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Budget Model

Revenue Effects of President Biden's Capital Gains Tax Increase

PWBM will analyze macroeconomic effects of the tax change in a followup post

Summary: PWBM estimates that raising the top statutory rate on capital gains to 39.6 percent would *decrease* revenue by $33 billion over fiscal years 2022-2031. If stepped-up basis were eliminated—as proposed in President Biden's campaign plan—then raising the top rate to 39.6 percent would instead *raise* $113 billion over 2022-2031.

Introduction

Yesterday, Bloomberg reported that the Biden administration is considering raising the top statutory marginal tax rate on long term capital gains and qualified dividends from 20 percent to 39.6 percent. The proposed tax increase would apply to households making more than $1 million in annual income, and would exist in addition to the existing 3.8 percent Net Investment Income Tax (NIIT), bringing the combined federal top rate on capital gains from 23.8 percent to 43.4 percent. The proposal is similar to a provision from the President's campaign tax plan which PWBM analyzed last year.

Revenue effects of the proposal depend on how unrealized capital gains are treated at death. Under the current-law regime where investors have numerous avenues to avoid capital gains taxes, we estimate that raising the top statutory rate on capital gains to 39.6 percent would *decrease* revenue by $33 billion over fiscal years 2022-2031. In contrast, under a regime without stepped-up basis at death—as proposed in President's campaign plan—the proposed tax rate increase would *raise* $113 billion over 10 years.

Background

A large body of empirical research shows that when taxes on capital gains increase, realizations of capital gains fall (and vice versa). Compared with other forms of income taxed under the individual income tax, capital gains are relatively responsive, or *elastic*, with respect to tax rates.

One reason for this degree of responsiveness is the treatment of unrealized capital gains at death. Under current law, when someone passes an appreciated asset to an heir in death, the asset's cost basis is "stepped up" to its current market value, thereby wiping out accrued gains from a tax perspective. Higher taxes on capital gains make this option more attractive, especially for wealthier taxpayers who plan to leave large bequests to their heirs.

Another cause of the relatively large elasticity is the discretionary nature of capital gains realization. Because taxes are due upon realization rather than accrual, taxpayers can use several strategies to time realizations in way that reduces liability. For example, investors may defer realization a capital gain in hopes of lower tax rates in the future, or they may tend to realize gains only in years when they experience other losses. Recent evidence suggests that this type of tax planning plays a large role in realization patterns.

Finally, a large share of corporate equity is held in tax-sheltered investment vehicles like 401(k)s. Together, avenues for legal tax avoidance limit the revenue-raising potential of capital gains taxation. Reforms such as eliminating stepped-up basis and mark-to-market taxation would restrict those avoidance opportunities, therefore increasing revenue raised per percentage point of capital gains tax.

Projected revenue effects

Table 1 shows the projected revenue effects of raising the top rate on capital gains and dividends to 39.6 percent under two scenarios. First, we model the proposal under current law, where a large share of capital gains escape taxation altogether through stepped-up basis at death. Second, we model the proposal in the context of a regime of constructive realization at death, under which decedents with appreciated property would owe tax on the difference between market value and cost basis. This scenario is consistent with what President Biden proposed on the campaign trail.

In both scenarios, we assume enactment starting in 2022.

Table 1. Conventional Revenue Estimates, Fiscal Years 2022-2032

Billions of dollars, Change from Current-Law Baseline

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	2022	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**2031**	**Budget window**
39.6% with stepped-up basis @ death	-15	-7	-3	0	-2	-2	-2	-1	-1	-1	-33
39.6%, no stepped-up basis	-4	7	11	14	13	13	14	14	15	16	113

Our results indicate that the broader tax policy context is key. Under current law, PWBM estimates that raising the capital gains rate would cost $33 over the budget window. If some of these opportunities for tax planning were restricted, the proposal would raise $113 billion. Even with stepped-up basis eliminated, several avenues for tax avoidance remain. PWBM expects that realizations would surge in 2021 in anticipation of higher rates; taxpayers with incomes around $1 million would realize more gains in years when taxable income falls below the threshold; and a greater share of business income would be organized via pass-through businesses instead of C corporations in order to avoid the second layer of shareholder tax.

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