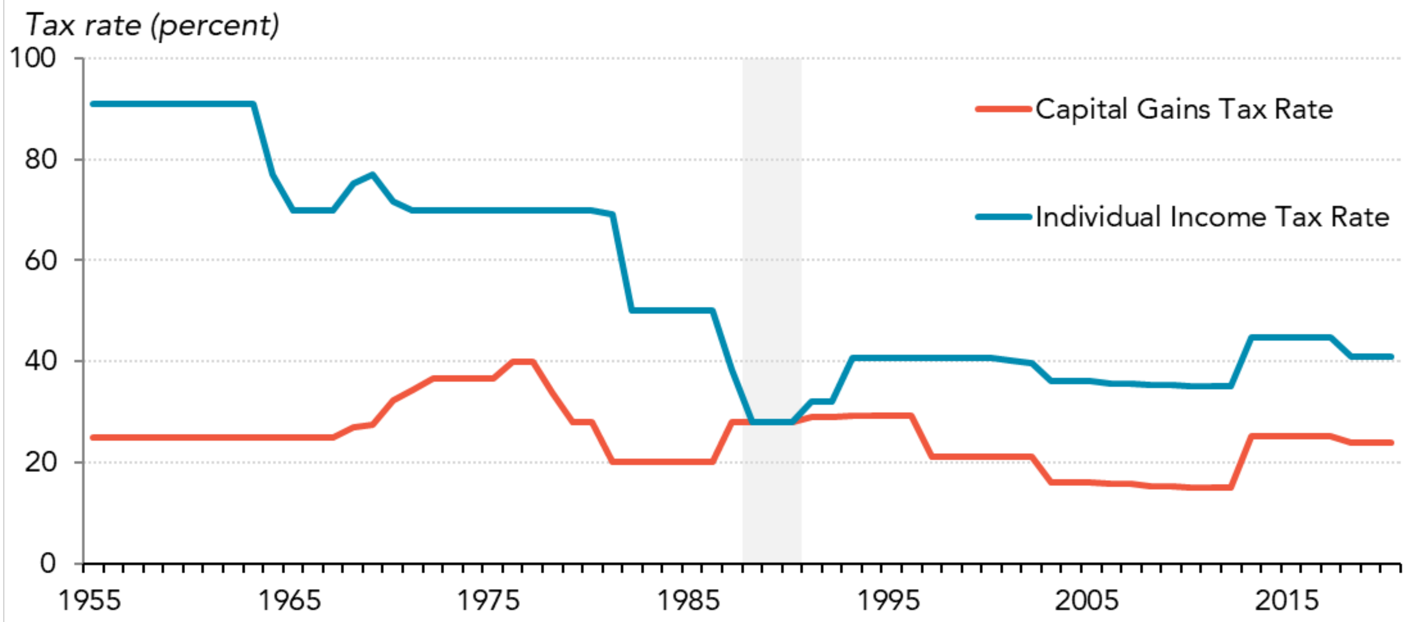
In 1986, the exclusion of some long-term capital gains from tax was eliminated, and the Tax Reform Act of 1986 set the maximum statutory rate on long-term capital gains equal to the maximum statutory rate on ordinary income at 28 percent. This equality lasted from 1988 to 1990 and eliminated the incentive to invest in assets held for long-term gains simply for the lower tax rate. However, it may have worsened the lock-in effect.

Those years have proven to be an exception to the rule. The top statutory rate on ordinary income was raised to 31 percent in 1991, while the top statutory capital gains rate was lowered to 20 percent in 1997,[6] lowered again to 15 percent in 2003, then raised to the current 20 percent in 2011. In 2013, the net investment income tax was enacted, which applied a surtax of 3.8 percent on most types of capital income, including capital gains, above an income threshold.[7]

FIGURE 1

Maximum Capital Gains and Individual Income Tax Rate

Tax years 1955–2020



Sources: US Department of the Treasury (2016), Urban-Brookings Tax Policy Center calculations.
Note: The maximum rates include the 3.8 percent tax on net investment income (2013–) and adjusts for the phase out of itemized deductions (1991–2009, 2013–2017).

Several groups have since proposed raising the maximum rate for long-term capital gains. In 2010, the National Commission on Fiscal Responsibility and Reform (commonly known as the Simpson-Bowles commission) proposed, once again, equalizing the top rates for long-term capital gains and ordinary income at 28 percent (NCFRR 2010). In 2012, the Domenici-Rivlin Debt Reduction Task Force made a similar proposal, with an exclusion for the first $1,000 in gains.[8]

The two proposals, like the Tax Reform Act of 1986, did not address the problem with step-up in basis, which incentivizes taxpayers to delay realization and have their gains escape taxation at death. However, in 2015, then-President Barack Obama proposed raising the tax rate on capital gains to 28 percent for couples with at least $500,000 in income as well as taxing unrealized gains at death.[9] Unlike the other proposals mentioned in this section, it did not equalize the two tax rates; instead, it left the rate on realizations of long-term capital gains lower than the top rate for ordinary income.

II. CONSIDERATIONS FOR DESIGNING A NEW CAPITAL GAINS TAX RATE

When designing a new long-term capital gains tax proposal, three fundamental factors must be addressed:

1. Where to Set the Tax Rate

While increasing the tax rate on long-term capital gains should lead to an increase in the amount of tax collected, policymakers need to consider how the magnitude of the increase may affect taxpayer behavior. Theoretically, taxpayers with consistent, very high incomes would be more responsive to changing tax rates than other filers, given they have the ability and resources to hire sophisticated financial advisors.

Some proponents of lower capital gains taxes argue that raising the rate will exacerbate the lock-in effect by giving taxpayers an incentive to not realize their gains. Past research of anonymized individual tax data has supported this reasoning, finding that permanently raising tax rates on capital gains by 10 percent lowered realizations by 7 to 8 percent (Dowd and McClelland 2019; Dowd, McClelland, and Muthitacharoen 2015). One recent report using aggregate state data found only a 3 percent decline (Agernsap and Zidar 2021), while another report using individual tax data found a 6 percent decline (Dowd and McClelland 2024).

McClelland and Smith (2023a), however, find that persistent millionaires are not more responsive to changes in the tax rate of capital gains than taxpayers with lower incomes, even though they have greater capacity to respond. The research includes several analyses of alternate causes or assumptions, and they verified the robustness of this result.

Conversely, taxpayers may rush to realize existing capital gains at the lower rate before the new policy goes into effect, using it as an opportunity to rebalance their portfolio or simply repurchase assets they just sold.[10] Any anticipatory sales would lower the amount of revenue generated by the new, higher rates, possibly for many years.

Following are examples of taxpayer behaviors in response to previous capital gains tax hikes:

- **The Tax Reform Act of 1986** increased the maximum tax rate on long-term gains from 20 percent to 28 percent, the same rate as ordinary income at the time. The year before the policy went into effect, realizations were more than 60 percent higher than a linear model would have predicted. Next year, realizations fell to about 70 percent of the predicted amount and did not return to the 1985 level until a decade later.[11] As a result of these declines, while the top tax rate increased by 40 percent between 1985 and 1987, revenues increased by only 26 percent. Most of that revenue increase was predictable using existing trends: the actual revenue in 1987 was only 8 percent higher than what a linear model would have predicted.[12]
- **The 2013 tax hike** increased the maximum tax rate on capital gains from 15 percent to 23.8 percent. Despite a larger proportionate increase than in 1986, capital gains realizations were only 30 percent higher than predicted in 2012 and fell only by 13 percent than predicted in 2013. The smaller effects in 2012 and 2013 could be attributed to a smaller pool of unrealized gains after the Great Recession in 2009. Also, the new policy was not passed until January 1, 2013, potentially limiting taxpayer knowledge of the increase, even though it was actively discussed far enough in advance to give them time to realize gains prior to implementation (Auten, Splinter, and Nelson 2016).

2. Where to Set the Income Threshold

How high policymakers decide to set the income threshold for long-term capital gains tax rate will determine not only how much additional revenue is generated but also how extensively inequality concerns are addressed. A higher threshold will generate less revenue and do less to allay inequality concerns.

A $10 million threshold, for example, means that taxpayers earning up to $9,999,999 are unaffected, even though they have higher incomes than all but a few taxpayers. A threshold of $1 million would affect more high-income taxpayers, but it would still leave those with $999,999 unaffected. Furthermore, higher thresholds may offer taxpayers near the cutoff (who typically have larger shares of their income in capital gains realizations) more opportunities to time their realizations to keep their income under the threshold. But lower thresholds, while it may offer fewer opportunities for timing realizations and raise more revenue, subject people with lower incomes to the new tax rate.

Another issue is indexing thresholds for inflation. By not indexing, a tax meant for high-income taxpayers may affect lower real incomes and eventually apply to a much larger share of taxpayers than originally intended. For example, the alternative minimum tax applied to a very small number of taxpayers in 1970 but because its thresholds were not indexed for inflation, about 5.2 million taxpayers were affected by 2017.[13]

Some taxpayers will have taxable income above the threshold every year and thus must pay a potential tax, but many will not. Between 2012 and 2021, about two-thirds of taxpayers who had more than $1 million in taxable income, including long-term capital gains, had it for three or fewer years (McClelland and Smith 2023b). Reasons for exceeding the threshold for only a few years included the one-time sale of a business, an interest in a business, or an expensive home. Because their incomes are not consistently above the threshold, they have significant latitude in shifting or spreading out their realizations and deductions to avoid paying the higher tax rate. How much of a person's capital gains realizations can be deferred depends on several factors, such as the following:

- **Value of assets held:** The value of a taxpayer's capital assets affects the flexibility of deferring or spreading out realizations. If policymakers set a higher income threshold, fewer capital gains would count toward the value needed to trigger the new tax rate. It would also likely target taxpayers who derive a greater share of their income from capital gains; in other words, taxpayers who have more latitude when timing their income.
- **Type of assets held:** The composition of capital assets in a taxpayer's portfolio plays a key role in determining how much can be realized quickly. Some assets, such as stocks and bonds, are privately owned and very liquid. Other assets may be owned as part of a partnership or S Corporation and require coordination among parties with different motivations. Over the long run, contracts could change; but in the very short run, some taxpayers will be subject to contracts that would not allow them to adjust their realizations to avoid the new, higher rate. .

Consider, for example, a taxpayer with a taxable income of $750,000 from a salary and $1.25 million from unrealized gains. If they needed to immediately realize all their gains, under current law, they would pay the same 23.8 percent tax rate on all $1.25 million since their income exceeds the current threshold. If the tax rate on gains above $1 million in taxable income was raised, then $250,000 would be taxed preferentially (the amount below the threshold after accounting for the taxpayer's salary) and $1,000,000 would be taxed at the higher rate. However, if the taxpayer spread out their realizations over

- two years, then $500,000 would be taxed preferentially and $750,000 of gains would be taxed at a higher rate;
- three years, then $750,000 would be taxed preferentially and $500,000 of gains would be taxed at the higher rate;
- four years, then $1 million would be taxed preferentially and only $250,000 of gains would be taxed at the higher rate; or
- five years, then all the gains would be taxed at the preferential rate.

Phase-in regions, where the increased tax rate could apply to an increasingly large share of capital gains for incomes between $1 million and $1.5 million, are one way to reduce, but not eliminate, the incentive for taxpayers to spread out their realizations. The capital gains of taxpayers with incomes in the phase-in region would not be subject to the maximum, and so they would have a smaller incentive to rearrange gains. But a disadvantage would be that the effective tax rate can dramatically exceed the statutory rates. For example, suppose the tax rate on realizations is 20 percent for incomes below $1 million and increases linearly to 37 percent at $1.5 million. A taxpayer with $1 million of salary income and $400,000 of realizations would pay $134,400 in taxes on those realizations. If they realized another $100,000, the taxes would increase by $50,600 to $185,000. That is an effective tax rate of 50.6 percent, much higher than the maximum statutory rate of 37 percent.

Proposals to tax high-income or high-wealth taxpayers could spur some to attempt to hide their income or wealth and thus evade taxes. It could also encourage some to migrate to other countries, although this scenario is unlikely. First, evidence suggests that the very wealthy do not migrate within the United States to pay preferential state tax rates (Young et al. 2016). Second, US citizens are taxed on a worldwide basis, so leaving the country would not relieve them of their tax burden, unless they also renounced their citizenship.

3. What to Do about Step-Up in Basis

Proposals that do not include or are paired with a proposal to change step-up in basis at death strongly encourage taxpayers to never realize gains and pass them to heirs free of capital gains taxes. While little research exists on how much unrealized gains would be deferred under a new, higher long-term capital gains tax rate, current evidence shows that unrealized gains at death account for a substantial share of estates and that those assets have been held for many years.

A report by the US Department of the Treasury find that in 2010, decedents owned approximately $59 billion in assets, of which $23 billion (or 39 percent) was unrealized gains (US Treasury 2014).[14] Data from the report show that, among assets with known purchase dates, more than 85 percent of unrealized gains were from assets held for at least 10 years, which suggests that high-wealth taxpayers hold substantial amounts of assets for many years, accumulating large amounts of unrealized gains.

Those faced with a substantial tax increase may begin to use or increase their use of the buy-borrow-die strategy. However, the magnitude of this change in behavior will depend on many factors, including the real cost of borrowing. If the total cost of borrowing is low, the strategy becomes more cost efficient. If the cost of borrowing is high, the strategy could exceed the taxes on gains realized during life, which would mean a smaller after-tax estate for heirs. The size of the reduction in realizations will vary across taxpayers and over time. In general, higher tax rates will lead to fewer taxpayers using the buy-borrow-die strategy.

III. THE BIDEN ADMINISTRATION PROPOSAL

The Biden administration, as part of its proposed 2025 fiscal year budget, outlined increasing the tax rate for long-term capital gains to the same rate as ordinary income for taxpayers with annual taxable incomes above $1 million. If the top rate on ordinary income is also raised, as outlined in the proposed budget, the maximum tax rate on long-term capital gains would be 39.6 percent. With the inclusion of the 3.8 percent net investment income tax and a proposed 1.2 percentage increase for those with incomes above $400,000, the effective maximum rate would be 44.6 percent. The proposed budget also includes a tax on unrealized gains at death above $5 million (or $10 million for joint filers).

Although an income threshold of $1 million limits the number of affected taxpayers, a rate of 39.6 would still apply to about 63 percent of long-term capital gains. Among taxpayers with more than $1 million in taxable income, about 40 percent report long-term capital gains. In this section, we discuss the Biden proposal as an example of how to apply the three fundamental factors above.

1. Where to Set the Tax Rate

As noted previously, introducing a higher tax on capital gains may accelerate realizations between the announcement and implementation of the policy as taxpayers attempt to avoid paying the tax increase. The Tax Policy Center predicts that, under current law, taxpayers with more than $1 million of taxable income will realize $742 billion in 2025, generating about $169 billion in federal revenues.

If something like the Biden budget proposal were enacted without the accompanying rate increases on ordinary income (meaning an increase in the maximum capital gains rate from 23.8 percent to 40.8 percent) and taxpayers subject to the tax increase did not change their behavior, it would generate about $120 billion in additional federal revenue in 2025.

But taxpayers would certainly avoid realizing their gains in response to a tax hike of that size. How would this affect the federal revenue? In 1987, following a 40 percent increase in tax rates, realizations were about 30 percent below their predicted value. The Biden proposal would increase tax rates by about 71 percent, which means that a proportionate decline in realized gains would be about $527 billion, generating about $36 billion in additional revenue. Benchmarking the Biden proposal against the 2013 increase—when tax rates increased from 15 percent to 23.8 percent and realizations fell by only 15 percent—a similar increase in 2025 would lead to realizations of $592 billion and $61 billion in additional revenue.

Lastly, recent research on the responsiveness of high-income taxpayers to changes in tax rates on realizations also suggests that an increase from 23.8 percent to 40.8 percent would lead to about $527 billion in gains and $36 billion in additional revenue (McClelland and Smith 2023b). But the actual changes could differ from these numbers for several reasons. First, the estimate omits the change in revenue as a result of taxpayers rushing to realize gains before the law took effect. Second, it does not account for the timing of realizations discussed in McClelland and Smith (2023a), which estimate that up to a third of realizations could be timed to stay under the threshold. Assuming half of that estimate, about 16 percent of realizations, were timed and the remaining taxpayers reduced their realizations as shown in McClelland and Smith (2023b), it would lead to about $507 billion in realized gains, generating $28 billion in additional revenue.

Finally, research in McClelland and Smith (2023b) is based on numerous changes in state taxes, but those changes are typically less than 5 percentage points.[15] With changes that small, some taxpayers may not be aware of a policy change and other factors may play a larger role in their realization decision; that is, taxpayers may respond more strongly to the magnitude of the increase in the Biden proposal. Furthermore, there may be a bandwagon effect in which investors sell assets in response to others selling theirs.

Without a bandwagon effect, Dowd and McClelland (2019) demonstrate that capital gains realizations respond to large differences in tax rates just about as much as to small changes. For example, a 10 percent increase in tax rates lead to an 8 percent decline in average realizations, and while such increase in tax rates may cause a sharp short-term reaction, the long-term reaction will likely be of similar magnitude.

2. Where to Set the Income Threshold?

Because the Biden administration proposed raising the tax rate only for people with more than $1 million in taxable income, the drop in realizations would occur among those whose incomes are always above the threshold. Taxpayers whose incomes are occasionally above the threshold or above it once would have more difficulty acting in advance of enactment. Some could sell at a predetermined time, such as retirement, and others may have contractual obligations that prevent them from accelerating the sale of their assets. Some may not even know that their realizations and other income will exceed the threshold.

Once a new policy was in place, those who are only occasionally above the threshold because they have capital gains realizations with easily liquidated assets would have many opportunities to time their realizations and stay below the threshold. It would be straightforward to change the timing of personally held liquid assets, such as stocks, bonds, and various mutual funds, and more “lumpy” assets could be sold through installment sales.

In a recent study, McClelland and Smith (2023b) projected how much taxpayers may reduce their taxable gains above the $1 million threshold by timing realizations. They consider avoidance strategies where taxpayers defer gains over a maximum period of five years, ten years, and indefinitely. Using taxpayer data from 2012 to 2021, the 5-year avoidance scenario resulted in a 10 percent reduction in gains above the $1 million threshold and a 3 percent drop in realizations; the 10-year avoidance scenario showed that 16 percent of gains could escape the tax increase, with realizations falling by about 5 percent. These timings correspond to decreases in new revenue from $742 billion to $720 billion under the 5-year scenario and to $705 billion under the 10-year scenario.

These estimates of changes in gains from personally held assets represent about a third of all potentially taxable gains. Realizations from partnerships and S corporations may need agreements from other investors, and some estates and trusts are highly structured contracts that do not allow for strategic timing of realizations. Although there are many different types of partnerships, generally those that are realizing gains do so for all the partners and distribute them according to a preset formula. In that case, one partner cannot decide to forgo accepting a distribution of gains in a given year because it would raise their income above a threshold.[16] Some S corporations could face similar restrictions.

Given the difference in capital gains taxes for those with incomes above or below a threshold, it is likely that new agreements would be constructed to allow some partners to stay below the threshold. McClelland and Smith (2023b) show that spreading realizations from assets of all types, not just personally held assets, over five years would reduce realizations subject to the tax increase by 9.9 percent. This would cut additional federal revenue from $126 billion to $113 billion. However, because of the difficulty in rearranging or resetting partnerships and other agreements, a 10-year time frame may be more realistic.

Other methods taxpayers could employ to reduce their income below the $1 million threshold are more difficult to quantify. One method is for taxpayers to time their charitable contributions to coincide with realizations. McClelland and Smith (2023b) show that, in 2017, among taxpayers with at least $1 million in adjusted gross income, 22 percent had more contributions than realizations. For many of those taxpayers, their contributions pushed them under the $1 million threshold for taxable income. Another method is for taxpayers to realize gains and losses in the same year. Although it may seem intuitive that investors do this, research suggests that taxpayers are averse to realizing losses, even when it is in their best interest. However, the extremely large difference in tax rates for those above and below the threshold may push some taxpayers to consider the timing of losses and gains.

Following are changes to the Biden proposal that could mitigate some taxpayer responses that would lead to losses in revenue:

- **Creating a phase-in region,** rather than subjecting all gains above $1 million to the new tax rate at once, could reduce, though not eliminate, taxpayers' incentive to engage in the methods discussed above to stay below the income threshold. But this would raise the effective marginal tax rate in the phase-in range.
- **Basing the threshold on adjusted gross income,** rather than on taxable income, would eliminate the incentive to use deductions such as charitable contributions to stay below the threshold, because adjusted gross income is calculated before deductions.
- **Setting a lower threshold** would not only raise more revenue but also reduce the share of taxpayers who could time their realizations to escape the tax, because for taxpayers in lower income groups, a smaller share of income comes from long-term capital gains. In 2021, those with incomes between $200,000 and $500,000 received only 8 percent of their income from capital gains, compared with 40 percent for those with income above the $1 million threshold.
- **Allowing Qualified Opportunity Zone Funds** to expire at the end of 2025 would end investors' ability to defer or avoid capital gains taxes on some types of investments.

Taxpayers who cannot time realizations to stay below the tax threshold could defer gains for a short time, hoping that the law will change, or offset deferred gains with future losses. They could also defer their gains until death, although this strategy would hurt their heirs if the tax on unrealized gains is also enacted.

3. What to Do about Step-Up in Basis?

The Biden proposal includes a provision to tax all unrealized gains at death above $5 million (or $10 million for joint filers). This provision would mitigate some declines in realizations as there is less incentive to hold on to gains until death. It would also reduce the benefit of the buy-borrow-die strategy, because holding unrealized gains until death would not eliminate the tax bill.

To what extent the realizations would change under this or a similar proposal is unclear, because, again, most analyses examine responses to state tax rates, which change more frequently than federal rates and may not represent long-run considerations.[17] Very high-income taxpayers, however, can be expected to take a long-run approach given their resources.[18]

Taxpayers may still defer realizations if they believe that taxation of unrealized gains at death would be repealed. The anticipation (or hope) for that possibility may result in taxpayers continuing to hold unrealized gains until death, just as they would if they were untaxed.

Under current law, Tax Policy Center predicts that people with more than $1 million in taxable income will realize gains that produce about $169 billion in revenue in 2025. Under the Biden proposal or one similar to it:

- $120 billion in additional revenue would be generated in 2025, assuming taxpayers will not change their behavior.
- If taxpayers respond to the tax increase by deferring realizations until death or simply timing their realizations to stay under the $1 million threshold, the additional revenue would fall to $30 billion.
- If unrealized gains are taxed at death and those gains lower the deferral rate by half, the additional revenue would be $66 billion.

IV. CONCLUSION

Proposals to implement higher tax rates on capital gains for people with high incomes have been discussed as methods to raise funds for federal spending priorities and address wealth inequality.[19] Many members of the next Congress and new administration will likely advocate for a reduction the tax rate on capital gains rather than an increase. Other policymakers may look to increases to help offset the cost of extending expiring provisions of the Tax Cuts and Jobs Act of 2017.

If policymakers debate such proposals, they should consider the following:

- **the magnitude of the increase** and how it may affect the willingness of a taxpayer to realize their gains
- **the income threshold** that dictates who is required to pay a higher tax rate on capital gains, with special attention given to the share of taxpayer's income comprised of capital gains and how that threshold may incentivize them to time or spread out capital gain realizations
- **the step-up in basis policy** that allows taxpayers to permanently escape capital gains taxes if assets are transferred to an heir at death, which, if not altered, will continue to encourage taxpayers to retain their assets in response to a tax rate increase

Research shows that taxpayers could avoid as much as a third of their long-term capital gains tax burden by timing their realizations or matching gains with losses and other deductions. Furthermore, a large share of gains could be realized in advance of the law change, which would reduce additional federal revenue for the first few years after the new policy takes effect. Taxpayers who do not have the capacity to avoid a tax hike—for example, those who consistently have taxable incomes above the enacted threshold without capital gains—will substantially reduce their realizations and likely pass many of their assets to their heirs at death untaxed, if the step-up basis provision remain the same. Some taxpayers may also choose to hold on to their capital assets with the hope that the tax would be repealed.

Increasing the tax rate on long-term capital gains is not the only option for raising taxes on the highest-income and highest-wealth taxpayers. Other proposals include taxing the change in an asset's value each year (known as mark-to-market taxation), taxing gains at death like ordinary income but maintaining the preferential rate for gains realized during life, and taxing wealth directly. All have their own implementation considerations and challenges, such as determining the value of assets, administrative burdens, and constitutional challenges. The Tax Policy Center has explored each of these approaches in-depth in other research publications.

Ultimately, increasing taxes on the highest-income taxpayers, especially through the taxation of long-term capital gains, offers policymakers an avenue to increase federal funds. But the path to effective implementation is challenging. As other proposals continue to surface, policymakers should consider the three fundamental factors—magnitude of the tax increase, income threshold, and step-up in basis—and weigh the trade-offs of each accordingly.

NOTES

1 Single taxpayers with a taxable income equal or greater than $492,300 and married taxpayers filing jointly with a taxable income equal or greater than $553,850 are subject to a maximum long-term capital gains rate of 20 percent. However, single taxpayers with modified adjusted gross incomes above $200,000 and married taxpayers filing jointly with incomes above $250,000 are subject to an additional 3.8 percent net investment income tax on short- and long-term capital gains. A few exceptions apply: the maximum tax rate for capital gains from selling collectibles, including artworks, or section 1202 qualified small-business stock is 28 percent, while any unrecaptured section 1250 gain from selling section 1250 real property is 25 percent. These are both substantially below the maximum rate for ordinary income. See "Topic no. 409, Capital Gains and Losses," Internal Revenue Service, last reviewed or updated January 30, 2024, https://www.irs.gov/taxtopics/tc409.

2 https://www.irs.gov/pub/irs-soi/21in14acg.xls

3 Erica York, "An Overview of Capital Gains Taxes," Tax Foundation, April 16, 2019, https://taxfoundation.org/research/all/federal/capital-gains-taxes/.

4 Steven M. Rosenthal and Robert McClelland, "Taxing Capital Gains at Death at a Higher Rate than during Life," *TaxVox* (blog), May 13, 2022, https://www.taxpolicycenter.org/taxvox/taxing-capital-gains-death-higher-rate-during-life.

5 Tax Policy Center, "How Are Capital Gains Taxed?" *Tax Policy Briefing Book*, accessed October 15, 2024, https://www.taxpolicycenter.org/briefing-book/how-are-capital-gains-taxed.

6 From July 29, 1997 through July 21, 1998, assets held for 12–18 months faced a 28 percent rate, and those held for longer faced a 20 percent rate.

7 Although net investment income tax was originally intended to fund Medicare, because of procedural issues related to the congressional reconciliation process, the Health Care and Education Reconciliation Act of 2010 did not dedicate its revenue to Medicare's health insurance trust fund.

8 Bipartisan Policy Center, "Domenici-Rivlin Debt Reduction Task Force Plan 2.0 Senator Pete Domenici and Dr. Alice Rivlin," accessed October 15, 2024, https://bipartisanpolicy.org/download/?file=/wp-content/uploads/2019/03/D-R-Plan-2.0-FINAL.pdf.

9 White House, "FACT SHEET: A Simpler, Fairer Tax Code that Responsibly Invests in Middle Class Families," press release, January 17, 2025, https://obamawhitehouse.archives.gov/the-press-office/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-fami.

10 While there are regulations prohibiting the sale of capital assets at a loss and immediately repurchasing the same or similar assets (known as "wash sale"), there are no such restrictions if a gain is realized.

11 The predicted amount was based on a simple linear model of realizations from 1980 to 1985.

12 As with the predicted realizations, predicted revenues are based on a linear model from 1980 to 1985.

13 Tax Policy Center, "What Is the AMT?" *Tax Policy Briefing Book*, accessed October 15, 2024, https://www.taxpolicycenter.org/briefing-book/what-amt.

14 According to a report by the US Department of the Treasury, about 5 percent of the asset appreciation came from reported nontaxable assets, such as primary residences. See US Treasury (2014).

15 Recent work by Agersnap and Zidar (2021) find that capital gains are much less responsive. McClelland and Smith (2023b), however, show that if implausibly large migration elasticities are disregarded, the estimated response is close to 7 percent.

16 The authors would like to thank Steve Rosenthal, senior fellow in the Urban-Brookings Tax Policy Center at the Urban Institute, for speaking to us on this issue.

17 Dowd and McClelland (2019), using data from 2012, compare average short-term realizations (taxed like ordinary income) with average long-term realizations (taxed at the preferred rate) and calculate their elasticity. From 2009 through 2021, there were 84 changes in state's top tax rate, 25 increases and 59 decreases. The largest number of changes in any state was 6, and the average number of changes was 2.6. During that time, there was one change in the top federal rate.

18 Auten and Joulfaian (2001) find that capital gains realizations of those within two years of death respond to changes in the estate tax rate.

19 For an overview of ways to implement higher tax rates on capital gains, see Tax Policy Center, "How Might the Taxation of Capital Gains Be Improved?" *Tax Policy Briefing Book*, accessed October 15, 2024, https://www.taxpolicycenter.org/briefing-book/how-might-taxation-capital-gains-be-improved.

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